tjryan FOUNDATION

RESEARCH REPORT 38: A Comprehensive Review of Proposals for Taxation Change

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Introduction

Taxation is a unilateral payment made to the government by its citizens without expectation of a *quid pro quo*.

Paying tax 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 fines or imprisonment.

Taxes are unrequited, in the sense that benefits provided by government to taxpayers are not necessarily in proportion to the payments they have made.

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.

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 so the system has a structural deficit.
3. Does not allow for increased taxation that is required for re-distributive purposes. (Like all advanced economies, Australia has seen over the previous 30 years an increase in inequality in the distribution of income and wealth at the same time as the taxation system has become less progressive.)
4. Masks the long-term structural problems with the allocation of taxation and expenditure responsibility between the Commonwealth and States.

Some proposals that have already been put forward on tax reform

This review will assess a number of tax changes proposed by official inquiries and think tanks based on fundamental principles of taxation. These are that the most important base for taxation is income-defined in the broadest possible way, and founded on both 'horizontal' and 'vertical' equity.

The fundamental aims of taxation are to finance government expenditure and to re-distribute income. There is also a place for taxing wealth, as wealth confers an independent capacity to pay tax on top of the capacity through income.

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Taxation - an essential component of government policy

The neo-conservative view is that government itself is an infringement of individual rights and that taxation is an unjust appropriation of individual income.

This view contrasts with an older tradition in US politics, one which found its most eloquent expression and policy effectiveness during the presidency (1913-21) of Woodrow Wilson. Wilson believed that it was the obligation of the US Federal Government 'to protect Americans from the consequences of great industrial social pressure which they cannot, alter, control, or singly cope with'.[2]

In order to meet this obligation, the government needs powers to intervene in the economy, create institutions to give effect to its policies, and taxing powers to meet its expenditure and to re-distribute income. There are many activities which can be undertaken by government which increase both individual and community welfare; many people have a strong preference for the collective consumption of government services.

Horizontal and vertical taxation equity

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

Horizontal equity requires that people in the same economic circumstances, and with the same capacity to pay, 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.[3] Vertical equity is based on the proposition that a dollar means more to a person on a low income than someone on a high income (technically economists call this the principle of 'diminishing marginal utility' income). It implies that people on a high income pay proportionately more tax than someone on a lower income.

The present tax system fails on equity grounds as it does not meet these equity criteria. It fails the 'horizontal equity' criterion because it taxes income from different sources at different rates and allows some form of income to be exempt from tax. It fails the 'vertical equity' criterion because income from personal exertion is taxed more heavily than dividends from shares, due to the operation of franking credits.[4]

However, in 2000 the system was made even more generous to shareholders by allowing them to get a cash refund if they receive more in 'franking credits' than they actually owe in tax. Concessions for superannuation allow those contributing large amounts to pay a lower tax rates, and negative gearing allows net income from residential property (and some other investments) to

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[2] 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 a new anti-trust ban; the first eight-hour day in the private sector; the first inheritance tax; lower tariffs; and to establish the Federal Reserve and the Federal Trade Commission.

[3] Economists use the Haig/Simons 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. See Haig, Robert M, 'The Concept of Income-Economic and Legal Aspects', in *The Federal Income Tax,* Robert M Haig, ed. New York: Columbia University Press, 1921; Simons, Henry C, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy,* Chicago: Chicago University Press, 1938, reprinted in *Readings in the Economics of Taxation*, George Allen and Unwin for the American Economic Association, London, 1966.

[4] When companies pay dividends to Australia shareholders out of 'after-tax' profits, shareholders receive 'franking credits' which are credit against their own tax obligation and based on the tax paid by the company. This system, known as 'dividend imputation' is very unusual; few other countries in the world use it.

be 'offset' against income from personal exertion so as to be taxed at a lower rate or not taxed at all. In 2007 taxation on income earned from superannuation was reduced to zero for Australians over the age of 60.

Income from capital gains is taxed at a lower rate than other income.

Since 1999 only half the capital gains on assets held for a year are subject to tax. In 1999 the capital gains tax discount was introduced. Capital gains tax applies when someone sells an asset for more than the price they paid for it. This includes things like shares or investment housing. The capital gains tax discount means that, for assets owned for more than 12 months, only half the capital gain will be taxed.

A well-functioning taxation system will levy taxes on all sources of income consistently, and will ensure that the higher a person's income the higher, proportionately, is the tax paid.

There are no taxes on wealth. Some classes of persons and institutions do not pay tax at all (and do not pay local government rates). Religious organisations do not pay tax even on commercial undertakings, and other not-for–profit groups do not pay on commercial activities. Foreign companies use elaborate and contrived arrangements such as 'transfer pricing' not to pay tax in Australia. Mining companies do not pay a resources rent tax.

Structural deficit and profligate decisions by the Howard / Costello government

During the tenure of the conservative government led by Prime Minister John Howard and his Treasurer Peter Costello between 1997 and 2007, Australia experienced the greatest mining boom in its history, which brought heavy streams of revenue to the Commonwealth government. Even before the mining boom got under way in 2002-3, the government began lowering personal income tax, with a sharp focus on reducing tax rates for higher income earners.

The Howard Government completely missed the opportunity to institute a minerals rent resource tax, unlike, for example, Norway, which taxes resource extraction companies at the rate of 78 percent and places the proceeds in a Sovereign Wealth Fund (which now amounts to some US$700 billion). The Australian mining boom resulted in an enormous inflow of tax, leading to successive budget surpluses. Had the Howard Government applied sound financial principles it would have placed this in an Australian Sovereign Wealth Fund, or used it to finance infrastructure expenditure, or increased the superannuation balances of Australians. Any of these responses would have increased community welfare in the future. But the government did nothing more than give tax cuts, which are unsustainable over the medium and long terms.

Peter Martin wrote in 2013 that Australia's most needlessly wasteful spending took place under the Howard Government rather than under the ALP governments led by Whitlam, Rudd or Gillard.[5] Richard Denniss wrote in 2015 that it was Costello's most 'profligate' and inequitable decisions which created the structural deficit inherited by his successors.[6] These decisions included introducing: permanent income tax cuts during the boom; capital gains tax discounts; abolition of fuel excise indexation; superannuation tax cuts; and converting franking credits into cash refunds for shareholders.

The top ten percent of income earners received 42 percent of the income tax cuts, while the remaining 80 percent of taxpayers received only 38 percent. According to John Hewson, former Liberal leader (1990-94):

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[5] http://www.smh.com.au/federal-politics/political-news/hey-big-spender-howard-the-king-of-the-loose-purse-strings-20130110-2cj32.html - ixzz3s5rCMtvd

[6] http://www.theguardian.com/commentisfree/2015/apr/15/peter-costellos-five-most-profligate-decisions-as-treasurer-cost-the-budget-56bn-a-year

> The tax cuts Howard and Costello gave are now costing [the budget] about $30 billion a year, and the deficit's $40 billion.[7]

In 1999 the Howard Government introduced the capital gains tax discount, which meant that only half the capital gain on an asset sold after it had been held for a minimum of a year would be taxed.

Superannuation

The previous taxation arrangements for superannuation were complex, but recognised that major benefits flowed to high-income earners who were able to 'game' the system.

The basis of the superannuation tax is that contributions to a fund are taxed at 15 precent, and earnings in the fund likewise at 15 precent. The gains to higher earners, on marginal tax rates of over 30 precent, are substantial, while there are no gains to low-income earners.

In 2007 the superannuation surcharge was abolished and the tax rate on withdrawals from superannuation for people over 60 was reduced to zero. This meant that superannuation tax was 15 precent on contributions, 15 precent on earnings, and zero on withdrawals in the form of either pensions or lump sums. This was a bonanza for all those in superannuation funds, but especially for high-income earners. Economist Saul Eslake described it as 'One of the worst taxation policy decisions of the past 20 years'.[8]

The Association of Superannuation Funds has gone on record for saying that these changes go too far for very high earners. It says a small group of 24,000 retirees receives average super payouts of $216,000 a year – all tax-free, while non-retirees, earning a fraction of that income, pay tax.

> It is appropriate for the community to start questioning whether it should fund growing tax concessions on very high balances.[9]

The Howard Government also decided to make the dividend imputation system even more generous to shareholders by allowing them to get a cash refund if they receive more in franking credits than they actually owe in tax. This was a bonanza for high-income retirees who paid no tax on their income from superannuation and received all their franking credits in cash.

Correcting some misconceptions about tax in Australia

Australians, despite some complaints to the contrary, are not heavily taxed. The chart below shows the amount of tax collected as a proportion of Gross Domestic Product (GDP) for economies in the Organisation for Economic Cooperation and Development (OECD).

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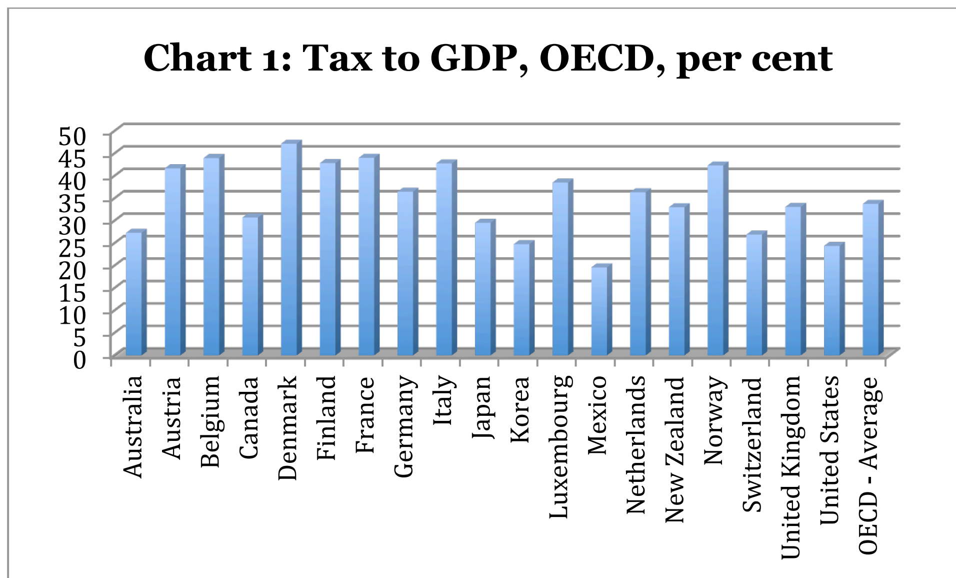
[7] https://www.thesaturdaypaper.com.au/news/politics/2014/12/20/how-john-howards-tax-cuts-undid-his-protege-tony-abbott/14189940001389

[8] http://grattan.edu.au/wp-content/uploads/2014/04/111_eslake_tax_reform_parl_library.pdf

[9] http://www.theage.com.au/comment/why-hockey-will-have-to-clean-up-costellos-superannuation-mess-in-may-budget-20150409-1mi15l.html - ixzz3s5nsdN5U



Source: OECD

The Australian rate is below the OECD average, suggesting strongly that we are not over-taxed. The tax/GDP proportion is low for the United States.

The United States - a poor comparison

We must remember that unlike modern, progressive advanced economies (such as the European economies, Canada and Australia), the USA does not have a universal tax-financed health scheme. The US cannot be compared with Australia as it has the most expensive health system in the world, which costs 17 precent of GDP, as against the 10 precent of the European economies, Canada and Australia.

The US health system, judged by usual indicators such as infant mortality and life expectancy, has the worst outcomes.

Mexico's low tax rate - a worse comparison

Those with an obsession about low taxes might find might the low tax rate in Mexico appealing, but there are very compelling reasons why emigration from Australia to Mexico is non-existent. On just about every one of the standard indicators Mexico ranks as the worst of OECD economies. The Sustainable Government Indicators network[10] claims that Mexico is among the most dangerous countries in the world, mainly as a result of criminal activity; for the drug cartels which provide the conduit for transport of illegal drugs to the USA; the Mexican military and other security forces are notorious for breaching human rights while the courts do not provide adequate protection; it is not rare for police officers to extort money from members of the public.

The *CIA Fact Book* summary on Mexico identifies low real wages; high under-employment; inequitable income distribution; and few advancement opportunities for the largely indigenous population in the impoverished southern states.[11] The US Department of State reports that impunity for human rights abuses remains a problem throughout Mexico with extremely low rates of prosecution for all forms of crime.[12]

[10] http://www.sgi-network.org/2015/

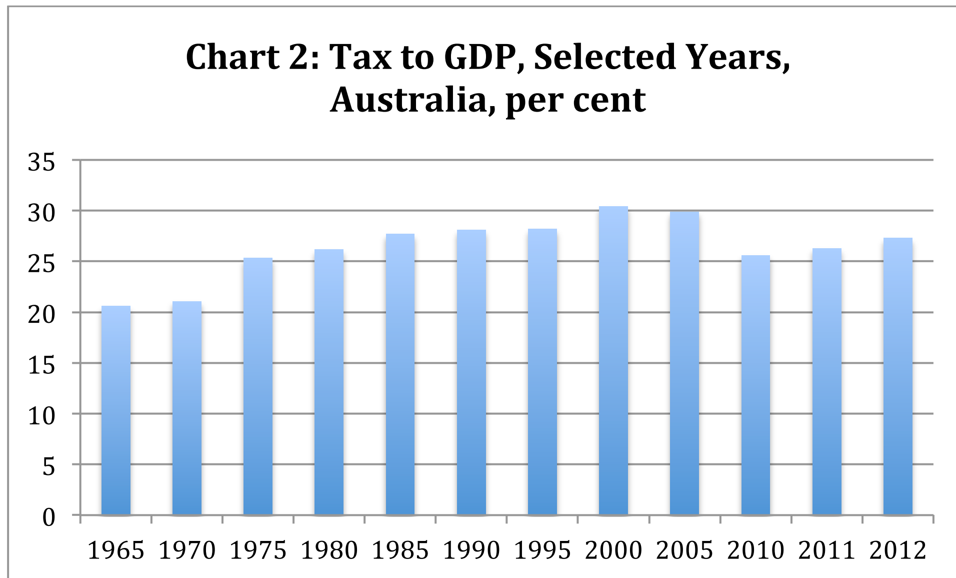
[11] https://www.cia.gov/library/publications/the-world-factbook/geos/mx.html

[12] http://www.state.gov/j/drl/rls/hrrpt/humanrightsreport/index.htm - wrapper

The situation in Australia

Taxation has not increased in Australia over the years. Chart 2 shows the tax/GDP ratio for selected years, from which we can note the decline in tax paid after 2005 as a result of the Howard Government's tax cuts (and to a smaller extent the ALP government under Prime Minister Kevin Rudd and his Treasurer Wayne Swan).

We have previously noted that these tax cuts were unsustainable and inequitable and responsible for the continuing budget deficit.



Source: OECD

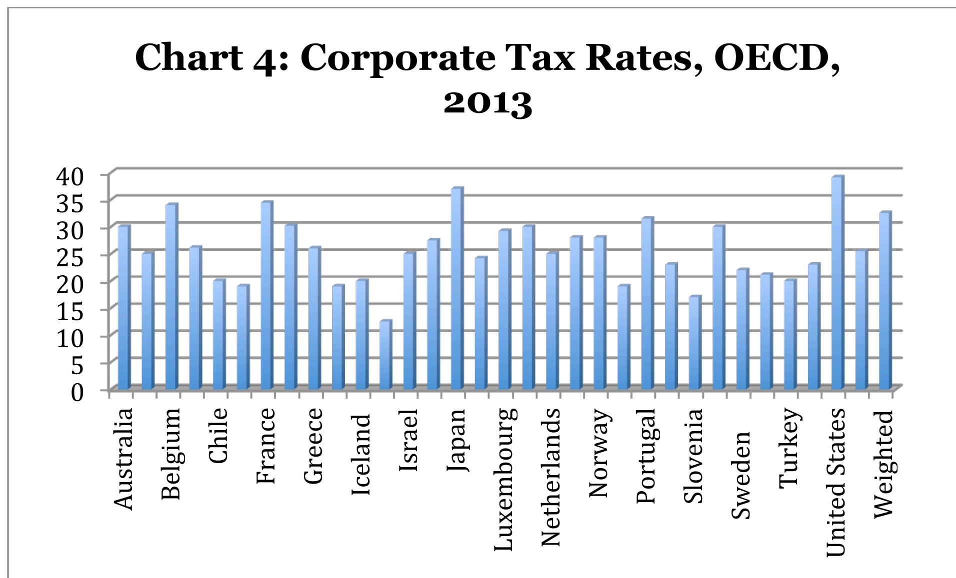
The tax cuts mentioned above have been inequitable, one feature being that most of the benefit has flowed to the top one precent of income earners.

This has, of course, increased inequality.

Source: OECD

The illiberal Right has a concern about high rates of company tax. However, an international comparison of corporate tax rates as shown in Chart 4 shows no evidence that Australia's tax rate

is high. Australia's rate is, in fact, lower than the weighted average of the OECD, and lower than the US rate.



Source: OECD

Some of the countries have purely nominal rates of course. Ireland, for example, has a tax rate of 12.5 precent, but few companies registered there pay such a rate. Ireland is a notorious tax haven, which provides artificial arrangements for tax dodging which are inducements to encourage productive foreign enterprises to locate to Ireland in order to avoid paying tax. The rationale for this is that a small cut of pie is better than none at all.

Other notorious tax havens in Europe are Luxembourg, Belgium and the Netherlands. *De Spiegel* explains how it was done:

> Finance policy experts in Belgium, the Netherlands and Luxembourg led the pack in transforming tax advantages into an instrument allowing corporations to steer proceeds from patents or licenses to their Benelux subsidiaries in order to pay lower taxes there. Under the system, national subsidiaries of large corporations in countries with higher corporate tax rates would pay large patent and licensing fees to subsidiaries in lower tax countries. The system ensured that money got pumped into the government coffers of the Benelux countries, but it also put other EU countries at a disadvantage, in addition to the majority of small- and middle-sized businesses for whom such preferential treatment wouldn't even be considered.

The result was entirely predictable:

> Even for profits in the billions, the tax bill was close to zero, as a list compiled by EU experts shows. In Belgium, which introduced the patent box in 2007, the corporate tax rate plunged from 33.99 percent to 6.80 percent. In Luxembourg, it sank from 29.22 percent to 5.84 percent.[13]

[13] http://www.spiegel.de/international/europe/eu-documents-reveal-how-benalux-blocked-tax-haven-laws-a-1061526.html

Inequality in Australia

In Australia, tax cuts contributed to increased inequality in Australia. The findings on inequality in Australia by the OECD[14] were that the richest one per cent of Australians saw their share of total national income almost double, from 4.8 precent in 1980 to 8.8 precent in 2008 while that of the richest 0.1 precent rose from 1 precent to 3 precent.

At the same time, top marginal income tax rates declined markedly, dropping from 60 precent in 1981 to 45 precent in 2010. Labour market changes have been a key driver of inequality trends in Australia. The earnings gap between the 10 per cent best- and least-paid full-time workers increased by a fifth between 1980 and in 2008.

As in most other countries, the divide in hours worked between higher- and lower-wage earners in Australia is growing, confirming a trend seen in most OECD countries. Since the mid-1980s, annual hours of low-wage workers fell from 1300 to 1100 hours; while those of higher-wage workers remained stable at around 2300 hours. Since the mid-1980s, taxes have become less redistributive. Both 'progressivity' (a tax that takes a larger percentage from the income of high-income earners than it does from low-income individuals) and average tax rates have declined. The flattening of the personal income tax system in the mid-2000s (e.g. through increases to the top threshold) also contributed to reducing redistribution.

Effects of high-income inequality

The effects of high inequality, according to the International Monetary Fund (IMF), are that it can be detrimental to achieving macroeconomic stability and growth; it is harmful for the pace and sustainability of growth; intergenerational income mobility is lower. Intergenerational earnings mobility is low in countries such as Italy, the United Kingdom and the United States, which have high-income inequality; in contrast, mobility is much higher in the more egalitarian Nordic countries. In low-mobility countries, about 50 percent of any economic advantage that a father possesses is passed on to his offspring, whereas in high-mobility countries this falls to less than 20 percent.[15]

Remedies for inequality

The IMF says that fiscal policy has played a significant role in reducing income inequality in advanced economies. Personal income taxes make an important contribution to reducing inequality, whereas empirical evidence suggests that indirect taxes, such as the Goods and Services Tax (GST) in Australia, tend to be regressive or proportional to incomes.

On the other hand, personal income taxes (PIT) are often preferable for achieving redistribution than taxes on consumption because they directly take account of the ability of households or individuals to pay. The IMF estimates that the optimal top rate of PIT lies between 50 and 60 percent (Australia's is 37 percent).

The OECD notes that the growing share of income going to top earners means that this group now has a greater capacity to pay taxes and that reforming tax and benefit policies is the most direct instrument for increasing redistributive effects. The OECD considers employment is a key fact in reducing inequality in which the real challenge is to create more and better jobs that offer good career prospects and a real chance for people to escape poverty.

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[14] OECD (2011), *Divided We Stand: Why Inequality Keeps Rising, Country Note*: Australia, http://www.oecd.org/els/social/inequality

[15] The Staff Report on Fiscal Policy and Income Inequality, IMF Policy Paper, 2014.

Proposals taxation changes in Australia

Expand the tax base

Groups currently exempt from tax should be brought into the system. Churches' exemption should be removed and the taxation of not-for-profit organisations should be reviewed. Other candidates for inclusion are capital gains from owner-occupied housing and lottery wins.

Reduce tax avoidance by foreign multi-national companies operating

Evidence before the Senate Committee on Tax Avoidance indicates the extent to which foreign companies operating Australia use transfer pricing and shifting of revenue overseas to avoid paying Australian income tax. On July 1, 2015 nine large global pharmaceutical companies appeared before the Committee and when asked if they knew the costs of the drugs they were selling, there was only demurring and obfuscation:

> They didn't know. Here were nine companies who notched up $8 billion in sales in Australia last year – and who were the recipients of $3.5 billion in subsidies from the Australian taxpayer via the Pharmaceutical Benefits Scheme (PBS) – but who paid collectively just $85 million in income taxes.[16]

- Uber: the controversial share-riding taxi service, has admitted to the inquiry into corporate tax avoidance that about 25 percent of each transaction in Australia is routed to its head company in the Netherlands.
- Airbnb: the alternative accommodation booking service, sends three percent of its booking fee to Ireland.[17]
- Microsoft admitted to the Committee that $2 billion worth of software sales generated in Australia is billed to Singapore which has a lower corporate tax rate than Australia;
- Apple Australia is owned by Apple Ireland, which has a relatively low corporate tax rate, but the Australian head of Apple he had never been on a business trip to Ireland. Apple had turnover of $6 billion in Australia last year and paid $80 million in tax. The Apple spokesman was unable to say how much of the money paid by Australian consumers buying Apple products went offshore.
- Chevron, which is based in California, described by the Senate Committee as the biggest tax dodger in Australia, and whose tax arrangements were described as a 'rort', pays no tax in Australia, and pays none in the US because it "paid almost all of its taxes to foreign governments[18]."

The 'double Irish, Dutch sandwich'

European countries have complained about companies such as Google, Apple, Amazon, Facebook, and Starbucks using the strategy known as the 'double Irish, Dutch sandwich'. In questioning before the Committee the representative from Apple denied knowing this avoidance arrangement under which a company uses two Irish Companies and a Dutch company to avoid paying tax.

It is a complicated arrangement but an account of how Google uses it is as follows. Google transfers its intangible assets to an Irish holding company. This company has a subsidiary sales

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[16] http://www.smh.com.au/business/comment-and-analysis/big-pharma-bosses-front-up-to-senate-inquiry-into-corporate-tax-avoidance-20150701-gi2u7v.html#ixzz3sB0EoxdK

[17] http://www.smh.com.au/business/the-economy/uber-sends-25pc-of-fares-to-the-netherlands-20151118-gl1yqs.html - ixzz3sB3GvgbK

[18] http://bigthink.com/politeia/how-multinational-corporations-dodge-taxes

company that sells advertising (the source of Google's revenues) to Europe. However, sandwiched between the Irish holding company and the Irish sales subsidiary is a Dutch subsidiary, which collects royalties from the sales subsidiary and transfers them to the Irish holding company. The Irish holding company claims company management (and tax home) in Bermuda, with a 0% tax rate, for purposes of the corporate income tax. This strategy allows the Irish operation to avoid even the low Irish tax of 12.5% and, by using the Dutch sandwich, to avoid Irish withholding taxes (which are not due on payments to European Union companies).[19]. There is, of course, no valid commercial reason for this arrangement; it is made to avoid tax. This is one reason why Ireland and the Netherlands have become notorious tax havens.[20]

Mineral Resources Rent Tax

The Henry Review recommended that the current resource charging arrangements should be replaced with a uniform resource rent tax administered by the Australian government and that it would also ensure that the Australian community receives an appropriate return on its non-renewable resources.

The problems with this recommendation were that there was no proposal to co-ordinate with the States who have the power to levy royalties; they were relucent to lose a source of revenue without compensation. The proposal was taken up by a government which was unable explain the proposal and to respond to the barrage of mendacious propaganda; the pitiful short-lived Resources Tax was abolished by the Abbott government to advantage predominantly foreign mining companies at the expenses of Australian citizens. Taxing the economic rent which arises from exploitation of mineral resources is a valid taxation measure.

Increase Tax on Not-For-Profit Enterprises

The Henry Review found that where Not-For-Profit clubs operate large trading activities in the fields of gaming, catering, entertainment and hospitality, the rationale for exempting receipts from these activities from income tax on the basis of a direct connection with members is weakened. New concessional tax arrangements should be established for clubs with large trading activities in these fields. One option, as recommended by Henry, is to apply a concessional rate of tax to total net income from these activities above a high threshold.

Capital Gains Tax

The Financial System Inquiry maintained that capital gains tax concessions for assets held longer than a year provide incentives to invest in assets for which anticipated capital gains are a larger component of returns. Reducing these concessions would lead to a more efficient allocation of funding in the economy.

Increase the top rates of Personal Income Tax

Current Rates of PIT are shown below[21]:

Taxable income	Marginal Tax Rate
0 – $18,200	Nil
$18,201 – $37,000	19 percent
$37,001 – $80,000	32.5c
$80,001 – $180,000	37c
$180,001 and over	45c

[19] Jane G. Gravelle, Tax Havens: International Tax Avoidance and Evasion, Congressional Research Service, January 15, 2015,p13
[20] http://www.socialeurope.eu/2015/12/curbing-tax-avoidance-tax-evasion-and-tax-havens/
[21] https://www.ato.gov.au/rates/individual-income-tax-rates/

The above rates do not include the medical levy of two precent and the budget repair levy on incomes over $180,000 due to expire in 2017.

There is an infinite array of tax rates to choose from but one example is abolish the Medicare and budget repair levies and increase the progressivity of the PIT and introduce two new tax brackets as shown below

	Current Marginal Rate of Tax %	Proposed Marginal Rate Tax % By incorporating the Medicare levy and budget repair levy in the Tax rates
0 – $18,200	0	0
$18,201 – $37,000	19	21
$37,001 – $80,000	32.5	32.5
$80,001 – $180,000	37	39
Over $180,001 -	45	49

The measures are not designed to be prescriptive but merely illustrative.

	Current MRT %	Proposed MRT % By lowering the rate for lower incomes and increasing it for higher
0 – $18,200	0	0
$18,201 – $37,000	19	19
$37,001 – $80,000	32.5	30
$80,001 – $180,000	37	41
$180,001 - $500,000	45	49
$500,001 - $1,000,000	45	52
Over $1,000,000	45	55

Effects of high Personal Income Tax Rates

A key consideration in setting the top Personal Income Tax rate is what effect it will have on taxpayers' willingness to work, that is - will a high rate cause people to work less? Economic theory tells us that taxation of remuneration in excess of the value of marginal product[22] or which is a quasi-rent[23] will have no disincentive on work effort.

Earnings in in excess of marginal productivity are likely to be prevalent in economies with a high degree of concentration in industry (where there are only a very small number of firms in any area as is in Australia). Under these circumstance individual companies can earn above normal profits (i.e. above the risk-adjusted level of profits necessary to keep the company in business.

[22] Under purely competitive markets (in which no economic agent has market power) the theory concludes that the wage rate will be determined by the worker's marginal productivity and the market price of the commodity produced. It is like piecework. For example, a worker in a widget factor will receive a wage determined solely by the price of widgets and how many the worker can produce in an hour. Unfortunately for the application of this theory life outside the widget factory, especially in complex modern organization which do not produce readily recognizable commodities, is more complex. It is extremely difficult to estimate the marginal productivity of a worker in an advertising agency. Or, indeed, a researcher in a think-tank.

[23] A quasi-rent is a payment to a worker in excess of opportunity cost. A top sportsperson may be paid $1 million dollars a year but the opportunity cost is the earnings from an alternative occupation (e.g. a curator at a sporting field). An increase in the marginal rate of tax will not cause the sportsman to take up the alternative occupation.

Executive salaries

Executives in such companies are able to appropriate some of the excess profits. Precise measurement of marginal productivity of top executives, especially the CEO, is so difficult as to be near impossible. However, to fill this empirical void there are conventions which serve to exaggerate the value of an executive. Business favours a 'great man' theory of performance; only men possessed of exception qualities (and it is almost invariably men) can lead a company to higher and higher profits. Such men, it is said, ought to receive extra-ordinarily remuneration packages not just a wage or a salary but a package which includes other terms usually designed to minimise tax. One business convention is that CEOs should have 'some skin in the game', which we are to take to mean some capital at risk by the company's performance. A common device is a company issued option, which gives the executive the right to purchase shares under defined circumstances. More on this later.

It is usually considered now that modern companies are run by the executives for their own benefit; the notion that shareholders, the owners of the company who make important decisions is now regarded as quaint. The separation of ownership and control has increased the power of executives. Management is able to obtain the lion's share of above normal profits while keeping shareholders quiet with steady if unspectacular dividend payments.

CEO remuneration has increasingly been determined by a committee of the Board of Directors, the composition of which is strongly influenced by senior management or by a committee of executives from outside the company. In both cases, committees favour the technique of comparison of remuneration of executives in other companies with the home CEO; this technique, in the past called 'comparative wage justice' in Australian industrial relations, is now ignored. Wages and salaries must be decided on a basis of productivity improvement, which in the case of executives cannot be determined. The usual outcome is a large increase in remuneration if the CEO has outperformed his compatriots. Once awarded this large package can now become the basis for the remuneration of the members of the Board (who have supported the CEO and thus deserve an increased remuneration). Likewise, outside members can report to their own company the large increase, which now justifies a corresponding increase for them and their Boards.

This process had become so blatant that, in 2011, amendments were made to the *Corporations Act* to give shareholders a greater say over executive remuneration. Under these arrangements, shareholders at the company's Annual General Meeting vote on executive pay recommended by the Board. A 25 per cent vote against the proposal means that the Board must re-consider its proposal. If a further vote of 25 precent against the proposed executive pay occurs the 'two strikes' policy instigates a spill of all Board positions and a fresh election is required.

The reasoning behind this is that many profit increases result from events and circumstances outside the influence or control of the CEO, but under the 'great man' theory this favourable outcome is attributed solely of the efforts of the CEO. One recent instance of this was the increase in profits by Qantas. This was attributed to the results of a cost-cutting campaign by the CEO who was awarded a large bonus. Critics pointed out that the increase in profit was due almost solely to the global fall in oil prices (fuel is a major cost for airlines). Other criticism of the increased bonus was that the CEO had not been penalised when profits fell due to an increase in oil prices.

A very recent example of a furore over CEO remuneration is Woolworths, where the retiring CEO's multi-million dollar golden handshake was deemed to be excessive, given the destruction of shareholder value during the last few years of the CEO's tenure. A corporate advisor recommended that shareholders vote against the remuneration report recommendation, suggesting that the golden handshake was 'payment for failure' because the total value of Woolworths rose by only 2 precent over the period October 2011 to November 2015, against a rise in the overall stock market of 37 precent. Woolworth's share price reached a peak in April 2014, but since then had fallen to such an extent that the aggregate loss to shareholders was $16 billion.

This is consistent with academic research on the subject. Piketty and two colleagues point out that some parts of CEOs' compensation packages are deliberately hidden from shareholders, which flies in the face of the proposition that packages are determined competitively: CEOs are rewarded for good outcomes and not symmetrically punished for unlucky events (as in the airlines case above); CEO remuneration has decreased under the effect of regulatory change aimed at improving board control (as in the Australian “two strikes’ legislation; and there is widespread malpractice in compensation setting (e.g. backdating option agreements) which indicates rent extraction.

Negative gearing

The Financial System Inquiry (FSI) report[24] recommended re-consideration of negatively geared investments.

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. All else being equal, the increase in the after-tax return is larger for individuals on higher marginal tax rates.

The tax treatment of investor housing, in particular, tends to encourage leveraged and speculative investment. Since the Wallis Inquiry, higher housing debt has been accompanied by lenders having a greater exposure to mortgages. Housing is a potential source of systemic risk for the financial system and the economy

The means to change the taxation of negatively geared investments is to quarantine losses from the investment from being offset against income from other sources but allowing the losses to be carried forward to offset against future profits from the investment.

A justification for allowing negative gearing is that increases the supply of housing; however, most negatively geared dwellings are existing housing. Australians are, in general, very well housed occupying much larger houses than is usual in other advanced economies. In Australia there are more dwellings than ever before, on average dwellings have more rooms than ever before and again on average there are fewer people per room.

Franking credits

The Henry Review noted that, as the Australian economy has become more open, the benefits of dividend imputation have declined; if the trend of increased international openness and integration with international capital markets continues, alternatives to dividend imputation should be considered.[25]

The FSI Report makes the same point in relation to the cost of equity when it says that the benefits of dividend imputation, particularly in lowering the cost of capital, may have declined as Australia’s economy has become more open and connected to global capital markets.

If global capital markets set the (risk-adjusted) cost of funding, then dividend imputation acts as a subsidy to domestic equity holders. That would create a bias for domestic investors, including superannuation funds, to invest in domestic equities. The Report notes that dividend imputation can act as a subsidy to domestic equity holders creating a bias for domestic investors, including superannuation funds, to invest in domestic equities. Under certain circumstances the value of imputation credits received may exceed tax payable; unused credits are fully refundable to

[24] http://fsi.gov.au/publications/final-report/

[25] http://taxreview.treasury.gov.au/Content/Content.aspx?doc=html/home.htm

investors, with negative consequences for Government revenue. Mutuals cannot distribute franking credits, unlike institutions with more traditional company structures. This may adversely affect Mutuals' cost of capital, with implications for corporate structure.

Tax concessions for superannuation

The FSI Report identifies that tax concessions in the superannuation system are not well targeted to achieve provision of retirement incomes. This increases the cost of the superannuation system to taxpayers and increases inefficiencies arising from higher taxation elsewhere in the economy, particularly in regard to the distortions arising from the differences in the tax treatment of savings. It also contributes to the broader problem of policy instability, which imposes unnecessary costs on superannuation funds and their members and undermines long-term confidence in the system.

Aligning the earnings tax rate between accumulation and retirement would reduce costs for funds, help to foster innovation in whole-of-life superannuation products, facilitate a seamless transition to retirement and reduce opportunities for tax arbitrage

Land Tax

The Henry Review noted that the structure of land taxes could be improved by broadening the land tax base to include all land and maintained that land tax rates should be based on the value of a given property, so that the tax does not discriminate between different owners or uses of land.
A Grattan Institute Working Paper[26] suggests that a levy of just $2 for every $1000 of unimproved land value would raise $7 billion with an annual charge of $772 on the median priced Sydney house, $560 in Melbourne and lower amounts in other capital cities. It notes that property taxes are unpopular because they are highly visible and hard to avoid but they are fair and efficient but don't change incentives to work, save and invest. In the last decade about 60 percent of the increase in private wealth in Australia has been in the market value of land providing a solid base for a tax; it is also unearned which ensures the effects on incentives are so small as to be ignored.

Estate duties

Estate duties and inheritance taxes have a long history as means to reduce the inequality of inherited wealth. Estate duties constitute a tax on the entire estate of a deceased person whereas an inheritance tax taxes (usually as income) in the hands of the person receiving the bequest.

Inheritance Tax

The Henry Review notes that a bequest tax would be an economically efficient way of raising revenue and would allow reductions in other, less efficient taxes. It would not affect saving decisions to fund an adequate standard of living in retirement. Saving decisions motivated by the desire to leave a bequest would be affected, but only to a limited extent.

Given the controversial history of bequest taxation in Australia, the Review has not recommended the introduction of a bequest tax, but believes that there should be full community discussion and consultation on the options. Most OECD countries impose bequest taxes — either through taxes on the whole estate or individual inheritances. The case for such taxes is strong because of their effects on inequality, difficulty in avoiding and lack of effects on incentives.

[26] John Daley and Brendan Coates, Property Taxes, Grattan Institute, 2015

Goods and Services Tax

Extend to financial services

Currently there is no GST applied to financial services. The Henry Tax Review recommended that financial services should be taxed equivalently to other forms of consumption.

The Financial System Report (December 2014) claimed that failure to levy GST on financial services may contribute to the financial system being larger than it otherwise would be. Financial service providers not charging GST still must pay GST on inputs, but cannot claim input tax credits. Providers pass this cost on to consumers in the form of higher prices. As a result, households could be over-consuming financial services whereas businesses may consume fewer financial services than otherwise would be the case.

Include health and education

The Australia Institute report[27] notes that increasing or broadening the scope of Australia's Goods and Services Tax (GST) is an option that has long been popular with conservative politicians, business groups and economists for significantly enhancing public revenue.
Such a move would be regressive placing a greater burden on the lower income groups while lightening the load on those proposing the change. The paper comes up with an innovative idea for broadening the GST without enhancing the burden of the tax on low-income households. It proposes that the tax would be extended to goods and services consumed most regularly by higher income earners, such as private schools and private health insurance. The paper estimates that this move could raise $2.3 billion per year in additional revenue.

What is the optimal tax change package?

The analysis has shown that there are many possible changes to the tax system based on fundamental principles of equity and efficiency.

At the present time there are two important requirements for tax change: the first to move towards a more equitable system which will concurrently reduce the high levels of inequality of income and wealth in Australia and the second is to eliminate the structural deficit which would take increased tax collections of $30-40 billion a year which would provide enough for the inevitable increase in necessary expenditure. In total, the changes considered here, if implemented immediately, would raise much more than this. So it is necessary to have a judicious selection from this menu and to allow for practical matters such as the implementation costs. However the direction of change is clear:

1. Rely on the progressive income tax for most of the change (contrary to the assertions of the illiberal Right for a regressive consumption tax). Note that the effects of increased marginal rates of PIT at the top on incentives to work, save and invest are slight at best (contrary to the assertions of the illiberal Right);
2. Introduce new, or expand existing taxes, on wealth.

The important changes to the income tax system are:

1. to scrutinise critically the current exemptions from the base on which income tax is levied; this means some concessions in the area of capital gains and superannuation must be ignored;
2. The current highest marginal tax rate of 45 percent is too low. All the research and available evidence suggests a rate of 55 percent is entirely feasible and fair.

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[27] Matt Grudnoff, 'How to extend the GST without hurting the poor', *The Australia Institute*, December 2014. ISSN 1836-9014: http://www.tai.org.au/content/how-extend-gst-without-hurting-poor