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Disney

## **TAX REFORM: SOME PROBLEMS AND OPTIONS**

Julian Disney

# 1

### KEY IMPACTS OF TAX POLICY

The main role of governments is to promote economic and social opportunities for all their citizens. This includes opportunities to learn and work, to enjoy good health and relationships, to have affordable housing and transport options, to raise children and pursue pastimes, to be treated fairly and to be helped when hardship strikes. Lack of these opportunities is the main cause, and also the main consequence, of hardship and injustice.

The tax system is the major source of money governments can use to promote these opportunities by, for example, funding education, health care, social security and transport. The funding may directly benefit individuals and families or it may assist them by promoting economic or community development which will provide them with work and income.

The system’s impacts on the availability of opportunity and help goes very much further, however, than just raising money. This is partly because it has increasingly been used as a vehicle for providing financial benefits of a kind that would previously have been delivered through the social security system or some other form of direct grant. Family Tax Benefits are obvious examples.

The design of the tax system also greatly affects people’s ability to generate their own resources through work, saving and investment and to draw on those resources when needed. This obviously applies to the way in which wages are taxed but also includes, for example, tax rules concerning superannuation, housing, health insurance and child care. The design can create effects which greatly increase or reduce hardship and inequity.

Some of the system's deepest impacts stem from tax concessions and exemptions for particular types of economic activity. They greatly influence key aspects of life such as the amount of work available and the income which it provides, the effect of work on health and family relationships, and the cost of accessing housing and transport. These influences arise, for example, from the current Capital Gains and Fringe Benefits Taxes.

Public discussion of taxation often focuses mainly on the personal income tax scales. But much greater impacts, whether beneficial or not, can result from other aspects such as the tax treatment of housing, savings, inheritances and fringe benefits. These impacts can affect when people are born and how they are educated, where they live and for how long, whether and how they raise a family, and even what they eat, drink and drive.

People who are substantially disadvantaged by lack of income or other difficulties are especially vulnerable if the tax system fails to treat them fairly. They may be less able to access benefits and incentives, or avoid barriers and disincentives, which have been designed without taking due account of their circumstances. They may be less able to mount pressure for reform to address these problems or get administrative discretion to be exercised in their favour.

### SOME KEY PROBLEMS

Total tax revenue in Australia is very low by international standards. On the most recent available figures it would need to increase by 10–20% to reach the Organisation for Economic Co-operation and Development (OECD) average. Yet as a country with a relatively large area and rapidly growing population, Australia might be expected to require above average levels of public investment. Certainly, there are major unmet needs in areas like health, aged care, child care, disability services, education and transport.

The global economic crisis will sharply reduce government revenue while greatly increasing the needs for public expenditure. The same applies to the longer-term effects of our ageing population. Governments may often be justified in running budget deficits but should always seek to avoid unnecessary loss of revenue through gaps and loopholes in the tax system. Areas of current concern in this respect include the taxation of property, savings and international transactions.

It is also important to avoid distortions that provide unjustifiable tax advantages for some types of economic and social activity to the detriment of others. Our system gives excessive encouragement to borrowing while failing to provide an efficient or equitable regime of encouragement for saving, especially for lower-income people. It tends to favour speculation in land and financial markets rather than long-term investment in productive, job-creating enterprises.

Weaknesses in the tax system have also contributed substantially to inflation in house prices and rents, a serious housing shortage and yet also the under-utilisation of many houses. For example, the system encourages many older people to remain in large homes for much longer than they would otherwise have preferred. Weaknesses in the system have aggravated the time and cost of travel between home and work, especially for many people forced by excessive housing

costs to live a long way from their workplace. These impacts tend to be more severe for those people who have lower incomes and lesser opportunities.

The interaction of taxation with social security rules unduly discourages and penalises lower-income people trying to re-enter the workforce or increase their working hours. The pension income test is too harsh, and the superannuation system too generous, towards some people who need or want to continue working in their later years. These and the other failings I have mentioned tend to promote unfairness and divisive pressures in the community rather than equal opportunity and social inclusion.

Loopholes and distortions in the tax system have encouraged highly complex structures and activities to be adopted largely to take advantage of tax avoidance options. This not only reduces the productivity of investment but often involves waste of resources on expensive advice and financial manipulations. It is also unfair to other businesses and people who cannot, or do not wish to, engage in these strategies.

### SOME MISCONCEPTIONS

On the other hand, some aspects of the current system are unduly criticised, often with the aid of distorted statistics and inexpert media. For example, contrary to some assertions, our corporate income tax rate is not especially high by international standards. Moreover, we have a very generous system of dividend imputation and our employers' compulsory contributions based on payrolls are lower than in many OECD countries.

Also, contrary to some assertions, Australia's general taxation of assets is not particularly stringent by comparison with other OECD countries, partly because almost all of them have a gift, death or wealth tax. Our tax rates on capital gains are not especially high by international standards and nor are our personal income tax rates for high-earners. Moreover, we have an unusually generous approach to so-called 'negative gearing'.

In any event, it is unwise to place too much emphasis on standard tax rates when focusing on economic competitiveness. The long-term investors we need will base their decisions on deeper assessments of competing tax systems and on factors such as a well-educated workforce and political stability. The current woes of Ireland and Iceland starkly illustrate the dangers of attracting speculative or ill-conceived investment through excessively low tax rates.

### SOME PRIORITIES FOR REFORM

#### WORKERS AND FAMILIES

The economic crisis is increasing the need to avoid imposing high effective marginal tax rates on lower-income people, particularly those who can only find part-time or intermittent work. The main problems arise from the social security system and could be reduced by relaxing Newstart income tests to allow averaging over three months or even longer, cutting the withdrawal rate and raising the threshold at which it starts, at least during the current recession.

Some improvements could also be made in the tax system. At the very least, the Low-Income Tax Offset (LITO) should be indexed and its value could be passed on in full (rather than only at 50%) when calculating fortnightly Pay as You Earn

(PAYE) rates. There is also a good longer-term case for substantially increasing the LITO while abolishing or greatly reducing the tax-free threshold enjoyed by higher-earners, especially if their marginal rates are to be reduced.

Tax assistance for families is unnecessarily complex and poorly targeted. Family Tax Benefit B and the Baby Bonus should be subsumed in a stronger and better-directed form of Family Tax Benefit A. Support for child care could be made much more cost-effective and equitable by strengthening the Child Care Benefit and increasing grants to non-profit child-care providers, while also abolishing the Child Care Rebate and Fringe Benefit Tax concessions for workplace child care.

## HOUSING AND TRANSPORT

House price inflation has severely damaged our economy by inflating debt, increasing pressures on interest rates and wages, fuelling excessive luxury consumption and eventually creating a collapse in the housing industry. The main enduring victims will be lower-income private renters and would-be homebuyers who do not have access to substantial family assistance.

It is futile to expect 'market forces' to fix the problem when they are so severely distorted by the unrestricted exemptions which owner-occupiers enjoy from capital gains tax, land tax and the pension assets test. A much better approach would be to limit the land tax and pension test exemptions, albeit at a very high level, and to reduce barriers to housing mobility by cutting stamp duty on all transfers below, say, the median value.

Inflation of prices, rents and debt has also been fuelled by excessive tax incentives for 'negative gearing'. As in the US, interest and other landlord expenses should be deductible only against income from the same source (eg, property investment, not an executive salary). The new National Rental Affordability Scheme (NRAS) neatly complements this approach by providing a transparent, capped and targeted incentive for investment in *low-rent* housing.

For many lower-income people, the time and expense of travelling to work has been aggravated by the provision of excessive tax incentives for motor vehicle use and none for travel by public transport. The current Fringe Benefit Tax concessions for allegedly work-related travel should be sharply restricted, if not abolished, using the savings to boost public investment in passenger rail services for outer suburbs and commuter towns.

## SAVINGS

Tax concessions for superannuation can be a desirable way of encouraging saving and reducing hardship in retirement. The current system, however, provides little or no tax concessions for contributions by lower-income Australians and very large concessions for people on higher incomes. Yet lower-income people are more adversely affected by having to forego wages in order to make contributions, and most higher-income people did not need this added incentive to save.

A much more cost-effective and equitable approach would be to tax superannuation contributions in the same way as other remuneration, but then provide a tax credit or co-contribution which is more progressive and

less wasteful than the current concessions. For example, it could match a person's contributions at a decreasing rate per dollar up to a modest level which is very much lower than the concessions currently enjoyed by higher-income earners.

This approach would open the way to abolishing or greatly relaxing the pension income test in order to provide an overall system of retirement income which is not only more cost-effective and equitable, but also less complex and counter-productive in its impact on older people's decisions about retirement and investment. An integrated package of reforms could be designed to increase the relative support for lower-income people without increasing the budgetary cost.

Many lower-income people have special mid-life needs relating to parenting, unemployment, or other causes but have no tax-assisted way of saving for them. Yet those needs may be at least as pressing as those in retirement and, indeed, may have impacts which endure into retirement. Early access to some accrued superannuation should be allowed on a broader, fairer and more cost-effective basis, in place of the largesse now provided for the wealthy over-55s.

A broader reform would be to provide tax concessions for designated Lifelong Savings Accounts into which contributions up to a modest total can be made at any time. Withdrawals would also be permissible at any time, subject to age-related limits but preferably not to restrictions on the purpose for the withdrawal. As in the UK, governments, welfare organisations and other donors could make contributions on behalf of lower-income people.

## OTHER REFORMS

The current system provides excessive scope for tax avoidance which increases the pressures on other taxpayers and government budgets as well as diverting investment and administrative resources away from more productive activities. It also erodes fairness, simplicity and public confidence. Priorities for action include tighter restrictions on tax avoidance through manipulation of private companies, trusts, 'golden handshakes' and offshore transactions.

Tax concessions for charities and religious bodies have become increasingly susceptible to exploitation and irrational distinctions. This is due partly to the ideological trend towards using non-government organisations to provide services previously delivered by governments. Greater reliance should be placed on direct and transparent subsidies which are based on the services being provided rather than, for example, tax breaks based on alleged spirituality.

## CONCLUSION

Each of the changes which I have canvassed would make the tax system simpler, fairer and more cost-effective. Most would enhance productive economic development and none would retard it. Some could be politically or technically difficult to introduce quickly, especially in the current crisis. But their importance could be endorsed and time scales set for implementation, possibly as part of broad packages which provide a suitable balance of impacts.

**JULIAN DISNEY**, July 2, 2009. Julian is Director of the Social Justice Project at the University of NSW. He is also the National Convenor of TaxWatch and the Chair of the Community Tax Forum, but this article is written in an individual capacity.

#### **KEEP IN TOUCH WITH THIS ISSUE**

Further information and ideas on issues mentioned in this article is available on the website of the new community information service, TaxWatch ([www.taxwatch.org.au](http://www.taxwatch.org.au)). It includes a special section on the activities of the Community Tax Forum which is an alliance of the Australian Council of Trade Unions (ACTU), the Australian Council of Social Service (ACOSS), the Australian Conservation Foundation and the Consumers' Federation of Australia. The section includes presentations, issues papers and summaries relating to the two National Tax Reform Symposiums which were convened by the Forum earlier this year in Canberra and Sydney.