

# Summary of Research Report 38: A comprehensive review of taxation changes

Jon Stanford<sup>1</sup>

The current discussion of taxation in Australia, despite the oft repeated assertion that 'everything is on the table', is remarkable for the narrow range of changes under review.

The illiberal Right is pushing a now-outmoded and discredited trickle-down, supply-side ideology based on the assertion that we shouldn't pay tax but people we don't like should.

A review of taxation is required because the current tax system:

1. is ramshackle but highly inequitable;
2. fails to collect enough revenue to fund over the medium term necessary government outlays –the system has a structural deficit;
3. does not allow for increased taxation which is required for re-distributive purposes.
4. masks the long term structural problems with the allocation of taxation and expenditure responsibility between the Commonwealth and States.

## The Nature of Taxation

Taxation is a unilateral payment made to the government by its citizens without expectation of a *quid pro quo*. Payment of taxation is not voluntary; it is enforced by the coercive powers of the State with the more commonly employed techniques to deal with tax evaders being monetary fines and imprisonment. Taxes are unrequited in the sense that benefits provided by government to taxpayers are not necessarily in proportion to their payments.

## A Progressive view of government and taxation

The US neo-conservative approach asserts government is an infringement of individual rights and taxation is an unjust appropriation of individual income. This approach contrasts with an older tradition in US politics, one which found its most eloquent expression and policy effectiveness during the presidency of Woodrow Wilson who believed that it was the obligation of the federal Government 'to protect Americans from the consequences of great industrial social pressure which they cannot, alter, control, or singly cope with'.<sup>2</sup>

---

<sup>1</sup> Dr Jon Stanford is a TJRyan Foundation Research Associate.

<sup>2</sup> Jill Lepore, The Tug of War: Biographies of Woodrow Wilson, The New Yorker, 9 September 2013. During Wilson's term legislation was passed to create new anti-trust ban, the first 8 hour day in the private sector, the first inheritance tax, lower tariffs and to establish the Federal Reserve and the Federal Trade Commission.

## Equity in Taxation

The general notions of equity in taxation are summed up in the concepts of horizontal equity and vertical equity.

### a) Horizontal equity

Horizontal equity requires that people in the same economic circumstances and with the same capacity are treated the same and pay the same tax. Vertical equity requires that people in different economic circumstances are treated differently and pay different amounts of taxation. Economists use the Haig/Simons<sup>3</sup> measure of income as the indicator of economic circumstances and capacity which says that a person's income is the maximum amount that they can spend over a given time period without running down their capital.

### b) Vertical equity

Vertical equity is based on the proposition that a dollar means more to a person on a low income than a high income (technically economists call this the principle of diminishing marginal utility of income). What is required that people on high incomes pay proportionately more in taxation than someone on a lower income.

## Inequality in Australia

An OECD study has shown that the share of income going to the top 1% in Australia has doubled in 28 years while at the same time taxes have become less redistributive.<sup>4</sup> Both progressivity and average tax rates have declined. The flattening of the personal income tax system in the mid-2000s also contributed to a reduced capacity of redistribution.

The effects of inequality, according to the International Monetary Fund (IMF), are that high income inequality can be detrimental to achieving macroeconomic stability and growth; high levels of inequality are harmful for the pace and sustainability of growth; intergenerational income mobility is lower in countries with higher income inequality; intergenerational earnings mobility is low with high levels of inequality such as Italy, UK and USA; whereas mobility is much higher in the more egalitarian Nordic countries.<sup>5</sup>

---

<sup>3</sup> Haig, Robert M. 1921. "The Concept of Income-Economic and Legal Aspects." in *The Federal Income Tax*, Robert M Haig, ed. New York: Columbia University Press. Simons, Henry C. 1938. *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy*. Chicago: Chicago University Press. (Reprinted in Readings in the Economics of Taxation, George Allen and Unwin for the American Economic Association, London, 1966 [originally published 1939]).

<sup>4</sup> OECD (2011), *Divided We Stand: Why Inequality Keeps Rising, Country Note: AUSTRALIA*, <http://www.oecd.org/els/social/inequality>

<sup>5</sup> The Staff Report on Fiscal Policy and Income Inequality, IMF Policy Paper, 2014: <https://www.imf.org/external/np/pp/eng/2014/012314.pdf>

The IMF says that personal income taxes (PIT) make an important contribution to reducing inequality whereas empirical evidence suggests that indirect taxes (such as the GST in Australia) tend to be regressive. The IMF estimates that the optimal top rate of PIT lies between 50 and 60 per cent (Australia's is 45 per cent.)

### **IMF Priorities for Tax Reform**

#### **More Urgent:**

1. Implement progressive Personal Income Tax (PIT) rate structures
2. Reconsider income tax exemptions
3. Develop more effective taxation of multinationals
4. Utilize better the opportunities for recurrent property taxes

#### **Urgent:**

1. Examine scope for more effective taxes on inheritances and gifts
2. Relieve low-wage earners from tax or social contributions
3. Expand coverage of the PIT
4. Impose a reasonable PIT exemption threshold
5. Tax different types of capital income in a neutral manner

### **The analysis of TJRyan Foundation Research Report 38 recommends**

#### *Increases in Personal Income Tax (PIT) through:*

1. Extending the base;
2. Abolishing the Medicare and Budget Repair levies and re-adjusting the tax rates;
3. Reducing PIT on incomes below \$80,000;
4. Increasing the top marginal rates of tax.

#### *Abolish negative gearing and franking credits*

#### *Review and reduce concessions to superannuation and capital gains*

#### *Increase GST on Health, Education and Financial Services*

## Ratings of the tax change proposals

In the ratings system below, good changes start with the lowest score ★.

The more ★ ★ ★, the more desirable.

Bad changes start with a lowest score of x. The more xxx, the more undesirable.

Taxation Proposal	Rating	Comments
Extending GST to all goods and services in order to reduce MRT of PIT	xxxxx	Reverse Robin Hood Tax: Taking from poor to give to the rich.  Ross Gittins asks: 'Why would any Treasurer consider this stupid thing?'  Answer: 'Because he's allowing ideological preferences to override the plain facts' (Ross Gittens)
Extending GST to all goods and services	xxxx	Highly regressive. If compensation paid increases "churn" (pointless collection and return of much of the tax revenue). Gains to tax revenue low compared with other proposals.
Eliminating tax evasion, avoidance by foreign countries	★ ★ ★ ★ ★	This is an unqualified win for Australian taxpayers Has no effect on economic activity in Australia
Taxation of superannuation pension as income	★ ★ ★ ★	Logically: required under definition of income. Removal in 2005 'worst decision in 20 years' according to Saul Eslake.
Increasing Marginal Rate of Taxation in Personal Income Tax.	★ ★ ★ ★	Good effect on equity and on reducing inequality. Little effect on incentive to work. Can be avoided by emigrating to Mexico.
Introducing two new income tax brackets for higher income earners.	★ ★ ★ ★	Good effect on inequality. Little effect on incentive to work. Can be avoided by emigrating to Mexico.

Eliminate negative gearing	★ ★ ★ ★	Case has been made by Financial Systems Inquiry (FSI). Will eliminate over-investment in housing and distortions in capital market. Losses on investments can be carried forward to offset against profits.
Eliminate franking credits	★ ★ ★ ★	Case has been made by responsible body (FSI). Will eliminate distortions in capital market.
Improve Land Tax	★ ★ ★ ★	A good tax for the States; current taxes are ludicrously low and exemptions ludicrously high. Extremely difficult to avoid. Case made by Grattan Institute.
Estate duties	★ ★ ★	Good for inequality. Case made by Henry Review Good Tax for the States.
Inheritance Tax	★ ★ ★	Good for inequality. Case made by Henry Review. Integrate with PIT.
Capital gains tax exemptions	★ ★ ★	Treasury estimates total revenue foregone from all capital gains tax exemptions at approx. \$50 billion. Logically - required under definition of income. Capital gains taxation needs fundamental overall review.
Concessional taxation of superannuation	★ ★ ★	Treasury estimates revenue foregone as \$30 billion. Main benefit to high income earners.

GST on Education	★ ★	Revenue foregone \$4.0 billion Regressive effects likely to be smaller than all other GST proposals. Case made by the Australia Institute.
GST on Health	★ ★	Revenue foregone \$3.6. Regressive effects likely to be smaller than all other GST proposals. Case made by Australia Institute.
GST on Financial Services	★	Recommended by FSI as it distorts size of financial sector. Still work to be done on design.
Exemption for public benevolent institutions from taxation.	★	Logically required under definition of income.

Note: FSI = Final Report of Financial System Inquiry.