

Re:think or repeat? Australia's tax system needs a better vision

Deteriorating economic conditions are making tax reform more essential than ever. The underlying budget deficit is widening as the resources boom unwinds, compounding existing issues, such as an ageing population, with sluggish economic growth and decade-high unemployment levels. Just five years after the Henry Tax Review released its recommendations, another federal tax review is underway – this time with all options up for discussion.

The Government released its *Re:think* tax discussion paper on 30 March 2015, reopening the conversation on reforming Australia's tax system. The objective of this most recent review is to create a tax system that delivers lower, simpler, and fairer taxes. How could anyone argue with these objectives? They have underpinned tax reviews for time immemorial.

In the 17th Century Louis XIV's finance minister, Jean-Baptiste Colbert, famously stated that "The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing". This definition remains as relevant as it was four centuries ago. In today's parlance, a good tax system is one which raises sufficient revenue to finance public expenditure without imposing unnecessary cost on the economy.

In addition, the design of individual taxes is important for the performance of the tax system as a whole. From an economic standpoint, there seems to be near universal acceptance of what constitutes a 'good' tax.

First, the tax must be simple. That is, it must be easy and relatively inexpensive to comply with and administer. Second, a tax must be efficient. An efficient tax creates minimal distortions in production and consumption decisions, ensuring resources are allocated to their best use. A more efficient tax does not necessarily mean lower tax, however, although with all else being equal a lower tax would have a less distortionary impact.

The third element of a good tax system is equity, usually defined as 'even distribution of the tax burden'. The *Re:think* review has stated an objective to deliver 'fairer' taxes, a redefinition which confuses the concept. Fairness is a more subjective idea, likely to differ depending on a person's point of reference, which makes achieving it difficult if not impossible. Regardless, achieving equity is hardly a simple goal, as the distribution of the tax burden – i.e. who

ultimately pays the tax – is not easily determined.

It is well established in economic literature that the cost of a tax is not necessarily borne by the party upon which the tax is levied. Instead, the tax burden is passed forward to consumers, or back to factors of production, or shared by both. Reflecting on this for a moment it will be obvious that ultimately all taxes are borne by households as they consume or supply labour and capital.

For example, the burden of a corporate income tax could be divided a number of ways. As corporations are just legal constructs, the tax cost must eventually be borne by individuals. When a corporation pays tax, either shareholders could receive lower returns, consumers could pay higher prices, workers could receive lower wages, or some combination thereof could occur.

As economies become more open, the burden of taxation is believed to shift towards workers and consumers as an effect of increased capital mobility – in essence, capital (in the form of investment) can go offshore relatively easily, whereas people cannot.¹ In reality the story is not as simple – capital may not be fully mobile, or may respond to factors other than the tax rate – but evidence shows that multinationals tend to locate higher return activities in lower tax countries.

This is just one example of how a notionally 'equitable' tax can have unintended consequences: a tax designed to be imposed upon wealthy shareholders is instead borne by consumers and workers. In practice, it is very difficult to determine exactly where the burden of taxation falls, and there is significant disagreement amongst academics on the issue. This makes the design of a *fair* tax much more difficult than the design of an *efficient* tax. This is only compounded when trying to design a fair tax that is also simple and efficient.

For this reason, a better tax system should be focused

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¹ R. Alison Felix (2007) *Passing the Burden: Corporate Tax Incidence in Open Economies*

on raising revenue in the simplest and most efficient way possible, rather than trying to chase the potentially unachievable goal of uniformly distributing the burden of taxation. There already exists another system designed to achieve the equitable redistribution of wealth – the transfer system. This can achieve redistribution of wealth much more effectively.

There is a clear incentive to move away from an approach where the tax system is used to both raise money and redistribute it according to highly politicised ideas of ‘fairness’. The *Australia’s Future Tax System* (AFTS) report, released in 2010, provided a similarly unfavourable summation of the tax system to this year’s *Re:think* tax discussion paper:

“Australia has too many taxes and too many complicated ways of delivering multiple policy objectives through the tax and transfer systems... The tax and transfer architecture is overburdened and beginning to fail in dealing efficiently and effectively with multiplying policy goals and demands.”²

Five years on, this assessment remains accurate. Only a handful of the 138 recommendations of the AFTS report have been implemented – generally in modified form - and two of those (the carbon and mining taxes) were later repealed.

Tax reform has been, and continues to be, approached in a piecemeal fashion. In part, this is a result of the magnitude of the challenge faced by government. But the absence of progress is also a function of the lack of an ambitious, bi-partisan, long-term vision for the nation’s tax system.

What should a better tax system for Australia look like? A litany of tax forums, conferences, and discussion papers dating back to the 1975 *Asprey Tax Review* have all come to similar conclusions. Consistent across the last 40 years is the view that there are too many individual taxes, and that many of the taxes we rely on are inefficient and complex. These reviews outline similar goals, too: for a tax system designed to promote economic growth, productivity, and employment, and to do so without compromising the opportunities and living standards of Australians.

There is much that stands in the way of achieving broad, ambitious reforms to the tax system. The most obvious impediments are the political risks – convincing the electorate and vested interests that reforms are necessary requires significant effort and

political will, especially where changes go against self-interest. The complexity of the existing system also acts as a deterrent to change, as the effects of significant reform are difficult to determine before they are implemented. Major changes to the range and mix of taxes also tend to be associated with large transaction costs, which reduces the desirability of undertaking ambitious reforms.

The vision for a better tax system should not be driven by political objectives, such as a smaller government which raises lower taxes (though there is certainly a need to address the widening fiscal imbalance). Nor should the taxation system be overburdened with competing policy objectives, such as ineffectual attempts to simultaneously raise and redistribute income according to subjective notions of fairness. A good tax system must instead be driven by an ambition to deliver taxes that are simple, efficient, and, where possible, equitable.

Treasurer Joe Hockey is correct when he says that we need to rethink the tax system. What we do not need is a repeat of the multitude of politically motivated, unproductive tax reviews. Past attempts to reform the tax system one recommendation at a time have failed dismally. Broader consensus is required before changes to individual laws can be contemplated. Businesses, unions, political parties and consumer groups must find agreement at a high level on the shape of Australia’s future tax system. This vision does not need to be detailed; it could be as simple as recognising the types of taxes that must be used to raise revenue, and an approximation of that tax mix.

Once that vision is in place, the debate on tax reform can be framed not by the obstructions that prevent changes to the status quo, but by the steps that must be taken to create an ideal tax system for Australia.

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² Henry et al (2009) *Australia’s Future Tax System - Final Report*

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