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Progressive tax reform: Reform of the personal income tax system

This paper was prepared by ACOSS Senior Policy Officer, Peter Davidson with the benefit of the very helpful advice from independent experts who are our economics and tax policy advisers (the policy advisers are Julie Smith, Rick Krever, Nicholas Gruen, Rosanna Scutella, and Andrew Leigh). However, responsibility for the content rests with ACOSS.

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Australian Council of Social Service
Locked Bag 4777
Strawberry Hills, NSW, 2012 Australia
Ph 02 9310 6200
Fax 02 9310 4822
Email: info@acoss.org.au
Website: www.acoss.org.au

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Contents:

Summary	2
Raising public revenue to support an ageing population	2
A fairer tax system	2
A tax system to support economic development	3
Frameworks for tax reform.....	4
Benchmarks for tax reform	5
A. Options for reform to strengthen the personal income tax system.....	6
B. Objectives for reform of personal income tax	11
1. Raising adequate public revenue for benefits and services.....	12
2. Raising revenue fairly	14
Income tax rates	15
Which tax base is fairest – income or consumption?.....	16
Taxing individuals or couples.....	19
Company income taxes and fairness.....	20
3. Strengthening economic development	21
Impact of taxation on foreign investment	22
Taxation and incentives to save	23
Taxation and incentives to work	26
Taxing incomes more consistently through base broadening.....	32
4. A simpler, more sustainable tax system	33
Simplicity	33
Sustainability	34
C. Frameworks for income tax reform	37
Attachment: The main tax bases – personal income, consumption, and company income	41
The role of company income tax.....	44

Summary

This report argues that the key to progressive tax reform is to strengthen the personal income tax system and puts forward a set of benchmarks and options for reform. These will be used by ACOSS to evaluate the proposals of the Government's Australia's Future Tax System (AFTS) Review after its report is finalised later this year.

There are four good reasons to reform the tax system:

- To raise the public revenue needed to fund the services and income support needed by Australians as the population ages
- To raise revenue more fairly than we do now, based on people's ability to pay tax, not their ability to game the system
- To make tax less of a factor in investment and workforce participation decisions
- To create a system that people can understand and comply with

Raising public revenue to support an ageing population

The role of the tax system in solving Australia's economic and social problems is often exaggerated. Its main purpose is to raise revenue for the public infrastructure and services on which Australians rely. In future, Governments will need more revenue to provide health care and other services for an ageing population. Otherwise, people who are sick or need care will have to meet more of these costs from their own resources. The Treasury has estimated that in 40 years' time, expenses associated with population ageing will rise by \$40 billion per year (in current dollars) - more than the federal education budget. Yet Australia would still be a low taxing country if it raised this extra revenue. As the 8th lowest taxing OECD country, tax revenues in Australia are \$60 billion below the average level.

To help meet these costs, we propose extending the Medicare Levy into a broader health services levy that rises gradually as the population ages. For example, if the exemption from the Medicare Levy surcharge for high income earners that use health insurance were removed, then for every 1% increase in the levy and surcharge, over \$8 billion in additional revenue could be raised. In addition, income tax revenue could be increased substantially without raising tax rates by closing off shelters and loopholes currently used by high income earners to avoid paying income tax.

A fairer tax system

When the fairness of the tax system is discussed, debate usually turns to income tax rates. While it is true that the tax scale has become less progressive in the last decade and a half (for example, only the top 3% of taxpayers are required to pay the top rate of 45%), this is not the biggest problem with the system from an equity point of view. For many people in the top two tax rates, paying tax at their marginal rate is voluntary. A high income earner with good tax advice, investment opportunities, and a cooperative employer can easily reduce the top tax rate from 45% to 15% by sacrificing salary for superannuation, to 15% or 30% if they obtain a 'golden handshake' on leaving a job, to 30% by sheltering income in a private company, to less than zero if they can claim deductions against their wages for the interest costs of borrowing to invest in property or shares, and at a discounted rate of 23% once they sell these assets and obtain a capital gain.

It is often forgotten in debates on the fairness of the tax system that we also pay tax when we buy things: 27% of taxes on households are collected from taxes on consumption. When these taxes (including those at state and local level) are added into the mix, Australia's overall tax system is close to a flat tax on all households, collecting 26% of the income of the bottom 40% of households compared with 33% from the top 40%.

To raise the additional revenue Governments will need, we favour strengthening the personal income tax rather than increasing taxes on consumption. Although annual income is far from a perfect measure of people's ability to pay tax, it is the fairest. The main difference between income and consumption taxes is that consumption taxes do not tax income from savings and investments. This greatly benefits high income earners but is of less benefit to low and middle income earners whose ability to save is more limited. For example, the top 10% of income earners receive less than 30% of all wages but receive over 60% of all dividends and capital gains. Further, consumption taxes tax people more when their incomes are low and they are drawing down their savings, for example in retirement.

The most important progressive tax is the personal income tax, which raises about half of all federal revenue. Company tax is also vital to a progressive tax system, but not because it 'taxes big companies'. Its most important role from an equity standpoint is as a backstop to the personal income tax to make sure that the incomes of foreign investors in Australia are taxed and to prevent individuals from sheltering their personal income in private companies.

A tax system to support economic development

It is often argued that reform of the tax system would solve some of our major economic problems – in particular that Australia would attract more foreign investment, and that people would save or work more, if tax rates on investment, saving, or earnings were reduced. These arguments are usually overstated.

Compared with most wealthy countries, Australia has enjoyed high and growing levels of foreign investment that helped finance a prolonged period of economic growth. Over the last decade and a half, foreign investment grew from 80% to 150% of GDP. Although higher levels of investment could help the economy grow stronger, this is not the picture of an economy that has experienced a shortage of foreign capital due to 'uncompetitive' tax levels.

International evidence suggests that the effect of taxes on saving by households is very modest – tax breaks for saving are more likely to encourage people to shift their savings into tax-favoured accounts than to increase saving overall. For example, although taxes were imposed on superannuation contributions and fund earnings from the late 1980s, voluntary investment in superannuation has since risen from around 6% to 8% of overall wages. In any event the main source of growth in saving through superannuation over the last two decades was not tax incentives – it was the introduction of compulsory employer contributions.

Another argument is that income tax scale should be 'flatter' (reducing tax rates for high income earners) to encourage people to work harder. Yet the evidence suggests that the people who are most responsive to taxes on their wages are mothers in low and middle income families, not individuals on the top tax rate (mainly married men). In many cases, the parent caring for children in a low income family loses over 50 cents of their next dollar of earnings due to child care costs and the income tests on social security and family payments. To increase workforce participation we should make child care more affordable and ease some of the income tests applying to unemployed people those who care for children. Cutting the top tax rate would make little difference.

The most harmful economic effects of the tax system stem from the failure to tax different kinds of income consistently. Although taxes have only a modest impact on overall *levels* of investment and earnings, they have a substantial impact on *choice* of investment. For example, there is a bias in the tax system in favour of speculative investment in property and shares financed by debt. This is due to the 50% discount on taxes on capital gains (profits from sale of property and shares) together with the ability of investors to deduct their

investment expenses against their wages. These features of the tax system contributed to a speculative boom in real estate investment. Borrowing to invest in rental properties grew by one third each year in the early 2000s. This inflated housing prices, increased household debt, made housing less affordable for many, and made the economy harder to manage.

Prior to the GFC, our main economic problem was not so much a lack of investment, but the inefficiency of much of it. Australia has weathered the storm better than most, but concerns remain about high household debt levels and the danger that asset prices (especially housing) will again become over-inflated. These concerns could trigger higher interest rates

Similarly, there is a tax bias towards investment in housing generally, towards the use of private trusts and companies as business and investment structures because they can be used to minimise tax, and towards fringe benefits like company cars in lieu of paying wages.

If different kinds of investment income (capital gains, bonds, dividends and bank interest) were taxed at the same rates, then investment decisions would be less influenced by tax.

Frameworks for tax reform

By taxing different kinds of income more consistently - 'broadening the tax base' - we can improve fairness and economic efficiency at the same time. High income earners could no longer use loopholes in the system to reduce tax and tax would take a back seat to commercial considerations in investment decisions. By closing off loopholes in the system, this approach to tax reform could generate the same revenue from lower rates of tax, or more revenue if tax rates remain the same. It was successfully applied in 1986 in Australia when taxes on capital gains and fringe benefits were introduced while tax rates were cut, yielding more revenue overall. It is likely that high income earners overall paid more tax despite the lowering of top marginal tax rates.

The income tax base can be broadened using three different frameworks:

- By moving towards a system where income from employment and investment are taxed as far as possible at the same progressive rates (*a comprehensive income tax*). There would have to be exceptions to this rule but each should be justified on its merits.

On the face of it, this is the fairest approach. The main problems arise in applying standard marginal tax rates to investment income. Ideally, investors should not be taxed on that portion of their returns that only compensates them for inflation, but this is hard to achieve in practice. Also, investment decisions are generally more sensitive to tax than work decisions - for example it is usually easier to switch investments than change jobs. The extent of these problems emerge depends on the rates of tax that apply and whether long term savings attract lower tax rates (as is the case with superannuation).

- By moving towards the *dual income tax* system in Scandinavian countries, which taxes earnings from work (wages, fringe benefits, etc) using a progressive rate scale similar to ours, but applies tax rates that are less than the top marginal rates to investment income (for example, interest, capital gains and dividends). The tax rate for investment income is often equal to the company tax rate.

The dual income tax attempts to deal with the above problems in taxing investment income by taxing it at a lower rate. The main problem with this is that on the face of it this is not as fair as a comprehensive income tax, especially given the concentration of investment income in the hands of high income earners. A single rate of tax on investment income would also increase taxes on low income earners

such as retirees with small investments, though this could be addressed by introducing a tax free threshold for investment income.

Whether we move closer towards a comprehensive income tax system or a dual income tax system, the result is likely to be fairer than the present system. This is because much of the investment income of high income earners is already taxed at well below the top marginal tax rate (for example, capital gains are typically taxed at a maximum rate of 23%). Also, it is generally fairer to tax different kinds of income in a more consistent way.

In addition, if wages and investments are taxed separately under a dual income tax, investors should no longer be able to deduct their investment expenses (e.g. interest on borrowings) against their wages. This restriction on deductions led to a large increase in tax revenue from investment income when the dual income tax was introduced in Sweden, despite the halving of the top tax rate on investments to 30%.

However, tying the rate of tax on investment income to the company tax rate is too inflexible, and could lead to future reductions in the tax rate on investments (relative to tax rates on wages) if there is international pressure to cut company tax rates.

- By basing income tax of the *value of investment assets*, as we do in pension income tests by 'deeming' a standard rate of return on people's investments such as bank account balances.

Instead of taxing the actual annual return from investment, this approach taxes an assumed rate of return. The main advantage is that the authorities only need to identify the value of the investment asset, not the annual flow of income obtained from it. This would be simpler for many pensioners (who are already subject to the deeming arrangements via the pension income test, so the pension system could also be used to collect their income tax). It may also make it harder for investors to avoid tax. In theory, capital gains (the income derived from increases in the value of an asset) could be taxed annually alongside other investment income such as dividends using the deeming approach.

One difficulty with 'deeming' is the difficulty in valuing some investments every year, especially property. The main problem is that it provides 'rough justice' since actual income from investments may be more or less than the deeming rate. For example, it would be difficult to tax the 'above-normal profits' often obtained by high income earners from their investments using this approach, especially in the absence of a higher deeming rate on taxpayers with relatively large investments.

Benchmarks for tax reform

It is not possible to assess the pros and cons of these approaches without knowing the details of any proposed base-broadening, tax rates, exemptions, and so on. ACROSS will therefore assess the Review's reform proposals using the set of benchmarks listed below. In this report we also advance our own set of proposals to remove unfair and economically harmful biases and loopholes from the personal income tax system.

Benchmarks and strategies for progressive tax reform

1. Overall tax revenues should rise (in proportion to GDP) as the population ages
2. Different kinds of income should be taxed more consistently so that people contribute to meeting the needs of the community according to their ability to pay

Opportunities for taxpayers to avoid paying tax at their appropriate marginal tax rate should be kept to a minimum.

3. The share of tax revenue from high income earners should increase and that from low and middle income earners should reduce

For example, top tax rates should not be reduced unless the revenue foregone is recouped by closing tax shelters

4. The overall share of tax revenue from taxes on investment incomes and assets should not be reduced

This implies that the share of revenue raised from taxes on income should not fall and the share from consumption taxes should not rise

5. The overall level of revenue from corporate and business income taxes should increase (and at least not decline)

This means that company tax rates should not be reduced unless the revenue loss is recouped by broadening that tax base and/or raising more revenue from taxes on Australian-sourced incomes of foreign investors, and opportunities to shelter personal income in private companies are restricted.

A. Options for reform to strengthen the personal income tax system

The following are specific options for reform that could be pursued either within a comprehensive income tax or a dual income tax framework. These are mainly designed to tax incomes from different sources more consistently, since this is the best way to improve the fairness and economic efficiency of the tax system at the same time. Given future public revenue needs, tax rates should not be lowered for high income earners unless this is paid for by broadening the tax base.

These base broadening and simplifying options do not cover the full range of tax reform possibilities, and they would be implemented differently depending which tax reform framework is adopted. Some complement one another while others are alternatives.

Capital gains

Problems:

- There is a strong bias in the tax system favouring investment in assets that appreciate in value such as shares and property, which has encouraged overinvestment in these areas, especially speculative investment during booms
- Capital gains are taxed at half the rate of other investment income, and only when the asset is sold

- Related investment expenses (e.g. interest payments) can be deducted immediately from higher taxed income (e.g. earnings)
- Recently introduced concessions for small business mean that taxes on capital gains are taxed at quarter of standard marginal tax rates and the tax can be deferred almost indefinitely. This is inequitable and likely to distort investment decisions by small business owners.

Options:

- Remove the 50% discount of tax on capital gains and either tax at standard marginal rates or (in the case of a dual income tax system) at standard rates of tax for investment income
- Tax at least those capital gains that can readily be valued (such as shares) as they accrue, and allow individuals to defer the tax until they sell the asset if they are unable to pay annually, subject to an interest charge for the delay in payment
- If capital gains are not taxed at the same effective rates as other income, limit deductions for expenses for investments mainly yielding capital gains (e.g. shares or property) against other income (in a dual income tax system, against wages only)
- Remove recent capital gains tax concessions for small business including the halving of the standard rates of tax (in addition to the general 50% discount), the exemption from capital gains tax of business assets sold on retirement, and the exemption for assets held for 15 years where the owner is over 55 years old
- Collect any capital gains tax liabilities accrued by an individual against their estate (or in the hands of the beneficiaries) rather than rolling over this tax liability.

Housing

Problems:

- Over-investment in housing (especially top-end housing), resulting in higher housing costs for low and middle income earners, and asset price 'bubbles' during booms
- Tax subsidies for housing are highly inequitable, mainly benefiting high income earners and those who already own housing assets and increasing housing costs for renters and those attempting to buy a home.
- State and Local Governments will have to raise their investment in urban infrastructure (for example public transport in outer urban areas) as the population grows. Since this investment raises land values, taxes on land are a fairer and more efficient way to meet these costs than other State taxes such as Stamp Duties, which make it harder for people to enter the housing market.

Options:

- If, as proposed above, the deductibility of certain investment expenses against other income is restricted, the tax revenue saved from rental property investments could be earmarked to expand tax credits under the National Rental Affordability Scheme (NRAS) to encourage investment in low cost housing ¹
- Integrate Council Rates and State Land Taxes into an Urban and Regional Development Levy whose proceeds go to Local and State Governments for public and social infrastructure purposes, and broaden the base and/or increase the rates of this tax to partially replace housing-related Stamp Duties
- Place a cap (at a high level) on the level of capital gains that attract the principal residence exemption

¹ It is sometimes claimed that limits on deductibility of rental property expenses introduced in 1986 was the main cause of a decline in rental property investment at that time. This is not the case. Other factors, including higher interest rates and a sharemarket boom, played a greater role. See Badcock & Browett 1996, The responsiveness of the private rental sector in Australia to changes in Commonwealth taxation policy, Housing Studies Vol6 No3. Nevertheless, unlike the 1986 reforms, our proposals would be biased *in favour of* (low cost) rental housing investment because deductions for other investments such as shares would also be restricted but the NRAS scheme would be expanded.

Superannuation

Problems:

- Tax concessions for long term saving are skewed towards high earners (who are likely to save anyway) and towards retirement and housing only although most people also have other long term savings needs
- Incentives for mature age people to take lump sum super benefits and use superannuation for tax avoidance and estate-management purposes rather than to provide a secure income in retirement

Options:

- Tax employer contributions at the individual's marginal tax rate by withholding tax through the employer, and abolish the 15% contributions tax
- Replace all tax concessions for super contributions (including existing deductions, the spouse contributions tax offset and the co-contribution) in revenue neutral fashion with an annual two-tier co-contribution for all compulsory and voluntary contributions made by an individual, based on a percentage of contributions (100% up to a low level of contributions plus a lower percentage such as 30% up to a higher annual ceiling).
- Allow use (within strict limits) of a part of superannuation savings for other long term saving purposes such as child raising costs, unemployment, loss of earnings through disability, and housing, and subject to the above reforms to the taxation of superannuation, raise compulsory contributions by 3%.
- Restrict lump sum benefits (especially before pension age) and the 'churning' of income through super accounts by mature age people to avoid tax.²

Wages and salaries

Problems:

- High income earners can avoid tax on their earnings by having it converted into lower-taxed forms of income such as 'company cars', employee shares, or 'golden handshakes'
- Work related deductions are often skewed towards those on higher incomes and lead to complexity and evasion of tax

Options:

- Tighten the statutory formula for valuing 'company cars' under the Fringe Benefits Tax and remove the Fringe Benefits Tax exemption for employer-provided child care
- Include discounted employee shares and rights, where the discount is worth more than \$1,000 per year, in the Fringe Benefits Tax
- Tax golden handshakes like redundancy payments (i.e. by providing an additional tax free threshold for this form of income, rather than a low flat rate of tax)
- Provide a standard deduction for work related expenses, tighten the rules for claims above this amount, and cap deductions in areas where they are consistently 'over-claimed', especially by high income earners

Private trusts and companies

Problems:

- High income earners can avoid tax by diverting income through discretionary trusts to lower taxed family members or a private company
- Tax can also be avoided by sheltering earnings in a private company where it is taxed at 30%

Options:

² More details of our proposals regarding superannuation and long term saving are in our submission to the Tax Review Panel on Retirement Incomes at <www.acoss.org.au>

- Either tax private trusts in similar fashion to companies, or attribute trust income back to the controller(s) of the trust as applies in social security income tests
- Tax private company incomes (minus an investment allowance based on the value of the assets of the company) at the top marginal tax rate plus Medicare Levy³

Tax expenditures

Problems:

- Many tax expenditures are the same as direct Government expenditures, but are not subject to the same budget scrutiny
- These often particularly benefit high income earners, and are of no benefit to people whose incomes are too low to pay tax
- Tax concessions for charities are based on outdated 19th century laws, resulting in a system of public support for charities that is complex and inequitable.⁴

Options:

- Review tax expenditures every year and abolish the most poorly-designed and targeted concessions or integrate them with direct expenditure programs (examples of poorly designed tax expenditures include the Senior Australians Tax Offset, the Health Insurance Rebate, and the Self Education deduction)
- Take account of reductions in their cost within budgetary expenditure restraint targets (such as the 2% ceiling on annual growth in expenditure)

Health levy

Problems:

- In coming decades, a growing proportion of Australians will be retired and paying less tax, yet more people will be at an age when they need costly health care services
- If these additional costs are not met collectively by taxation, the burden will fall on those needing the services

Options:

- Progressively introduce an income tax levy (as an extension of the Medicare Levy) to finance expected increases in public health care costs as the population ages – so that these costs are equitably borne across generations, standard tax offsets and exemptions would not apply to the calculation of the levy in the case of individuals over age-pension age.

The table below lists 10 of the major tax shelters and rebates discussed above that allow individuals to avoid paying tax at the top marginal tax rate. The second column explains how this occurs, the third lists the effective tax rates paid by those who use these tax shelters, and the last column estimates the annual public revenue foregone. While some of these have sound public policy objectives (for example to support saving for retirement), they are poorly targeted. As indicated above, we consider that some should be abolished and others should be redesigned to make them more equitable and cost effective.

³ Note that owners whose marginal tax rate is lower than this could transfer company income to themselves as wages or dividends instead of retaining it in the company.

⁴ Options to reform the tax treatment of charities will be discussed in our forthcoming submission to the Productivity Commission inquiry into charities.

Table 1: Selected tax shelters and poorly targeted rebates and deductions

	How tax is avoided	Marginal tax rate for high income earner	Tax revenue foregone ⁵ (\$ millions)
Top marginal tax rate for a high income earner		45% ⁶	
Investment incomes			
Capital gains tax 50% discount	Income from increased value of assets such as shares and property is taxed at half normal rates	23%	\$8,600m*
Capital gains tax small business concessions	Income from increased value of small business assets is taxed at a quarter of standard rate and not at all if the proceeds of sale are used for retirement	0-11%	\$1,000m ^{7*}
Deductions for expenses for investments in shares, property and agricultural schemes	Taxpayers who borrow to invest in assets that yield capital gains can offset the interest and other costs against their wages (even though these are taxed at higher rates – see above)	Negative (taxes on their wages are reduced)	\$4,000m ⁸
Employer superannuation contributions	These are taxed at a flat rate of 15% instead of the marginal rate of the employee	15%	\$10,200m*
Employment incomes			
Company cars	High income earners sacrifice salary for a car subsidised by their employer, but the employer does not pay the full Fringe Benefits Tax on this	Depends on value of car and distance travelled	\$1,900m*
Termination payments	Lump sum payments of up to \$140,000 on leaving a job (such as golden handshakes) are taxed at low flat rates instead of the taxpayers marginal rate	Usually 15% (if over 55 years old) or 30% (if under 55)	\$1,500*

⁵ Note that the revenue that could be raised by closing these tax shelters would be less than these amounts, due to behavioural change, the need to take account of special circumstances, and transitional arrangements.

⁶ Marginal tax rate for incomes above \$180,000. Excludes 1.5% Medicare Levy and 1% Medicare Surcharge.

⁷ Comprising \$560m for the 75% discount on the tax rate, \$95m for the exemption for over-55 yr olds holding assets for over 15 years, \$390m for the exemption for those using the proceeds of sale of business assets for retirement.

⁸ \$3,000m for rental losses, plus conservatively another \$1,000m for losses on other investments mainly yielding capital gains including shares and agricultural investment schemes. Source: ACROSS calculations using ATO 2009, Taxation Statistics, data for 2006-07.

Table 1 (cont'd): Selected tax shelters and poorly targeted rebates and deductions

Private companies and trusts			
Private companies	A business owner or investor can use a company they control to shelter income from tax at the 30% company tax rate	30%	\$1,300m ⁹
Private trusts	A high income earner can divert their income to a trust they control, splitting their income with lower taxed family members and otherwise avoiding tax ¹⁰	Depends on the structure and the beneficiaries	\$1,000m ¹¹
Tax offsets and deductions			
Senior Australians Tax Offset	This tax offset is paid to retirees who are too wealthy to receive the age pension ¹² , who have incomes up to \$47,000 for singles and \$75,000 for couples	Reduces tax by up to \$2,230 p.a.	\$900m*
Private health insurance rebate	This 'refund' typically covers 30% of private health insurance costs up to an annual ceiling.	Reimburses 30% of premium	\$4,900m ^{13*}
Total:			\$35,400m

* Source: Treasury 2009, Taxation Expenditure Statement (estimate for 2008-09).

B. Objectives for reform of personal income tax

The main purpose of the tax system should be to raise the public revenue needed to fund services, income support and community infrastructure as fairly as possible and with the least harm to Australia's economic development. Reform should pursue 5 main objectives:

- *Revenue adequacy*: to raise at least as much revenue, in proportion to gross domestic product, as the present system, and to increase public revenue progressively to meet the growing health care and other costs associated with an ageing population.
- *Equity*: to raise revenue according to individuals' capacity to pay. This requires stronger personal income tax system, the main progressive tax base. The reformed tax system should raise at least the same share of tax revenue overall from high income earners (those who have the greatest capacity to pay) compared to that raised from low and middle income earners.
- *Economic efficiency*: Remove economically harmful biases in the tax system that favour one form of investment over another, and improve work incentives for those groups whose work decisions are most affected by the tax and social security systems.

⁹ ACOSS calculations using ATO 2009, Taxation Statistics.

¹⁰ Private trusts have also been used to avoid tax by concealing income within complex networks of trusts and companies, by converting other forms of income into capital gains, and by using trust losses to offset unrelated investment income.

¹¹ Based on estimate of \$500m in revenue savings (see Review of Business Taxation 1999, A Tax System Redesigned) from the taxation of private trusts as companies (in the second year of implementation of the proposed change - 2001-02) taking account of additional revenue losses from income splitting using these trusts, and the increase in income obtained from private trusts since that time.

¹² For example, assets (apart from their home) worth more than \$890,000 if a married couple.

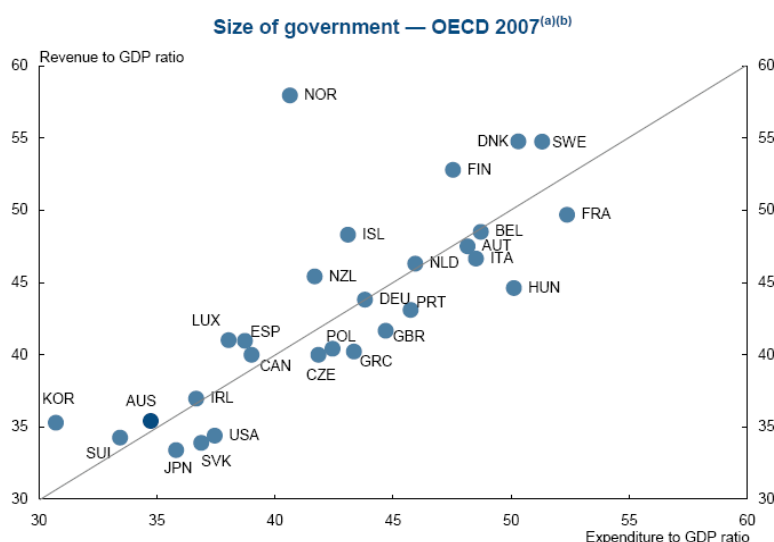
¹³ Comprising \$3,875m (private health insurance rebate) + \$1,050m (income tax exemption for rebate). Sources: Portfolio Budget Statements, Tax Expenditure Statement

- *A simplicity and sustainability.* Taxpayers should understand how the tax system applies to them and the costs of complying with it should be kept to a minimum. As far as possible, remove opportunities for people to avoid tax by shifting their income from one source or activity to another, which have created a culture of tax avoidance and undermined public support for the system.

1. Raising adequate public revenue for benefits and services

The main purpose of the tax system is to raise revenue for the services and benefits people receive from governments, and to provide essential public infrastructure. In 2006, Australian Governments (Federal, State and Local) spent 35% of GDP compared to an average of 40% across the OECD nations. In that year, Australian governments raised 31% of GDP in taxes, compared to an OECD average of 36% of GDP. Australia was the 8th lowest taxing and 5th lowest spending country of 30 OECD countries.¹⁴

Graph 1



(a) Data for Mexico and Turkey not available.
 (b) Revenue refers to receipts of tax and non tax revenue.
 Source: OECD (2008a).

Source: Australia's Future Tax System 2008, Architecture of Australia's tax and transfer system.

The main difference between Government spending levels here and overseas lies in the design of our social security system. Expenditure on social security in Australia is 8% of GDP compared with an OECD average of 12%. The system is targeted mainly towards people on low incomes and benefits are paid at low flat rates instead of a proportion of people's previous wages, (as in the social insurance schemes of most OECD countries). This system is cost effective but the low payments leave many people in poverty, especially at times like the present when unemployment is rising. The Newstart Allowance for a single unemployed adult was just \$227 per week in October 2009. Partly due to our low social security payments, Australia has above average poverty levels – in 2006 11% of Australians including 412,000 of children lived below an internationally recognised poverty line of 50% of median disposable income (\$281 per week for a single adult)¹⁵.

Although Australian Governments' spending on health education, housing and community services are about average by OECD standards, there is growing concern in the community that we have under-invested in these services. While public concern about health care often focuses on hospitals, the greatest deficits in health services are in primary and preventive health care, especially mental health and dental services. Community services for people needing care and support, including disability support services, home care and respite care,

¹⁴ OECD 2009, Revenue statistics; OECD Expenditure data base.

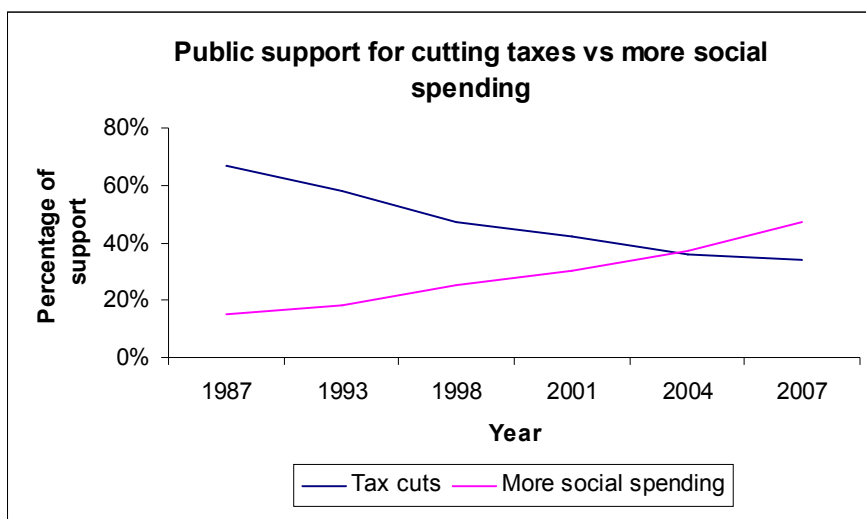
¹⁵ Australia Fair (2007), Update on poverty in Australia.

are also underfunded. For a country with relatively high housing costs, Australia seriously under-invests in social housing. This has forced many low income people to move away from cities with job opportunities to outer urban and regional areas where jobs are scarce and social disadvantage is concentrated.

Population growth is putting a great deal of pressure on urban public infrastructure such as public transport, especially in outer suburban growth corridors. Inadequate public investment in these areas has increased housing costs for first home buyers (for example due to developer levies), and raised the premium attached to home ownership in inner city areas with well established services.

For all of these reasons, public opinion surveys have tracked a marked shift in public preferences for more spending over more tax cuts over the past decade (see graph below).

Graph 2



Source: Australian Election Study

Australian Governments will need to raise their expenditures as the population ages and the need for health and aged care services grows. By 2049, 22% of Australians will be over 65, (up from 13% now) and 6% will be over 85 (up from 2%). Health, aged care and pension costs are projected to rise by 3.5% of GDP, or around \$40 billion in current dollars. This is more than the current federal education budget.¹⁶ The only alternative to raising more public revenue to meet these needs is to require people to pay for their own health and aged care services through higher fees or health insurance. ACOSS does not support this approach as it would lead to a two tier system of health care where those who can't afford the fees are relegated to poorer quality services.

One option to share these costs equitably across the community is to introduce a health services levy (as an extension of the existing Medicare Levy) that gradually increases with the rise in the proportion of Australians over retirement age. If the exemption from the Medicare Levy surcharge for high income earners that use health insurance were removed, then for every 1% increase in the levy and surcharge, over \$8 billion in additional revenue could be raised. Since mature age people will be the main users of these services, and tax concessions effectively exempt many people over 65 years from paying income tax, it would be reasonable to set aside these concessions when calculating the levy.¹⁷

¹⁶ Swan 2009, The population challenge and Australia's future, Sydney 18/9/09; Treasury 2007, Intergenerational report.

¹⁷ These include the Senior Australians Tax Offset, the Mature Age Workers Tax Offset, and the Superannuation Tax Offset.

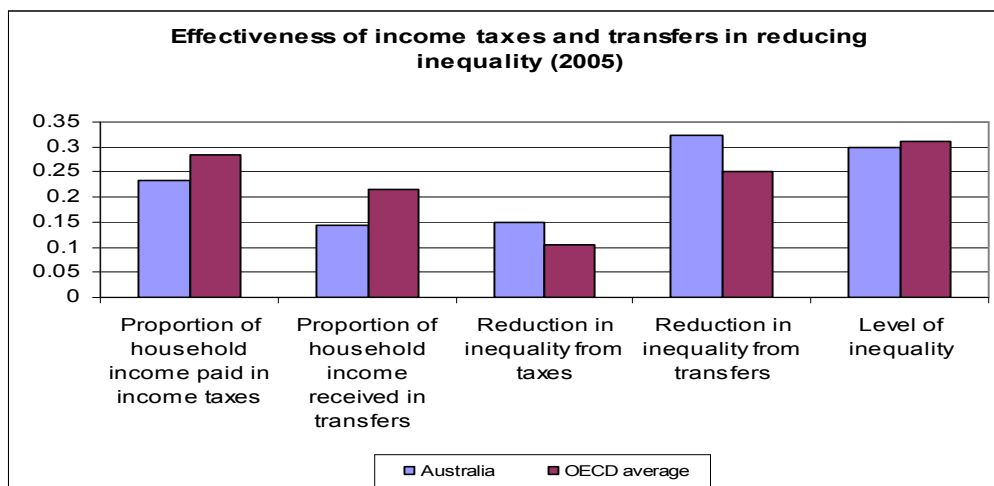
Benchmark for reform:

- 1. Tax revenue collected by Australian Governments should rise as a proportion of GDP as the population ages.**

2. Raising revenue fairly

Because the size of Government is much smaller in Australia than in most OECD countries, both the social security and tax systems have to work harder to achieve the same distributional outcomes (the same redistribution of resources for those on higher incomes to those on lower incomes) as most other countries. That means targeting social security payments towards people on low incomes and a progressive tax system that taxes high income earners at higher rates than low and middle income earners. Despite the relatively strong redistributive efforts of our tax and transfer systems, income inequality in Australian is close to the average OECD level. This is due to the higher level of inequality in private incomes (from wages and investments) in the first place (see graph below).

Graph 3



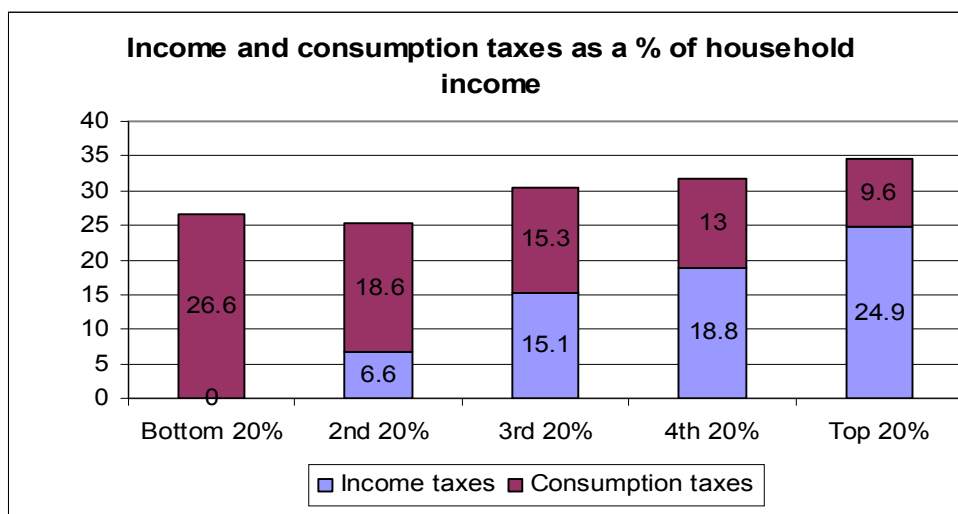
Source: OECD 2008, Growing unequal.

A fair tax system is widely understood to be one where people with greater capacity to pay a higher rates of tax (that is, the system is progressive), and where people in similar circumstances or engaged in similar activities (different investments, for example) pay a similar rate of tax. These benchmarks are referred to as vertical and horizontal equity.

There is debate over whether income or consumption is the best measure of ability to pay tax (which we discuss below). If income is used as the measure of capacity to pay, then the personal income tax is progressive for two reasons: higher tax rates apply to people on higher incomes, and the 'base' for taxation is personal income rather than consumption (spending). When measured as a proportion of people's incomes, taxes on consumption are regressive – that is, they tax low income earners at higher rates than apply to those on higher incomes. When we combine the impact of income and consumption taxes on households at different income levels, the progressive impact of income taxes is almost offset by the regressive impact of taxes on consumption (from which around 27% of all Government revenue is collected¹⁸). This is illustrated by the graph below.

¹⁸ Treasury 2008, Architecture of Australia's tax and transfer system.

Graph 4



Source: ABS, Government benefits taxes and household income 2003-04, table 9¹⁹

When the main income and consumption taxes are combined, the overall system (including state and local taxes) is close to a flat tax on all households. Overall tax collections comprise 26% of the income of the bottom 40% of households compared with 33% from the top 40%.

Consumption taxes have much less impact on the top 20% of households than those on lower incomes because on average they save 17% of their income and these savings are not taxed under a consumption tax. Conversely, they have a greater average impact on low income households because many of these households spend more than their annual income as they draw down their savings (for example retired people)²⁰

Income tax rates

Since the mid 1990s the personal tax scale has become much less progressive. Between 1996 and 2009, the overall level of tax paid by a taxpayer on 250% of the average wage (around \$150,000) fell by 22%, compared to 14% for one on half average wages and 9% for an average wage earner.²¹

Tax rates are only part of the story, however:

- First, the tax thresholds are equally important in determining the overall or average tax rates faced by people on different income levels. For example, the tax free threshold has a strongly progressive impact on the entire tax scale even though high income earners also benefit. This is because it is of greater value to low income earners, in proportion to their incomes, than it is to high income earners. Similarly, although the top tax rate has not declined much in recent years, substantial increases in the threshold at which it cuts in mean that only the top 2% or so of taxpayers pay tax at that rate.
- Second, when income tests in the social security and tax systems are also taken into account (such as the Newstart Allowance income test that claws back 60 cents

¹⁹ ABS did not model all taxes – the exclusion of some income and consumption taxes would have under/overstated the degree of progressivity of the whole system. It is also likely that a minority of households included in the bottom quintile under-declared their income and belonged in higher quintiles. These caveats are unlikely to affect the overall pattern shown here.

²⁰ ABS Household Expenditure Survey 2003-04

²¹ See Taxwatch.org.au

of each dollar earned above a low threshold), we often find that low and middle income earners face higher effective tax rates than the top rate in the income tax scale (when income tax and the effect of income tests are combined).²²

- Third, the rates of tax people actually pay on their income depends on the tax base that is used (which forms of income are taxed). For example, if the wages of a high income earner are taxed at 45% but a company car is not taxed at all, those who are able to sacrifice salary for a company car can reduce their effective tax rates. The starting point for genuine structural reform of the tax stem is to choose a fair and efficient tax base. If the tax system lacks a strong foundation, a fairer system cannot be built by adjusting tax rates and thresholds alone.

Which tax base is fairest – income or consumption?

A ‘commonsense view’ of taxation holds that annual income is the best measure of ability to pay tax. Most people consider that those on higher incomes have a greater capacity to pay than those on lower incomes.

However this issue is much debated in tax policy circles. Proposals have been advanced in the English speaking countries, to replace all or part of the personal income tax with a tax on consumption or expenditure - either an ‘indirect’ tax on goods and services or a direct ‘progressive expenditure tax’ (see the description of these different tax bases in the Attachment at the end of this paper). In the United States, these proposals are badged ‘fundamental tax reform’. The basic difference between an income tax and a consumption tax is that only an income tax taxes annual income from savings and investments. A consumption tax only taxes savings after they are withdrawn or spent, which may be many years later (for example, on retirement).

During the late 1970s, ‘progressive expenditure taxes’ were proposed in the Meade Report in the United Kingdom and by the US Treasury Department. These taxes have a similar progressive rate scale to the personal income tax, but the difference is that taxpayers receive a full deduction for any new investments they make, and the interest payments are tax free. Thus, as with a goods and service tax, savings are not taxed until they are withdrawn for spending.²³

Advocates of expenditure taxes argue that they are fairer than taxing annual income. They point out that, in theory, if an individual spends all of their income over their lifetime (that is, they do not leave an inheritance), the difference between the two taxes is largely one of timing. The income tax brings forward the taxation of investment income whereas the expenditure tax applies to the proceeds of investment at a later time. Advocates of taxing expenditure rather than income argue that an annual tax on investment income effectively taxes future consumption at a higher rate than current spending, and that this is unfair.²⁴

These ideas are not limited to the realm of tax theory. Many forms of income are already taxed in this way, or at least closer to ‘pure’ expenditure tax treatment than ‘pure’ income tax treatment. For example, capital gains on the value of shares are not taxed until the shares are sold, which may be many years after the shares were acquired. Self employed people receive a tax deduction for income invested in superannuation and the annual investment income held on their behalf in the fund is taxed at the low rate of 15%. Thus, our

²² On the other hand, social security payments themselves make the overall tax-transfer system much more progressive because they increase the incomes of jobless people.

²³ Institute for Fiscal Studies 1978, *The structure and reform of direct taxation*, London, Allen & Unwin; US Dept of Treasury 1977, *Blueprints for tax reform*; Auerbach 2006, *The choice between income and consumption taxes, a primer*, Key issues in public finance, New York University May 2006; Head 2008, *Musgrave on taxation*, Musgrave Memorial Colloquium on taxation and risk taking, Sydney 5 June 2008.

²⁴ Institute for Fiscal Studies, *op cit*.

personal income tax system is actually a hybrid that lies somewhere between a pure income tax and a pure expenditure tax.

Nevertheless, we agree with the 'commonsense view' that it is generally fairer to tax income than consumption, for the following reasons:

- In any given year, it is fairer to raise taxes on the basis of an individual's *spending power* – their incomes- rather than their actual spending. Compare, for example, two individuals whose spending last year was the same: a high income earner who saved half their income and a middle income earner who spent all of their income. The high income earner had the freedom to set aside half their income for future consumption while the middle income earner's choices were more constrained because they had only half the income to allocate between saving and spending. An income tax recognises the high income earner's greater capacity to pay whereas a consumption tax taxes them equally, at least in that year.
- Taking a longer view, a consumption tax raises more tax at stages of life when people's choices are more constrained (such as unemployment, the early child rearing years, or retirement) whereas an income tax takes better account of those constraints (and their capacity to pay).
- Over a lifetime, people with higher earning potential have a greater capacity (more freedom) to smooth their incomes, for example by saving for retirement. By taxing saving, the income tax recognises that the ability to save is distributed unequally.
- Related to this, wealth is distributed very unequally, and this is a major contributing factor to wider inequalities in society (for example, access to credit, to decent housing, and to educational opportunities).
- Tax rates are not the same from one year or stage of life to the next. Thus, if saving is not taxed, a high income earner has a choice to reduce the level of tax they pay over their lifetime by saving a large proportion of their incomes when their incomes are high and withdrawing their savings when their incomes are lower, especially in retirement. Low and middle income earners do not have the same capacity to do so.²⁵

There is also a debate over the extent to which income and expenditure tax bases actually differ. For example, most tax economists argue that the difference is confined in effect to taxation of the 'safe rate of return' on investments and not 'above-normal' returns including those from riskier investments. If so, this would narrow, but not eliminate, the difference between taxes on income and expenditure.²⁶ Further, as indicated above, most countries have hybrid individual tax systems that combine elements of income and consumption taxation, which reduces the impact of moving from the system we have now towards a pure expenditure tax system.

Nevertheless, any substantial move away from income taxation (that is, away from taxing investment incomes) is likely to weaken the equity of the system by reducing average tax rates on high incomes and increasing them on lower incomes to collect the same level of overall public revenue. Since high income earners save a much higher proportion of their

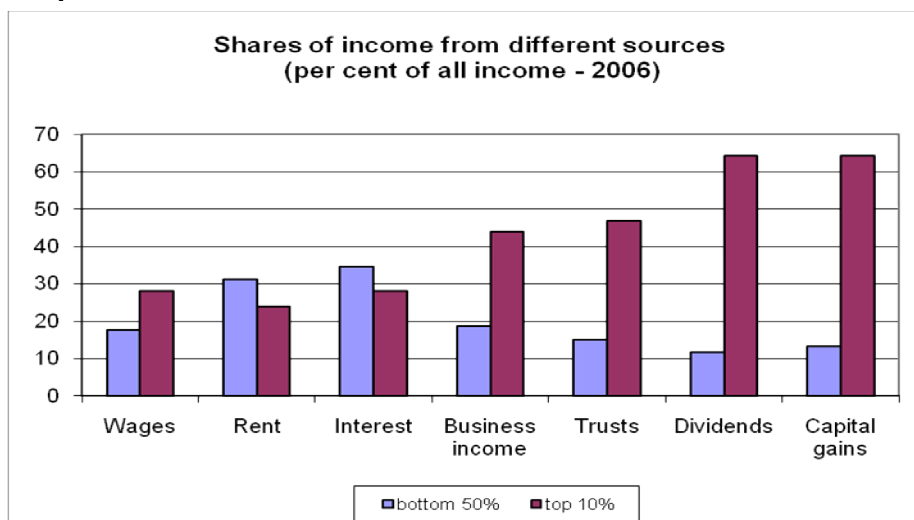
²⁵ See also Banks & Diamond 2008, The base for direct taxation, Paper for Mirrlees review of taxation, Institute for Fiscal Studies, London www.ifs.org.uk/mirrleesreview; Goode 1976, The individual income tax, Brookings Institution Washington; Brooks 2006, An overview of the role of the VAT, fundamental tax reform, and a defence of the income tax in Krever & White 2006, GST in retrospect and prospect, Thomson Bookers.

²⁶ Head 2008, Musgrave on taxation, Musgrave memorial colloquium on taxation and risk taking., Sydney, 5 June 2008; Slemrod 2005, Does the United States tax capital income? Paper for conference on Taxing capital income, Brookings Institution 23 September 2005.

incomes, they would be the main beneficiaries of a major shift from taxing income to taxing consumption.

The likely effect of removing taxes from investment incomes (that is, taxing consumption rather than income) is illustrated when we compare the shares of investment income and wages across the income distribution (see graph below).

Graph 5

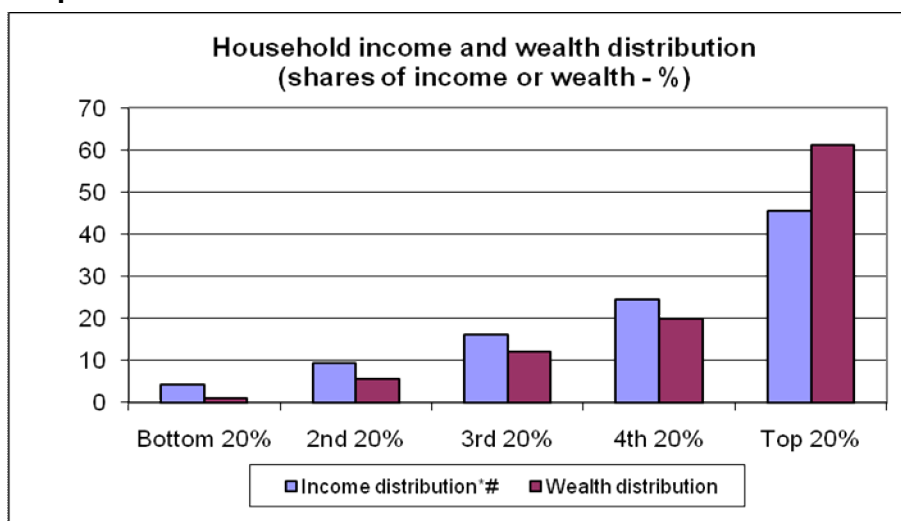


Source: Treasury 2008, Architecture of Australia's tax and transfer system.

The graph indicates, for example, that the top 10% of income earners receive less than 30% of all wages but receive over 60% of all dividends and capital gains. Removing taxes from these forms of investment income would disproportionately benefit those on the highest incomes.

The effect of removing taxes from investment incomes is also illustrated by comparing the distribution of income and wealth, which is the source of investment income (see graph below).

Graph 6



ABS, Household wealth and wealth distribution 2005-06

The graph shows that wealth is much more unequally distributed than income. The removal of taxes from investment incomes would exacerbate inequality of wealth.

Aside from the above arguments over the fairness of different tax bases, there are also equity arguments for and against taxing capital incomes (income from investments) at lower *rates* than income from labour (wages and self employment). The main argument for higher taxes on capital incomes is the 'vertical equity' argument that wealth is much more unequally distributed than income. The main equity argument for taxing capital income at lower rates is the 'horizontal equity' argument that account should be taken of the impact of inflation on the value of savings, especially long term savings. A 'pure' income tax does not tax the annual increase in the value of savings that is due to inflation (as discussed in more detail in the Attachment to this report).

Benchmarks for reform:

- 3. The share of tax revenue from high income earners should increase (or at least not decline) and that from low and middle income earners should decline (or at least not increase)**

For example, top tax rates should not be reduced unless the lost revenue is recouped from high income earners by closing tax shelters.

- 4. The overall share of tax revenue from taxes on investment incomes and assets should not be reduced**

This implies that the share of revenue raised from taxes on income should not fall and the share from consumption taxes should not rise

Taxing individuals or couples

Another key issue in determining the best base for personal taxation is whether to tax individual or family income, and how to take account of the costs of children. Australia taxes married couples on an individual basis, but single income families receive a Dependent Spouse Tax Offset, and Family Tax Benefits are income-tested on the basis of family incomes.

There are two views on this issue. According to the first view, the capacity to pay tax should be judged on the basis of the resources available to a family since couples share their incomes. One argument against this approach is the efficiency argument that family unit-based taxation reduces work incentives for second earners in families (usually women), an issue we discuss later. However, family based taxation also raises an important equity issue: whether the value of unpaid domestic work should be taken into account. Although this work is unpaid and therefore not taxed, it contributes to a family's living standard and reduces costs such as child care and take-away food.

The second view is that couples should be taxed on an individual basis in order to compensate them, albeit imperfectly, for the non-taxation of unpaid domestic labour. Under an individual income tax, a couple who are both employed fulltime (and have less access to unpaid domestic labour) benefit from the lower tax rates on the first part of their earnings (including two tax free thresholds). Under a system of taxation based on the combined income of a couple, two-income families benefit from only one tax free threshold and are no longer compensated for their more limited access to unpaid domestic labour.

We favour retaining the individual as the unit for taxation for this reason, and also to preserve work incentives for the principal carers of children in married couple families. However, there is a strong case for targeting income support payments designed to reduce poverty on the basis of family income as outlined in our preliminary submission to the Review. These payments have a different purpose to the tax system, which is more

concerned with vertical equity (ensuring that low income households have a minimum adequate standard of living).²⁷

Company income taxes and fairness

Whether or not taxes on companies are progressive does not depend on the size of the company – it depends instead on whether shareholders, employees or consumers ultimately pay the tax. This is not a straightforward issue – for example under the dividend imputation system any change in company tax levels is offset by imputation credits paid to its shareholders. Nevertheless company income tax acts as a vital backstop to the personal income tax in two ways:

- by taxing the share of company profits that goes to foreign investors (a major and growing source of public revenue for Australia)
- by making it more difficult for individuals to avoid tax by sheltering income in private companies.

A tax on company income is therefore needed to protect public revenue and to prevent erosion of the personal income tax base. Options to raise tax more efficiently from foreign investors include resource rent taxes, which would tax 'super-profits' from resources such as minerals at a higher rate than the corporate tax rate. Since these investments are less 'mobile' than others, it is possible to collect more public revenue from this source without discouraging investment.

One option that is often advanced to deal with the sheltering of personal income in private companies is to align the company tax rate with the top personal tax rate (usually by reducing the latter). The problem with this approach is that the top personal tax rate would then be subject to the same downward pressures that affect the company tax rate from time to time, due to international tax competition. If international competitive pressures affect personal and company tax rates differently, then it makes little sense to bind the two tax rates together. As discussed later, this is a weakness of most of the Scandinavian 'dual income tax' systems.

There are better ways to address the problem of the gap between the two tax rates, including by taxing income retained in a private company at the top personal tax rate, as Australia did prior to 1988. This discourages owners from retaining income within their company, and encourages them instead to 'withdraw' the income from the company through dividend payments or wages. One problem with this approach is that many business owners need to invest in their company (for example in physical capital) in order to grow the business. An option to deal with this problem is to separate out the 'investment' component of company income, for example by deeming an annual return on the business assets and taxing that part of private company income at the corporate tax rate. The remaining income would be taxed at the top personal tax rate. As discussed in the Attachment, this is the way that countries with dual income tax systems separate the 'capital' and 'labour' components of small business income.

Benchmark for reform:

- 5. The overall level of revenue from corporate and business income taxes should increase (and at least not decline)**

This means that company tax rates should not be reduced unless the revenue loss is recouped by broadening that tax base and/or raising more revenue from taxes on Australian-sourced incomes of foreign investors, and opportunities to shelter personal income in private companies are restricted.

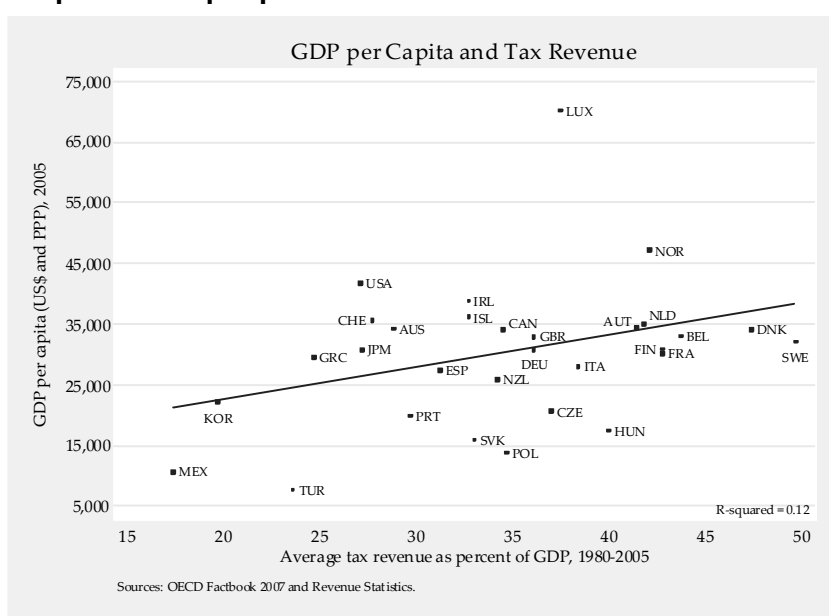
²⁷ ACOSS 2008, Submission to Review of the Australian tax and transfer system.

3. Strengthening economic development

Tax systems can harm economic efficiency and development, so improving economic efficiency or growth is often advanced as a goal for tax reform.

The fact that taxes transfer resources from the private to the public sector does not in itself threaten economic efficiency or growth. There is no clear relationship between tax revenue and national income or economic growth among wealthy countries. In fact, if we compare tax revenues with gross domestic product per person across OECD countries, those with a higher public revenue share to GDP have on average slightly *higher* levels of national income per person (see graph below).

Graph 7: GDP per person and tax revenue share of GDP



Source: Brooks 2008, Tax reform, presentation to Community Tax Forum symposium, Canberra November 2009.

Although taxes may reduce incentives within the private sector to work and invest, they finance public benefits, services and infrastructure that are essential to economic development. These include modern legal systems, physical infrastructure such as public transport, education for the future workforce, and income support to sustain people during periods of unemployment or illness. In practical terms the impact of Governments on economic development therefore depends more on the quality of the economic and social infrastructure the taxes pay for and *how* taxes are raised, rather than the overall level of taxation.

The tax system can impair economic development in two ways: by reducing overall levels of saving, investment or labour, or by distorting or biasing decisions to work, save or invest in favour of one activity over another (for example, in favour of investment in shares rather than bonds). That is, the tax system can reduce the overall level of resources available to the private sector or it can encourage workers and investors to use those resources inefficiently. We discuss each of these issues in turn, beginning with the impact of taxes on foreign investment, saving by Australian households and workforce participation and then turning to the effect of inconsistencies in taxation of different forms of income on the efficiency of investment.

Impact of taxation on foreign investment

An increase in levels of investment is generally desirable on the grounds that productivity will improve and the economy can grow more strongly. However, not all private investment has a positive impact on the economy.

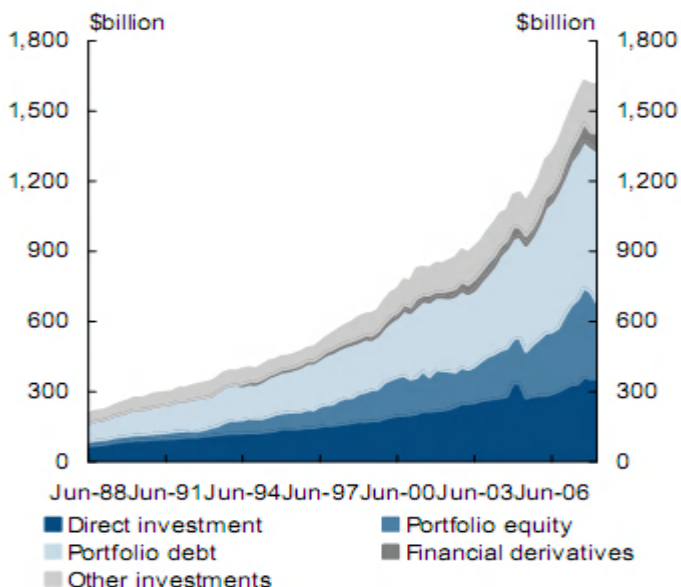
For example, during the 1990s a number of East Asian countries dramatically liberalised controls over financial markets and their currencies with a view to attracting more overseas investment. Their financial markets and regulatory systems were subsequently unable to cope with the inflow of 'hot money' that was stimulated by these policy changes. This aggravated the 'East Asian financial crisis' of the late 1990s, from which it took some countries many years to recover.

Another example was the lowering of tax rates on incoming investment by Irish Governments to encourage foreign investment in manufacturing and financial services. Along with other policies this contributed to the very strong economic growth in Ireland over recent decades, but it also contributed to an inflationary boom in wages and asset prices, leaving that country more economically vulnerable than most other industrialised countries when the global financial crisis hit.

Tax policy was not solely responsible for these outcomes, but they illustrate the point that not all investment is 'good for the economy'. Greater access to capital is only useful as long as there are economically worthwhile projects in which to deploy it. That requires steady growth, efficient markets and effective regulation.

As the graph below indicates, Australia has enjoyed high and growing levels of foreign investment. This helped finance a long period of economic growth. Over the last decade and a half, foreign investment grew from around 80% of GDP to around 150% of GDP. Although higher levels of foreign investment could help the economy grow stronger, this is not the picture of an economy experiencing a shortage of foreign capital due to 'uncompetitive' tax levels.

Graph 8: Foreign investment in Australia (\$billions of dollars per year)



Source: Australia's future tax system review 2008, Architecture of Australia's tax and transfer system.

International capital may become more scarce in future but it is not clear whether Australia will be adversely affected, or even what the optimal level of foreign investment might be. As we argue below, aside from the immediate effects of the global financial crisis there is more

cause for concern about the quality of investment in Australia, than an overall lack of capital.

Further, the impact of tax levels on access to foreign capital is very difficult to measure. In theory, it is difficult to tax investment incomes in a small open economy as long as financial markets operate seamlessly and efficiently. If capital is perfectly mobile but labour is not, foreigners will either decline to invest in a country with high taxes on investment incomes, or will shift the taxes to labour (for example by paying lower wages). But these conditions do not all apply. Australia's economy is the 14th largest internationally and about half of private investment is funded domestically. This does not mean that Australian businesses can set their own prices on global markets, but it does give us some leeway to tax investment income. Further, capital markets are far from seamless or perfectly efficient.²⁸

Taxation and incentives to save

The other source of capital for investment is saving by Australians. Around half of all investment in Australia is financed domestically.

There is a long standing debate over the effect of income taxes on the level of saving in Australia and other countries with large current account deficits such as the United States. Some argue that by taxing saving, income taxes discourage it. Their policy solution is to move towards taxing consumption instead, so that investment income is no longer taxed. Since Australia and most other OECD countries already tax at least long term savings at heavily discounted rates (especially superannuation), our tax treatment of saving already lies somewhere between income and consumption tax treatment. So the real issue is whether our tax treatment of saving should be brought closer to 'pure' income or consumption tax treatment. Pure income tax treatment of saving is similar to the tax treatment of bank savings accounts: there is no tax deduction for deposits, interest is fully taxed (though ideally with an adjustment for inflation), but withdrawals are not. Pure consumption tax treatment is similar to the tax treatment of superannuation before the 1980s. Contributions attract a tax deduction, interest is not taxed, but withdrawals are fully taxed. As discussed previously, the key difference lies in timing - an income tax brings taxation forward, a consumption or expenditure tax postpones it.

Moving towards expenditure tax treatment of saving (via special deductions and rebates for saving) - appears to have only a modest impact on overall household savings. In the United States, household saving levels have fallen over the last two decades despite sharp reductions in personal income tax rates (especially for high earners) and more generous tax concessions for long term saving plans.²⁹ Despite the considerable efforts of economic researchers in the United States and elsewhere, it is difficult to draw clear conclusions about the impact of taxes on overall household saving levels, because many factors other than tax levels affect saving decisions. What may appear at first to be an increase in household saving in response to a change in the tax treatment of a particular savings vehicle often turns out to be a shift of savings from one investment to another.³⁰

A more promising framework for understanding the responsiveness of household saving to taxes is one that takes account of the impact of taxation on decisions of women to enter

²⁸ See Devereux & Griffith 2003 Economic analysis and policy V33 No2, for a detailed discussion of some of difficulties in measuring the impact of taxes on foreign direct investment. See Gravelle & Smetters 2001 and Aiyagari 1994, for examples of studies that conclude that, in the absence of perfectly efficient markets, the optimal level of taxes on capital incomes is well above zero.

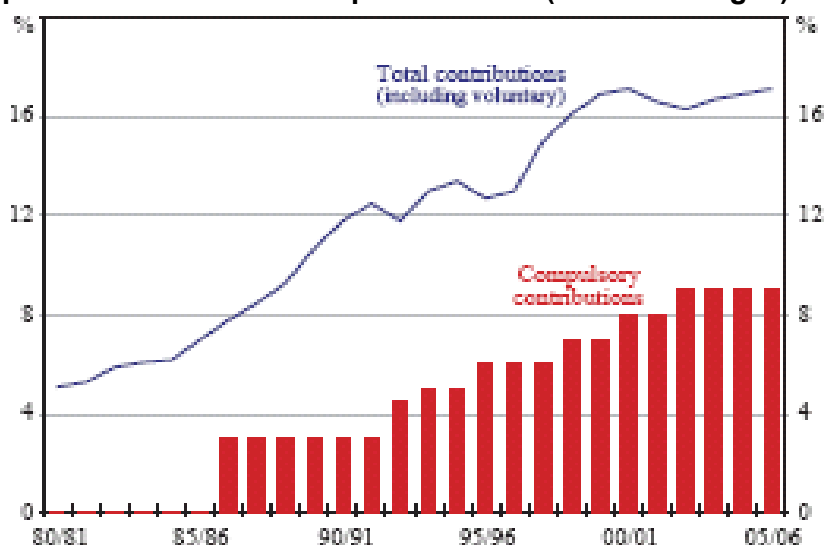
²⁹ Slemrod & Bakija 2008, Taxing ourselves, MIT Press.

³⁰ Bernheim & Douglas 2002, Taxation and saving, in Auerbach & Feldstein 2003, Handbook of public economics Vol3, Elsevier, Amsterdam.

paid employment (see next part of this report, below), since two earner households are more likely to save than those with a single, usually male, wage earner.³¹

Changes in the tax treatment of superannuation in Australia illustrate the modest impact of tax incentives on household saving levels. Prior to the 1980s the tax treatment of superannuation was more generous than consumption tax treatment where taxpayers withdrew their benefits as lump sums. Since these were often tax-free, a significant proportion of superannuation savings were not taxed at all. Despite this, investment in superannuation was low until compulsory super was introduced via the superannuation guarantee from 1990. At about the same time, elements of income tax treatment were introduced into the superannuation system via a flat 15% tax on employer contributions and fund earnings. Despite this shift towards income tax treatment of superannuation, voluntary contributions did not decline (see graph below).³²

Graph 9: Contributions to superannuation (as a % of wages)



Source: Connolly 2007, The Effect of the Australian Superannuation Guarantee on Household Saving Behaviour, RBA Research Discussion Paper 2007-08.

From the late 1980s to 2006, voluntary investment in superannuation rose slightly from around 6% to 8% of overall wages, despite the higher taxes on saving through superannuation. In any event, the main source of growth in saving through superannuation over the last two decades was not tax incentives – it was the introduction of compulsory employer contributions.³³

We argued previously that a shift towards consumption tax treatment of income would weaken equity. This discussion suggests that it would do so without substantially raising household saving levels.

Although in theory consumption tax treatment should encourage saving, it is possible that a form of income tax treatment would have more impact. The reason for this is that the benefits of consumption tax treatment are skewed towards those who currently have high incomes. For example, a tax deduction for saving provides more relief to those on the highest tax brackets. However, since high income earners are more likely to save with or without tax incentives, they are less responsive to saving incentives than low and middle

³¹ Apps 2001, Household saving and full consumption over the life cycle, Centre for Economic Policy Research Discussion Paper 428.

³² More recently, another major step towards income tax treatment of superannuation was taken in 2006 when taxes on most benefits paid to fund members over 60 years were abolished.

³³ Connolly 2007, The Effect of the Australian Superannuation Guarantee on Household Saving Behaviour, RBA Research Discussion Paper 2007-08

income earners. Their main response to tax incentives is to shift their savings from one savings vehicle to another.³⁴

If our aim is to raise overall household saving levels, this can best be achieved by either encouraging or compelling low and middle income earners to save, as seems to be the case with the superannuation guarantee. Even then, the overall impact on household saving is likely to be modest. This requires a tax incentive that is targeted towards low and middle income earners. Unlike the present tax concessions for superannuation, it should also be highly visible and transparent if our aim is to influence saving behaviour.³⁵ An example of such a tax incentive is the present co-contribution for superannuation contributions paid by low and middle income employees from their after-tax earnings.³⁶

Although the taxation of superannuation has moved towards income tax treatment, it is far from progressive. In some ways, it is more generous than consumption tax treatment for those on high incomes.³⁷ In addition to the low 15% tax rate on employer contributions (which would otherwise be taxed as wages at higher marginal income tax rates in most cases), there is a flat 15% tax on investment income. The 15% tax on employer contributions also undermines the personal income base, because high income earners can avoid tax on their earnings by sacrificing salary into superannuation.

These tax concessions are in effect targeted towards high income earners. The 15% tax rate on contributions and fund earnings has a similar distributional effect to replacing the existing progressive tax scale with a flat 15% tax. As indicated previously, the top 5% of taxpayers (those on around \$180,000 or above) account for one quarter of concessionally-taxed superannuation contributions.³⁸ Both on equity grounds and to encourage more long term saving, there is a strong case for redirecting them towards low and middle income earners. The simplest option is to replace existing tax breaks for superannuation contributions with a co-contribution for all contributions up to an annual cap. This has the important advantage of making the tax incentive more visible to those lacking sophisticated investment advice (the majority of taxpayers). This in itself should substantially improve the effectiveness of the incentives in encouraging voluntary saving.

Another key weakness of the present tax treatment of long-term saving is the strong bias towards saving for retirement and towards housing as a savings vehicle. There is little encouragement for long term saving for other purposes such as raising children, insurance against the risk of unemployment, or further education and training in mid-life. In this sense, the system fails to meet the needs of people on low incomes whose household budgets are likely to be constrained at many stages of life, not only in retirement. If the current bias towards saving for retirement continues, this is likely to be undermined in any event as income-constrained low and middle income earners borrow against their retirement incomes to finance mid-life needs. For example, more low and middle income earners are retiring with substantial debts outstanding on their homes, which they use their superannuation to pay.

One option to redress these imbalances is to expand the purpose of superannuation to deal with other long term savings needs. For example, fund members could be allowed to withdraw a portion of their superannuation savings, up to a flat lifetime dollar limit, for any purpose (or for approved purposes) provided the money had been saved for at least five

³⁴ Antolin et al 2004, *Long term budgetary implications of tax favoured retirement plans*, OECD Economics Dept. Working Paper No 16.

³⁵ Bernheim & Douglas 2002, op cit.

³⁶ To target saving by low and middle income earners, an income test is not needed. Provided the level of annual saving that attracts a co-contribution is capped at a level appropriate for a middle income earner, its benefits would be limited for high income earners.

³⁷ Henry 2009, *Towards a better taxation of savings*, Australia's Future Tax System, October 2009.

³⁸ Australia's Future tax System 2009, Retirement incomes system report.

years. This would be more cost effective than introducing a separate tax incentive for long term saving for non-retirement purposes (such as those in the UK and US) because the caps on deductible superannuation contributions would limit the benefits for high income earners, who are likely to save in the absence of the incentives.

A scheme along these lines could also help overcome another major flaw in the present superannuation system – the ability of individuals to withdraw all of their superannuation savings as a lump sum benefit once they reach 55 years. This encourages early retirement, and undermines policy efforts to ensure that savings that are heavily supported through the tax system are used to generate an income in retirement and reduce reliance on the age pension. A system of ‘early access’ to superannuation would facilitate the introduction of limits on large lump sum benefits (especially before people reach the age pension age) by allowing people with a genuine need to withdraw part of their savings when they need to do so.

More details of our proposals to reform superannuation are in our submission to the Tax Review Panel on retirement incomes.³⁹

Taxation and incentives to work

The available evidence also suggests that the impact of income tax on work incentives is low in most cases. Although advocates of a flatter personal income tax scale argue that this would strengthen work incentives, the evidence suggests that the impact at the margin of higher after-tax wages on work incentives is close to zero for married men (who comprise the majority of high income wage earners). For example, a review of Australian studies of the responsiveness work force participation of different groups to changes in wage levels by the Treasury found that the average level of responsiveness (wage elasticity) for married men was zero, compared with 0.3 for married women and 0.5 or higher for sole parents. These findings are consistent with overseas evidence dealing more specifically with the effects of tax rates on decisions to participate in the paid workforce and increase working hours.⁴⁰

It is sometimes argued that ‘high tax rates’ for skilled workers encourage many to leave Australia and work overseas. Although high-skilled workers are more internationally mobile than low-skilled workers, Australia is a net importer of highly skilled labour (inward migration of skilled workers exceeds emigration), which suggests that top personal tax rates are not a major impediment to attracting highly skilled workers.⁴¹

The primary carers of dependent children (usually mothers) are more sensitive to tax rates of on their earnings because since they have an alternative role to paid employment.⁴² The labour force participation decisions most affected by the tax system are those to enter employment in the first place (for example after a period of caring fulltime for a child), rather than decisions to increase working hours. For low income families, those decisions are affected by child care costs and the interaction of marginal income tax rates and the family income tests that apply to social security payments, which often give rise to effective tax rates well above the top personal income tax rate.⁴³ For example, the income test for Newstart Allowance typically reduces this payment by 60 cents per dollar earned, which is well above the tax rate that normally applies to low income earners. Together with income

³⁹ At <www.acoss.org.au>

⁴⁰ Dandie & Mercante 2007, Australian labour supply elasticities, Treasury Working Paper 2007-4; Meghir & Phillips 2008, Labour supply and taxes, Paper prepared for Mirrlees Review, Institute of Fiscal Studies, London.

⁴¹ Department of Immigration and Citizenship 2008, Population flows.

⁴² Heckman 1993, What has been learned about labour supply in the US in the past 20 years? *American Economic Review* 83 No2.

⁴³ Kalb 2009, Children labour supply and child care, *Australian Economic Review* 42(3); Harding et al 2008, Interactions between wages and the tax-transfer system, report for the Fair Pay Commission,

tax and child care costs this often reduces the returns from part time work for many sole parents on income support to almost zero.⁴⁴

This discussion suggests that the case for across the board reductions in tax rates on work incentive grounds is weak. The review of Australian evidence on wage elasticities referred to above found evidence to suggest that on average, those on lower wages were more responsive to variations in their wage levels. A flatter income tax scale (with lower tax rates for high income earners) could therefore *reduce* workforce participation to the extent that tax rates for those on lower incomes have to rise to pay for it. This is especially likely if mothers in low income families are confronted with higher effective tax rates.⁴⁵

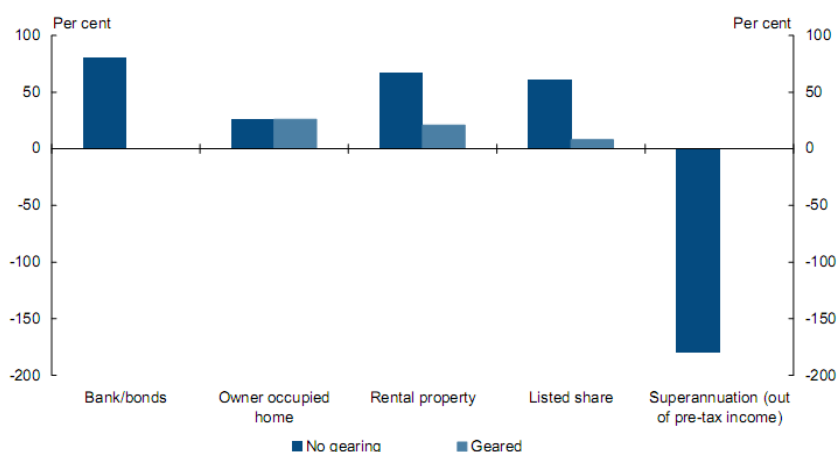
To improve financial work incentives, tax and transfer reforms should focus on the income tests applying to income support payments for jobless people, the effective tax rates facing primary carers in low and middle income families (both sole parents and ‘second earners’ in married couples) and child care costs. For example, the income test for social security Allowance payments such as Newstart Allowance heavily penalises part time employment, and Family Tax Benefit Part B penalises ‘second earners’ in married couple families. Careful attention should also be paid to the phasing out of income tested tax offsets such as the Low Income Tax Offset, which also raise effective marginal rates for many low and middle income earners.

Economic effects of inconsistencies in the taxation of investment

It is the inconsistency of the present tax treatment of different activities rather than the overall level of taxation on saving, investment or earnings that most undermines economic efficiency, though these inconsistencies probably have more impact at higher tax rates. Whenever a tax is levied at a higher rate on one activity, for example investment in bonds, than another, for example investment in property, taxpayers may be encouraged to invest in the lower taxed activity even if the investment returns (before tax) are lower. Taxpayers are thus encouraged to invest inefficiently, and also to devote time and resources to strategies to avoid tax instead of contributing productively to the country’s economic development. Effective tax rates of different investment choices vary dramatically (see graph below).

Graph 10:

Real effective marginal tax rates on different investments by a high income earner



Source: Australia’s Future Tax System 2008, op cit. Note that these estimates take account of the effects of inflation.

The graph also shows that taxes can distort incentives to *finance* a business or investment. For example, if a business receives a full tax deduction for the costs associated with raising

⁴⁴ NATSEM 2005, Distributional impact of welfare to work reforms upon single parents;

⁴⁵ Apps 2009, Tax reform, targeting and the tax burden on women, Centre for Economic Policy Research Discussion Paper 609.

capital from borrowing but not those associated with issuing shares, this will encourage borrowing.

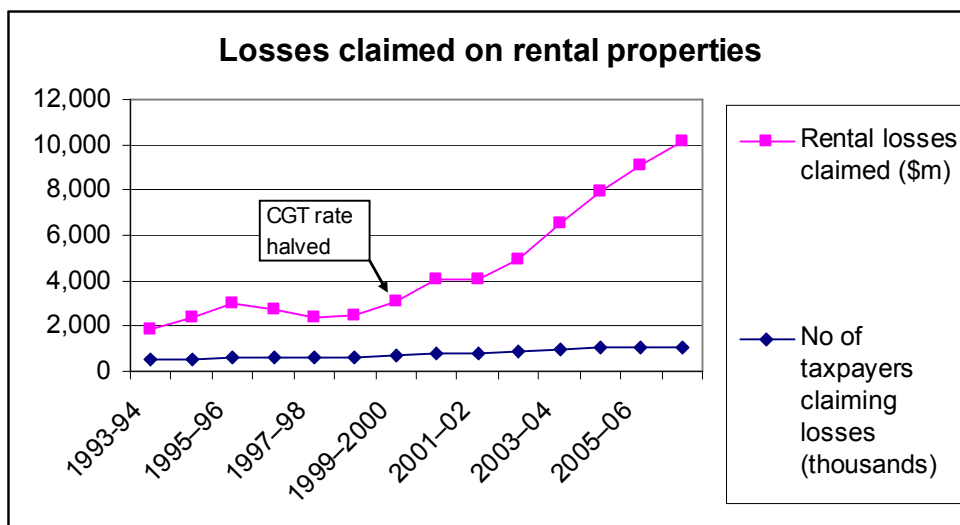
Another way in which taxes can distort economic activity is by influencing the choice of *business and investment structures*. For example, business owners are encouraged by the tax system to conduct their business and investment activities through private trusts (to take advantage of tax concessions on their investments and facilitate income splitting with family members) or private companies (to take advantage of the gap between the top marginal tax rate and company income tax rate), or both structures combined (to take advantage of all of these tax avoidance opportunities).

Biases within the tax system for or against different activities are not necessarily economically harmful. The tax system includes deliberate incentives for activities that are regarded as desirable (such as research and development expenditure) and disincentives for those seen as undesirable (such as environmental pollution). However, these should be used with care because the original goals of tax incentives are often distorted or even undermined as taxpayers focus on how best to avoid tax rather than achieving the best return on their investment. Tax incentives for investment in specific industries are especially problematic from this standpoint, as illustrated by the impact of incentives for investment in the film industry and plantation timber on those industries. Tax incentives are also less carefully scrutinised in the Budget process to ensure cost effectiveness than are direct expenditures.

The adverse economic effects of inconsistencies in the tax treatment of different forms of saving and investment are sometimes pronounced. One example is the encouragement of investment in rental property financed by debt by two features of the income tax system: the discounted rates of taxation of personal capital gains and the unlimited deductability of expenses associated with such investment from other forms of income including wages. These factors together make investment in rental property financed by debt particularly attractive from a tax point of view even though the pre-tax investment returns are typically low.⁴⁶ The perception that capital gains taxes had been dramatically reduced by the 50% discount introduced in 2002, together with aggressive marketing of tax avoidance schemes utilising 'negative gearing' contributed to a boom in rental property investment from 2002 to 2005 - along with other factors including low interest rates, financial innovation, a sharemarket crash, and favourable economic conditions. For example, the overall level of losses claimed on rental properties to the Australian Taxation Office rose from \$3.1 billion in 1999 to \$10.1 billion by 2006 (see graph below).

⁴⁶ Fane & Richardson 2004, Capital gains, negative gearing and effective tax rates on income from rented houses in Australia, The Economic Record Vol 81.

Graph 11:



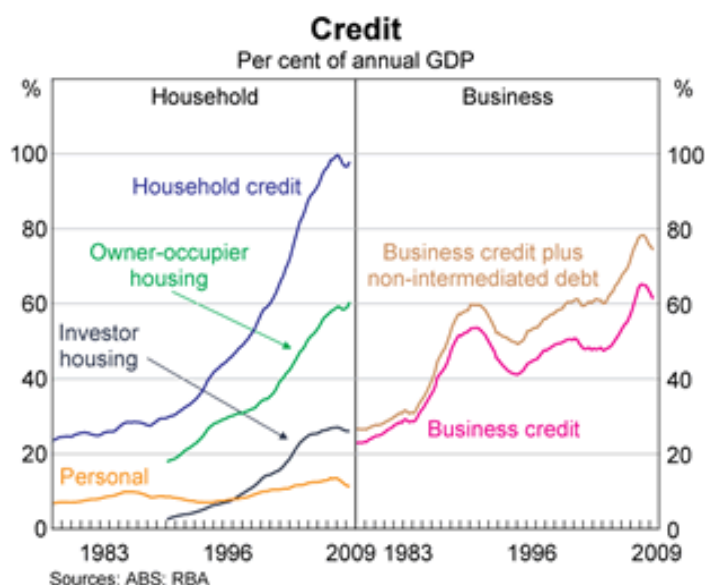
Source: ATO 2009, Taxation statistics ['CGT rate' refers to rates of tax on capital gains for individual taxpayers]

These factors led to overinvestment in inner city and coastal resort apartments and contributed to inflation of housing prices and higher household debt levels. In the early 2000s, borrowing to invest in rental property increased by about one third each year.⁴⁷ Despite this surge of investment, there was still a critical shortage of low cost rental properties at the end of the boom.

Much of the savings used to invest in these properties could have been invested more efficiently elsewhere. Of greater concern in the short term, inflation in asset prices, especially housing prices, makes it more difficult for the Reserve Bank to manage economic growth during boom periods. This was a major contributing factor contributing to the Global Financial Crisis. Further, most of the recent increase in household debt is housing-related, and high household debt levels are likely to act as a drag on economic growth for years to come. (see graph below).

⁴⁷ RBA 2003, Submission to Productivity Commission Inquiry into home ownership.

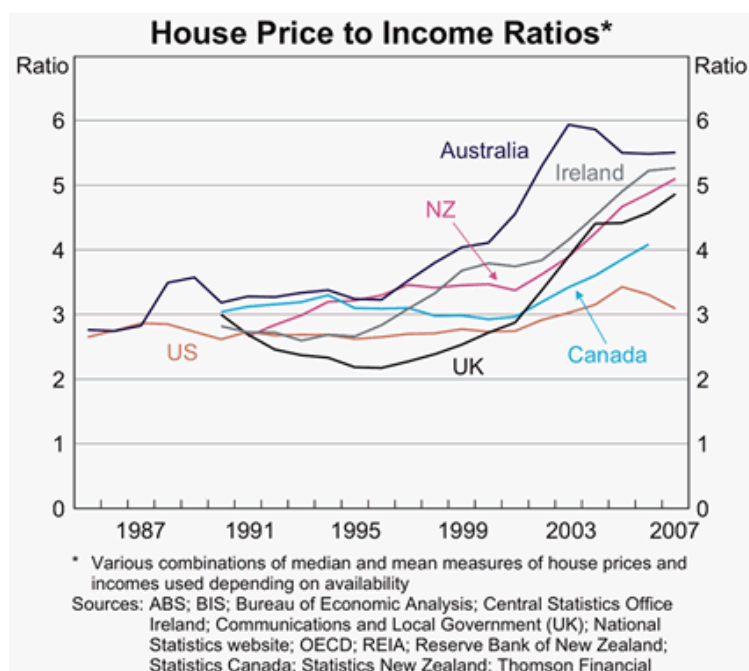
Graph 12:



Source: RBA 2009, Bulletin.

Biases in the tax system also have adverse social consequences. Once again, a good example of this is the tax treatment of housing. Owner occupied and investment housing are concessionally taxed in Australia. A major purpose of tax concessions such as the exemption of owner occupied housing from capital gains tax and land tax is to improve the affordability of housing. However, over the long run these concessions seem to have had the opposite effect. Preferential tax treatment has encouraged over-investment in housing, especially at the top end of the market, and this has inflated house prices. Despite having more land available for housing than most countries, Australia has among the expensive housing in the world. House prices have risen dramatically as a proportion of average incomes since the early 1990s.

Graph 13:



Source: RBA Bulletin, April 2008.

As shown in the following graph, housing affordability has declined over the past two decades despite the very generous tax treatment of both owner occupied housing (including the exemption from capital gains and land taxes) and rental property investment (as indicated above). Part of the reason for this is that the tax concessions for housing encourage investment in 'high-end' properties more likely to yield capital gains. Apart from the tax credits for construction of low cost housing in newly introduced National Rental Affordability Scheme (NRAS), they do not seem to have encouraged investment at the low cost end of the market.

Graph 14:

Average housing cost as a proportion of household income, Australia, 1975/76 to 2003/04



Source: Yates and Milligan (2007), from ABS Household Expenditure Surveys 1975/76 to 2003/04; housing costs for purchasers defined to include mortgage repayments (principal and interest) and rates.

Source: Judith Yates, Hal Kendig and Ben Phillips with Vivienne Milligan and Rob Tanton 2007, Sustaining fair shares: the Australian housing system and intergenerational sustainability, AHURI Final Report 111

A number of factors have contributed to this problem, including a preference for larger homes, underinvestment in public transport, resistance to urban consolidation, and innovations in housing finance which made credit more readily available. However, concessional tax treatment has also spurred overinvestment in both owner occupied and rental housing, especially at the top end of the market, and has probably contributed to high housing prices. Moreover, excessive growth in house prices mainly benefits older and wealthier home owners at the expense of younger people and low income earners. They especially disadvantage first home buyers and tenants.⁴⁸

In addition, exemptions from Land Tax for owner occupied housing deprive State and Territory Governments of an equitable source of revenue for improving urban infrastructure, the benefits of which are capitalised in home values. They rely instead on less equitable and inefficient taxes such as Stamp Duties, which increase costs for those attempting to enter the housing market. Local councils collect revenue from Rates, which are based on land values, but the small size of many councils means that the benefits of this tax base accrue largely to councils located close to the centre of cities which are already relatively well serviced by public infrastructure.⁴⁹

⁴⁸ Productivity Commission 2003 Inquiry into home ownership, Report; Reserve Bank 2003, Submission to Productivity Commission Inquiry into home ownership; Yates 2009, Tax expenditures and housing, Brotherhood of St Laurence and AHURI

⁴⁹ Productivity Commission 2003 Inquiry into home ownership, Report; Reserve Bank 2003, Submission to Productivity Commission Inquiry into home ownership; Yates 2009, Tax expenditures and housing, Brotherhood of St Laurence and AHURI

Taxing incomes more consistently through base broadening

Economically harmful biases in the tax system can be reduced by taxing different forms of income more consistently, that is by 'broadening the tax base'. One approach to base broadening is to move towards a *comprehensive income tax* – one in which all forms of income are taxed at the same progressive tax rates. As well as being fairer, the consistent treatment of income from different sources is economically efficient to the extent that tax biases that get in the way of efficient investment decisions are removed. Examples include the income tax reforms introduced in Australia in 1985 and the United States in 1986.

The main problem with this approach to base broadening is that different activities and taxpayers are more or less sensitive to tax incentives. For example, parents who are the primary carers of their children are more sensitive to personal income tax and other costs of employment than the main income earner in a family because they face a choice between participation in the paid workforce and care for children. This implies that from an economic efficiency standpoint, the ideal income tax structure would tax different activities at different rates. However it is difficult to anticipate the effect of taxes on different activities. This can also open up the system to competing claims for tax relief from different sectors of the economy, spur avoidance activity, and undermine both fairness and public confidence in the system.

In practice, the main argument raised against a comprehensive income tax is that investment incomes should generally be taxed at lower rates than earnings (wages) or land and resources on the grounds that investment is more mobile, and more sensitive to tax levels. In theory, for a given overall level of taxation, the tax system will have less adverse impact on economic growth if it is targeted towards those resources and activities that are the least responsive to taxation. A good example is taxation of land. Since investors and home-owners cannot 'move elsewhere' in response to higher levels of taxation, land is a relatively efficient tax base. Labour is more responsive to tax than land, to the extent that individuals can vary their working hours and earnings. Although overall levels of household saving do not appear to be greatly affected by tax, the choice between alternative investments is. One reason for this is that capital is mobile – it is relatively easy for individuals and businesses to switch from one investment to another.⁵⁰

As discussed previously, this has given rise to arguments to either remove or defer the taxation of saving and investment altogether, so that taxes are shifted towards earnings from work (labour incomes) or land and resources. Proposals for so-called 'fundamental tax reform' are of this kind. The problem with this approach to reform is that equity is undermined in a pursuit of uncertain efficiency gains. An intermediate option, which we discuss later, is to tax capital incomes each year but at a lower rate than earnings from work. This is referred to as a 'dual income tax'.⁵¹

Debate over whether investment incomes should be taxed at lower rates than earnings (wages) often ignores the fact that the personal income tax system already does this. Many forms of capital income are taxed at much lower effective rates than earnings from work (see graph 10 above). As Treasury Secretary Ken Henry pointed out recently:

'We have a savings tax base that exempts the lion's share of savings (owner occupied property, personal use assets), fully taxes a very small proportion of savings (returns from interest bearing deposits) and lightly to moderately taxes everything else at varying rates.'⁵²

⁵⁰ Griffith, Hines & Sorensen, International capital taxation, paper prepared for Mirrlees Review, Institute of Fiscal Studies, London; Freebairn 2007, Changing the Tax Mix, Australian Economic Review, 40 (2).

⁵¹ Sorensen & Johnson 2009, Taxing capital income, options for reform in Australia, Paper presented at Australia's Future Tax System conference, University of Melbourne 18 June 2009.

⁵² Henry 2009, Towards a better taxation of savings.

Superannuation, capital gains, life insurance, income accumulating in private companies, and investments in shares and real estate financed by debt are all taxed at well below the top two marginal tax rates, the tax rates that apply to the biggest personal investors.

As indicated above, national income tax systems in wealthy nations including Australia are actually hybrid systems that lie between a pure income tax (which taxes investment income annually) and pure consumption tax (which delays the taxation of investment income). It is not clear whether economic efficiency would be improved by shifting taxation *further* away from investment income and *more* towards wages. Many of the efficiency gains often claimed for replacing income taxes with a tax on consumption actually come about because it is assumed that the new tax would tax all consumption consistently, whereas existing income taxes do not tax income consistently. Modelling to 'prove' the economic superiority of a consumption tax over an income tax often compares a pure consumption tax with the very imperfect income taxes we have today. A further problem with a reform of this kind is the need to compensate taxpayers who have accumulated investment assets (such as shares) under a tax regime in which investment income was more highly taxed and now face a higher rate of tax on the consumption of those resources (for example in retirement). A once-off increase in taxes on consumption would in effect devalue their investments.⁵³

It is therefore important to separate out the claimed benefits of reducing the overall level of taxation of investment incomes from those of taxing income more consistently (removing tax biases between different investments). Given the uncertainty surrounding the benefits of a further shift away from taxing capital incomes, and the risk that this would undermine equity by reducing taxes on high income earners at the expense of low and middle income earners, it is better in our view to focus on reducing inconsistencies in the taxation of both earnings and investment incomes. As discussed in more detail below, this can be achieved either by moving closer towards a comprehensive income tax or a dual income tax system.⁵⁴

4. A simpler, more sustainable tax system

Simplicity

Most Australians have to use a tax accountant to process their returns. In addition, low income people on social security payments have a great deal of difficulty understanding the income and assets tests for their payments. This poses particular problems for many mature age people and people with low English literacy skills.

The system could be greatly simplified for most employees and social security recipients if a standard work related deduction was introduced and tax and social security income tests were better integrated. In our retirement incomes submission to the Tax Review Panel, ACOSS indicated that we were sceptical about whether the tax and social security systems could be fully integrated but we advanced a proposal to use the pension system to collect income tax from age pensioners.⁵⁵

The personal income tax system is much more complex for those with substantial investment income and small business people. A major reason for this is the inconsistent tax treatment of different kinds of income discussed above. These inconsistencies also contribute indirectly to complexity through the anti-avoidance provisions that are required to stop individuals from taking advantage of them to avoid tax – for example by converting earnings into capital gains through the use of employee shares and options.

⁵³ Hubbard 2001, How different are income and consumption taxes? Prospects for fundamental tax reform; Sorenson 1994, op cit.

⁵⁴ Randolph & Rogers 1995, The implications for tax policy of uncertainty about labour supply and savings responses. National Tax Journal V48 No3.

⁵⁵ See ACOSS 2009, Submission to the Taxation Review Panel on retirement incomes.

The tax treatment of investment income could also be greatly simplified for many low income earners if there was a general exemption or tax free threshold for investment income.

Simplicity in tax law and administration is also desirable in areas where tax policy is attempting to influence behaviour. As discussed previously, a good example of this is tax concessions for superannuation contributions. Few taxpayers understand that a flat 15% tax rate on employer contributions is a discount on tax for most people, since they would otherwise pay higher rates of tax on their earnings. Media stories have given the impression that superannuation is taxed 'too often and too much' and that the 15% contributions tax is an additional impost on wage earners. This is a very inefficient way to design a tax incentive (tax concessions for superannuation contributions) that cost over \$11 billion in 2007. There would be few Government programs that cost this much yet are less visible to the general public. A more transparent, more easily understood personal tax offset for superannuation contributions is likely to be more effective in encouraging people to save through superannuation.

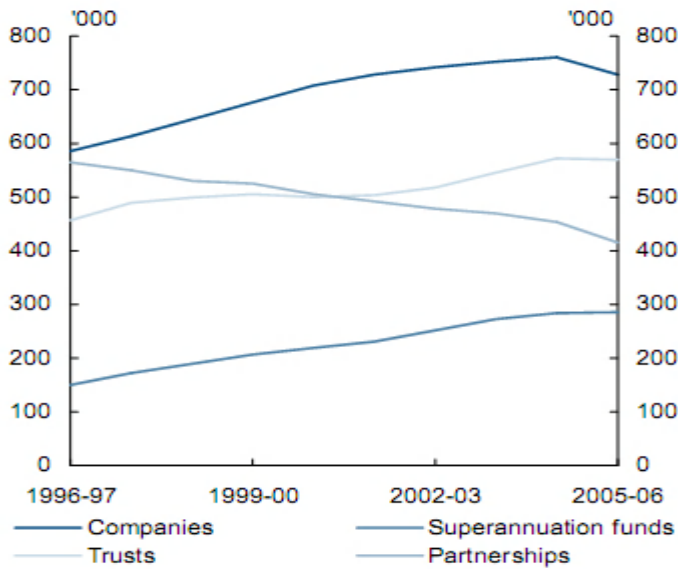
Sustainability

Although paying tax is a legal obligation, to a large extent the personal income tax system relies on people to voluntarily comply with it. This in turn requires a degree of public acceptance that the system is fair. If this is eroded by perceptions that the tax system treats people differently in an inequitable way, or that others get away with avoiding their obligations, then the culture of voluntary compliance will be replaced by a culture of avoidance.

Tax avoidance is no longer a 'boutique' activity confined to a small minority of taxpayers, if it ever was. Elaborate strategies to reduce income tax are now mass-marketed to people on above-average incomes. These include the 'churning' of wages through superannuation accounts by mature age people, borrowing to invest in property and shares so that the investment yields losses that can be deducted against wages, salary sacrifice arrangements, and the use of private companies and trusts.

One indicator of the growing reach of tax avoidance activity is the growth in the numbers of private companies, trusts, and superannuation funds (see graph below – most of the entities are privately owned though the data includes a smaller number of large public companies and trusts). Although these entities have purposes other than avoiding tax, they are also widely used for this purpose.

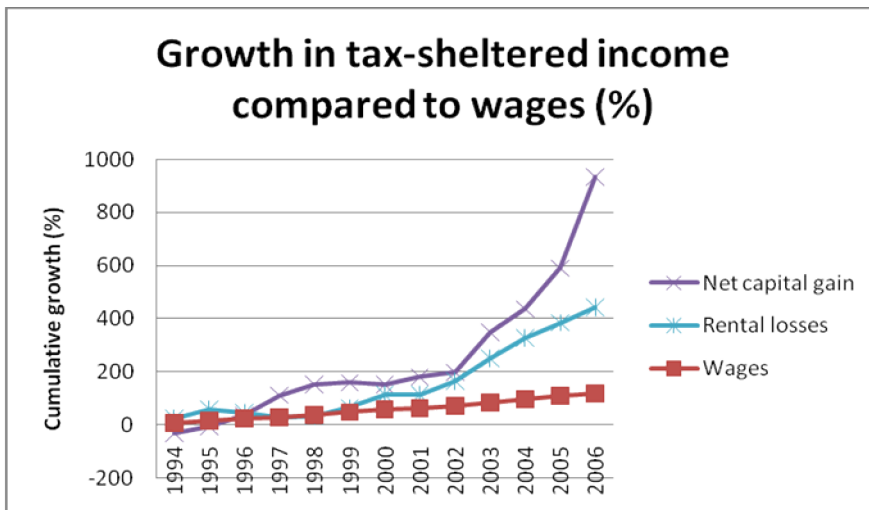
Graph 15: Growth in the numbers of companies, trusts and superannuation funds



Source: Australia's future tax system review 2008, Architecture of the Australian tax and transfer system.

Although this is probably not mainly due to tax avoidance, income from some sources that face low effective tax rates, such as capital gains and rental losses, has grown at a much faster rate than income from higher-taxed sources such as wages (see graph below). This lop sided growth in incomes weakens growth in tax revenues.

Graph 16:



Source: ACOSS calculations based on taxation statistics

An income tax system in which different kinds of income are taxed more consistently would be more sustainable as well as fairer and more economically efficient. Two related strategies also have an important role to play in stemming tax avoidance:

First, deductions should match income. Ideally, if all income is taxed consistently, taxpayers should be able to deduct the cost of earning income and the costs of their investments, against their total income. This encourages people to undertake risky investments since the Government becomes in effect a silent partner in the investment – losing tax revenue in the start-up phase and sharing in the profits if the investment is successful. However, if different forms of income are not taxed consistently, allowing individuals to deduct their expenses against all of their current income gives rise to tax avoidance opportunities that are very costly to public revenue. For example, if an investor on the top tax rate borrows most of the

cost of an investment in shares (leveraged equities) they can deduct the interest payments against this year's wages. However, if no dividends are paid and the only income from the investment is a capital gain when the shares are sold a decade later, then that income is only taxed at half the marginal tax rate and tax is deferred for a decade. In this case, the failure of the tax law to match deductions with the associated income stream creates an opportunity to avoid tax that is very widely used in Australia.

One solution to this problem is to tax income more consistently, in this case by taxing capital gains on the value of shares annually as they accrue, and at the same tax rate as wages. If this is not achieved, then another solution is to 'quarantine' the expenses so that they can only be claimed against income from each investment, or a class of investments that attract a discounted tax rate (in this case, assets mainly yielding capital gains such as shares, rental property, and agricultural investment schemes). This is done in Scandinavian 'dual income tax' systems where wages and investment income are taxed separately and deductions are generally not allowed against the other form of income. The United States also introduced a system of quarantining of investment losses against income from such investments in 1996, which was effective in closing down tax avoidance schemes used by high income-earners.⁵⁶

The second strategy to curb tax avoidance is to tax income in a timely way. A year's tax foregone is equivalent to an interest-free loan from the Government to the taxpayer. This is illustrated by the above example. Tax on capital gains was deferred until the asset was sold. In the case of capital gains, 'rollover' provisions for assets owned by small business proprietors mean that they can often avoid paying tax on capital gains throughout their working lives. The rollover of capital gains tax liabilities on the death of the owner of an asset means that tax is deferred even as the asset is passed on to the next generation. Another illustration of the importance of timing in taxation is the ability of the owners of private companies to accumulate income within the company where it is often taxed at a lower rate than their personal tax rate. Although the owner still has to pay tax once the income is 'withdrawn' from the company (in the form of wages, dividends or capital gains), they benefited in the meantime from many years of discounted tax rates.

The solution to this problem is to tax income on an annual basis as it accrues, as far as possible. This is difficult to achieve for capital gains since it requires annual valuations of assets and could lead to liquidity problems for taxpayers. However, some assets such as shares are easy to value on this basis, and taxpayers could elect to defer the tax (with an appropriate interest charge) where they cannot afford to pay tax on capital gains each year.⁵⁷

'Withholding taxes' are another strategy to bring the payment of tax forward. For example, one of the purposes of company income tax is to bring forward the taxation of shareholders on their share of company income. Although in theory, company income tax could be abolished and shareholders could be taxed on their dividends (and capital gains once the shares are sold), in practice this would give rise to many opportunities to defer or avoid the tax altogether. This was one of the reasons behind the previous Government's proposal to tax private trusts more like companies (which was subsequently abandoned). Withholding taxes capture tax revenue that might otherwise be lost.

⁵⁶ Muten, Sorensen & Hagen 1996, Towards a dual income tax? Foundation for European Fiscal Studies, Erasmus University, Rotterdam; McIntyre 1993, Tracing rules and the deduction for interest payments. Wayne Law Review Vol 39 No 67.

⁵⁷ Fane & Richardson 2004, op cit.

C. Frameworks for income tax reform

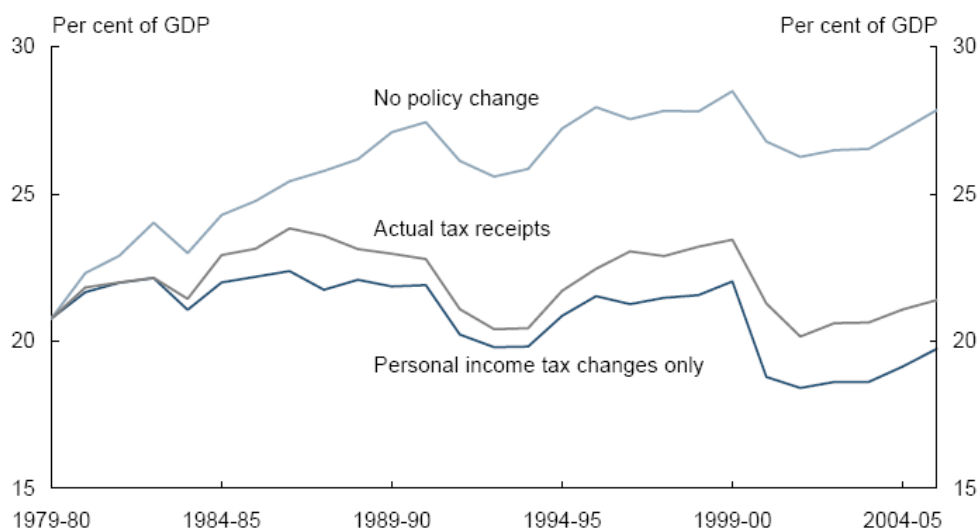
Governments will need to raise more revenue to meet the costs of an ageing population. The fairest way to do this is by strengthening the income tax base rather than increasing our reliance on taxes on consumption. Both fairness and economic efficiency would be improved if we taxed incomes more consistently – by reducing the number of ‘discounted’ tax rates and exemptions in the personal income tax or ‘broadening the tax base’.

A common approach to tax reform is to broaden the tax base and reduce tax rates at the same time.⁵⁸ This enables Governments to collect the same amount of revenue more efficiently and fairly. By strengthening the revenue base and closing off opportunities for avoidance, this strategy may increase revenue over the medium to long term.

The graph below which estimates the effect of policy decisions on Australian Government tax revenues over the past 30 years. The top line shows what would have happened to tax revenues if there was no policy change over the period – they would have increased mainly due to income tax ‘bracket creep’. The bottom line shows the effect of changes in tax rates over the period (mainly reductions in personal income tax to return the proceeds of tax bracket creep). The middle line shows actual federal tax revenues. Therefore, the gap between the two bottom lines shows the effect of ‘base broadening’ efforts and other changes to the tax system apart from changes in income tax rates (including base broadening measures and changes in consumption taxes). When we compare the beginning and end of this period, actual tax revenues are about the same in proportion to GDP. Without the base broadening and other measures, however, it would have declined substantially as a result of income tax rate cuts.

Graph 17:

Chart 3.17: Impact of policy change on Australian Government tax receipts, 1979-80 to 2005-06



Source: Treasury 2007, Intergenerational report.

The gap between the bottom two lines is Treasury's estimate of the impact of policy changes apart from changes to tax rates.

⁵⁸ Treasury 1985, Reform of the Australian taxation system; Auerbach & Slemrod, 1997, The economic effects of the Tax Reform Act of 1986, Journal of Economic Literature V35, p589.

There are three approaches to broadening the personal income tax base:

1. **By taxing incomes generally at the same rates within a *comprehensive income tax framework***

This was the approach taken to tax reform in Australia in 1986 when the capital gains tax and fringe benefits taxes were introduced to plug gaps in the taxation of income

2. **By taxing earnings (wages) at the same rates, and taxing investment incomes at rates below the top tax rate for earnings, within a *dual income tax framework***

This was the approach adopted by Scandinavian countries in the 1990s in response to international competition over tax rates for investment (as barriers to investment in other European countries were lowered through the European Union). Tax rates on investment income were lowered but the progressive tax scale for earnings was retained.⁵⁹

3. **By *taxing investment assets rather than the income derived from them, which could be done within either a comprehensive income tax or dual income tax framework***

Land is taxed by State and Local Governments through Land Taxes and Council Rates. These taxes are separate from, and *in addition to*, the income tax system. Another form of asset taxation is the 'deeming' of investment income of pensioners from the value of their investment assets (such as bank account balances) under the pension income test. The 'deeming' approach has been extended to the calculation of personal income tax in the Netherlands. In this case the taxation of asset values is a *substitute* for taxing income directly.⁶⁰

In practice, there would still be a need to tax different forms of earnings and investment income at different rates. For example, it is desirable to provide some form of tax incentive for long term saving. But both equity and economic efficiency would be improved if different kinds of income were taxed in a more consistent way than they are now.

The main difference between a comprehensive income tax and a dual income tax is that under the dual income tax there would be two 'top tax rates' – a higher one for earnings from work and a lower one for investment incomes.

The main advantage of the *comprehensive income tax* is that it is fairer to tax different forms of income at the same rates, provided allowance is made for the effects of inflation on investment incomes. A shift towards a comprehensive income tax would increase effective tax rates (mainly for those on high incomes) on those forms of investment income that are now taxed the least (including capital gains generally and income from investment in housing). Income from work would also be taxed more consistently, for example by taxing 'company car' fringe benefits at the same rates as wages. Increases in effective tax rates in these areas are also likely to improve economic efficiency by removing tax biases in favour of certain investments and employment arrangements.

⁵⁹ Sorensen 1994, From the global income tax to the dual income tax, recent tax reforms in the Nordic countries, *International tax and public finance* 1, p57; Genser 2006, Dual income tax, implementation and experience in European countries, *Ekonomski Pregled*, 57 (3-4).

⁶⁰ Cnossen & Bovenberg 2000, Fundamental tax reform in the Netherlands, CESifo Working Paper No 342.

The main difficulties with a comprehensive tax are the problems associated with measuring and taxing investment income. Ideally, investment income and related deductions would be adjusted downwards for inflation before tax is calculated, so that investment returns that merely compensate for inflation are not taxed. However this is difficult to achieve in practice. Similarly, capital gains should ideally be taxed annually rather than waiting until the investment asset is sold and this requires an annual valuation of the asset. Further, since the choice of investment income is generally more responsive to taxes, there is a risk that high income investors will shift their money into another tax shelter (such as salary sacrifice into superannuation) if one is closed (such as negatively geared property investment). For all of these reasons, tax reforms based on comprehensive income tax principles often reduce tax rates at the same time that they broaden the tax base. However, a cut in top tax rates without base broadening to pay for it would represent a windfall for high income earners.

The *dual income tax* attempts to deal with these difficulties in taxing investment income by taxing them at a lower rate than earnings from work. It is a pragmatic response to the greater sensitivity to tax of investment decisions. A major reason for its introduction in Scandinavian countries was to help preserve their progressive tax rate scales (at least for income from employment) in the face of international competition for the savings of their residents following the easing of controls over the movement of savings and investments across Europe. For example, a Swedish investor could readily shift their savings into offshore bank accounts where interest might be taxed at a lower rate. The dual income tax is outlined in more detail in the Attachment to this report.

On the face of it, a lower tax rate on investment income for high income earners would increase inequality of incomes. However, most investment income is already taxed at well below the standard marginal tax rates, especially for high income earners. Whether the dual income tax is more or less equitable than the present system would depend on the level of tax chosen, and whether tax rates on the lowest-taxed investments were increased. For example, if the dual income tax reduced effective tax rates for high income earners on their bank deposits but increased them on their capital gains and superannuation, it is likely that more revenue would be collected from high income earners than under the present system. Further, under a dual income system, investors normally cannot deduct the expenses associated with their investment income (such as interest on borrowings) against their income from work. When this system was introduced in Sweden in the early 1990s, it raised overall taxes on investment income for this reason.⁶¹

Dual income tax systems often impose a flat rate of tax on investment incomes equal to the company tax rate. A problem with this approach is that this would lead to higher taxes for many people on low incomes. One option to deal with the problems that might arise for low income investors is to introduce a tax free threshold on investment income. This would also have the advantage of simplifying the system for small investors by removing taxes from their investment incomes, though it would also open up opportunities for income splitting.

A significant weakness of the dual income tax is the need to prevent small business owners from converting their earnings from work into investment income (for example using a private company) to take advantage of the lower tax rate on that form of income. Scandinavian countries attempt to resolve this problem by splitting personal business income into a capital income component (based on a deemed rate of return from the assets of the business) and a labour income component (comprising the remaining income from the business), but this is not simple to achieve.

Asset based taxes could be used within either a comprehensive income tax or dual income tax framework. They can be levied in addition to income taxes (as with Land Tax) or as a

⁶¹ Sorensen 1994, op cit.

substitute for income taxes (as with the Dutch income tax system for investments which deems a standard rate of return from investment assets such as bank accounts). The main advantage of this approach is that it may be simpler to levy tax based on the value of an investment asset than to trace the income that is derived from it. Further, it may be possible in this way to integrate the taxation of capital gains (that is, the annual increase in the value of an asset) with taxation of other investment income (such as interest). Replacing income tax on the investment income of pensioners with a 'deemed rate of return' system would be simpler for pensioners because a system of deeming already applies to the pension income test, so the pension system could be used to collect income tax from pensioners.

The main problem with the 'deeming' approach is that it provides 'rough justice' since actual investment returns will generally be higher or lower than the deemed rate of return. This means that the 'above-normal' returns often achieved by high income earners with substantial assets and sophisticated investment advice would be difficult to tax under this system. For this reason it would be important to have at least two deeming rates, as we do in the pension income test – one for those with low levels of investment assets and a higher assumed rate of return for those with more substantial assets. There are also two difficulties with deeming from an administrative point of view: arrangements would have to be made to defer tax where as a result of low investment returns the taxpayer is unable to pay, and to regularly value assets such as property.

Taxes are levied on land by State and Local Governments to help finance local infrastructure. A broadly based tax on land is economically efficient because land is immobile. However, in practice many exemptions apply, limiting their effectiveness and distorting investment decisions. If more revenue could be raised from these taxes, it should be possible for State and Territory Governments to rely less on Stamp Duties on property transactions, which discriminate against those who have to change properties more frequently, disrupt the operation of housing markets, and are a very unstable source of funding for State Governments because they are too sensitive to the business cycle.

Frameworks for personal income tax reform

1. Tax incomes generally at the same rates within a *comprehensive income tax* framework
2. Tax earnings at the same rates but tax investment incomes at lower rates within a *dual income tax* framework
3. Tax investment *assets* rather than the income derived from them, which could be done within either a comprehensive income tax or dual income tax framework

The choice between these options comes down to which of them best meets our objectives: that is, revenue adequacy, fairness, economic efficiency, simplicity and sustainability. This is difficult to assess in the abstract. It depends very much on the detailed reform package, especially rates of tax and the degree of base broadening that is introduced. We shall therefore use the benchmarks discussed above to assess proposals to reform the personal income tax system.

Attachment:

The main tax bases – personal income, consumption, and company income

Much of the debate over tax reform focuses on rates of tax, yet the choice of tax base – the range of activities that are taxed – is arguably just as important for both fairness and economic efficiency than tax rates. For example, if only wages were taxed and not the fringe benefits commonly used by people on higher incomes (such as share options and company cars), many high income earners could end up paying a lower overall rate of tax on their labour income than middle income earners.

One of the key debates in tax policy circles over the past 30 years in English speaking countries is whether it is fairer to tax income or consumption. To clarify the choice of tax bases, we need to understand the different options available, including a comprehensive income tax, various forms of consumption tax, and a dual income tax.

Many people think of their income as wages plus investment returns such as interest and dividends. However, income is broader than this. For tax policy purposes, income is generally defined as the increase in an individual's spending power over a period of time (usually a year). One way to calculate this is the sum of an individual's consumption and the increase in their wealth over a given year. Income thus includes capital gains (the annual increase in the value of an asset) as well as direct flows of income to the taxpayer such as wages and interest payments. The idea is an increase in the value of an individual's assets increases their spending power and whether they spend their income or save it, they enjoy economic benefits from the increase in their wealth. This is important for equity reasons because of the highly unequal distribution of investment assets, as noted previously. For example, 54% of all taxes on capital gains are paid by the top 3% of taxpayers (those earning \$150,000 or more).⁶²

The basic difference between taxing income and consumption or expenditure is the tax treatment of saving and investment (income from capital), since the amount people save is the difference between their income and spending over a given period (for example, a tax year).

A consumption tax can either be imposed according to its popular meaning, as an 'indirect' tax on spending on goods and services such as the GST, or it can levied as a 'direct' tax on individual incomes minus the amount they save each year (a direct tax is targeted towards particular individuals whereas an indirect tax is tied to a transaction such as the sale of goods). This is often referred to as an 'expenditure tax'. This means it is possible to tax consumption at progressive tax rates, by taxing annual income with a deduction for saving. This is essentially the same as taxing only the earnings (wages) component of income. An example of a wage tax is the tax deducted via the PAYG system from people's wages each fortnight.

⁶² Australian Taxation Office (2008) Taxation Statistics, 2006-07.

Table 2: Income and consumption taxes

	Income taxes	Consumption taxes	
Types of income and consumption taxes	Personal income tax,	Direct	Indirect
	Company income tax	Personal expenditure tax or wage tax	Goods and Services Tax
Treatment of savings	Growth in value (e.g. interest and capital gains) taxed annually	Not taxed	Not taxed

There are also different types of income taxes. The ‘purest’ form of income tax is a *comprehensive income tax* which taxes all forms of income at the same (usually progressive) rates. All losses (for example from investments) can be offset against current income. A defining feature of the personal income tax is that income from investments (capital incomes) is taxed at the same rates, and at the same time (that is, annually) as income from labour (earnings from work). This means, for example, that capital gains (profits from an increase in the value of an asset such as land or shares) are taxed annually as they accrue, at the standard marginal tax rates. The Taxation Office would not wait until an asset is sold, and then tax the gains at half the normal tax rate, as is the practice in Australia today. However, under a comprehensive income tax, investment income, associated deductions, and other aspects of the tax system are adjusted for the effects of inflation. This means that the effect of inflation is deducted from any increase in investment income for income tax purposes.⁶³

No country’s personal income tax system is designed in this way. There are many exemptions from the full taxation of annual income, as we discuss later. Tax concessions for superannuation, housing, and capital gains are three of the most important ones. Also, our personal income tax generally does not adjust incomes for the effect of inflation.

Another form of income tax is the *dual income tax* which splits the personal income tax system into two tax schedules, one for earnings (labour income) and one for investments (capital income). A progressive rate scale applies to labour incomes (as it does in income tax systems in most countries) but capital incomes are taxed at rates that are below the top marginal tax rate on earnings (often at a flat rate equal to the company income tax rate). A number of Scandinavian countries adopted the dual income tax approach in the early 1990s. The dual income taxes in Nordic countries are illustrated in the following table.

Table 3: Dual income tax systems in Nordic countries (2004)

	Norway	Finland	Sweden	Denmark
Tax rate for earnings	28-48%	29-52%	32-57%	38-59%
Tax rate for investments	28%	29%	30%	28/43%
Company tax rate	28%	29%	28%	30%
Offset of investment losses	Within 1st tax bracket only	Tax credit	Tax credit	Within 1st and 2nd brackets only
Net wealth tax	0.9-1.1%	0.9%	1.5%	None

Source: Genser 2006, op cit

⁶³ See Brooks 2007, An overview of the role of VAT, fundamental tax reform and a defence of the income tax in Krever & White 2007, GST in retrospect and prospect, Thomson Brookers for a good description of the comprehensive income tax.

The lower tax rate on capital incomes is premised on a view that investment incomes are more sensitive to tax than work decisions. It is also a pragmatic response to some of the difficulties in measuring and taxing income such as capital gains. Unlike the comprehensive income, there is no adjustment of investment or other income for inflation. One of the immediate objectives of the Scandinavian dual income tax systems was to shore up tax revenue from investment income in the face of competition from lower tax rates in other European countries, as European economic integration made it easier for residents to shift their investments overseas. These countries were vulnerable to such tax competition because their top marginal tax rates were much higher than in Australia today, and also because of the integration of European financial markets.⁶⁴

Idealised versions of a comprehensive income tax and dual income tax are shown in the table below.

Table 4: Types of income taxes

	Comprehensive income tax	Dual income tax
Scope	All income taxed equally	Separate taxation of investments and earnings from work
Treatment of earnings	Taxed annually, generally at progressive rates	Taxed annually, generally at progressive rates
Treatment of investment income	Taxed annually, generally at progressive rates, with an offset for inflation	Taxed annually, generally at a flat rate that is lower than the top rates on earnings (with no inflation adjustment)
Deductability of losses	Generally unlimited	May be limited to other forms of investment and earnings respectively
Treatment of business income, including private companies and trusts	Shareholders and beneficiaries taxed annually, but there may also be a withholding tax on the income of the entity (e.g. company tax) to protect the personal income tax base	A separate company income tax also applies. Small business incomes are separated into capital and labour components for tax purposes.

Another way to tax investment incomes, or to supplement revenue from that source, is to apply an annual tax to the value of investment assets. For example, State Land Taxes and Local Government Rates supplement the taxes imposed on income derived from ownership of land such as rents and capital gains. Other countries levy small annual taxes on an individual's general wealth holdings.

Taxes on assets can also *substitute* for income tax. For example, under the pension income test, a pensioner's income is 'deemed' by applying a fixed rate of return to the value of an investment asset (such as a bank account). The 'deeming' approach has been adapted to personal income tax in the Netherlands, where individuals are taxed on an assumed rate of return on certain investment assets. The idea is that it may be simpler to tax investments in this way rather than identifying the annual flow of income from investment assets (for example, interest and dividends).

The pension income test attempts to take account of the higher average returns obtained from large investments (compared to, say a small bank account) by deeming income from

⁶⁴ See Sorensen 1994, From the global income tax to the dual income tax, International tax and public finance Vol 1 No 1.

such investments at a higher rate. It deals with the liquidity problems of asset-rich but income-poor pensioners with a set of hardship rules.

The role of company income tax

Company income tax is not the main focus of this report, but it does play an important role in backing up the personal income tax.

Whether company income tax is progressive depends on which individuals ultimately bear the tax, not the size or wealth of a company. A tax on the income of a company can either fall on shareholders, employees, and/or consumers. This is not a straightforward question, as it depends on the functioning of capital, labour and product markets both domestically and internationally. However it makes a major difference to the progressivity of the tax because wealth in the form of shares in companies in Australia and other OECD countries is heavily concentrated in the hands of a small minority of high-income taxpayers.

In the first instance, company income tax is a withholding tax (a down-payment of tax, rather like Pay As You Go withholdings for employees) for shareholders. When dividends are paid to shareholders, an adjustment is made through the dividend imputation system to offset tax paid by the company (in effect, the 30% paid by the company is subtracted from the tax rate paid by the shareholder). In theory, the end result is that shareholders are taxed only once on their share of company income at their own marginal tax rate. It might therefore be argued that the level of company income tax has only limited impact on the distribution of personal income within Australia (though it still has an impact to the extent that shareholders benefit from any increase in the value of their shares). If the company income tax rate increases, shareholders receive a larger 'discount' of tax on their dividends through increased imputation credits. If it falls, the opposite occurs. However, if the company tax rate is lower than the personal rate of the shareholders, there will be a 'retention bias' where profits are retained in the company so that they compound at the lower company tax rate

Nevertheless, company income tax acts as a vital backstop to the personal income tax in two ways:

- by taxing the share of company profits that goes to foreign investors (which is a major and growing source of public revenue for Australia)
- by making it more difficult for individuals to avoid tax by sheltering income in private companies.

Most of the controversy over who actually pays company income tax centres on the tax collected from overseas investors. Those who argue that it ultimately falls mainly on labour believe that international investment flows are highly sensitive to company tax rates. A high tax rate will deter international capital from investing in a country (unless it is investing in a business such as mining, which cannot easily be located in another country). The end result is a less productive economy and lower wages. Those who argue that company income tax falls mainly on shareholders argue that capital markets are not as responsive to better after-tax returns as this theory suggests. This is similar to a wider debate among economists over whether it is feasible for countries to tax investment incomes generally in an environment of internationally integrated capital markets.⁶⁵

Another complicating factor is that some countries such as the United States tax the global income of their own companies, with an offset for any tax they pay to another country. In

⁶⁵ Devereaux & Griffith 2003, The impact of corporate taxation on the location of investment, in *Economic analysis and policy* Vol33 No2; Gravelle & Smetters 2001, Who bears the burden of the corporate income tax in the open economy? NBER Working Paper 8280; Aiyagari 1994, Optimal capital income taxation with incomplete markets, borrowing constraints and constant discounting, Federal Reserve Bank of Minneapolis Research Department.

theory, this means that a US company investing in an Australian subsidiary cannot benefit from any reduction in company income tax in Australia, because the benefits would flow instead to the US Treasury. In practice, it seems that the US authorities have encountered problems in taxing the overseas profits of 'their' firms, due to the use of tax havens and 'transfer pricing' to shift profits to related entities in lower-taxing countries.

In any event, corporate income tax is an important and growing source of public revenue for Australia Governments, which would have to be replaced if the tax rate was reduced and as a result less tax was in effect collected from foreign investors.

Further, in the absence of a tax on the income of private companies, opportunities would open up for their owners to avoid or defer tax on their personal incomes by sheltering them within the company. This is one of the problems with the tax treatment of private trusts, which are not taxed on 'their' income (instead the beneficiaries are supposed to be taxed annually on their share of trust income).



Australian Council of Social Service

Level 2, 619 Elizabeth Street, Redfern NSW 2016

Locked Bag 4777, Strawberry Hills, NSW, 2012

Telephone: 02 9310 6200 Fax: 02 9310 4822

Web: www.acoss.org.au Email: info@acoss.org.au