THE COAG TAX DISCUSSIONS: NOT A PLACE TO START ON TAX 'REFORM'?

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The meeting of COAG held at Sydney in July 2015 started discussion on 'tax reform' but considered only two options: an increase to 15 per cent in the GST and an increase in the Medicare Levy. This might be described as 'tax reform' but is not a start on tax reform. I consider 'tax reform' to be an approach to making changes to taxation which focus solely on revenue raising but are not reform in the sense of changing taxation to meet the requirements of long-standing principles of equity.

The background to the discussion is that the Australian taxation system is unduly complex and markedly unfair. Tax evasion is rife and tax avoidance through artificial schemes is the core business of much of the accounting and legal professions. All governments are facing fiscal pressures. The Commonwealth government is finding it difficult to balance its budget as, following ill thought-out reductions in income taxation by the Howard and Rudd governments, and in the aftermath of the GFC, taxation receipts have declined so much that the Commonwealth now has a structural[1] as well as a cyclical deficit. The structural deficit implies that there is no level of economic activity at which the current taxation policies will produce a balance.

Two responses by the Commonwealth government in response to their deteriorating fiscal position has been, firstly, to reduce payments to the States, thus increasing in turn the fiscal pressure on them, and, secondly, to attempt to reduce unfairly Commonwealth social security outlays to persons.

The general principles of taxation equity are two: horizontal equity under which people in the same economic circumstances should pay the same tax and vertical under which people in different economic circumstances should pay different amounts of tax. Vertical equity holds that taxation should be progressive so that people with a greater command over economic resources should pay a higher proportion of their income or wealth than people with a lesser command over economic resources. Thus, on equity grounds, the appropriate tax is a progressive income tax levied on the broadest definition of income. The economists' concept of income is that referred to Simon-Haig definition of income[2] as the amount that a person can spend in a year and remain as well off at the end as at the beginning. In Australia, there are many deductions which reduce the income tax base and various forms of income are treated more leniently for taxation purposes. For instance, income from capital gains and company dividends is treated much more favourably than wage and salary income.

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[1] Estimates of the structural budget balance of the Australian Government, 2001-02 to 2016-17
http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Budget_Office/research_reports/Estimates_of_the_structural_budget_balance_of_the_Australian_Government_2001-02_to_2016-17

[2] Robert M. Haig, 'The Concept of Income – Economic and Legal Aspects', in Robert M. Haig (ed.), *The Federal Income Tax 54-59 (1921)*, reprinted in *Am. Economics Ass'n, Readings in the Economics of Taxation 59* (R. Musgrave and C. Shoup eds. 1959). Henry C. Simons, *Personal Income Taxation 50* (1938).

The two tax 'reforms' discussed at COAG are both unfair and largely irrelevant to the important issue of tax reform in Australia. Raising the GST rate to 15 per cent is unfair as it breeches the principle of vertical equity. It is not impossible to make the GST more equitable by, for instance, extending its coverage to health and education, as has been advocated by the Australia Institute[3], or by having multiple rates of GST with higher rates applicable to more expensive motor vehicles, recreational equipment and items of conspicuous consumption.

The suggestion to increase the Medical levy also fails the principle of vertical equity and ignores the position that Medicare was initially designed as a 'merit good', i.e. supplied outside the price mechanism to citizens who should have medical care because they are ill not because they have deep pockets. (If a Medicare levy is to be retained it should have a progressive structure so that the rates are graduated in a similar manner to the rates under the progressive income tax.)

Discussion of just these two items of 'tax reform' by COAG is myopic. While there is a taxation problem as outlined above, there has been no shortage of suggestions as to how to reform the taxation system. We'll consider only three.

The G20 talks in Brisbane, November 2014

The first is the G20 stance on tax evasion by multinational companies. The G20 Leaders' Communiqué Brisbane Summit, 15-16 November 2014 stated:

> We are taking actions to ensure the fairness of the international tax system and to secure countries' revenue bases. Profits should be taxed where economic activities deriving the profits are performed and where value is created.[4]

Since the G20 meeting at Brisbane in November 2014, details of profit shifting by multi-national companies through transfer pricing has emerged. More information about the activities of multi-national companies in shifting profits to reduce tax has emerged following the hearings by the Senate Economics References Committee on corporate tax avoidance. (The Committee is due to report on 15 August 2015.)

An analysis of Apple[5] by the Australian Financial Review revealed that, since 2002, Apple has paid only $193 million in tax in Australia. It was estimated that this represents only 0.7 per cent of its total turnover in Australia and that Apple had shifted $9 billion in profit from Australia to overseas. The ABC reported[6] that BHP has negotiated a tax incentive from the Singapore government. As a result BHP paid only $US121,000 ($AUD154,800) in Singapore and $945 million in Australia on profits of $US5.7 billion ($AUD7.29 billion) earned in Singapore between 2006 and 2014.

The profits were earned as a result of BHP's selling minerals (from its Australian mines) to its Singapore offshoot at one price and on-selling the minerals to China at a higher price. The Australian Taxation Office is pursuing BHP in relation to this and other matters. Effective action against these activities would result in more tax revenue than those discussed at COAG.

The Henry Tax Review

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[3] http://www.tai.org.au/content/how-extend-gst-without-hurting-poor.

[4] https://g20.org/wpcontent/uploads/2014/12/brisbane_g20_leaders_summit_communique1.pdf

[5] http://www.abc.net.au/news/2014-03-06/tax-expert-explains-how-apple-pays-193m-tax-on-27b-revenue/5303426

[6] http://www.abc.net.au/news/2015-04-27/bhp-fights-522-million-unpaid-tax-singapore-marketing-operations/6424996

The Henry Tax Review [7], released in 2010, recommended that one of the four robust and efficient broad-based taxes[8] should be personal income tax on a more comprehensive basis. The income base has been eroded by, among other things, tax evasion by international corporations by artificially shifting profits to countries with low rate rates (as explained above), the development of domestic tax shelters and the concessional treatment of some items of income. Elimination of these distortions would generate more revenue than in those discussed by COAG.

The Henry tax review, in considering the fiscal needs of the States, recommended that stamp duties should be eliminated and replaced a broadly based tax on land which could be levied on a progressive scale and be levied on individual land holdings not, as they are now in Queensland, on aggregated land holdings. This switch of taxes would be both more efficient and equitable.

Financial System Inquiry

The third call for action on tax reform was is the Financial System Inquiry Final Report[9] released in December 2014. Among the suggestions made were expanding the GST base by imposing GST on financial services; increasing the income tax base by eliminating some deductions from that base. The Report proposes to reduce tax concessions in the superannuation system and concessions in capital gains taxation, and to eliminate dividend imputation.

The Financial System Inquiry report pointed out that GST is not levied on most financial services and that this may contribute to the financial system being larger than it otherwise would be. It further argued that tax concessions in the superannuation system are not well targeted to achieve provision of retirement incomes i.e. these concessions will did little or nothing to reduce the outlays on the age pension and their cost is rapidly approaching the current outlays on age pensions. The overall effect is to increase the cost of the superannuation system to taxpayers and increases inefficiencies arising from higher taxation elsewhere in the economy.

The Report argues that the capital gains tax concession, which means that capital gains on assets held for more than 12 months are taxed at half the standard rate provide incentives to invest in assets for which anticipated capital gains are a larger component of returns. As well these capital gains receive a more favourable treatment than wage and salary income. In general, the capital gains tax concession ensures that the after-tax return is larger for individuals on higher marginal tax rates. The Report says that reducing these concessions would lead to a more efficient allocation of funding in the economy. This tax treatment, especially in relation to investor housing tends to encourage highly indebted and speculative investment.

For leveraged investments, the asymmetric tax treatment of borrowing costs incurred in purchasing assets (and other expenses) and capital gains can result in a tax subsidy by raising the after-tax return above the pre-tax return. Investors can deduct expenses against total income at the individual's full marginal tax rate. However, for assets held longer than a year, nominal capital gains, when realised, are effectively taxed at half the marginal rate.

The tax treatment of investor housing, in particular, tends to encourage leveraged and speculative investment. Housing is a potential source of systemic risk for the financial system and the economy.

The FSI report questions another sacred cow in taxation policy (that of dividend imputation) which provides a greater benefit to people who obtain income from company dividends. The income tax paid by the company is imputed to the shareholders who receive a credit for the tax paid which they can use in their own tax return to reduce their tax. The effects of this are to create a discrimination in favour of personal investment in shares and against debt securities which provide

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[7] http://fsi.gov.au/publications/final-report/appendix-2/

[8] The other three are business income, designed to support economic growth; rents on natural resources and land; and private consumption.

[9] http://fsi.gov.au/terms-of-reference/.

an income return in the form of interest. In providing in effect a subsidy to shareholders against other taxpayers it is inequitable.

Concluding remarks

The issue of tax reform in Australia is a pressing one. The current tax system is unfair, inefficient and incapable of generating enough revenue to meet the expenses of government.

A starting point for reform is to consider the already well-developed and consistent agendas and proposals for reforms instead of half-baked ad hoc proposals advanced at COAG.

In this case the Commonwealth government needs to follow up on the actions of the G20, the Henry Tax Review and the FSI Report and, when it is released, the Senate Committee report on corporate tax avoidance.

The State governments need to consider reviewing their own taxation structure with a clear and immediate focus on broadening the land tax and introducing a progressive rate structure for it.