Proposals for

Long- Term Tax Reform

In Australia

An Occasional Paper

Commissioned by
Taxpayers Australia Limited
January, 2016

Preface

The following paper has been commissioned by Taxpayers Australia addressing a number of major deficiencies in Australian Taxation Policy. The work and supporting documentation has been prepared by Taxpayers Research Foundation Limited – a wholly owned subsidiary of Taxpayers Australia Limited.

The Taxpayers Research Foundation Limited (the "Foundation") was established to conduct research into public policy issues and legislation impacting on the Australian taxpayers and to promote policy solutions that maximise the economic and social wellbeing of all Australians. To do this, the Foundation carries out, or contracts leading academics and consultants to carry out research projects on specific tax policy issues and promotes the outcomes of this research, including to policy makers.

The Foundation has a commitment to ensuring research findings are the conclusion of high quality, rigorous and objective analysis.

Long-term Vision

The long-term vision of the Foundation is to conduct quality research with outcomes that assist government in formulating policies that maximise the opportunity for Australian taxpayers to operate in an environment maximising equity and fairness to all while promoting economic efficiency and growth.

Objective

The objective of the Foundation is to enhance the economic and social well-being of Australians by conducting highly credible public policy research, and promoting the outcomes to the Australian community, including policy makers.

The Taxpayers Foundation Journal has consistently sought to publicise and challenge the methodology and burden of tax levied on Australian taxpayers. The Foundation welcomes a constructive debate of the recommendations of all of the recent reports received by government. It is the hope of the Foundation that this paper will assist in the rigorous debate and reform necessary to ensure the efficiency and equity of Australia's taxation system.

We encourage all Australian taxpayers to continue contributing in a constructive and positive way to the review process of the Australian taxation system.

This paper was commissioned by Taxpayers Australia to further encourage debate and outcomes that lead to better outcomes in setting Australia's long-term tax policy.

For further information on Taxpayers Australia Limited or to discuss this paper further:-

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Summary of Key Recommendations

(1) Expenditure Reform

Recommendation 1.1: That the first priority for government must be expenditure restraint to ensure efficiency improvements are the main means to deal with budgetary problems.

(2) Imposing GST on Fresh Food

Recommendation 2.1: That the GST is extended to all foods

(3) GST on Education

Recommendation 3.1: That the GST not be imposed upon fees for non-government schools.

Recommendation 3.2: That efficiency reforms be implemented in all education and health programs by the Commonwealth and state/territory governments.

Recommendation 3.3: That the GST not be imposed upon all other health and education programs unless major productivity gains have been achieved and there is no additional cost to all taxpayers.

(4) GST and Insurance Premiums

Recommendation 4.1: That stamp duties on insurance should be removed and replaced with an increase in the overall GST rate of 0.75% and state/territory governments be fully reimbursed from the GST collections.

Recommendation 4.2: That a formula be developed allowing for changes in the insurance bases in the different jurisdictions to compensate state/territory governments in the future.

(5) Taxation of Motor Vehicles

Recommendation 5.1: That taxes on motor vehicles not be replaced by a higher GST.

Recommendation 5.2: That alternative roads user charging mechanisms be introduced by the states and territories as they become available.

(6) Corporate Tax Rate

Recommendation 6.1: That the corporate tax rate not be reduced on large corporations.

(7) Dividend Imputation

Recommendation 7.1: That dividend imputation be maintained in Australia

(8) Bracket Creep

Recommendation 8.1: That indexation of tax thresholds be reintroduced.

Recommendation 8.2: That the index for changing tax thresholds be based upon the Wage Price Index.

(9) Income Taxation for the States

Recommendation 9.1: That State Governments be allowed to impose the equivalent income tax with a corresponding reduction in Commonwealth income tax and have the authority to impose surcharges or rebates on taxpayers in their states.

(10) Stamp Duties on Property Conveyances and Land Taxes

Recommendation 10.1: That all the State Governments implement the phasing out of conveyancing duties to be replaced by a comprehensive statewide land tax.

(11) Superannuation and Retirement Incomes Policy

Recommendation 11.1: That the Commonwealth establish an inquiry to investigate and provide recommendations on integrating superannuation policies and age pension policy to deliver the most efficient outcome to both an ageing population and all taxpayers current and future. The inquiry should have the capacity to commission any research deemed necessary for providing a robust analysis.

Recommendation 11.2: That "grandfathering" of inefficient or inequitable provisions be scrutinised as part of the Terms of Reference of the inquiry.

Recommendation 11.3: That the Terms of Reference of the Inquiry should not deal with extraneous policies.

(12) Wine Equalisation Tax

Recommendation 12.1: That the government as an immediate priority move the Wine Equalisation Tax to a volumetric basis to remove incentives for legal tax avoidance, address the externality health and social impacts and not provide a subsidy to foreign competitors.

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Issue 1

The priority for expenditure reform

Australia's budgetary problems with rising public debt and persistent government budget deficits must be addressed. This priority will ensure that taxpayers receive value for their money from spending programs before taxes are increased. Tax increases may arise due to legislation (such as with changes to GST or income tax structures) or as the result of 'fiscal drag'. Fiscal drag is a lazy way of raising taxes by allowing the interaction of growth in dollar incomes and 'bracket creep' to lift average tax rates, without legislation.

The Commonwealth's budget position was reasonably stable in balancing spending and taxation until 2007-08. Not only was there a balance but governments regularly provided tax cuts rather than holding on to the rising average tax takes from a prospering economy.
However, after the international economic downturn associated with the Global Financial Crisis, the Commonwealth launched a series of emergency and other spending programs to minimise the perceived risks of an international economic contraction on Australia.

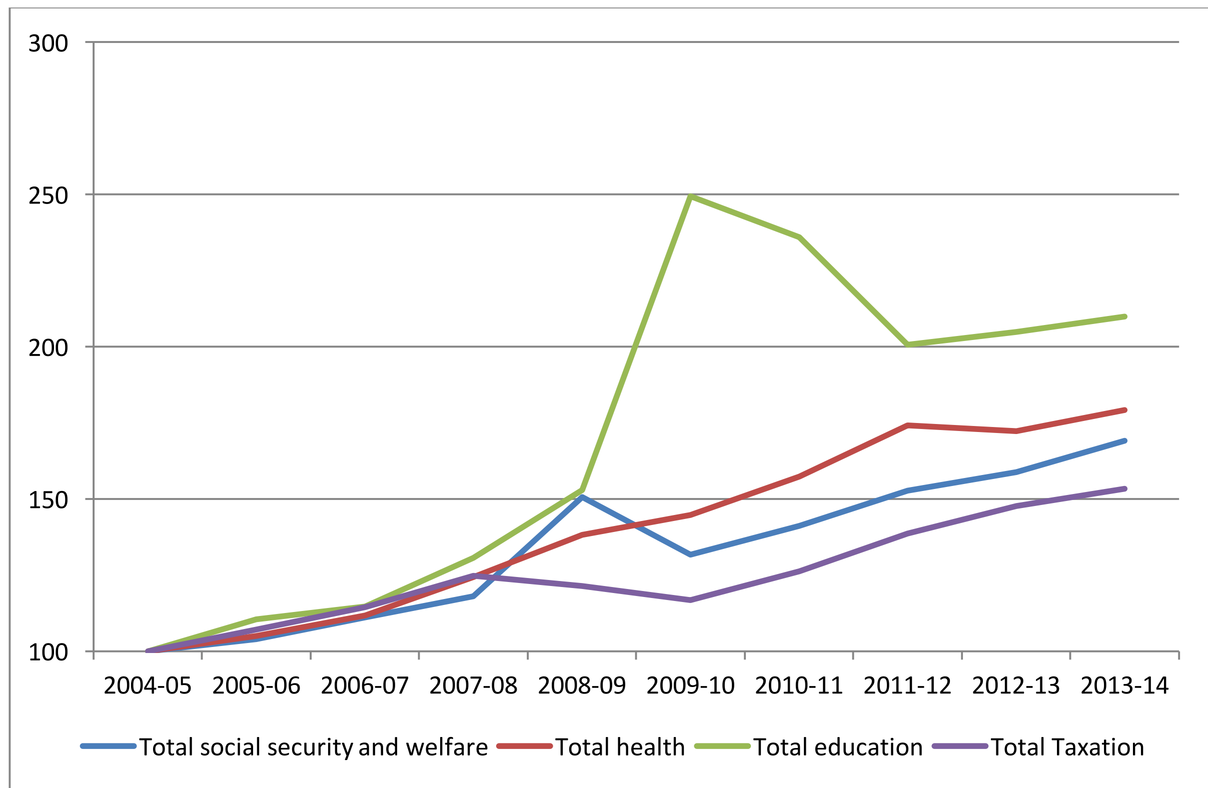
As shown in Figure 1.1, Commonwealth expenditure followed a higher growth trajectory than for taxation. It is a clear sign that there needs to be an incentive for the Commonwealth to adjust its spending to changed economic circumstances such as a decline in taxation revenue.

Figure 1.1: Levels of total Commonwealth Government Taxation Revenues and Expenditures 2000-01 to 2013-14 ($b)

Source: ABS Cat. No 5302.0

Figure 1.2 presents indexes for spending on selected categories over the last decade compared to total tax collections over the same period. The growth in spending, especially for education, has been quite startling and far in excess of trends in tax collection. These increases in growth in spending have occurred before the full impact of an ageing population have to be dealt with and were implemented partly for macroeconomic policy reasons rather than for efficiency gains in these spending categories.

Figure 1.2: Indexes of spending changes by category and total taxation 2004-05 to 2013-14



Source: ABS Cat. No 5302.0

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Increased taxes may appear to offer an easy solution to financing ever expanding spending. However, increased taxes would further reduce incentives and likely detract from economic growth.

Recommendation 1.1: That the first priority for government must be expenditure restraint to ensure efficiency improvements are the main means to deal with budgetary problems.

Issue 2

The case for Imposing the GST on fresh food

When the GST was introduced, it was proposed that all foodstuffs be subject to the uniform rate. Passing of the legislation required a political compromise where fresh food was exempted. Processed and cooked foods were subject to the GST.

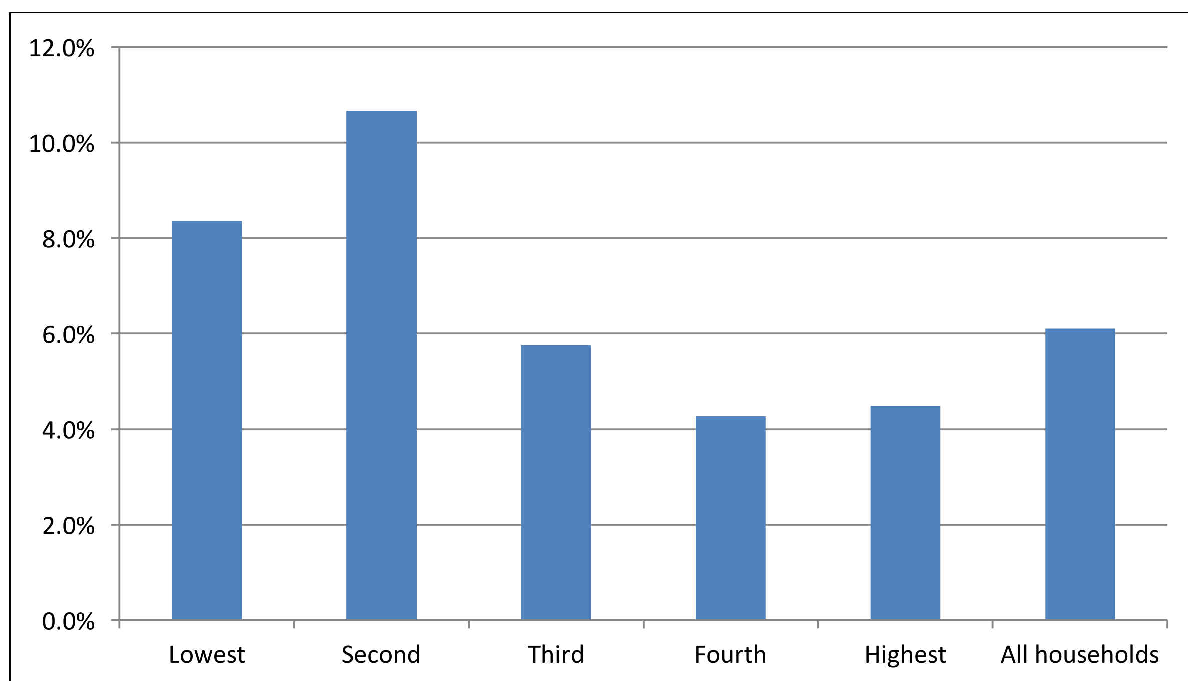
The fresh food exemption was defended on the grounds that poorer people would be protected, despite the proposed compensation package. It was also argued that fresh food provided greater health benefits, especially to poor people, than processed foods.

Nutritional values are the same for fresh and frozen foods and, as an example, home-cooked chickens have the same nutritional values as purchased cooked chickens.

The fresh food exemption made the GST more complicated in its administration and compliance.

A comparison of consumption patterns of fresh and processed foods by the different income groups since the introduction of the GST is revealing. The data comes from the Household Expenditure Surveys for 1998-99 and 2009-10.

Figure 2.1: Change in spending on taxable takeaways and dining out by income group 1998-2010



Source: ABS Cat. No 6530.0 and 6535.0

The change in the expenditure by the different income quintiles of households on takeaway foods and dining out compared to their total expenditure on goods and services over the two periods shows that the rate of increase of the consumption of purchased cooked food items has been highest for the two lowest income quintile groups. This is illustrated in Figure 2.1.

The original intention to shield the lower income people from the GST and encourage the consumption of fresh food is diminishing. Changing consumption patterns benefit higher income households to a greater degree than low income households than envisaged at the GST's inception. (As with most items, households in higher income quintiles spend more total dollars on food and non-alcoholic beverages than lower income quintiles.)

There would be efficiency gains from removing the exemption on fresh food in reducing the administrative costs of classification and gaming by food processors of the classification system. This reduction in costs would help reduce the compensation requirements from any extension in GST to currently exempt foods.

However the absolute impact is more onerous on the lower income households but the proportional increase in effective tax would be borne more extensively by higher income households.

Recommendation 2.1: That the GST is extended to all foods.

Issue 3

The case for not imposing GST on education and health

When the GST was introduced, it was not imposed on education and health expenses. One of the reasons provided at the time was that there was significant government provision of these services and applying the GST would put non-government providers at a competitive disadvantage.

There are many fundamental issues in the provision of education and health services in Australia in terms of delivering them efficiently and resolving the different roles that the government and non-government sectors can or should deliver.

There is also the fundamental issue of the possibility of cost shifting so that the different levels of government in our federal system could bear greater taxation and efficiency costs. As a simple example, imposing taxes on private medical services such as doctors could further encourage customers/patients towards 'free' hospital outpatients unit (funded by State and Territory governments) and away from visiting a General Practitioner (funded by the Commonwealth Government) whose fees are subject to GST.

Improving the efficiency of health and education services could make a greater contribution to the reduction of costs of these services with a lesser need for higher tax revenues.

As an example of problems that can be incurred from implementing a GST on education and health services, the impact of the GST on non-government school education fees is examined.

GST on non-government school education fees

Analysis of the impact of extending the GST to non-government school education is provided using 2012-13 as the reference year (as it has the most recent comparable data). The analysis of the economic impacts of imposing the GST on school education is based upon information provided by the Independent Schools Council, Australian Curriculum, Assessment and Reporting Authority, the *Productivity Commission Report on Government Services* and Federal Treasury's *Taxation Expenditure Statement (TES).*

Spending on education is shared between the Commonwealth and State and Territory governments and families. In 2012-13, the Commonwealth Government spent $12.6 billion on school education and the state and territory governments spent over $35 billion. Average government spending per student in public schools was $15,703, while the average subsidy for each non-government school student was $8,812. In 2012-13, each non-government school student saved taxpayers $6,891 – costing the Commonwealth ($4,519) but offset by much larger saving for the States and Territories ($11,410).

According to the TES, a 10% increase in non-government school fees would most likely lead to a reduction in enrolments of 10% of students, those students moving to the government school systems.

The impact of the changes on enrolments in non-government and government schools from imposing a GST is shown in Table 3.1.

Table 3.1: Full-year impact on school enrolments (2012 - 13)			
	FTE students	Enrolment share %	Change
Non-government schools	1,145,038	31.8	-113,260
Government schools	2,460,058	68.2	113,260
Total	3,605,096	100	

There is a drop in attendance at non-government school matched by the increase in attendance at government schools. For minor technical reasons, numbers decline by about 9% rather than 10% as does the potential school education GST taxation base.

The direct results of the impact of the GST on education on all governments' finances are provided in Table 3.2. With the states collecting all the additional GST from its imposition on school fees their direct net loss is $546 million. The Commonwealth on the other hand is $512 million better off but taxpayers overall lose $34 million from the reduction in private spending on education. This is only the direct costs as there will be an impact upon the CPI. The CPI will rise in response to higher private education costs. This increase in the CPI will flow through to all other indexed social welfare benefits. This has been estimated to be of the order of $200 million per annum.

Table 3.2: Impact on government finances, 2012 – 13, $m			
	GST increase	Change in school funding	Total
Federal government	-	511.8	511.8
State/territory government	746.3	-1292.3	-546
All governments	746.3	780.5	-34.2

Therefore, imposing a GST on non-government schools will likely increase costs to taxpayers beyond the extra revenue gained as there will be an increase in enrolments in government schools where a greater proportion of the costs is borne by taxpayers compared to private schools.

GST on health expenditures

Similarly to education, health provision and expenditures are split between the Commonwealth and the States and Territories. Imposing a GST on medical services provided through Medicare would lead to an increased usage of substitute medical services through, for example, hospitals where there would be a rise in costs for the state/territory governments and a reduction in outlays for the Commonwealth. Detailed examination would need to be undertaken before any implementation of expanded coverage of the GST to medical services to ensure that there is no additional net cost to all taxpayers.

Recommendation 3.1: That the GST not be imposed upon fees for non-government schools.

Recommendation 3.2: That efficiency reforms be implemented in all education and health programs by the Commonwealth and state/territory governments.

Recommendation 3.3: That the GST not be imposed upon all other health and education programs unless major productivity gains have been achieved and there is no additional cost to all taxpayers.

Issue 4

The case for GST on insurance premiums

State and Territory Governments rely significantly upon stamp duties on insurance policies as one of their own sources of revenue. Stamp duty rates vary from 6-11% in most jurisdictions and are subject to the GST as well.

The economic costs of this are well understood as increasing the price of insurance leads to non-insurance or under-insurance, which is to everyone's detriment. This especially applies to lower income groups in the community.

The Henry Report stated "All specific taxes on insurance products, including the fire services levy, should be abolished. Insurance products should be treated like most other services consumed within Australia and be subject to only one broad-based tax on consumption".

There are various proposals on changing the stamp duty arrangements to address these economic efficiency problems. The Insurance Council suggests removing all insurance-based stamp duties and replacing them with equivalent increases in local government rates.

A problem with this proposal is that the revenues would be diverted from the State/Territory governments to the local government level. The question of how the State/Territory governments would make up for this lost revenue has not been addressed.

KPMG proposed to abolish the stamp duties and impose a higher rate of GST. On 2014-15 Budget estimates for all the states and territories, these stamp duty collections are of the order of just over $4 billion. This would require an increase of the GST rate for all goods and services subject to GST to 10.75% to compensate for the loss of this stamp duty revenue alone.

A problem with this proposal is that the additional GST revenue collected would then be subject to the allocation formula of the Commonwealth Grants Commission. Individual jurisdictions would not necessarily receive full reimbursement for their surrendering of this revenue source and there is unlikely to be unanimous agreement from all the states and territories that full reimbursement should apply.

One method to resolve this problem is for the Commonwealth Treasurer to direct the Commonwealth Grants Commission to exclude revenues collected from this additional component of the GST from the current allocation formula. Instead, each state/territory would be separately reimbursed for the extra GST. This separate formula would be based upon current receipts and allow future changes to the allocation on changes in the take-up of insurance.

The beneficiaries of reduced insurance premiums are more likely to be skewed to the poorer income groups as they are more likely to be uninsured or underinsured. Lower insurance premiums will bring more insurance within their reach. Middle and higher income groups who refuse to insure their possessions don't stand out as obviously requiring compensation either. On this basis, no compensation for abolishing the state and territory stamp duties on insurance should be provided for the slightly higher GST rate due to the substitution of insurance stamp duties into a higher GST rate.

Recommendation 4.1: That stamp duties on insurance should be removed and replaced with an increase in the overall GST rate of 0.75% and state/territory governments be fully reimbursed from the GST collections.

Recommendation 4.2: That a formula be developed allowing for changes in the insurance bases in the different jurisdictions to compensate state/territory governments in the future.

Issue 5

The future of taxation of motor vehicles

There are a series of proposals for replacing state/territory taxes on motor vehicle use and ownership, including the stamp duty on transferring ownership of motor vehicles. The Commonwealth also imposes a variety of taxes on motor vehicles and their use, such as through the fuel excises. The fuel excises are a proxy usage charge and could later be incorporated into efficient direct usage charges, as technology further develops. This would have to be subject to negotiation between the different levels of government.

Taxes on motor vehicles are the third largest own source of revenue for state/territory governments. In 2014-15, they are estimated to account for $9.7 billion in revenue for the governments.

The Henry Report noted that these motor vehicle taxes "can impose significant costs. For example, taxing (motor vehicles) ... when ownership is transferred discourages people from buying and selling. Individuals and businesses may choose to continue to hold ... instead of a preferred alternative simply to avoid the tax" and "Transaction taxes can also be inequitable as people with similar incomes may pay different amounts of tax because they buy and sell a taxed good more frequently."

Their preferred recommendation was that these state taxes "should be replaced with efficient user charges where possible."

The recent Harper review also recommended governments consider a cross-jurisdictional approach to road pricing, including "introducing a user-pays system for the roads travelled on" and that state registration fees should be reduced as road pricing was introduced.

Another proposal has been put forward that car registration fees could be removed to compensate consumers for any GST rise.

If all state/territory motor vehicle taxes were removed and replaced with GST, it would require an increase in the GST rate of 1.8% to remain revenue-neutral.

Current motor vehicle taxes do not efficiently reflect road use. However, there are few effective alternatives available, at present. In the near future, new revenue-raising technologies are likely to become available which bear much more closely on road usage and costs. These technologies are likely to be able to charge by distance travelled, locations travelled and time of travel. Charges will likely vary by type of vehicle, weight, road space, urban and regional location and time of day. Road charges would signal where new infrastructure was needed in a way that would be impossible with conventional motor vehicle taxes, including GST. As the technologies become available, the state/territories can introduce improved charging mechanisms.

Our federal system of government could allow experimentation with the emerging technologies. Successful innovations in any State or Territory could be quickly copied or adapted by other states.

Recommendation 5.1: That taxes on motor vehicles not be replaced by a higher GST.

Recommendation 5.2: That alternative roads user charging mechanisms be introduced by the states and territories as they become available.

Issue 6

The case for keeping the corporate tax rate unchanged

There have been numerous claims that Australian economic growth would be lifted if we cut our corporate income tax rate. A cut, it is claimed, would attract more international capital.

According to the Henry Report "The company income tax rate should be reduced to encourage investment in Australia, particularly highly mobile foreign direct investment."

The Henry Report stated that "Australia reduced its company tax rate over the period from the late 1980s to 2000. This adjustment was an important element of policy reforms that have led to strong growth. A continuation of this responsive adjustment would underpin further growth."

At the time of the reduction in corporate tax rates there was a vast range of significant reforms, including:

- Floating of the $A, relaxed capital controls and major financial deregulation
- taxation reforms
- reduced import quotas and tariff barriers
- greater market forces in agricultural marketing arrangements
- industrial relations deregulation and waterfront reforms
- corporatisation and privatisation of government enterprises
- national competition policy

As the Henry Report does not provide any weighting of the relative contributions of the many reforms of the period, it is hard to know what they meant – in any meaningful quantitative comparison – by the corporate tax cut being an "important element". But to suggest or imply that the company tax rate reduction was "an important element" over and above the other tax reforms alone (eg GST, FBT, CGT), let alone the range and depth of the other reforms seems optimistic, to say the least as Treasury have provided no analysis or information to justify their assertion.

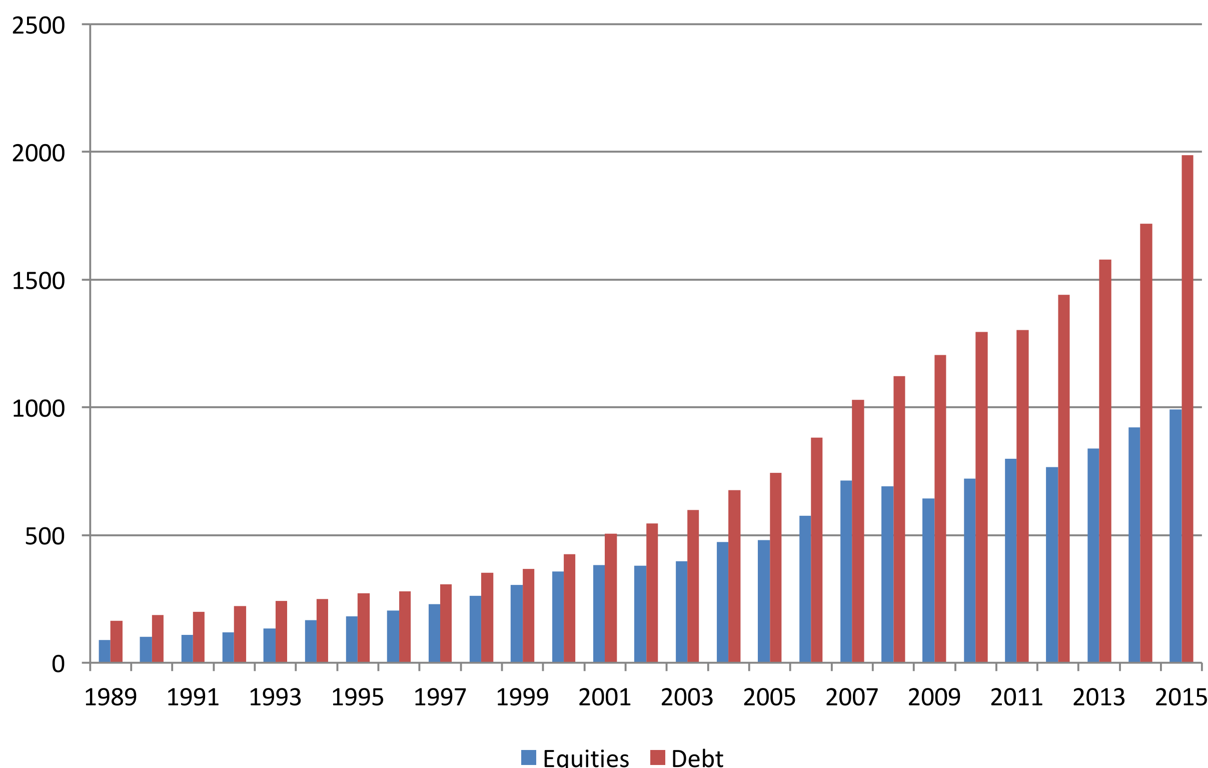
The Henry Report also noted that "Increasing capital and labour mobility will result in strong competition for capital, especially direct investment. Foreign direct investment in Australia as a share of GDP is low in comparison to many developed countries. The significant growth in the stock of foreign investment in Australia over the past 20 years has been largely in the form of portfolio equity and debt. This is likely to reflect our tax settings, at least to some extent. While it is likely that the strength of our financial sector will continue to ensure access to debt financing, and that the resources sector will have little difficulty in attracting foreign direct investment, the relatively high costs imposed on foreign direct investment by Australia's 30 per cent company income tax rate may make it harder for other sectors of the economy to secure capital." and "Empirical evidence indicates that company tax rates matter for investment decisions, particularly investments for which location is not critical, and decisions by firms about where to declare profits and pay tax."

These statements can be investigated empirically. Have there been problems in obtaining foreign direct investment into Australia even after the end of the mining boom and before the start of it?

Historically, Australia has been an importer of capital since the First Fleet. Our current account deficits have always been matched by capital account surpluses. Over the long term there have been very few problems in meeting the capital requirements for the development of Australia.

For more recent times, Figure 6.1 shows that there has been continuing growth in foreign debt and equity investment in Australia with downturns associated with the Global Financial Crisis and the diminution of the Mining Boom. Equity investment alone is now at record levels and has doubled in the last 10 years.

Figure 6.1: Direct foreign investment in Australia 1989-2015 ($b)



Source: ABS Cat. No 5302.0

There are other factors involved in the attractiveness of investment in Australia compared to many other countries other than the level of corporate tax rates. These advantages include:

- rule of law
- constitutional protection from government seizing private property without compensating under "just terms"
- a functioning democracy and Federal system of government
- a strong, competitive financial system
- a freely floating exchange rate to absorb the impact of many economic shocks

For many investors around the world these positive attributes provide a low Country Risk Rating and are more important in the determination of investment destinations than individual country corporate tax rates. It seems very unlikely that major corporations in Australia had difficulty in accessing international capital markets.

The need for access to international capital markets does not apply to the great majority of Australian businesses which are not big corporations and have to rely upon domestic financial intermediaries.

There is an international debate on how to effectively tax "footloose capital". These companies are paying market rates for factors of production such as labour and land but are otherwise making little

apparent contribution to overall Australian taxation receipts. This is in contrast to Australian companies subject to the dividend imputation arrangements. As the Henry Report noted "paying Australian company income tax on a domestic investment helps fund transfers and public services."

The taxation of “footloose capital” – often technology-based companies with a strong capacity to shift profits across international boundaries – is a notoriously hard policy issue. Even the US government has not been able to find an effective solution. It therefore seems unlikely that the Australian government alone can ensure that these "footloose companies" make an appropriate contribution. The biggest companies operating in Australia are not typically “footloose” – they are here because they have to be here. For example, the resources or customers they wish to access are located in Australia – and we provide location-specific ‘rents’, not otherwise available in the Cayman Islands etc. That is why we are not entirely powerless in where we set our corporate tax rate.

Even with a reduction in the Australian company tax rate, as long as it is higher than other countries there is still the incentive to shift profits away from Australian taxation. Small business corporation structures are less likely to be able to shift profits to lower taxation countries because of the nature of the scope of their businesses and the transaction costs and likely greater scrutiny from officials. The recent reduction of corporate tax for small enterprises in Australia is highly unlikely to shift profits away from Australian taxation. Countries such as Ireland and Singapore are home to many of these “footloose companies” and have lower corporate tax rates.

Recommendation 6.1: That the corporate tax rate not be reduced on large corporations.

Issue 7

The case for keeping dividend imputation

The Henry Report threatens the dividend imputation system in Australia. This would be a result of the desire expressed in the Henry Report and by many vested interests in the financial system to encourage greater international capital mobility into Australia. They aim to reduce the Australian corporate income tax rate. This is based upon the belief that Australia has to win the 'race to the bottom' of international corporate taxation rates. The issue of why corporate tax rates do not need to be reduced to encourage international investment in Australia is addressed in Issue 6.

The threat in the Henry Report comes from their statement that "*For the longer term, a continuing trend of increased openness and greater capital mobility suggests consideration needs to be given to eventually moving away from the dividend imputation system as a means of integrating the personal and company income tax systems.*" Note consideration of moving away from dividend imputation is for the longer term.

The Henry Report also provides arguments for why dividend imputation should be maintained in Australia. There are of course caveats around their statements but they explain why dividend imputation should be maintained for the benefit of Australians.

The following quotes in defence of maintaining dividend imputation are all from the Henry Report and its attached papers.

1. *Dividend imputation …encourage(s) domestic business investment by reducing the cost of capital for domestically owned companies... To the extent that domestic providers set the cost of capital, imputation may bias Australian companies owned by residents towards investing in Australia rather than overseas.*

2. *Imputation is likely to have a more positive effect in reducing the cost of capital for smaller and unlisted Australian companies, particularly when they are starting up or raising new equity. These companies typically have more limited or indirect access to international capital and, therefore, a higher reliance on residents' savings.*

3. *Dividend imputation continues to deliver benefits for Australia, particularly for smaller firms and those operating in the more closed segments of the economy.*

4. *Dividend imputation also provides integrity benefits. For Australian companies with largely resident shareholders... the benefit to companies and their shareholders of avoiding or deferring company income tax is therefore reduced. This can increase company income tax revenues and reduce the need for anti-avoidance rules in general.*

5. *The integrity benefits of imputation may partly explain why Australia's company income tax collections are high compared to other countries …While evidence of these integrity benefits is largely anecdotal, a recent quantitative cross-country study estimated that the presence of a dividend imputation system in a country gave rise to increased company income tax.*

6. *…restricting imputation to Australian company income tax and not giving a credit for foreign taxes, Australian companies treat foreign tax as a cost, so aligning their private interests with the national interest.*

7. *For companies with foreign operations and a significant proportion of resident shareholders, imputation provides an incentive to shift foreign profits into Australia*

This last argument is an Australian response to profit shifting by foreign corporations by providing an incentive for companies to pay tax in Australia in order to pay fully franked dividends.

The arguments put forward in the report in support of dividend imputation include that imputation:

- encourages Australian companies to invest in Australia
- helps small businesses in Australia
- maintains the integrity of the tax system in Australia; and
- encourages companies to align their interests with the national interest.

Those who seek to change (or abolish) our dividend imputation system will need to ensure that their proposals do not result in these benefits being lost. Until then, new proposals should be treated with caution to ensure that they are not showcases for rent seeking.

Recommendation 7.1: That dividend imputation be maintained in Australia

Issue 8

The necessity for defeating Bracket Creep

Bracket creep is a less visible means for raising income taxes on Australian workers.

Our progressive income tax system with increasing marginal rates of tax and fixed thresholds, combined with a Consumer Price Inflation (CPI) inflation target of 2 to 3 percent, automatically increases the average rate of tax for all taxpayers. Trend growth in wages rises at a faster rate than inflation because of the improved productivity of workers. This provides an extra element to 'fiscal drag' as the extra income is subject to higher rates of income tax because of bracket creep.

Occasionally, often coinciding with Federal elections, governments give back some of these tax increases through changes to the thresholds or marginal rates of taxation. Between these active changes to taxation arrangements there is an ongoing rise in average tax rates because nominal (or dollar) income is taxed, with no adjustment for changes in real incomes.

The obvious solution to this bracket creep is to index the tax thresholds to changes in the CPI on an annual basis. Such a system was introduced in 1976. However, it only lasted for one year after which the then government moved to half indexation; that is, the thresholds were adjusted by only half the rise in the CPI. Even this system of half indexation was abandoned in 1981.

To improve transparency in taxation, as well as improve the incentives for our elected representatives to maintain discipline on expenditure of taxpayer funds, annual indexation of tax thresholds should be reintroduced. This will not stop governments from changing thresholds or rates but ensures that the public is better informed on a timely basis that their taxes have been increased as legislation would have to be implemented to increase them.

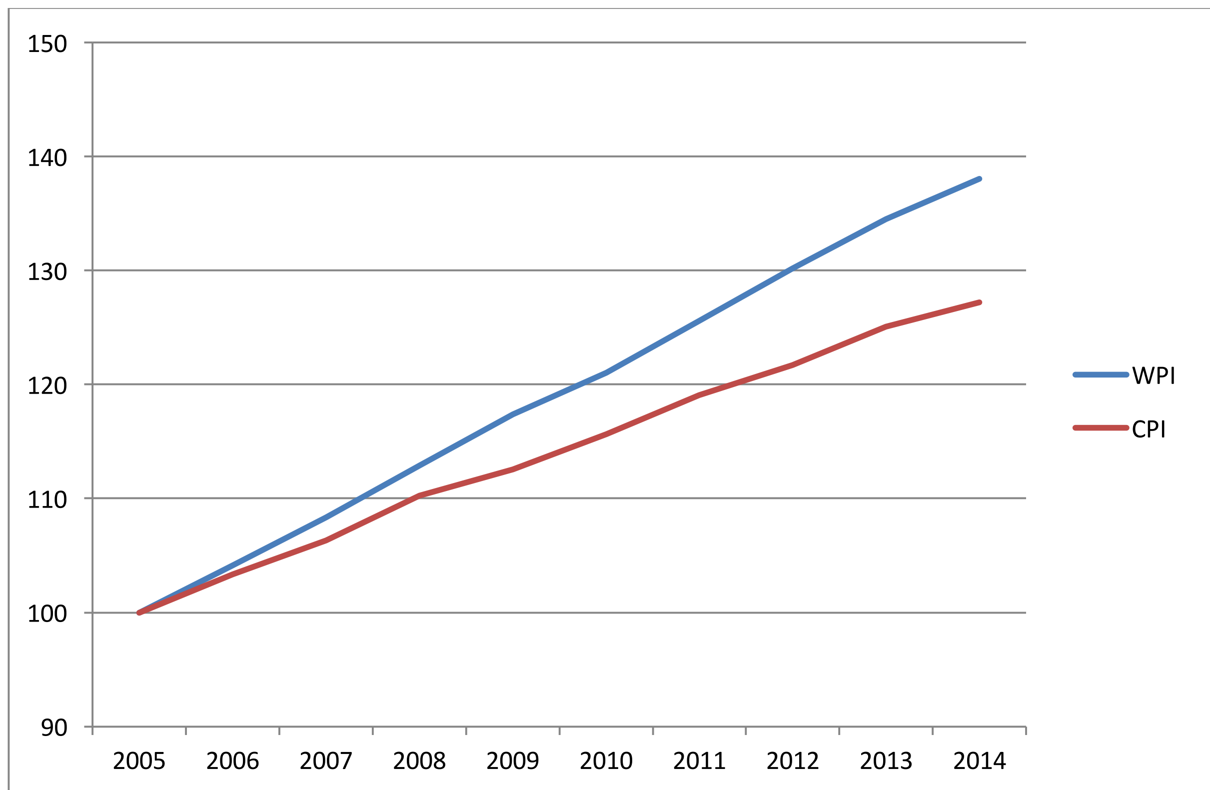
Assuming the principle of indexation of income tax scales, there is an issue as to which index is best. Wages, as measured by the Wage Price Index (WPI) usually rise at a greater rate than the CPI because of productivity improvements through attributes such as workers acquiring skills in their jobs. The divergence between the two measures, converted to indexes with base year 2005, for the period 2005 – 2014 is shown in Figure 8.1.

If only the CPI was used for indexation, the average taxable income would be over 8% higher at the end of the period reflecting the productivity improvements developed over that time period. Indexing to WPI would allow workers to keep their productivity improvements and not face a disguised bracket creep.

Recommendation 8.1: That indexation of tax thresholds be reintroduced.

Recommendation 8.2: That the index for changing tax thresholds be based upon the Wage Price Index.

Figure 8.1: Comparison of WPI and CPI 2005-14



Source: ABS Cat. No 6435.0 and 6401.0

Issue 9

The case for Income taxation by the States

The South Australian Government has proposed that the states and territories should be given a 17.5 percent share of all the income tax that the Commonwealth collects. In return, the Commonwealth would keep all GST revenue, rather than redistributing it back (less a collection charge) to jurisdictions as is current practice.

The premise of this proposal is that income tax grows at a faster rate than GST. Therefore the states and territories would be in a better position to finance quickly growing health spending.

Additional aspects of the proposal include:

- Raising the GST rate from 10 percent to 15 percent
- abolishing state stamp duties on insurance
- the Commonwealth retaining responsibility for collecting income tax and deciding income tax policy.

It is also claimed that this proposal would give "the states more fiscal autonomy to pursue productivity growth through policy innovation".

The states and territories surrendered – but never lost – their constitutional powers to levy income taxes to the Commonwealth. Although the GST is nominally for the states, the constitutional power for levying GST lies with the Commonwealth.

There have been previous unsuccessful attempts to allow the states to impose income tax surcharges, to be collected by the Commonwealth. Political unpalatability for the states should not be an excuse for avoiding political and policy responsibility.

Australia's federal system of taxation results in Vertical Fiscal Imbalance (VFI), whereby spending responsibilities and the taxing powers are mismatched between the federal and state tiers of government. By international comparisons with other federal systems, Australia has the largest VFI.

Providing the states with a fixed share of the income tax would appear to discourage the states from engaging in tax competition. On the other hand, federalism is consistent with competition between the states and territories. So, longer term, with states' income tax experience re-established, there should be no in-principle objections to the states competing with each other, for example by offering rebates. This might occur when they have been very effective in delivering efficient expenditure.

Horizontal Fiscal Equalisation, whereby the ability of states to provide services to their citizens is equalised across all Australia, can still be addressed by the Commonwealth if it wishes. (The standard approach would be to take advice from the Commonwealth Grants Commission.)

Devolving income taxation powers to the state governments will enhance responsibility and allow greater policy innovation and flexibility in our nation.

Recommendation 9.1: That State Governments be allowed to impose the equivalent income tax with a corresponding reduction in Commonwealth income tax and have the authority to impose surcharges or rebates on taxpayers in their states.

Issue 10

Stamp duties on property conveyances and land taxes

There is a general recognition that there are major economic efficiency costs from the significant imposition of additional costs on property purchases from the high rates of stamp duty.

The Henry Report noted some of the efficiency costs for the wider economy. These were:

- Stamp duty encourages people to stay in houses when they would prefer to move to properties that better suit their needs. The classic example is that of parents remaining in a large family home after their children have left because stamp duties would erode much of the financial benefit of moving to a smaller home.
- which leads to longer commuting times
- and lower labour mobility with an inequity component as it adversely impacts on people who need to move residences for work

It is also one of the most volatile sources of revenue as it is highly dependent upon the property cycle which has proven to be highly variable especially in the commercial and residential real estate markets throughout Australia.

The summary from Henry is that "Ideally, there is no place for stamp duty in a modern Australian tax system."

The general consensus as expressed in the Henry Report is "A land tax is efficient if it is broadly based. Existing land taxes are quite inefficient because they are not broadly based, and rates vary according to land use and landholding aggregation rules. An efficient land tax would apply equally to all land uses and aggregate holdings, but could have a threshold and different rates based on the value per square metre of land. In practice this could mean that most land in lower-value use (including most agricultural land) would not face a land tax liability and the tax would apply moderate rates to most other land."

Between them, Stamp duties on conveyancing and land taxes are the first or second largest own sources of taxation revenue for all the states.

The Henry Report did note that replacing the existing land tax still has issues to be resolved as "a flat rate would reduce the top marginal tax on many properties relative to the current land tax. Some of these are likely to be land of high value, leading to windfall gains to some landowners. "

The Henry Report did offer alternatives to resolve this issue. "One approach would be to adopt a slow transition to the new rate structure, such as only slowly reducing existing land tax rates." Or "increasing marginal rates of tax could be applied to the economic rent in land. That is, stepped rates could be based on the value of the property per square metre, starting with a zero rate on low-value land. Higher valued land with more significant economic rents would pay a higher rate of tax"

The Government of the Australian Capital Territory (ACT) is providing a demonstration of managing a transition away from reliance on the volatile stamp duty on conveyances to the more stable base of taxing land. They have already introduced a phasing out of conveyance duties and implemented a greater reliance on land taxes. These changes are meant to be revenue neutral in the long-term.

A significant difference between the ACT government and all other jurisdictions is that it has the responsibilities and functions of a state government and a municipal government in the one elected

assembly and single bureaucracy. However, this need not be a problem for the other states as rates could still be imposed by local governments and land taxes by the State government on the same taxable base.

The crucial components in the ACT model for changing the tax base are:

- it is revenue neutral;
- phased in over a 20 year timeframe;
- commercial land tax is merged into the local government rates; and
- pensioner concessions are available for people downsizing from their existing homes.

The process employed in implementing these major changes to the taxation of land generally satisfy the criteria outlined previously in the Henry Report and there appears to be acceptance of the changes from the local electorate.

For other jurisdictions it will be necessary to resolve the administrative collection mechanisms as there are two tiers of government using basically the same tax base. The ACT model provides a template for other jurisdictions to copy or modify.

Recommendation 10.1: That all the State Governments implement the phasing out of conveyancing duties to be replaced by a comprehensive statewide land tax.

Issue 11

Superannuation and retirement incomes policy

People are living longer and the retired are a rising share of the population. The problem posed for retirement incomes is: how and who will fund the retirees? This simple question has led to very complex attempts at solutions in the design of superannuation regulation and taxation, and age pension entitlements. These attempted solutions are failing. Policy arrangements for superannuation and the age pension must be considered together as they are part of a major policy challenge for Australia.

Currently, Australia has three broad mechanisms targeting the one policy outcome – that is, providing for adequate retirement incomes. These three mechanisms are:

- voluntary superannuation backed up with concessional tax treatment,
- compulsory superannuation (also, curiously, backed up with tax concessions) and
- a publicly-funded age pension providing a minimum income in retirement.

It is an accepted policy rule that using multiple instruments to achieve a single policy outcome is not desirable and if undertaken they should be subject to detailed scrutiny and analysis to minimise perverse outcomes and incentives.

Industry advocates are keen to support the view that this 'three pillars' policy is world-best practice, rather than acknowledging transparently their vested interest in maintaining the current arrangements. The mechanisms are contradictory, overlapping, confusing, overly complex and not delivering policy outcomes that benefit both the elderly and all the taxpayers who will have to pay for them.

There is currently a significant debate on superannuation taxation and the age pension. There have been multiple inquiries resulting in a plethora of recommendations with some resulting in changes to taxation of superannuation. As the Henry report noted "there has been concern that superannuation has undergone constant change." The same argument can be applied to pension changes.

Though superannuation and age pension provision are intertwined, they are rarely dealt with together in government inquiries. The only recent inquiry covering the three mechanisms for retirement was the Henry Inquiry. An input into the final report (published in May 2009) provided a framework for retirement incomes. However, the terms of reference for the Henry report into Australia's entire taxation system constrained its analysis as "The review will reflect the Government's policy... preserve tax-free superannuation payments for the over 60s". Another input was the Harmer review of the Age Pension, Carer Payment and Disability Support Pension. It had a blinkered focus as it did not look at the relationship between the age pension and superannuation.

As the Henry report noted "The retirement income system is still in transition and will not fully mature until the late 2030s when employees retire after a full working life". Nonetheless, the report recommended changes to superannuation to achieve yet another objective as it "would provide a significant increase in private savings mainly driven by the proposed elimination of the superannuation contributions tax and the halving of the earnings tax, both of which would significantly increase superannuation assets."

Improving national savings is one goal but superannuation concessions or arrangements should be targeted at reducing the costs to taxpayers for an ageing population.

Released in the same year as the Henry report was the *Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation* (Cooper report). The Cooper report investigates what the title states and does not investigate the relationship of the pension system with the superannuation system.

Since those reports were published we have also had a Productivity Commission report *Superannuation Policy for Post-Retirement which* was focused on superannuation, and the age pension was peripheral to most of the report. There has also been a National Commission of Audit report that focused on managing expenditure growth of the age pension.

The consistent theme from these reports is that they each have a blinkered view of retirement incomes policy without much consideration of how to integrate it.

An example of the conflict between different arms of policy is the divergent views about the most basic parameter for retirement incomes policy. At what age can retirement begin? The (preliminary) Henry Report recommended that retirement should be able to begin at age 67.

However:

- the preservation age for superannuation is being raised to 60 by the year 2025;
- eligibility for the pension age is being raised to 67 by the year 2023.

That is, the first and second 'pillars' of retirement incomes policy are predicated on the long run view that retirement begins at age 60. The third 'pillar' says that this basic parameter of retirement policy is seven years later. The logic of the divergence between the two trigger ages has not been explained.

As noted above, superannuation law has been subject to many changes and when these changes are implemented previous arrangements are grandfathered. This adds to complexity in administration and inequities between superannuation contributors under the previous rules and later contributors.

The following two examples demonstrate the complexity and inequity of how the two systems of superannuation and taxpayer funded benefits for the elderly operate together.

1. Under earlier legislative provisions, there is an opportunity to make a substantial part of a superannuation fund's income tax free by starting a transition to retirement pension once a person reaches 60. If a person has significant funds in super but is still working, they can commence a transition to retirement pension which puts the superannuation funds into pension phase and makes the income of the fund tax free. Under a transition to retirement pension, the person can still work and be entitled to have contributions paid on his/her behalf and simply put these contributions into another fund. For example, a person with a multi-million dollar fund but is over 60, and not retiring can commence a transition to retirement pension which makes all the income in the superannuation fund tax free. The contributions currently paid by his/her employer are going into another fund and are being taxed at 15% but are substantial.

2. Pensions paid out of a fund in pension phase are tax exempt. Tax free income is included in a tax return but any tax is rebated. It is, however, included in assessing eligibility to various entitlements. An example of this is a Fringe Benefits amount included on a PAYG Payment Summary. The amount is included in the individual's tax return and no tax is payable, but is included to assess entitlements to Family Tax Benefits, Private Health Insurance Rebate and income for excess contributions tax. Tax exempt income is not included in an individual's income tax return or in determining entitlements. Until recent changes, a person could be on a large pension and still meet the income threshold to access a Health Card which entitles the holder to cheap prescription drugs.

This loophole was cancelled but was grandfathered so that those who had the benefit continue to benefit.

The generosity of grandfathering most retirement income changes needs to be more closely scrutinised.

Another example of the problems we face in superannuation is highlighted by the National Commission of Audit which noted the lack of robust information for decision making when they stated "There are many sources of data on drawdown patterns, but little consistency in the measurement of lump sums and superannuation income streams. This frustrates comparisons of the data and can lead to contradictory conclusions on the prevalence and value of benefits taken as lump sums and income streams."

The complexity of the interactions between the two policy instruments and the policy of providing adequate income to an ageing population that is affordable over the long term has to be addressed and a sound policy basis must be implemented to reduce the costs for current and future taxpayers.

Recommendation 11.1: That the Commonwealth establish an inquiry to investigate and provide recommendations on integrating superannuation policies and age pension policy to deliver the most efficient outcome to both an ageing population and all taxpayers current and future. The inquiry should have the capacity to commission any research deemed necessary for providing a robust analysis.

Recommendation 11.2: That "grandfathering" of inefficient or inequitable provisions be scrutinised as part of the Terms of Reference of the inquiry.

Recommendation 11.3: That the Terms of Reference of the Inquiry should not deal with extraneous policies.

Issue 12

The slow reforming of the Wine Equalisation Tax (WET)

The operation of the Wine Equalisation Tax and the multiple objectives aimed at by these arrangements demonstrates the inertia of taxation policy processes. This is partly due to the capacity for industry to game taxation arrangements for their commercial benefit at the expense of other taxpayers.

When the GST was introduced, the government devised the 'wine equalisation' tax, which imposes a 29% loading on wine wholesale prices as well as GST (on retail prices). This replaced the then 41% wholesale sales tax applying to wines.

A producer rebate scheme was introduced in 2004 to reduce the impost of WET, and entitles wine producers to a rebate of 29% of the tax on domestic sales which is capped at a maximum. This cap has steadily climbed from its introduction of $290,000 per year to $500,000 currently.

Beer and spirits are subject to a volumetric taxation regime whereby the tax level is based on alcohol content with different excise rates applied depending on whether the alcohol is contained in beer or spirits. Wine in comparison is taxed on the basis of its value, by the WET, which was implemented as a direct substitute for the wholesale sales tax then applying.

The inconsistencies and slowness in rectification in alcohol taxation have a long history. In 1999, former Treasurer Peter Costello described alcohol taxation as "a dog's breakfast".

In 2010, the Henry Review stated that “shifting wine taxation from an *ad valorem* to a volumetric basis should be pursued as a priority".

In August 2015, Treasury released a discussion paper on changing the WET.

There are identified social costs of alcohol abuse by individuals which are not effectively targeted by current tax arrangements for alcohol.

At present, the typical amount of tax per standard drink (12 millilitres of pure alcohol) is 97 cents on bottled spirits, 43 cents on full strength packaged beer, and 30 cents on most bottled table wine. For cask wine it is 8 cents.

The stated intent of the WET rebate was to benefit small wine producers in rural and regional Australia.

Since 1 July 2005, New Zealand wines have been eligible for the WET rebate. This is in accordance with Australia’s obligations under the Australia-New Zealand Closer Economic Relations Trade Agreement 1983. Treasury have noted that “increased competition from New Zealand producers in the domestic market" has caused competitive difficulties for Australian wines in Australia. Where the benefit to small wine producers in regional Australia is, is very unclear.

At the time of its introduction, the WET rebate effectively exempted an amount of $1 million of each producer’s domestic wholesale wine sales from the WET on an annual basis. Since 2006, the rebate effectively exempts approximately $1.7 million of each producer’s domestic wholesale wine sales.

The New Zealand rebate scheme entitles New Zealand wine producers to a rebate of 29 per cent of the approved selling price of the wine in Australia. The approved selling price is the price for which the wine is sold net of any expenses unrelated to the production of the wine in New Zealand. The New Zealand scheme came into effect from 1 July 2005, and is in accordance with Australia's obligations under the Australia-New Zealand Closer Economic Relations Trade Agreement 1983.
The Treasury discussion paper on the WET noted that "Wholesalers and retailers are also incentivised to minimise the amount of WET paid and maximise WET rebate claims. Some of these arrangements are within the law but have the potential to erode revenue, contrary to the original intent of the law." They then provide examples of how participants in the wine production and marketing chains can maximise tax deductions and minimise tax payments of the WET.

Even the peak producer representative bodies, The Winemakers' Federation of Australia (WFA) and Wine Grape Growers Australia (WGGA), have recommended to "Phase out the WET rebate on bulk and unbranded wine over four years because we need strong brands to command margin and loyalty from consumers and retailers and to generate the profits that can be reinvested back into regional Australia."

Recommendation 12.1: That the government as an immediate priority move the Wine Equalisation Tax to a volumetric basis to remove incentives for legal tax avoidance, address the externality health and social impacts and not provide a subsidy to foreign competitors.