Lower Taxes for a Better Australia

Submission to Tax White Paper Task Force

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Executive summary

- Governments compulsorily acquire tax revenues from the population to fund public services, but given our excessively large public sector size Australia needs to lower its taxation burdens.
- The claim that Australia is a 'low-taxing' country is a myth. Adding in compulsory super, workers' compensation, and health insurance mandates raises Australia's tax-to-GDP ratio from 27.3 per cent, as reported by the OECD, to 34.3 per cent in 2012 (exceeding the OECD average of 33.7 per cent).
- Australian governments do not suffer from a deficiency of taxation revenues, with the likes of company taxes continuing to grow as commodity prices level off.
- Allegations of rife tax avoidance among corporations operating in Australia ignore the role of tax policies in enabling reduced effective company tax rates, and intense public scrutiny ensuring major firms pay their legal tax liabilities.
- Suggestions that tax concessions represent a massive budgetary cost tend to overlook that concessions usually serve a variety of worthwhile economic and social objectives, and estimates of revenue foregone are unreliable.
- The personal income tax system should be reformed by eliminating the current top base rate of 47 per cent, eliminating tax surcharges dressed as 'levies,' and eliminating bracket creep effects to provide tax relief to workers.
- Australian corporate income tax is internationally uncompetitive and deters inbound investment, and so from next financial year the top 30 per cent rate should be reduced to 28.5 per cent, and even further in subsequent years.
- Institutional arrangements governing changes to the GST have served Australians well, and these should be maintained by abandoning proposals for a 'Netflix tax' and avowing not to extend GST to essential services and imported goods.
- Australia's budgetary challenges are best resolved by substantially reducing government spending, rather than punishing workers, investors, savers and consumers with higher taxes.

1 Introduction

In modern societies governments compulsorily acquire revenue from a number of sources in order to fund the production and provision of certain goods and services - such as defence, justice and policing, education, health, and transportation. Taxation represents a key element within the broader revenue-taking armoury of Australian governments at all levels.

For classical liberals the extent to which governments compulsorily acquire tax revenues from citizens should be strictly limited, and this limitation is conditioned by what is deemed to be the most appropriate roles of the state in economic and social affairs. For proponents of liberal philosophy, the appropriate preserve for government action must, in itself, be limited to ensure a well-functioning market economy and harmonious civil society.

The famed moral philosopher and economist Adam Smith conjoined tax and spending activities, of a parsimonious scale, when he proclaimed, 'little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things.'[1]

Over two centuries later economist Ludwig von Mises described the functions that liberal doctrines assign to the state as being restricted to the protection of property, liberty, and peace, and stressed the importance of limited levels of taxation imposed upon individuals and businesses:

'Taxation is a matter of the market economy. It is one of the characteristic features of the market economy that the government does not interfere with the market phenomena and that its technical apparatus is so small that its maintenance absorbs only a modest fraction of the total sum of the individual citizens' incomes. Then taxes are an appropriate vehicle for providing the funds needed by the government. They are appropriate because they are low and do not perceptibly disarrange production and consumption. If taxes grow beyond a moderate limit, they cease to be taxes and turn into devices for the destruction of the market economy.'[2]

Given the extensive functions of governments today - spanning from protective and productive functions to redistributive and macroeconomic stabilisation activities - which are well in excess of the liberal principle of the limited state (grounded in the protection of life, limb, and property), it is not surprising that the modern classical liberal inclination principally leans toward lower taxation.

Given the broad terms of engagement with the general public through the Tax Discussion Paper consultation process, this submission canvasses a highly selective range of issues in Australian taxation policy from a classical liberal perspective. In a broad sense, these concern:

- the implications of taxation for the functioning of market economies, and the interdependence between taxation and the growth of government;
- critically responding to a multiplicity of claims that Australia is somehow a 'low taxing' nation, with the implication that taxation burdens need to increase;
- assessing the features of the Australian direct taxation regime, with a specific focus on personal income and corporation income taxes; and
- assessing the characteristics of indirect taxes, specifically incorporating the goods and services tax.

2 The economic consequences of taxation

[1] Adam Smith, [1776] 1976, *An Inquiry into the Nature and Causes of the Wealth of Nations*, University of Chicago Press, Chicago, p. xl.

[2] Ludwig von Mises, [1949] 2007, *Human Action: A Treatise on Economics*, Volume 3, Ludwig von Mises Institute, Auburn, p. 740-741.

2.1 Economists are in widespread theoretical agreement that taxes harm the economy

It is generally understood that taxes can have significant implications for the functioning of markets and the overall vitality of the competitive economic environment facing businesses and individuals, irrespective of the revenue-raising capabilities of taxation.

Specifically, taxes can affect behaviour by encouraging economic agents to shift from heavily taxed to lightly taxed, or from taxed to untaxed, goods and services. This could, in turn, alter the economic incentives to save, invest, or consume outputs that are otherwise of value to business. Furthermore, taxes also reduce the disposable incomes available to individuals, and affect the cash flows of a business.

In essence, taxes tend to discourage mutually beneficial exchanges by driving a wedge between the prices that suppliers wish to receive for their output, and the prices that consumers are willing to pay for these products. For example, income taxes drive a wedge between the wage that workers are willing to accept to supply labour, and the wage that employers are willing to pay them. Because of these wedges, some potential gains from mutually beneficial exchanges—which exist when demand prices exceed supply prices—are left unexploited. Agents instead are induced to conduct alternative exchanges which, while certainly involving mutually beneficial wealth creation, do not create *as much* wealth and are not *as* mutually beneficial.

In summary taxes, whilst raising revenue, also tend to divert economic resources from higher valued to lower valued economic uses. For various kinds of taxes, economists generically refer to these unexploited gains from trade as the 'deadweight loss' of a tax.[3]

In addition to the disincentive effects of taxation, which impose costs upon the economy over and above the amount of revenue raised and transferred to government, several other dimensions of the costs that taxation imposes upon civil society have been identified by economists.

The costs of collecting taxes, and transferring them to public treasuries, tend to be substantial in magnitude. As Adam Smith once described it, taxes impose administration costs: 'The levying of [a tax] may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose perquisites may impose another additional tax upon the people.'[4]

In addition to this, collecting taxes also imposes a range of administrative and other compliance costs upon taxpayers who seek to meet their legal obligations. These include, but are not limited to, the costs of acquiring the necessary knowledge of relevant aspects of the tax system; compiling records; acquiring and maintaining tax accounting systems and completing tax return forms;

[3] Alex Robson, 2005, *The Costs of Taxation*, Centre for Independent Studies, Policy Monograph No. 68, p. 1.
[4] Ibid., p. 2.

evaluating the tax effectiveness of alternative transactions or alternative methods of complying with the requirements of the law; and collecting and remitting taxes levied on employees and turnover.[5]

Added to the deadweight losses of taxation, and the costs of collecting them, are the losses associated with the fact that the raising of tax revenues encourages individuals and businesses to expend scarce resources to either defend their incomes or wealth from being taxed more punitively, or to lobby for additional taxes to fund preferred subsidies, transfers, or other redistributive government programs.

An important problem associated with such 'rent seeking' costs of taxation is that economic agents within the broader networks of civil society are encouraged, in the presence of tax exactions by government, to lobby for tax policy changes to their benefit, rather than to strive against one another in the more effective service of market customers. Whilst it is difficult to quantify the extent of rent seeking losses through the use of simplified, comparative static models of the economy, it is not inconceivable to suggest these costs are very substantial.

2.2 The detrimental economic effects of taxation are confirmed by the empirical literature

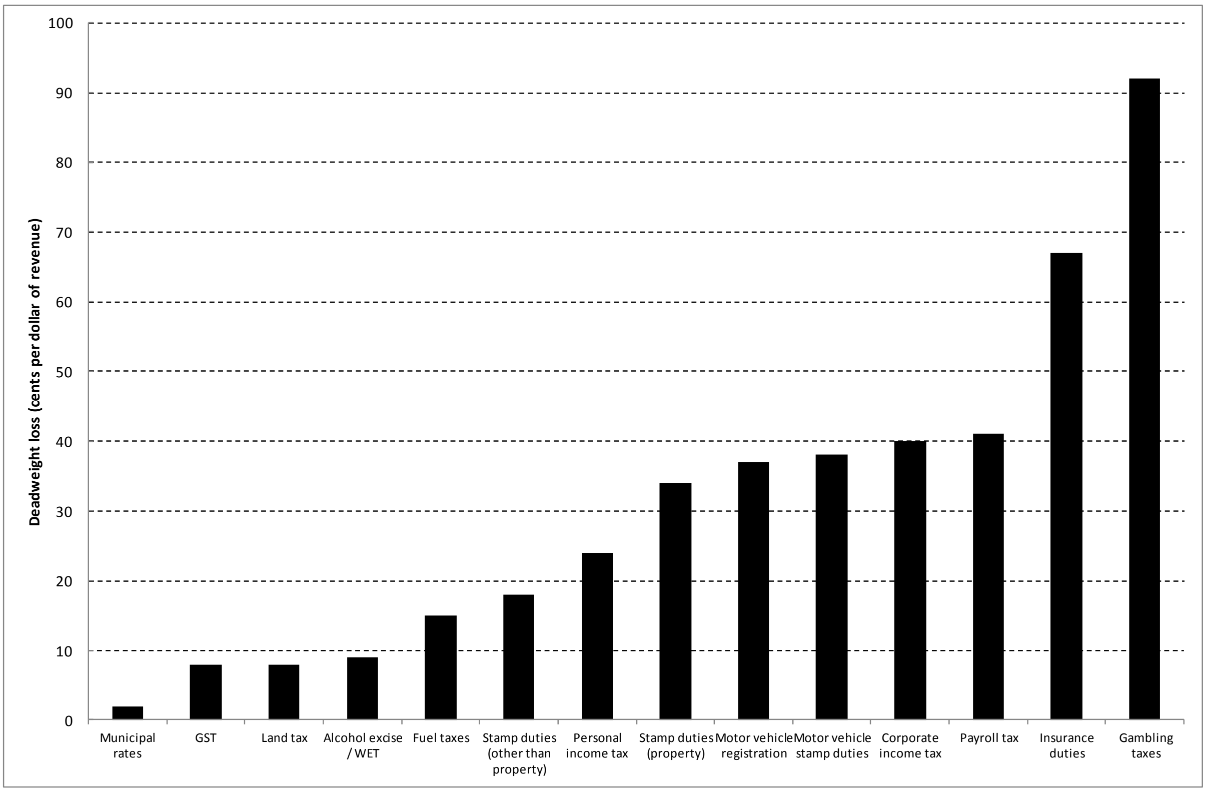
Over the last decade or so, Australian economists have taken a much greater interest in attempting to quantify at least the incentive (or deadweight) costs associated with imposing taxes upon productive economic ventures.

A reasonably representative example of the results of quantitative assessments of tax inefficiencies was presented by KPMG-Econtech in a study presented to the 2010 Henry Tax Review. This study ranked various Australian taxes in accordance with the 'marginal excess burden' they impose upon the national economy - or the additional welfare loss imposed by raising a given tax by a small amount, divided by the change in government revenue.

Figure 1 illustrates the marginal excess burden associated with a selected taxes imposed by commonwealth, state, and local governments. In general terms taxes imposed on relatively mobile activities, such as specific transactions in which consumers can readily withhold transacting in response to tax changes, tend to generate much larger deadweight costs than taxes imposed on relatively immobile activities.

[5] Tracy Oliver and Scott Bartley, 2005, 'Tax system complexity and compliance costs - some theoretical considerations', *Economic Roundup* (Winter): 53-68.

Figure 1: Marginal excess burden of selected Australian taxes



MEB defined as cents of consumer welfare loss per dollar of additional revenue.
Source: KPMG Econtech, 2010, *CGE Analysis of the Current Australian Tax System*, Commissioned paper for Future Tax System Review Panel.

Although econometric or simulation modelling of the efficiency consequences of taxation has been elevated in relative importance in public policy debates, there remains a need to carefully scrutinise the results of such exercises. This is due, for instance, to a tendency, certainly evident in recent years, to misapply modelling techniques to support certain, though hotly contested, positions on tax policy (Box 1).

Box 1: Modelling furphies: Questionable assumptions lead to questionable results[6]

In recent years several simulation studies have expressed the notion that certain taxes impose no, or *negative*, efficiency costs upon the economy. The contrarian implication of these findings is that the exaction of those selected taxes provide a (net) economic benefit, rather than a cost, to society.

Resource rent taxes

A consultancy report to the Henry Tax Review found that the petroleum resource rent tax (PRRT) imposed no marginal excess burden upon the economy. Since the tax is applied to a completely immobile tax base - that is, oil resources - the imposition of the PRRT merely taxes the excess profits of petroleum extractors, thus with no incentive effects exuded through the act of taxing those rental returns. Similar claims were made about the resources super profits tax (RSPT), and later the mineral resource rent tax (MRRT).

In an important early contribution to the Australian debate Ball and Bowers suggested that such taxes will have consequences for the real economy, to the extent that resource rent taxation would penalise risk-taking, and thus the entrepreneurial application of capital and other resources, within the mining sector.

Ergas, Harrison and Pincus argued that the MRRT altered the ex ante distribution of rates of return for various projects, particularly discouraging high risk projects requiring a high rate of return. Elsewhere, Ergas states 'the tax will raise large revenues in the short run precisely because the sunk investments it taxes can't flee the country. But it threatens future investments and discourages productivity growth.'

Land taxation

Following the release of the 2015 Tax Discussion Paper, the Commonwealth Treasury released a working paper assessing the efficiency and incidence of various Australian taxes. This included a hypothetical broad-based land tax similar to municipal rates levied by local government authorities, but which acts as a rental income tax collected before company tax.

Based on strong modelling assumptions that the rate of non-residential land tax is uniform across all industries, and a foreign ownership share of income from non-residential land in the order of ten per cent, the study concluded that such a tax would generate a negative marginal excess burden (in the order of ten cents per dollar of revenue raised).

The basis for this result is that 'the foreign ownership of land means that increasing broad-based land tax results in a small income transfer to domestic residents.' However, this confuses the distinction between fiscal transfers, which have no efficiency implications at least from the revenue side of public sector fiscal operations, and the real effects of taxation upon economic decision-making including entrepreneurial decisions concerning land use. If this foreign-income transfer effect were excluded, the study would show that broad-based land taxes would still impose deadweight losses upon the economy.

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[6] Ray Ball and John Bowers, 1984, The Resource Rent Tax: A Penalty on Risk-Taking, Centre for Independent Studies, Policy Monograph No. 5; Henry Ergas, 2010, 'About the rent we're charging', The Australian, 28 May; Henry Ergas, Mark Harrison and Jonathan Pincus, 2010, 'Some economics of mining taxation', Economic Papers 29 (4): 369-389; Jonathan Pincus, 2012, 'The Treasury-KPMG Econtech Modelling of the Excess Burden of Mining Taxation: Some Doubts', *Agenda* 19 (2): 23-38; KPMG Econtech, 2010, *CGE Analysis of the Current Australian Tax System*, Commissioned paper for Future Tax System Review Panel.

2.3 Heavier taxes also increase the size of government, again hurting our economic prospects

Based on a core foundation of orthodox (neoclassical) taxation theory that the imposition of taxes should impose the lowest efficiency burdens upon economic activity as possible, economists have long lauded the relatively high efficiency properties of low, flat, broadly-based taxes. The rationale for favouring these principles in the case of consumption taxation, for example, was explained by the Henry Tax Review as follows:

> 'A broad-based consumption tax is one of the most efficient taxes available to governments ... For a small open economy, investment is likely to be more mobile than consumption, suggesting economic growth is likely to be higher by shifting away from taxes levied on investment. Further, a single-rate consumption tax does not distort the timing preferences of consumption for individuals. The same tax is paid regardless of whether a person consumes now or in the future, imparting no bias for or against saving.'[7]

However, there are legitimate intellectual alternatives to the neoclassical perspective which must be carefully considered when weighing up new directions for taxation policy.

There is a long rival tradition in the public finance literature, most closely associated with Italian scholars of the late nineteenth and early twentieth centuries (notably, Amilcare Puviani), which analyses the underpinning properties of different taxes in terms of their mitigating resistance to their payment.

According to this 'fiscal illusion' analysis, the taxation system would elicit a less conspicuous behavioural response from taxpayers if the act of payment were less noticeable, or visible, to the taxpayer. It is for that reason that indirect taxes, such as the GST whose rate is embedded in final prices paid by consumers, would be preferred by taxation authorities than direct taxes, say the income tax regime, whose payment is more readily observed by the taxpayer.[8]

In recent decades the 'leviathan model' of the public sector, most famously espoused by James Buchanan and Geoffrey Brennan, has emerged as another alternative to orthodox theory. Using this construct it is argued that 'the political-bureaucratic process, as it is predicted to operate post-constitutionally, involves the maximisation of revenues within the tax constraints imposed in the fiscal constitution.'[9]

The tax policy implications of the leviathan perspective stand in stark contrast to the low rate, base broadening project of tax orthodoxy. To prevent an overexpansion in public sector size, it is in the

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[7] Australia's Future Tax System Review Panel, 2010, *Australia's Future Tax System: Final Report*, Commonwealth Department of the Treasury, Canberra, p. 273-274.

[8] Simon Blount, 2001, 'The Art of Taxation', Australian Tax Forum 16 (3): 345-360; Sinclair Davidson, 2007, *Fiscal Illusion: How Big Government Makes Tax Look Small*, Centre for Independent Studies, Policy Monograph No. 81.

[9] Geoffrey Brennan and James M. Buchanan, 1977, 'Towards a Tax Constitution for Leviathan', *Journal of Public Economics* 8: 255-273, p. 258.

greater interests of citizen-voters to restrain the government's inclination to impose tax including through institutional means. This would entail a preference for low rate taxes on limited, mobile, and highly visible bases:

'the standard analysis of excess burden is turned on its head. With the amount of revenues to be raised by taxation fixed, the optimal tax base is the one that induces the minimum amount of distortion of taxpayers' choices, namely, the most inelastic sources of revenues. With the amount of revenues to be raised the maximand, the citizens seek to limit the government to the more elastic tax bases, so to shelter parts of their income and wealth from the leviathan.'[10]

In essence a broadly based tax, with good 'efficiency' properties from the neoclassical standpoint, provides greater avenues by which the public sector can collect additional tax revenues from the populace, with which to spend. This, in turn, increases the relative size of the public sector, over and above that observed under a low and narrowly based taxing regime. These concerns were expressed by Australian economist Geoffrey Brennan almost two decades ago:

'Suppose, specifically, that the broadening of the tax base makes it easier for the government to raise additional revenue, and that government will in the long run adjust to this greater ease by increasing its total claim on resources. Suppose one believed, however, that the resultant increase in government spending would involve substantial waste, or would yield to taxpayers lower benefits than they would have received if they had spent the proceeds wisely. Then even if there were gains in terms of more neutral choices among private goods to be obtained from broadening the tax base, these would have to be set against the efficiency losses attributable to the expansion of public spending. … orthodoxy has an in-built bias towards public sector expansion: by recommending tax-base-broadening on other grounds, it secures public sector growth by stealth. Public sector growth is not necessarily something that can be regarded as promoting 'efficiency' overall.'[11]

Consider the following analysis presented in an important, yet underappreciated, paper by Australian public choice theorist Michael Brooks.[12] Figure 2 shows different configurations of the amount of governmentally-provided output on the X-axis, and the respective costs and 'tax prices' of providing those outputs on the Y-axis.

The marginal resource cost of providing public sector goods and services is given by OC, the citizen-voter's total demand for governmental outputs given by demand curve D, and the upward sloping curves are the marginal excess burden of taxes collected (essentially, supply costs).

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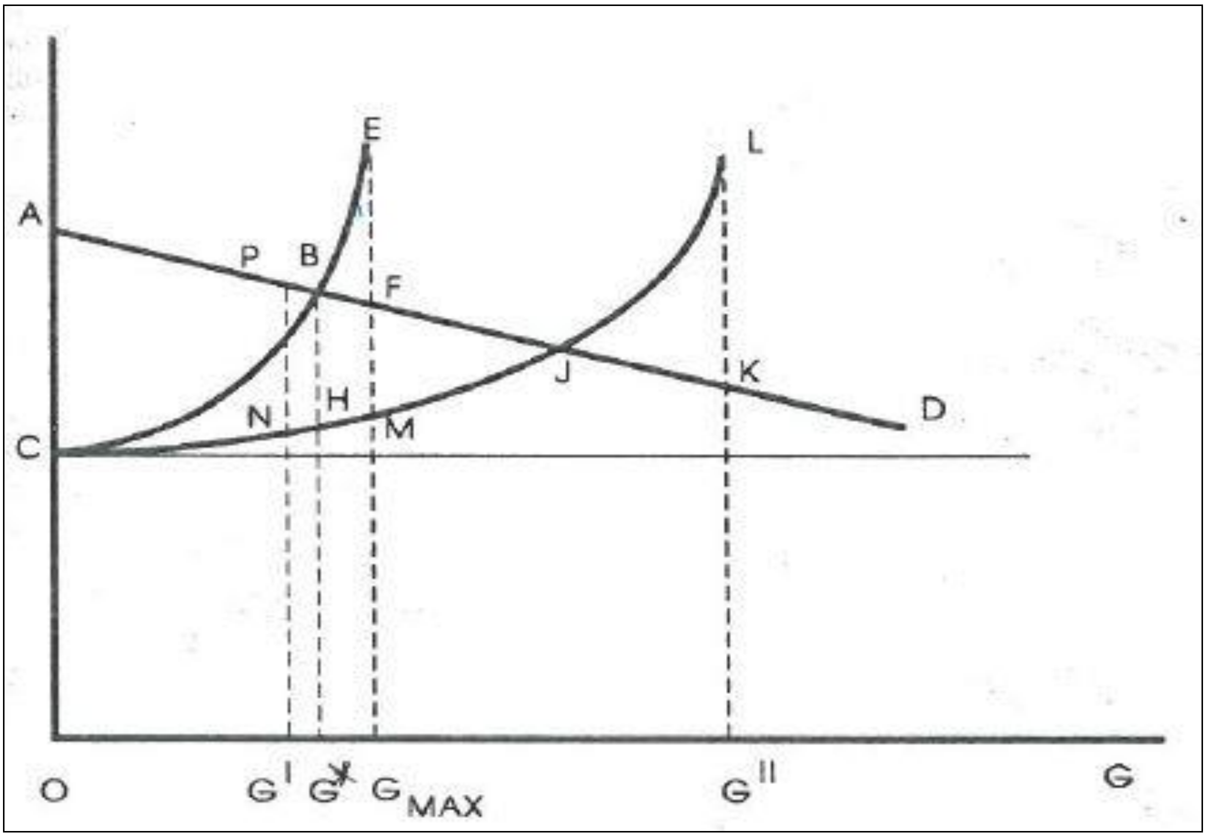
[10] Fabio Padovano, 2003, 'Leviathan models of government', in Charles Rowley and Friedrich Schneider, eds., *The Encyclopedia of Public Choice*, Kluwer Academic Publishers, Boston, p. 357.

[11] Geoffrey Brennan, 1987, 'The Case Against Tax Reform', Australian Institute for Public Policy, Critical Issues No. 7, p. 21-22.

[12] Michael Brooks, 1993, 'Fightback! A Public Choice Perspective', in John G. Head, ed., *Fightback!: An Economic Perspective*, Australian Tax Research Foundation, Sydney.

Figure 2: Implications of broadening tax bases in leviathan model



Source: Michael Brooks, 1993, 'Fightback! A Public Choice Perspective', in John G. Head, ed., *Fightback!: An Economic Perspective*, Australian Tax Research Foundation, Sydney.

The curve CE represents the marginal excess burden of existing taxes. The optimal supply of public goods and services is represented by G^*, where the marginal excess burden and demand curves intersect at point B. However, note that under the leviathan model the government will, instead, provide G_{max} level of output which is consistent with the maximum amount of revenue it can raise. The net economic losses associated with an overexpanded public sector are shown by the area BEF.

Suppose the federal government broadens the base of the taxation system, which leads to a lower marginal excess burden of taxation as shown by the curve CL. The efficient level of public goods supply will be at point J (greater than G_{max}), where the new marginal excess burden curve CL intersects the demand curve.

But note under the leviathan model the government would wish to radically expand revenue even further, such that it supplies, say, G'' level of public sector output. The net loss from overexpansion is also larger under this new scenario (JKL), as compared against area BEF under the pre-tax reform scenario.

That broadening the taxation regime would increase Australian public sector size could be manifested in several ways on the spending side, in addition to the stronger flow of revenue yields to the public fisc. It is possible that such base broadening would be accompanied by new spending packages providing redistribution payments to those politically deemed to be made worse off by the new taxing arrangements.

In an important recent commentary by Henry Ergas, it is conceived that extending the GST to presently GST-free areas of the economy, notably education and health, would increase the demand for public services and, by extension, the influence exerted by interest groups benefiting from government growth:

> 'in both health and education, governments supply services with a zero headline price. Public hospitals do not charge fees; nor do state schools. That means the GST could not be applied to those providers. But it could be applied to their private competitors, be they private health insurers, private hospitals or independent schools. As a result, extending the GST would make private providers less attractive, while reinforcing the public sector suppliers. Even a moment's reflection shows that is far more likely to reduce efficiency than to increase it. … In the short run, expect more crowding, longer waiting times and surlier treatment. It won't take long, however, before the public sector unions, exploiting the public sector's increased market power, extract the rents in the form of higher pay and cushier conditions.'[13]

Similarly, it is plausible to assume that growing welfare compensation, in the event of broadening the GST or any other tax, would increase the political influence of welfare lobbyists and bureaucrats involved in the administration of pensions, family payments, and the like, against all other groups (including individuals and groups representing the interests of the general taxpaying public).

More broadly, Gary Becker and Casey Mulligan have contended that 'an improvement in the efficiency of either taxes or spending would reduce political pressure for suppressing the growth of government and thereby increase total tax revenue and spending.'[14] It is this feature of the political process accompanying the imposition of broadly-based tax structures, which Becker and Mulligan have noted, which leads some pro-tax advocates to favour even further tax base broadening within the context of current policy debates.

3 Dispelling Australian taxation myths

3.1 Myth: Australia is a 'low taxing' country

Groups asserting the case that Australia can sustain greater tax burdens invariably cite headline data from annual releases of the OECD's *Revenue Statistics* publication. The commonplace measure of average taxation burden is the amount of tax collected, by all levels of government, expressed as a share of gross domestic product (see Table 1).

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[13] Henry Ergas, 2015, 'Extending GST to health and education would boost public sector unions', The Australian, 10 January.

[14] Gary S. Becker and Casey B. Mulligan, 2003, 'Deadweight Costs and the Size of Government', *Journal of Law and Economics* 46 (October): 293-340, p. 293.

Table 1: Total taxation revenue as percentage of gross domestic product, OECD countries

	1965	1975	1985	1995	2000	2007	2009	2011	2012	2013 p
Australia	20.6	25.4	27.7	28.2	30.4	29.6	25.8	26.3	27.3	n.a.
Austria[1]	33.6	36.4	40.5	41.0	42.1	40.5	41.0	41.0	41.7	42.5
Belgium	30.6	38.8	43.5	42.8	43.8	42.4	42.0	42.9	44.0	44.6
Canada	25.2	31.4	31.9	34.9	34.9	32.3	31.4	30.4	30.7	30.6
Chile	..	..	..	18.4	18.8	22.8	17.2	21.2	21.4	20.2
Czech Republic	..	..	..	34.9	32.5	34.3	32.4	33.4	33.8	34.1
Denmark[1]	29.5	37.8	45.4	48.0	48.1	47.7	46.4	46.6	47.2	48.6
Estonia	..	..	..	36.2	30.9	31.1	34.9	31.9	32.1	31.8
Finland	30.0	36.1	39.1	44.5	45.8	41.5	40.9	42.0	42.8	44.0
France[1]	33.6	34.9	41.9	41.9	43.1	42.4	41.3	42.9	44.0	45.0
Germany[2]	31.6	34.3	36.1	36.2	36.3	34.9	36.1	35.7	36.5	36.7
Greece[1]	17.0	18.6	24.4	27.6	33.1	30.9	29.6	32.5	33.7	33.5
Hungary	..	..	..	41.0	38.7	39.6	39.0	36.9	38.5	38.9
Iceland	25.5	29.2	27.4	30.4	36.2	38.7	32.0	34.5	35.3	35.5
Ireland	24.5	27.9	33.7	31.8	30.9	30.4	27.0	26.7	27.3	28.3
Israel[3]	..	..	..	35.2	35.6	34.7	29.8	30.9	29.6	30.5
Italy	24.7	24.5	32.5	38.6	40.6	41.7	41.9	41.4	42.7	42.6
Japan	17.8	20.4	26.7	26.4	26.6	28.5	27.0	28.6	29.5	n.a.
Korea	..	14.2	15.3	19.0	21.5	24.8	23.6	24.0	24.8	24.3
Luxembourg	26.4	31.2	37.5	35.3	37.2	37.2	39.0	37.5	38.5	39.3
Mexico	..	..	15.2	14.9	16.5	17.6	17.2	19.5	19.6	19.7[4]
Netherlands	30.9	38.4	39.9	39.0	36.8	36.3	35.4	35.9	36.3	n.a.
New Zealand	23.6	28.0	30.6	35.8	32.9	34.5	31.0	31.4	33.0	32.1
Norway	29.6	39.2	42.6	40.9	42.6	42.9	42.0	42.7	42.3	40.8
Poland	..	..	..	36.1	32.7	34.5	31.3	31.8	32.1	n.a.
Portugal	15.7	18.9	24.1	28.9	30.6	31.3	29.5	32.0	31.2	33.4
Slovak Republic	..	..	..	39.6	33.6	28.8	28.4	28.3	28.1	29.6
Slovenia	..	..	..	38.4	36.6	37.1	36.2	36.3	36.5	36.8
Spain[1]	14.3	18.0	26.8	31.3	33.4	36.4	29.8	31.2	32.1	32.6
Sweden	31.4	38.9	44.8	45.6	49.0	44.9	44.0	42.3	42.3	42.8
Switzerland	16.6	22.5	23.9	25.5	27.6	26.1	27.1	27.0	26.9	27.1
Turkey	10.6	11.9	11.5	16.8	24.2	24.1	24.6	27.8	27.6	29.3
United Kingdom	29.3	33.6	35.6	32.1	34.7	34.1	32.3	33.6	33.0	32.9
United States	23.5	24.6	24.6	26.7	28.4	26.9	23.3	24.0	24.4	25.4
Unweighted average:										
OECD total	**24.8**	**28.6**	**31.7**	**33.6**	**34.3**	**34.2**	**32.7**	**33.3**	**33.7**	**34.1**[5]

Source: OECD, *Revenue Statistics 1965-2013*.

Looking at the figures for 2012 (the latest actual estimates made available by the OECD), it is clear that the Australian tax-to-GDP ratio of 27.3 per cent is considerably lower than the unweighted OECD average of 33.7 per cent. It is on this basis that the claims are usually made that Australia is a 'low tax' country, and we are the fifth-lowest taxing economy behind Mexico (19.6 per cent), Chile (21.4 per cent), United States (24.4 per cent), South Korea (24.8 per cent), and Switzerland (26.9 per cent).[15]

However there is a good case to argue that the official statistics provide a misleading basis for interpreting Australia's taxation burden relative to other OECD-member countries. The exclusion of the 'superannuation guarantee' (SG) scheme from the Australian tax-to-GDP ratio estimate presented in Table 1 is a case in point.

[15] According to data for 2012, Australia's average taxation burden is level with that for Ireland.

Introduced in 1992 by the Keating government, the SG was intended to assist retirement living standards by ensuring Australians would not rely on the Age Pension as their primary source of retirement income. The government envisaged that 'by the beginning of the next [twenty-first] century, virtually all employees will be accumulating substantial superannuation savings to help fund their retirement income.'[16]

Employers are presently obliged to contribute a minimum percentage of each eligible employee's earnings (9.5 per cent as of 1 July 2014) to a complying superannuation fund. It is also important to note that failure by employers to provide prescribed superannuation benefits for their employees attract financial penalties.[17]

It is argued by the OECD that Australia's SG should be excluded from comparative taxation analysis because of the defined purpose of taxation, which is to provide compulsory unrequited payments to general government.[18] It is said that our compulsory super payments, by contrast, are made to a private fund chosen by the individual contributor, and the amount eventually payable to the contributor upon retirement depends upon their earnings history, service fees, and other conditions of the selected fund.[19]

The OECD itself freely acknowledges 'there are difficulties in eliminating voluntary contributions and certain compulsory payments to the private sector' when deciding which social security contributions are to be counted as taxes.[20] As a result of interest from some member countries, the OECD publishes statistics of the level of 'non-tax compulsory payments' (NTCPs) which the organisation states 'operate in a similar way to taxes in that they serve either to increase the employer's labour costs or to reduce the employee's net take-home pay.'[21]

A tax database maintained by the OECD shows the effective labour cost increase associated with the imposition of NTCPs, for employees earning average wages (Figure 3). While the Netherlands is a standout country by way of imposing NTCPs, Australian compulsory superannuation increases labour costs by a considerable margin - by over $4,700 in US dollar terms (purchasing power parity basis), the third-highest country for which NTCPs are estimated.[22]

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[16] Hon J. Dawkins, Second Reading Speech, Superannuation Guarantee (Administration) Bill 1992.

[17] A 'superannuation guarantee charge' (SGC) applies to any shortfall amount, together with 10 per cent per annum interest on the shortfall and a $20 administration fee per employee per quarter Australian Taxation Office, 2012, *Super: What Employers Need to Know - Introduction for Employers*, p. 18.

[18] OECD, 2013, *Revenue Statistics 1965-2012*, p. 318.

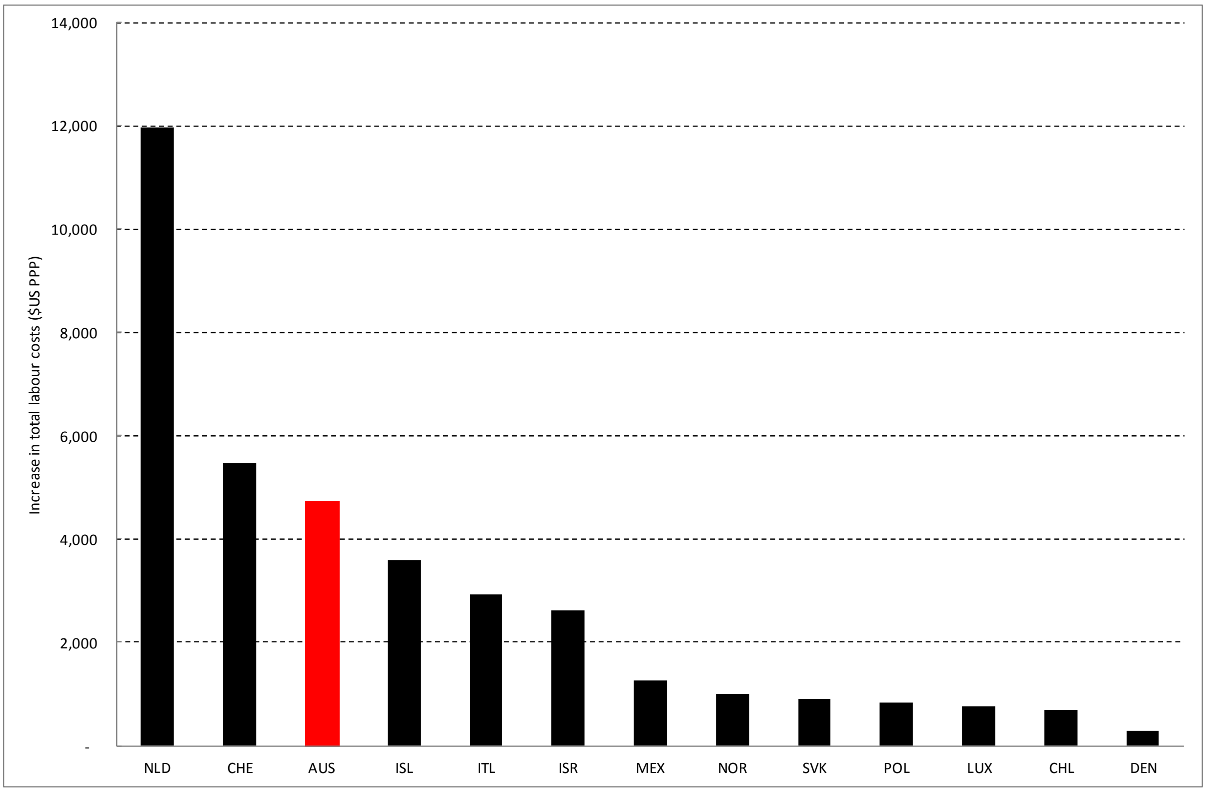
[19] There are also taxation concessions applicable to contributions made, fund accumulations, and payments to beneficiaries.

[20] OECD, op. cit., p. 319.

[21] OECD Tax Database, Non-Tax Compulsory Payments, http://www.oecd.org/tax/tax-policy/tax-database.htm#NTCP. In a number of OECD countries, NTCPs are imposed in addition to taxes regarded as social security contributions by the OECD.

[22] This paper does not add non-Australian NTCP burdens to tax-to-GDP ratio estimates for other OECD countries. However, it is noted that this treatment does not change the relative tax competitiveness position of the countries subject to comparisons.

Figure 3: Increase in total labour costs attributable to non-tax compulsory payments, selected OECD countries, 2013[23]



Estimates in US dollars using purchasing power parity benchmarks. Based on scenario of single employee earning average wage level in each country.
Source: OECD Tax Database.

Whilst the OECD has made its final determination to exclude the Australian SG regime from its estimates of social security contribution burdens, it should also be recognised there is much in common between the SG and social security contributions, particularly those imposed in European countries.

The most obvious similarity is the characteristic of compulsion shared by both the Australian and OECD regimes, even if the mechanisms to effect compulsion vary by country.[24] Another similarity is that 'the receipt of social security benefits depends, in most countries, upon appropriate contributions having been made.'[25] For a number of European countries, whose social security contributions are included by the OECD, the levels of contributions made to the pool of revenue are influenced by the salary of the recipients, whereas benefits are usually affected by the duration of time in residence within the given country.

[23] For this and remaining Figures in this paper, official three-letter country abbreviations are used. For further information, see http://www.worldatlas.com/aatlas/ctycodes.htm.
[24] Excluding New Zealand, which do not have a regime of social security contributions nor compulsory superannuation.
[25] OECD, op. cit.

Given the SG represents a political imposition to fulfil a policy objective of providing a retirement income, much like the European social contributions, and since employers are obliged by regulation and the threat of additional charges to meet the objective, it effectively operates as a social security tax. Hence, it is not unreasonable to add the SG as part of the overall Australian tax burden. If anything, the exclusion of SG from the OECD taxation statistics:

'tends to exaggerate differences between Australia and the countries in which compulsory social security contributions are applied to provide forms of assistance which in our country are funded from tax revenue.'[26]

Indeed, a number of Australian economists have endorsed the inclusion of compulsory superannuation for the purpose of making comparisons of Australian tax burdens with other OECD-member countries. These economists have included former Treasury Deputy Secretary Greg Smith,[27] consultant Geoff Carmody,[28] and banker Saul Eslake.[29]

It is also notable that an ACTU submission to the Productivity Commission treated Australian super contributions as a 'additional social security contribution' for the purposes of comparing labour costs across the OECD.[30]

An alternative to obtain a genuine, 'apples with apples' comparison of average tax burdens among developed economies would be to remove social security contributions (wherever they may apply) from the calculations entirely. Both options amending the official OECD statistical presentation are to be presented in this paper.

The OECD excludes other impositions imposed by Australian governments, which could also be construed as acting effectively as taxes. This includes the effectively compulsory purchase of private health insurance by individuals, through the threatened application of a Medicare Levy surcharge upon failure to buy insurance policies, and workers' compensation insurance premiums.

The fiscal implications of treating health insurance mandates in the United States as taxes, or not, also proves rather instructive when contemplating the appropriate treatment of Australia's arrangements (Box 2).

[26] TaxWatch, 2010, *A Comparative Update on Aspects of the Australian Tax System*, p. 4.
[27] Greg Smith, 2007, *Australia's Aggregate Tax Burden - Measurement, Interpretation and Prospects*, Australian Tax Research Foundation, Information Series No. 5.
[28] Geoff Carmody, 2014, 'Why we should worry about our rising tax load', The Australian Financial Review, 27 May.
[29] Saul Eslake, 2011, 'The Tax Reform Challenge', Australia Parliamentary Library Lecture, 21 September.
[30] ACTU, 2014, Submission to Productivity Commission Inquiry into Retail Costs, p. 2.

Box 2: The treatment of health insurance mandates in the United States[31]

The Congressional Budget Office (CBO) in 1994 revealed the full, and true, costs of the 'HillaryCare' - which entailed an enforced mandate for employers to provide health insurance coverage for their employees - playing a major contribution in politically scuttling the plan. According to the CBD report into the proposed health care mandates:

'[c]onsidering the Administration's proposal in its entirety, the Congressional Budget Office concludes that it establishes both a federal entitlement to health benefits and a system of mandatory payments to finance those benefits. In administering the proposed program, regional alliances, corporate alliances, and state single-payer plans (if any) would operate primarily as agents of the federal government. Therefore, CBO believes that the financial transactions of the health alliances should be included in the federal government's accounts and that premium payments should be shown as government receipts rather than as offsets to spending.'

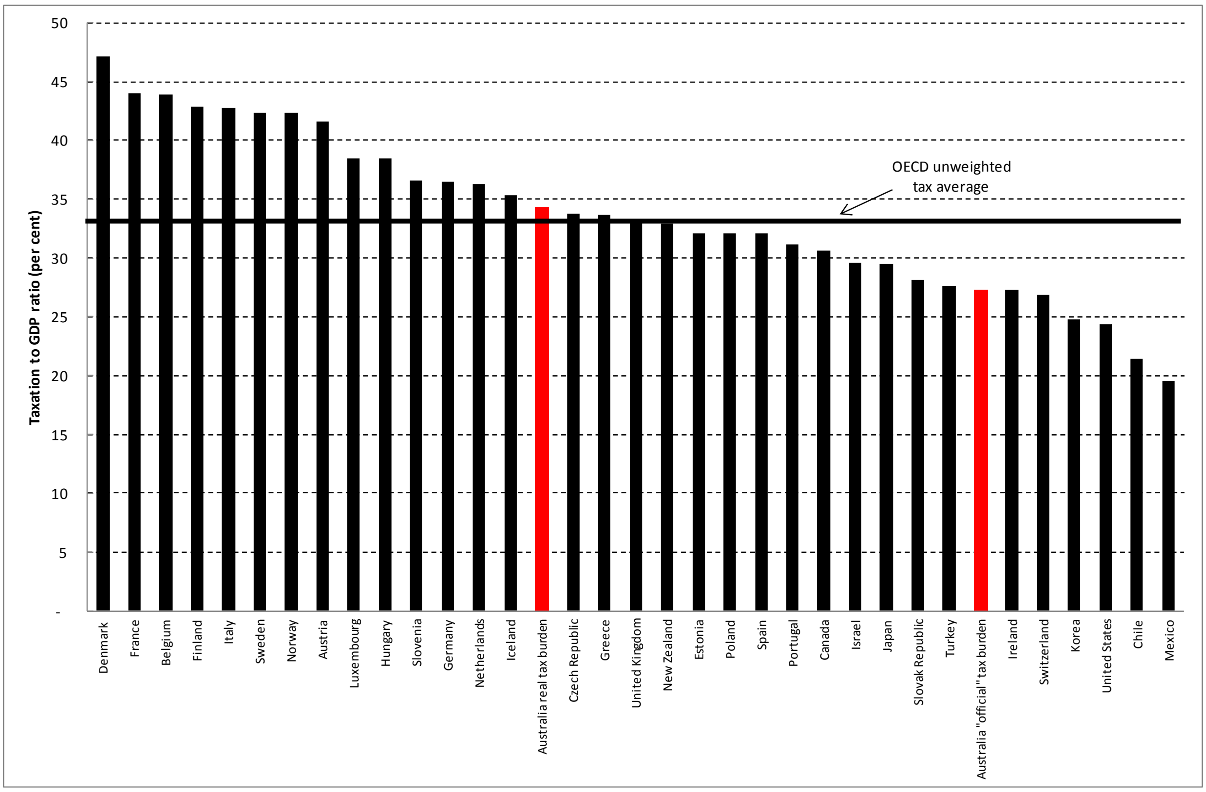
In other words, as discussed recently, 'if the government forces people to buy a product by law, then those transactions no longer belong to the privacy economy but to the U.S. balance sheet.'

In stark contrast, the modern CBO, which remains obliged, to this day, to scrutinise the implications of federal government policies for the US Budget, has elected not to determine health insurance mandates under 'Obamacare' as taxes, but rather as offsets to government spending in an attempt to artificially reduce the full fiscal burden of the US health care nationalisation measure.

Figure 4 provides a comparison of Australia's average taxation burden against other OECD countries, when our superannuation, workers' compensation and health insurance arrangements are included. The taxation-to-GDP ratio for Australia in 2012 was 34.3 per cent, exceeding the OECD average of 33.7 per cent for that year.

[31] Congressional Budget Office, 1994, *An Analysis of the Administration's Health Proposal*, p. 44; 'Jonathan Gruber's 'Stupid' Budget Tricks', The Wall Street Journal, 14 November 2014.

Figure 4: Total taxation revenue as percentage of gross domestic product, OECD countries, 2012



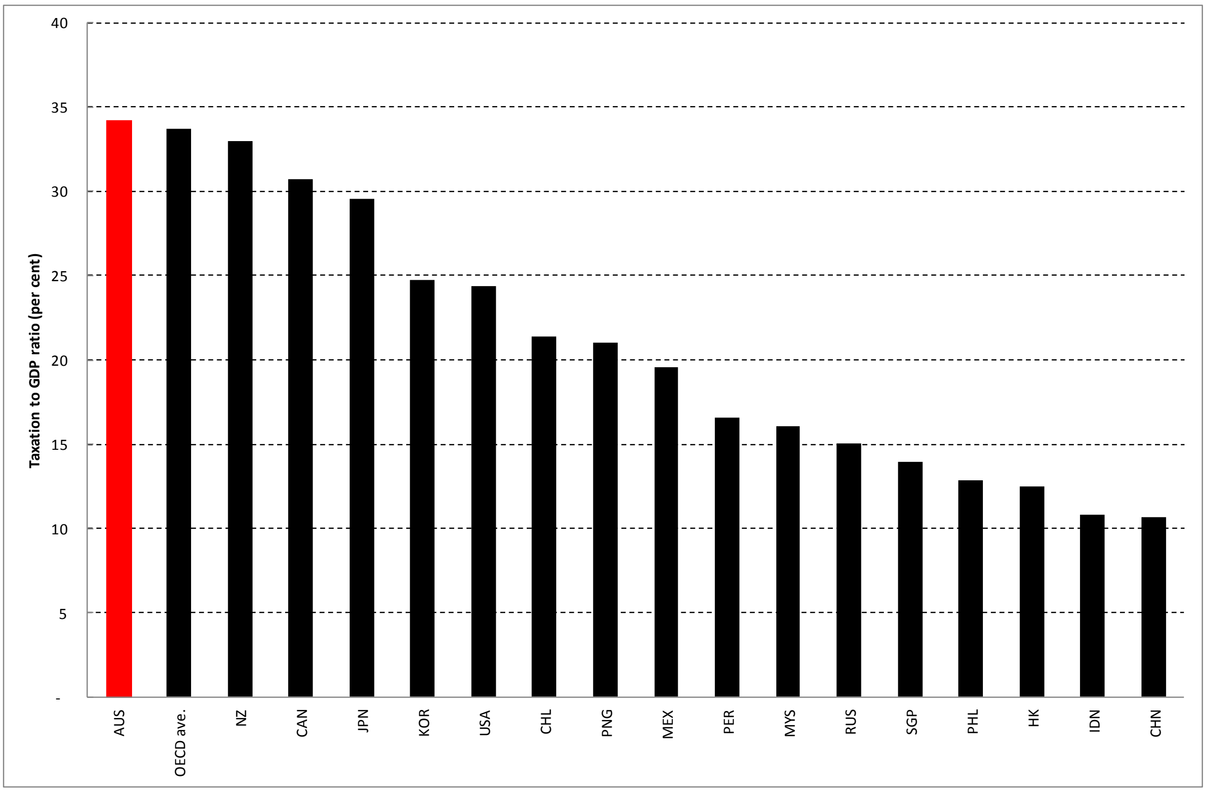
Real tax burden estimate for Australia includes employer contributions to compulsory superannuation and workers' compensation schemes, and health insurer premium income.
Source: OECD, *Revenue Statistics 1965-2013*; IPA estimates.

Given the trend towards greater international economic integration, it is important for Australian tax policymakers to bear in mind that decisions to set taxes has significant implications for our ability to maintain valuable mobile resources, and to foster home-grown entrepreneurship and innovation. Therefore, it is appropriate to consider the relative burden of Australia's taxation compared with countries in our region.

Figure 5 compares the Australian tax-to-GDP ratio (including compulsory superannuation and health insurance) against the OECD as well as for APEC member countries. Australia maintains close trading relationships within the APEC region and, indeed, maintains free trade agreements with many member countries. It is also notable that two APEC members (Hong Kong and Singapore) are the most economically free jurisdictions in the world, competing against Australia, among other countries, for regional shares of capital and skilled workers.

Australia maintains a relatively high tax-to-GDP ratio in comparison with other APEC member countries. Indeed, some Asian APEC members impose tax burdens, as a percentage of GDP, at about half the level of that of Australia.

Figure 5: Total taxation revenue as percentage of gross domestic product (adjusted figures), all APEC members, 2012



Australian figure includes employer contributions to compulsory superannuation and workers' compensation schemes, and health insurer premium income. All figures are for 2012, with the exception of China (2011), Hong Kong (2009), and Papua New Guinea (2002). Data for Brunei Darussalam, Taiwan and Vietnam are unavailable.

Source: OECD, *Revenue Statistics 1965-2013*; World Bank data.

As an aside, it should be noted that the information presented previously does not include the ratio of Australian general government spending to GDP (35.1 per cent in 2012). This indicator is important because, as Sinclair Davidson has noted, it is 'arguably a better indicator of the tax burden than the tax ratio. Expenditure must be financed from current tax revenue, debt (which can be viewed as deferred taxation) or the sale of assets.'[32]

Whilst the share of spending to the economy is smaller in Australia than in most other OECD countries, Australia nonetheless has a relatively large and costly public sector from a global perspective.

3.2 Myth: Australia is suffering a revenue deficiency problem

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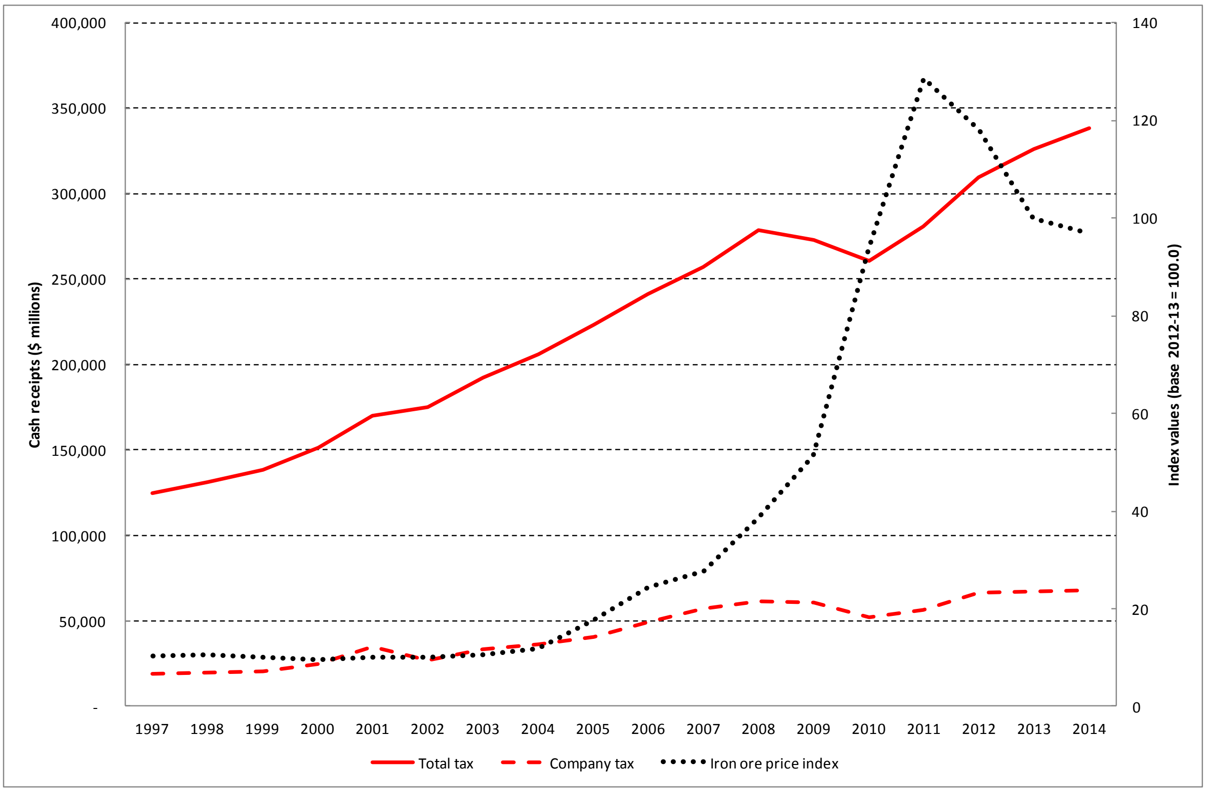
[32] Sinclair Davidson, 2005, *Personal Income Tax in New Zealand: Who Pays and is Progressive Taxation Justified?*, New Zealand Business Roundtable, p. 2.

Contrary to the oft-cited claims that Australia is afflicted by a 'crisis of the tax state,' general government revenues have continued to increase, certainly in trend terms, and in spite of more sluggish economic conditions and, more recently, more subdued commodity prices.

Figure 6 compares changes in taxation receipts against an index of iron ore prices, illustrating in more recent years that tax collections have remained resilient to recent reductions in prices received for Australia's most important commodity export.

Figure 6: Commonwealth government taxation receipts and iron ore price index



Source: Monthly iron ore price (US dollars per dry metric tonne), Index Mundi, http://www.indexmundi.com/commodities/?commodity=iron-ore&months=240; Mid-Year Economic and Fiscal Outlook 2014-15, Appendix D.

Despite this fact, over the last few years successive governments have continually alleged that the commonwealth indeed faces a revenue problem. However, when facing some shortfall in revenues, governments can either:

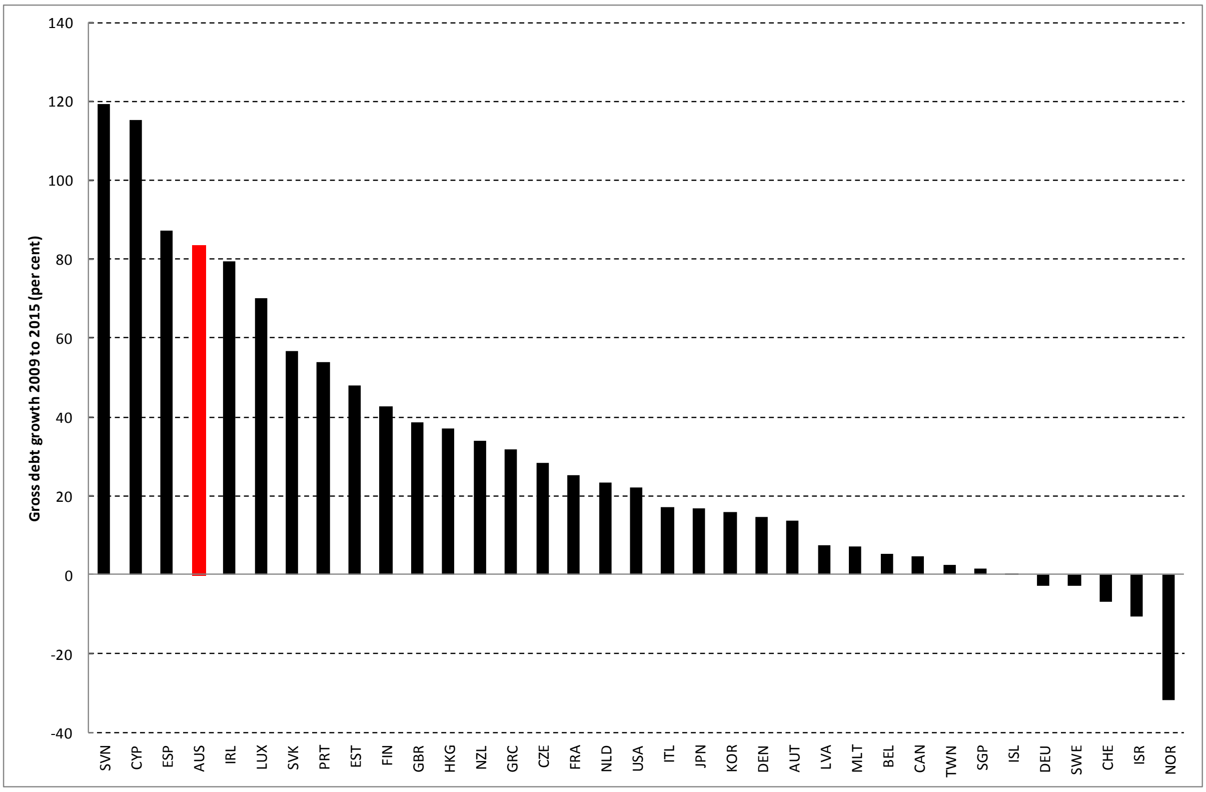
- reduce their level of expenditure, to ensure that aggregate spending is maintained at levels commensurate with actual revenues
- issue bonds and other forms of financial security to finance their deficit spending, thus smoothing their expenditure profile over time.

Instead of reduce spending to ensure a balanced budget, the former Rudd government rapidly increased public sector indebtedness to cover for revenue collection growth not meeting initial expectations. This fiscal strategy was confirmed as early as February 2009:

'The overwhelming majority of the increase in net debt is due to the collapse in tax receipts resulting from the deteriorating global economic outlook and the unwinding of the commodities boom.'[33]

It is estimated that during this financial year commonwealth general government gross debt will be in the order of $370 billion, or 23 per cent of GDP,[34] and this does not include the burgeoning debt commitments of commonwealth government enterprises. Indeed, changes in the indebtedness of the commonwealth has made a major contribution to the growth in overall gross debt of the Australian general government sector, which has risen at among one of the fastest rates in the developed world (Figure 7).

Figure 7: General government gross debt growth, 2009 to 2015



Source: International Monetary Fund, World Economic Outlook Database, October 2014.

The strong growth in public sector indebtedness in Australia has potentially significant implications for long run taxation policy, given that (absent spending reductions, or sales revenues associated with privatisations, to help defray the costs of borrowing) debt represents deferred taxation which must be paid by future generations of workers, consumers, and investors.

[33] Commonwealth of Australia, 2009, *Updated Economic and Fiscal Outlook*, Statement by Hon Wayne Swan and Hon Lindsay Tanner, Canberra, p. 45.

[34] Commonwealth of Australia, 2014, *Mid-Year Economic and Fiscal Outlook 2014-15*, Appendix D: Historical Australian Government Data.

Within this, the composition of spending which is financed by debt has implications for the productive performance of the economy in the longer term. In general terms debt-financed spending on efficient capital infrastructure more likely to contribute to 'growth dividend' revenue collections by government, without the need for discretionary taxation increases, relative to debt-financed expenditures on recurrent consumption or redistributive transfers.

3.3 Myth: Tax avoidance is rife, and it is intrinsically undesirable[35]

In recent months there have been campaigns prosecuted by certain Australian media outlets and non-government organisations seeking to expose the 'tax minimisation' practices of large multinational firms, particularly firms operating in the computing and communications industries. Specifically, many of these campaigns pronounce that major companies are paying much less in corporate taxation than they are obligated to, and that the Australian taxation base is being eroded by virtue of the global mobility of capital.

A prominent recent example of this was the report jointly prepared by the Tax Justice Network and United Voice, entitled *Who Pays for Our Common Wealth? Tax Practices of the ASX 200*. This report outlined the following allegations about the operation of the Australian corporate income tax system:

- The average effective tax rate paid by members of the ASX 200 was 23 per cent.
- If the ASX 200 members were paying tax at the statutory rate (30 per cent), an additional $8.4 billion could be raised in company tax revenue.
- Nearly one-third of ASX 200 members have effective tax rates of 10 per cent or less.
- About 57 per cent of the ASX 200 membership have subsidiaries located in so-called 'secrecy' jurisdictions.[36]

This kind of analysis, replete in mainstream media accounts of corporate tax avoidance, ignores some fundamental features of the company tax regime in practice. These includes the variations between accounting and taxable profits, used to inform (net) taxable income, arising from the treatment of such activities as research and development, depreciation, losses incurred in previous periods, as well as the tax treatment of profit contingent upon which countries in which those profits were earned.

There is no intrinsic reason to conceive that accounting profit and taxable profit should be equal, as confirmed by Australian Tax Office standards which calculates company net tax as shown in Table 2.

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[35] This section is largely drawn, unless otherwise stated, from Barry Bracewell-Milnes, 1980, *The Economics of International Tax Avoidance: Political Power versus Economic Law*, Kluwer, Boston; Sinclair Davidson and Chris Berg, 2015, Submission to Senate Inquiry into Corporate Tax Avoidance, Institute of Public Affairs; and Mikayla Novak, 2014, 'Cost-benefit analysis puts corporate tax avoidance in perspective', The Canberra Times, 15 November.

[36] Tax Justice Network Australia, 2014, Who Pays for Our Common Wealth? Tax Practices of the ASX 200, http://www.unitedvoice.org.au/news/who-pays-our-common-wealth.

Table 2: Calculation of company net tax liability

	Total income
less	Total expenses
equals	**Total Profit or Loss**
Add or Subtract	Reconciliation items
equals	**Taxable income**
Multiply by	Company tax rate (30 per cent)
add	R&D recoupment tax
equals	**Gross Tax**
Subtract	Non-refundable tax offsets and franking deficit tax offset
equals	**Net Tax**

Source: Australian Taxation Office.

All entities that are liable for Australian company tax pay 30 per cent of their *taxable* income. When reconstructing that calculation from annual financial statements, analysts that simply divide Net Tax by Total Profit, as did the Tax Justice Network, will almost certainly find an effective tax rate that is very different from the statutory 30 per cent rate. As indicated by Tran:

> '[t]he major causes of the book-tax income gap are attributable to deliberate government policies and different objectives of the tax and the financial reporting systems. Tax incentives, dividend rebates, concessional treatment of capital gains, and non-deductibles are all the results of government policy decisions. There are good economic, political, and administrative reasons for these policies.'[37]

As will be discussed later, the corporate income tax is overwhelmingly paid by larger firms in Australia. It is popularly claimed that firm size is an important determinant of tax planning activity, with larger firms bearing greater resources to more aggressively engage in tax minimisation and, similarly, influence political processes in their favour.

However, it is also conceivable, as Davidson and Heaney have suggested, that larger firms would be subjected to greater scrutiny from taxation authorities.[38] This implies that companies of a greater size are less likely to engage in tax minimisation, thus contributing to higher effective rates of taxation paid on their part.

Generally speaking, the increasingly emotive nature of this tax debate has, regrettably, blurred the important distinctions between tax avoidance and tax evasion:

- Tax avoidance is the act of reducing tax liabilities in accordance with the law. The Australian tax system actively encourages avoidance by providing for deductions across an enormous range of activities, and with many different purposes. Many deductions, for example, relate to the ability

[37] Alfred V Tran, 1998, 'Causes of the Book-Tax Income Gap', Australian Tax Forum 14: 253-286, p. 283.
[38] Sinclair Davidson and Richard Heaney, 2012, 'Effective Tax Rates and the Political Cost Hypothesis: A Re-Evaluation of Australian Evidence', *Australian Tax Forum* 27: 79-105.

to pay principle. In addition, some taxes are specifically designed to be avoided; for example, consumers are supposed to avoid paying 'sin taxes' by consuming less of the product being taxed.

- Tax evasion is the unlawful failure to pay tax as required by law, through acts of deceit, subterfuge or concealment (for example, under-reporting or omitting income, or deliberately making false entries in tax records). If companies are evading their tax obligations in contravention of the law, Australian laws should be policed to prevent such activities.

It is stressed that tax avoidance is completely lawful and, in most instances, is the result of deliberate policy decisions by government and legislatures. Further, there is nothing inherently wrong with an individual or company structuring their affairs to pay the minimum legal amount of tax. In many cases the system has been deliberately designed to encourage that, for various social and economic objectives.

With a relatively heavy, and indeed rising, tax burden attributed to the imposition of high and uncompetitive corporate tax rates, there is little evidence to suggest the Australian company tax base is eroding. Further, with the great degree of scrutiny toward large multinationals there is also scant evidence indicating that such firms are avoiding their lawful tax obligations.

Another point that should be raised is that the coverage given to recent tax avoidance matters, or allegations of them taking place, has not been presented from an economic perspective weighing up the relative costs and benefits of avoidance, to the avoiding taxpayer, other taxpayers, and governments.

It could be presumed that those engaging in tax avoidance acts construe such activities as providing a net benefit to them, even if it takes some effort to avoid taxes, although in the case of large firms there seems a growing risk of a loss of reputation resulting from such activity.

The assertion is often made that corporate tax avoidance costs the non-avoiding taxpayer through higher tax burdens, but other factors must be considered when rendering a final judgment.

For example, the taxes avoided by the firm are funds that could be used, instead, to invest and expand business operations, representing gains to shareholders and those situated within the broader economy.

In high-taxing countries vulnerable to avoidance activities there may be some deprivation of revenue experienced by government, but that may present a secondary benefit in terms of fewer subsequent expenditures toward unproductive (or at least relatively less productive) public sector undertakings.

Further, any costs of tax avoidance borne by high-tax countries could be offset, at least in part, by gains in tax revenue and general economic activity within low-taxing countries, the benefits of which could spill back over into high-tax countries in the form of, say, more goods and services trades.

Amidst high company tax rates in the developed world, and a lack of effective efforts by multilateral organisations to reduce fiscal barriers to international development, international tax avoidance can reduce tax-induced distortions to productive economic activity and yield some benefits analogous to a move towards free trade, even if avoidance does come at the cost of potential tax revenue received by governments.

Finally, policymakers should contemplate the fact that high-tax countries present just as strong a motive for international tax avoidance, as the existence of low-tax countries (including tax havens). As will be discussed later in this submission, a key to reducing the extent of tax avoidance, or even more forms of evasion, is for Australia to unilaterally lower its company tax burden.

3.4 Myth: Tax concessions are harmful, and are depriving governments of significant revenues

There has also been a growing chorus among some commentators and interest groups calling for the scaling back of tax concessions, exemptions and rebates, as a seemingly ready means through which governments can reduce tax mobility and claw back supposedly foregone revenues. A representative view of these concerns is exemplified in the following statement by a spokesperson for a government-funded think tank:

> ‘We are struggling to find good reasons to keep these policies (negative gearing, capital gains tax concessions, superannuation concessions, dividend imputation). They are resulting in a loss of money, primarily benefiting the wealthy, and are counterproductive from a policy perspective.’[39]

However there appears a significant degree of misunderstanding about the nature and purposes of tax concessions from an applied policy perspective, heightening the risk that prospective future policies to dilute tax concessions would only undermine legitimate and productive economic activities.

It is often contended, from the standpoint of conventional taxation theories, that since taxation influences economic decisions to earn, invest, or to spend then tax distortions, in themselves, can shape decision making by market participants. Specifically, the suggestion is often made that, in the presence of taxation, the existence of concessions artificially redirects the flow of economic activities preferencing those subject to lower, or no, tax.

However, in a complex policy landscape characterised by multiple taxing points often operating at cross purposes, all situated within a broader field of entangled fiscal and regulatory interventions by government, it is often overlooked that tax concessions are maintained for distinctive and explicit policy objectives which deliver economic and social benefits. This sentiment was expressed by twentieth century liberal economist Ludwig von Mises: ‘What is a loophole? If the law does not punish a definite action or does not tax a definite thing, this is not a loophole. It is simply the law.’[40]

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[39] Quoted in Robert Carling, *Right or Rort? Dissecting Australia’s Tax Concessions*, Centre for Independent Studies, Research Report No. 2, p. 4.

[40] Ludwig von Mises, 1952, ‘The Role of Fiscal Policy’, in Aaron Director, ed., *Defense, Controls, and Inflation*, University of Chicago Press, Chicago, p. 115-116.

Arguably the most popular target for contemporary criticism is that tax concessions applicable to long term superannuation savings are excessive in fiscal terms, and they they disproportionately favour wealthier individuals, compared with those on lower incomes and those who take more extensive spells from the workforce.

Since the introduction of compulsory superannuation by the Keating government in 1992, the commonwealth has forced people to forgo higher salaries for the sake of contributing to super funds that cannot be accessed until later in life.

Given the inconveniences of this financial policy paternalism, not to mention endless superannuation policy tinkering, tax biases against long-run savings patterns, and the existence of welfare programs, there are disincentives for individuals to save even more for retirement, which justifies at least some sort of concessional treatment for super.[41]

It has been claimed in some quarters the flat tax concessional tax structure applied to superannuation might relatively advantage the wealthy, but overall Australia has a very highly progressive tax system and, despite intense political pressures to loosen targeting, a fairly robust means-testing regime for accessing social services.

The top one per cent of income earners, for instance, pay nearly 20 per cent of all income tax revenue, thus they will receive most of the benefits of the concession; this is a natural consequence of progressive income tax and the welfare system.[42]

Australia is one of a few countries which maintains a full 'dividend imputation' system applicable to corporate income taxes, in which a tax credit is provided to shareholders for the company income tax already paid on the dividends paid to them. Far from representing a 'subsidy' to shareholders, the dividend imputation arrangement removes effectively the double taxation of dividends therefore reducing the biases faced by domestic investors to invest in domestic equities.[43]

Indeed, prior to this arrangement the commonwealth government would tax both the company and the shareholder who received the dividend. Since the introduction of dividend imputation, shareholders receiving a dividend are taxed the difference between the corporate rate of 30 per cent and their own marginal personal income tax rate.

Another arrangement subjected to recent intense criticism concerns the maintenance of income tax-deductibility arrangements for those who incur financial losses on investments financed with a high level of debt). Under this 'negative gearing' arrangement, if income derived from a certain investment (say, an investment property provided for residential rent) is less than the interest

[41] Mikayla Novak, 2015, 'Super reforms: Fact and fiction' The Canberra Times, 7 March.
[42] Robert Carling, 2015, op. cit., p. 14.
[43] Ibid., p. 13.

payable on the loan then the shortfall can be deducted from income from other sources (for example, salary income).

It is claimed by some that negative gearing represents a tax concession for wealthy property investors, who financially prey upon the need for housing tenants to enjoy shelter, but deductibility of losses against other forms of income is an inherent structural feature of income taxation systems, in which expenses in efforts to acquire an income are deducted, and cannot appropriately be construed as a concession.

By and large the maintenance of exemptions from tax liability had been enshrined into the GST regime were made following careful policy deliberations, rather than base political expediency as often portrayed by the advocates of a higher Australian tax burden. These are described in further detail in Box 3.

Box 3: Rejogging forgotten memories: The rationale for selected GST exemptions[44]

Supporters of a heavier GST burden claim the case of the fresh food exemption, brought about as a result of political negotiations between the Howard government and Australian Democrats party in the Senate, as representative of the nature of the GST policy design in its entirety. Those sorts of assertions ignore the thoughtful policy planning, taking due account of various complexities, in the formulation of the GST arrangements:

- child care: the provision of child care often includes an educational component for the benefit of enrolled children in recognised facilities (e.g., long day care, short care, family day care, etc.), and education in itself is GST-free. There is also significant government subsidisation of the child care sector, including in the form of payments to parents.
- health and medical services: the health care sector is subject to significant government intervention, in the form of subsidisation and regulation. Many health services are provided to customers free of charge, but applying GST would disadvantage private and not-for-profit health providers and medical services.
- education: government school education is provided free of charge, and significant assistance is given to non-government schools and tertiary and vocational educational providers. Applying the GST to education would discriminate against non-governmental providers of educational services.
- financial services: the structure and global reach of many financial services makes it difficult to subject all financial transactions to the GST. In particular, it is difficult to quantify for taxation purposes the value added associated with each step of transactional processes. It was determined that some financial services would be input taxed, in line with international practices.
- water and sewerage: fees and charges imposed for a number of services provided by government-owned entities are not commercial transactions by nature, for example water and sewerage charges. It was determined that the non-commercial activities of government would be outside the scope of the GST.

By way of a final example, the commonwealth government maintains a fuel tax credits scheme in which eligible businesses can claim a rebate (in full or in part) of the petroleum and diesel fuel excise they have already paid.

As explained by Sinclair Davidson, in the late 1950s an excise on diesel was introduced ensuring that operators of diesel vehicles contributed to the maintenance of roads. Acknowledging the existence of off-road users of diesel the government exempted all off-road diesel fuel users from the excise, with this initial exemption later reconfigured into a rebate scheme.[45] Outlining the rationale for the fuel tax rebate, the Commonwealth Treasury has previously stated that:

'Fuel tax credits are ... not a subsidy to businesses but, consistent with Government policy, it is a mechanism to ensure that, where possible, the incidence of fuel tax does not add to business costs but is levied on final consumers.'[46]

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[44] Commonwealth Department of the Treasury, 1998, *Tax Reform: Not A New Tax, A New Tax System, The Howard Government's Plan for A New Tax System*, Circulated by Hon Peter Costello, Canberra; Peter Hendy MP, 2015, 'Federal-state relations reform shouldn't be about raising tax levels', *IPA Review* 67 (1).

[45] Sinclair Davidson, 2012, *Mining Taxes and Subsidies: Official Evidence*, Minerals Council of Australia, Background Paper.

[46] Ibid., p. 19.

A powerful lightning rod for often misplaced claims that tax concessions are inappropriate stems from annual reporting of the magnitude of so-called 'tax expenditures' by Treasury.[47] The annual *Tax Expenditures Statement* identifies 297 such items, which are typically grossed up indiscriminately by commentators to propagate the notion that there are significant amounts of revenue foregone which could be easily clawed back by government, for instant revenue gain.[48]

The tax expenditure figures presented are subject to a variety of caveats, as identified even by Treasury itself:

> 'Tax expenditure estimates vary in reliability depending on the quality, detail and frequency of the underlying data; the extent to which calculations are based on assumptions; the sensitivity of the results to those assumptions and whether future taxpayer behaviour is reasonably predictable. In addition, unexpected changes in economic conditions or volatility in markets may influence the future value of tax expenditures, thus affecting the reliability of tax expenditures projections.'[49]

It is notable that only four of the 297 tax expenditure items have been rated by Treasury as 'high' in estimation reliability, whereas 48 items have been classed as being of 'low' or 'very low' reliability.[50]

A key aspect of the difficulty in estimating tax expenditures with any great degree of reliability is that such efforts involve judgments as to what a counterfactual ideal, or 'benchmark,' tax regime, which is then used to compare against actual taxing practices. Treasury broadly describe a benchmark tax regime as 'a standard taxation treatment that applies to similar taxpayers or types of activity.' Naturally, the choice of such benchmarks 'may be contentious and benchmarks may vary over time.'[51]

In addition to doubts raised over the identification of an idealised tax benchmark, Treasury adopts different approaches to the estimation of tax expenditures which, in effect, yield significantly different estimated results.[52] Under the 'revenue foregone' approach, the size of a tax expenditure reflects the difference between existing tax and the benchmark tax assuming no behavioural change. Alternatively, the 'revenue gain' approach involves making assumptions of behavioural change in response to abolishing the tax expenditure.

The debate over the appropriateness of tax concessions, exemptions and rebates is dominated by approaches to taxation theory, including 'optimal tax' conceptions, which suggest that reducing the

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[47] Commonwealth Treasury, 2015, *Tax Expenditures Statement 2014*, Commonwealth of Australia, Canberra.

[48] For example, Dale Boccabella, 2015, 'To cut fairly, you must look at tax expenditures', ABC Drum, http://www.abc.net.au/news/2014-03-12/boccabella-to-cut-fairly-you-must-look-at-tax-expenditures/5315620.

[49] Commonwealth Treasury, op. cit., p. 127.

[50] The estimation reliability of a further 18 tax expenditure items have been rated by Treasury as 'medium-low.'

[51] Commonwealth Treasury, op. cit., p. 3.

[52] Judith Sloan, 2013, 'Tax breaks a matter of opinion', The Australian, 12 February; Sinclair Davidson, 2014, 'Getting tax expenditure right is a game of hypotheticals', The Conversation, 13 March.

extent to which exemptions apply through the taxation system would represent a more efficient, if not equitable, treatment of taxpayers. This is because the application of taxation to formerly non-taxed activities suppresses the inclination of certain taxpayers to shift from taxable to non-taxable options.

However, this is by no means the only view of taxation. In their work *The Power to Tax*, Brennan and Buchanan desired the desirability of non-comprehensive tax bases as a means by which the revenue raising proclivities of governments can be restrained. To quote them at length:

'Our analysis provides support for the *noncomprehensiveness* of the allowable tax base. To the extent that activities which yield value to taxpayers remain outside the allowable reaches of the fiscal authority, the appetites of Leviathan are checked. Persons may resort to nontaxable options, and in the knowledge that they will do so, government necessarily curbs its revenue extraction. ... In the discussion of proposed tax-base changes, the attitudes of the traditional normative tax theorist and the members of the taxpaying public differ more sharply than anywhere else. Our analysis is helpful in "explaining" the attitudes of the taxpayers. For example, they are likely to react negatively and emphatically to proposals to move toward taxation on the basis of full income, as, for example, by including the imputed rental values of owned residences in the base for personal income tax. The normative tax theorist, who advocates such inclusion from reasoning based on equi-yield comparisons, responds to taxpayers by arguing that overall rates of tax may be lowered simultaneously with the widening of the base. But the taxpayers may be implicitly, but correctly, rejecting the equal yield postulate, in their predictions that *any* widening of the tax base must open up further taxing possibilities for a revenue-seeking government.'[53]

While the principle of non-comprehensiveness of the tax base is consistent with the need for the government to acquire the sufficiently minimal amount of revenue needed to defray the costs of their essential functions, the conscious avoidance of broadly based taxes stands sharply in contrast to tax orthodoxy which, in turn, implies a significantly continuous expansion of the public sector.

4 Personal income taxation issues

4.1 Australia is far too reliant upon income taxation for its revenue haul

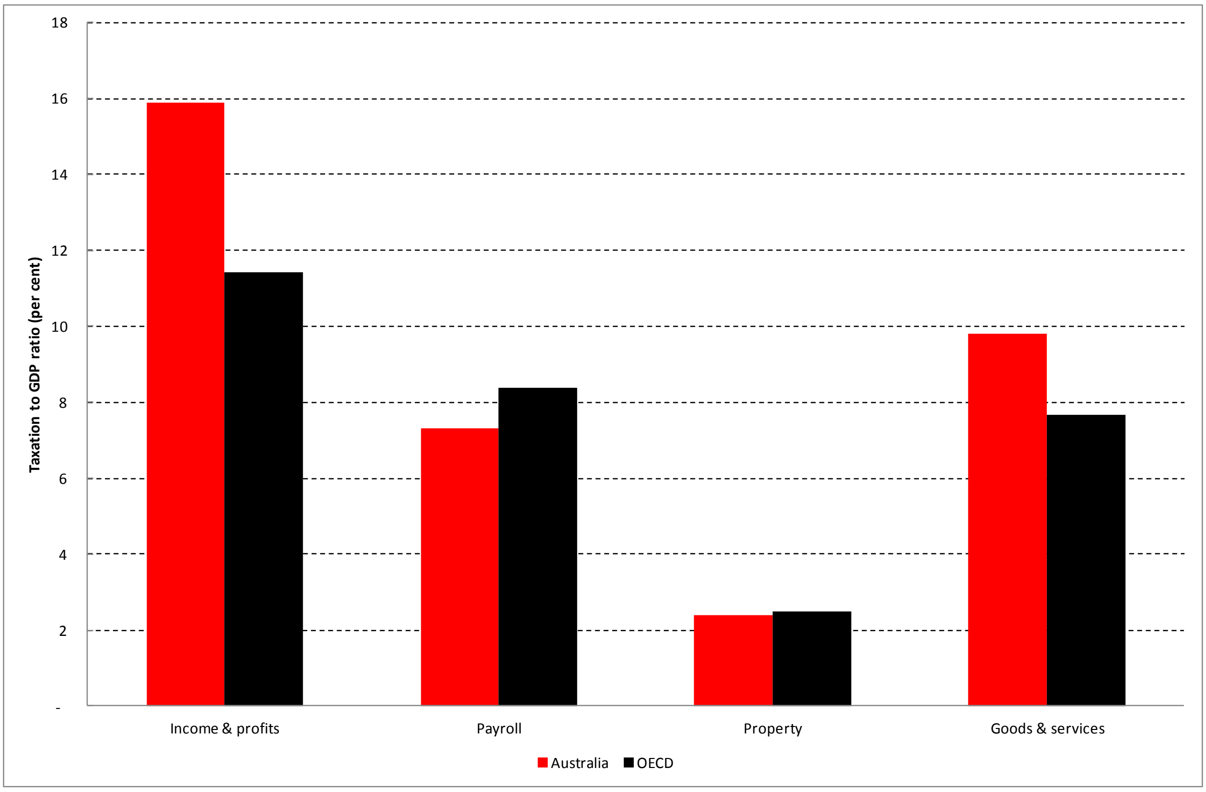
When assessing Australia's tax burden in an internationally comparative perspective, it is also important to consider national variations in the taxation structure. The more intensive use of some tax bases, rather than others, can have an important influence on production and consumption decisions made domestically, as well as affect the mobility of capital and labour.

Using official OECD statistics to compare the composition of taxes internationally is complicated by the existence of social security contributions. In addition to the issues surrounding the treatment of Australia's compulsory superannuation scheme, the fact is that the social security contributions quantified by the OECD are levied on either an income or payroll tax base.

[53] Geoffrey Brennan and James M. Buchanan, [1980] 2000, *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, Liberty Fund, Indianapolis, p. 59-60.

These bases are already separately identified in the relevant OECD published statistics, so an approach is taken here to apportion social security contributions back to their underlying income tax or payroll tax base.[54] These adjustments are reflected in Figure 8, comparing the structure of Australian (including compulsory superannuation, workers' compensation, and health insurance) and OECD average (weighted on a GDP basis) taxes.

Figure 8: Composition of taxation, Australia and OECD (GDP-weighted figures), 2012



Australia compulsory superannuation and workers' compensation added to payroll tax base estimate; health insurance mandate added to goods and services tax base estimate.
Source: OECD, *Revenue Statistics 1965-2013*.

What is most notable about the Australian taxation regime is its relatively strong reliance upon income taxes, being about 40 per cent greater than the GDP-weighted average of OECD members. With the inclusion of health insurance into the Australian goods and services taxing base, and as a result of the imposition of a GST since 2000, the Australian tax-to-GDP ratio for goods and services is also estimated as being greater than the OECD average.

4.2 Our top income tax rate is too high compared with most other countries

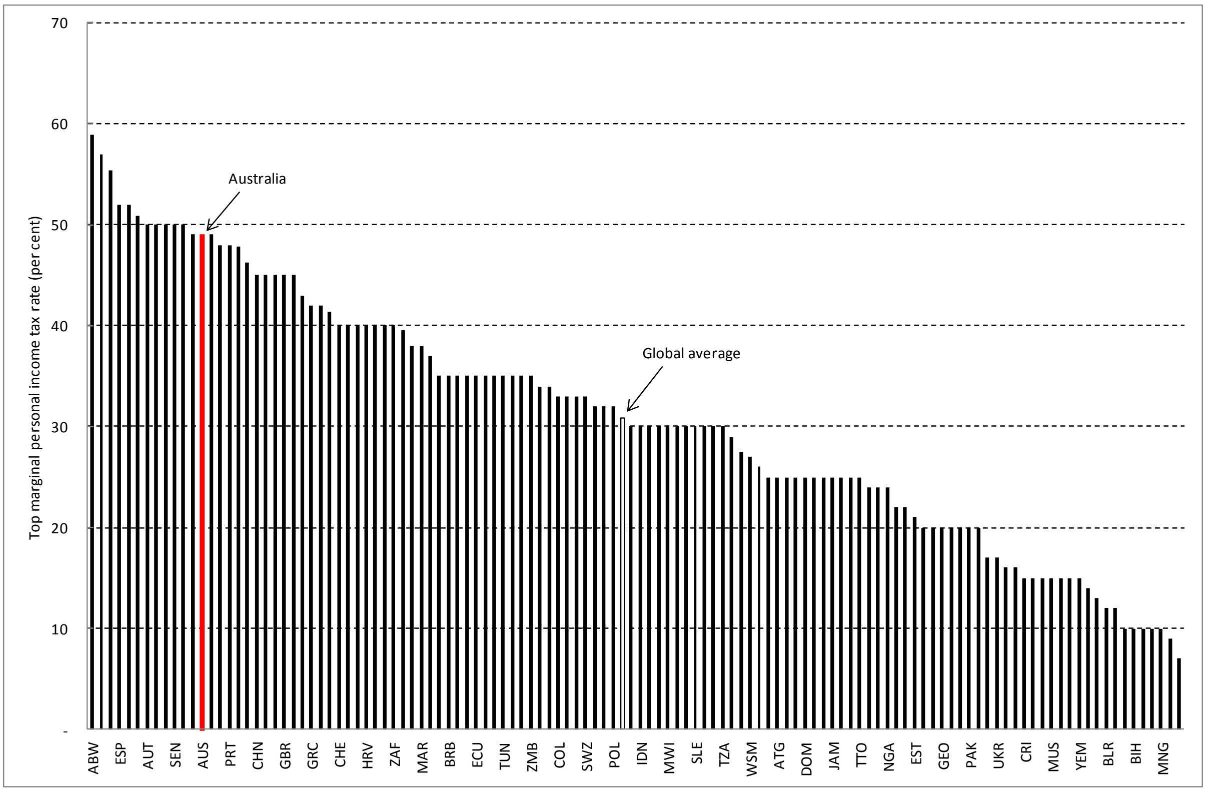
[54] The methodology employed to incorporate social security contributions to an income or payroll tax base is outlined in Peter Burn, 2004, *How Highly Taxed Are We? The Level and Composition of Taxation in Australia and the OECD*, Centre for Independent Studies, Policy Monograph No. 67.

An international comparison of top marginal personal income tax rates reveals that, with a rate of 49 per cent for those earning more than $180,000,[55] Australia is situated amongst the highest income-taxing countries in the world for higher income earners in 2013 (Figure 9).

Australia is only behind Aruba (58.95 per cent), Sweden (57 per cent), Denmark (55.38 per cent), Spain and Netherlands (52 per cent), Japan (50.84 per cent), and Austria, Belgium, Israel, Senegal and Slovenia (50 per cent) in the global club of high income taxers. It shares the 49 per cent top marginal tax rate with Netherlands Antilles and Finland.

By contrast the (unweighted) global average for the top marginal tax rate is 30.9 per cent, and some of our East Asian competitors do not impose top marginal tax rates higher than 15-20 per cent.

Figure 9: Top marginal income tax rates, global, 2013



Australian top marginal rate includes Medicare Levy, NDIS Levy, and Temporary Budget Repair Levy.
Source: KPMG, 'Individual income tax rates table', http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/individual-income-tax-rates-table.aspx.

It is true that Australian top personal income tax rates had fallen considerably during the 1980s, in efforts to encourage greater domestic labour supply and in response to increasing global tax competition from other developed countries such as the United Kingdom and United States.[56]

[55] Excluding Medicare Levy Surcharge (of up to 1.5 per cent) for those high-income earners who elect not to purchase health insurance policies.
[56] Chris R Edwards and Daniel Mitchell, 2008, *Global Tax Revolution: The Rise of Tax Competition and the Battle to Defend It*, Cato Institute, Washington DC.

However, subsequent reductions to the top marginal rate have been frustrated, in no small part, by initiatives by successive governments to impose additional income taxes, masquerading as 'levies,' upon higher income earners.

Table 3 provides a chronology of selected levies added to the baseline top marginal income tax rate.

Table 3: Chronology of selected Australian income tax 'levies'

Levy title	Commencement date	Levy description
Medicare levy	1984	Levy of 1.5 per cent on personal taxable income to help fund Medicare. Originally 1 per cent.
Gun buy-back levy	1996	Additional 0.2 per cent on Medicare levy for one year to fund buy-back of guns from the public.
East Timor levy	2000	Additional levy (rates of 0.5 per cent and 1 per cent) to partly fund Australian defence operations in East Timor.
Flood levy	2011	A progressive levy (rates of 0.5 per cent and 1 per cent) to help rebuild essential infrastructure after flood and cyclone damage.
NDIS levy	2014	A levy of 0.5 per cent to help fund the National Disability Insurance Scheme.
Deficit levy	2014	A 2 per cent levy to assist with the repair of Australia's finances.

Source: Australian Taxation Office website; 'Australia's previous levies', The Australian, 1 May 2013.

There is ample anecdotal evidence, at least, that some young skilled labourers and entrepreneurs are deterred from either staying in Australia, or migrating to this country, because of our relatively higher income tax burdens.

A 2005 Senate inquiry into the nature and causes of Australian emigration received 'a substantial amount of submissions' about income tax rates as an issue encouraging some people to leave Australia, or to prevent or delay repatriation.[57] Similar concerns have been raised in the context of other government inquiries, including a Productivity Commission inquiry into migration which cited high taxes as a potential deterrent to skilled migration.[58]

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[57] Parliament of Australia, 2005, *They still call Australia home: Inquiry into Australian expatriates*, Senate Legal and Constitutional References Committee, Commonwealth of Australia, Canberra.

[58] Productivity Commission, 2006, *Economic Impacts of Migration and Population Growth*, Final Report, Productivity Commission, Melbourne.

Less directly, surveys of emigrants by demographic researchers had shown that work-related factors dominate the reasons for people leaving Australia.[59] While tax was not explicitly distilled as a factor in the survey evidence it is not unreasonable to suggest that taxation factors, alongside the usual factors such as the availability of lucrative economic opportunities, may play some role in the decisions that individuals make to work overseas.

The broader proposition that taxes affect migration decisions is supported by a growing empirical literature. For example, Claus, Claus and Dörsam found that taxes imposed by ASEAN and APEC economies (including Australia) had some impact on migration decisions, with more educated migrants more sensitive to taxation.[60] There are also a number of studies, outside of Australia, which show the migrants are attracted to low-taxing environments in Europe, North America, and elsewhere.[61]

4.3 The income tax burden is being shouldered by too few

The high top marginal rate in Australia is a function of the high degree of progressivity built into the personal income tax structure. Progression has remained a longstanding feature of the income tax system, to ensure that higher income earners with a capacity to pay more tax do so.

Numerous measures could be used to quantify the degree of progressivity inherent in a given income tax system. The measure chosen here compares the progressivity of income tax for a single individual, with no dependents, on 67 and 167 per cent of average wages (Figure 10). A higher number denotes greater progressivity, with the Australian income tax ranked above the (unweighted) OECD average in terms of degree of tax progressiveness.

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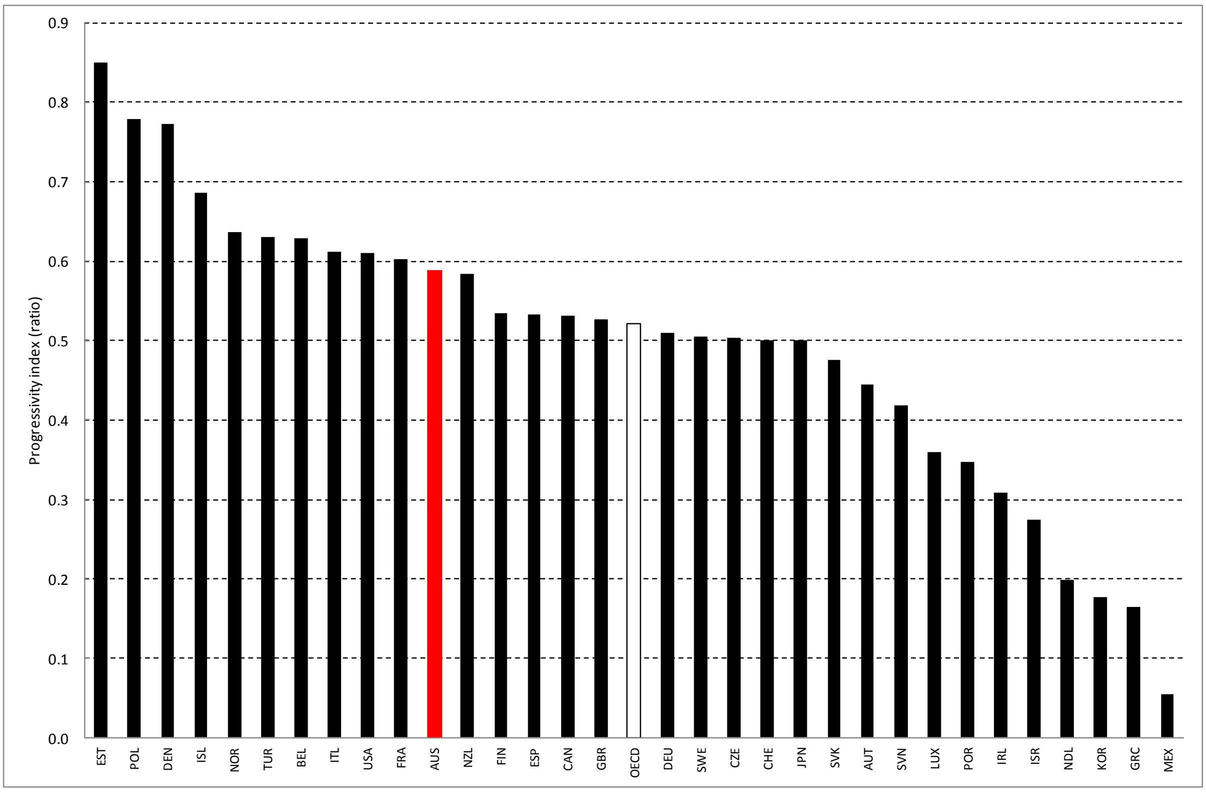
[59] Graeme Hugo, Dianne Rudd and Kevin Harris, 2003, *Australia's Diaspora: Its Size, Nature and Policy Implications*, Committee for Economic Development of Australia, Information Paper No. 80.

[60] Edda Claus, Iris Claus and Michael Dörsam, 2010, 'The effects of taxation on migration: Some evidence for the ASEAN and APEC economies', Australian National University, Centre for Applied Macroeconomic Analysis, Working Paper 36/2010.

[61] Richard Vedder, 2001, 'Taxes and Economic Growth', The Taxpayers Network; Emmanuel Saez, Joel Slemrod and Seth H Giertz, 2012, 'The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review', *Journal of Economic Literature* 50 (1): 3-50; Henrik Jacobsen Kleven, Camille Landais and Emmanuel Saez, 2013, 'Taxation and International Migration of Superstars: Evidence from the European Football Market', *American Economic Review* 103 (5): 1892-1924.

Figure 10: Income tax progressivity, OECD, 2013



Excluding Chile and Hungary, estimated to have tax progressivity scores of zero and one, respectively.
Source: OECD, *Taxing Wages 2012-13*.

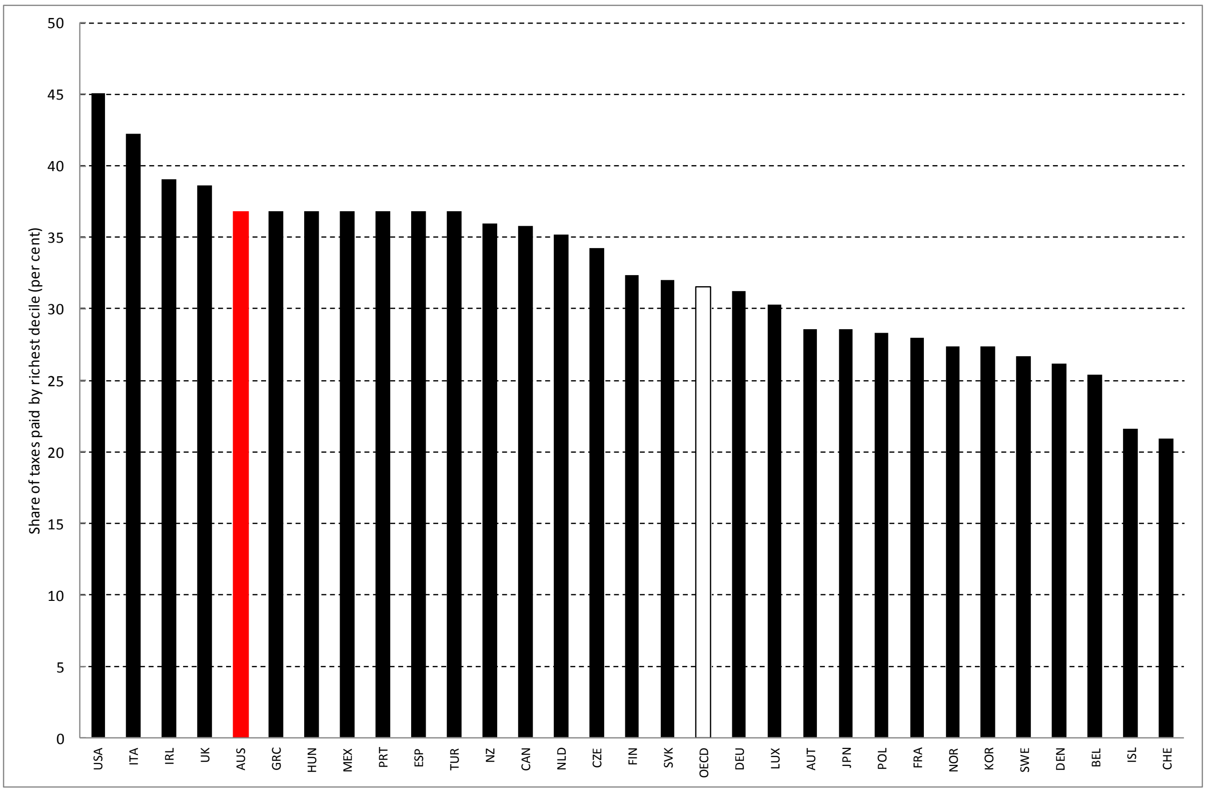
The available evidence suggests that arguably too few Australian taxpayers, at the higher ends of the income spectrum, are paying the burden of progressive direct taxes, and for income taxation more specifically, as a consequence of tax progressivity.

A few years ago, the OECD released a study on income inequality for member countries which revealed the share of direct taxes (mainly income taxes and social security contributions)[62] paid by those in the top ten per cent of the income distribution (Figure 11).

Using 2005 data the OECD found that Australia was in the top five of advanced countries imposing the heaviest tax burden on the richest decile of income earners - it was estimated that top ten income earners accounted for about 37 per cent of the total direct taxes collected in Australia, greater than the OECD average of 32 per cent.

[62] The information presented here does not include Australian compulsory superannuation payments made by employers, which has been argued to effectively represent a form of direct taxation. See Mikayla Novak, 2014, *The Australia 'low taxing country' myth*, Institute of Public Affairs, Occasional Paper.

Figure 11: Direct taxation paid by top ten per cent of income distribution, OECD, 2005



Source: OECD, *Growing Unequal? Income Distribution and Poverty in OECD Countries*.

Australian economist Sinclair Davidson has undertaken more extensive analysis of the income tax shares paid by various income brackets. Drawing from Australian Taxation Office data, Davidson illustrates that the top quartile of taxpayers paid a substantial, and growing, share of net income tax (i.e., income tax less deductions) liabilities since the second half of the 1990s. The respective shares paid by the bottom 25 per cent, and the middle 50 per cent, have each fallen (Figure 12).

Figure 12: Net income taxation paid by various income cohorts, Australia

Source: Australian Taxation Office, Taxation Statistics; Sinclair Davidson, IPA.

The extent of redistribution is magnified by the levels of transfer payments and services from taxpayers to non-taxpayers, and from certain classes of taxpayers to others who pay tax.

Recent analysis suggests that redistribution resulting from the interaction of tax and transfer systems is widely prevalent, with half of all Australian families receiving more in welfare subsidies than pay in income tax.[63]

On average, it has been estimated families will pay $12,935 in income tax this year, but receive $9,515 in benefits (including pensions, family benefits, jobless support, and childcare support). For couples with children, one in four families pay no net tax. For single parent families it is estimated that 85 per cent contribute no tax once welfare benefits are deducted.

Supporting this analysis, the Australian Bureau of Statistics occasionally publishes data on the distribution of income, benefits and taxes by income bracket (Table 4). According to the latest analysis, for 2009-10, the bottom 20 per cent of households received cash transfers and social services (e.g., education and health) valued at $890 but paid relatively miniscule amounts of income tax. The highest 20 per cent paid a significant amount of taxes on average (including $756 per week for income tax), but received far less in benefits from government.

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[63] Jessica Irvine, 2014, 'Half of families pay no net tax is welfare benefits deducted, new figures reveal', http://www.news.com.au/finance/money/half-of-families-pay-no-net-tax-if-welfare-benefits-deducted-new-figures-reveal/story-e6frfmci-1226910739573.

Table 4: Distribution of income, benefits and taxes, 2009-10, average weekly value ($)

	Lowest	Second	Third	Fourth	Highest
Private income	170	810	1,447	2,090	3,650
Income tax	1	58	167	317	756
Production taxes	105	149	181	216	273
Total taxes	106	207	348	533	1,029
Social assistance benefits in cash	435	251	103	35	15
Social transfers in kind	455	435	359	292	234
Total benefits	890	686	462	327	249
Net benefits (benefits minus taxes)	784	478	114	-206	-780

Equivalised private household income quintiles.

Source: Australian Bureau of Statistics, Government Benefits, Taxes, and Household Income, Australia 2009-10, cat. no. 6537.0.

Those within the middle quintile of the income distribution also receive more in weekly benefits than they pay in taxes, although not by a substantial amount, which implies the incidence of wasteful 'fiscal churn' experienced by the middle class. In effect, many households, who are capable of sustaining themselves and their relatives, are paying taxes and receiving some, or even perhaps most, of that money back through welfare cash and services (less bureaucratic administration costs).

From a fiscal accountability perspective, these trends are most problematic. Putting aside the well-known phenomenon of 'fiscal illusion,' in which the operation of tax and expenditure systems are not accurately perceptible to taxpayers, if individuals and families are paying little (or even no) net taxes they may have a reduced sensitivity to the need for tax reforms which lower tax rates or reduce the extent of progressivity.

4.4 An incomprehensible tax structure also punishes the less well off

The statutory personal income tax rate published by the Australian Taxation Office does not provide the full picture as to how taxpayers of different income levels are impacted by the various elements of the tax system working together. In particular, some individuals who pay income tax effectively face tax rates above the published marginal rates in the tax scale.

In Australia, the Medicare levy is often reported at a flat rate of two per cent (from 1 July 2014, comprising Medicare levy of 1.5 per cent and NDIS levy of 0.5 per cent) but, in fact, has three different tax brackets. For people earning less than $20,542 (excluding those eligible for the seniors and pensioners tax offset, which is not considered here), there is no Medicare levy applied. For those earning between $20,542 and $24,167, the levy is phased in at a marginal rate of ten per cent. For those earning above $24,167, the marginal rate is two per cent.

A low income tax offset (LITO) is also applicable to all income taxpayers, providing a tax offset to those on lower income levels. In addition to the general tax-free threshold of $18,200 for all taxpayers, the LITO provides an offset of $445 for those earning $37,000 or less. Between $37,001 and $66,666, a withdrawal rate for LITO applies at 1.5 per cent for every dollar in excess of $37,000. For those earning $66,667 and above, the LITO does not apply.

To calculate the true marginal tax rates imposed upon all taxpayers, it is necessary to consider the impact of the Medicare levy and LITO upon the published income tax rate scales (Table 5).[64] In addition to the additional tax brackets (nine in total), the actual tax rate structure is anomalous in nature, with various increases and reductions as one progresses up the scale.

Table 5: Published versus actual personal income tax rate scale, 1 July 2014

Published personal income tax rate scale		**Actual personal income tax rate scale**	
Income ($)	**Tax rate (per cent)**	**Income ($)**	**Tax rate (per cent)**
0 - 18,200	0.00	0 - 18,200	0.00
18,201 - 37,000	19.00	18,201 - 20,541	19.00
		20,542 - 24,167	29.00
		24,168 - 37,000	20.50
37,001 - 80,000	32.50	37,001 - 66,667	35.50
		66,668 - 80,000	34.00
80,001 - 180,000	37.00	80,001 - 88,000	38.50
		88,001 - 179,999	38.50
180,000 -	45.00	180,000 -	49.00

Source: Australian Taxation Office.

The most significant problem associated with this illogical tax rate structure is that it, all else being equal, discourages labour market participation for those on lower incomes.[65]

For example, the minimum wage is presently $640.90 per week ($33,327 per annum) but somebody earning that amount is effectively paying 1.5 per cent more in taxation than stated in the published ATO tax rate scale. Minimum wage earners, or Newstart recipients, seeking to earn incomes above this wage level would incur an actual marginal tax rate of between 1.5 and four percentage points greater than those published.

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[64] The figures represented in this Table represent an update of calculations by economist John Humphreys. See John Humphreys, 2009, 'Revealing Australia's Real Income Tax Rates', Policy 25 (2): 32-34; Tim Andrews, 2012, 'Australia's REAL Income Tax Rates', https://www.taxpayers.org.au/australias-real-income-tax-rates/.

[65] The disincentive effects of high effective marginal tax rates may be compounded by the withdrawal rates of certain welfare payments.

Such arrangements, that risk punishing reward for effort, are clearly incompatible with the basic objectives, enunciated by policymakers in other contexts, of promoting additional labour supply in the face of long term demographic ageing.

4.5 The income tax system stealthily slugs taxpayers through bracket creep

Another longstanding problem with the Australian income taxation arrangements is the effects of rising wages and price inflation upon the average tax rate paid by individual taxpayers, otherwise known as 'bracket creep.' Since income tax thresholds are not (fully) adjusted for inflation through discretionary tax policy changes, bracket creep implies that a larger proportion of an individual's income in paid in income tax even if the purchasing power of their pre-tax income has not changed.[66]

Recent analysis has suggested that bracket creep will continue to redistribute even more income from the private to public sector.[67] It has been estimated that 1.8 million Australians could be forced into higher income tax brackets over the next four years as a result of bracket creep. This is expected to provide the commonwealth government with an extra $25 billion over the period.

More generally, in the absence of reforms to lower the income tax burden, the average income tax rate for average earners will increase from 23 per cent to 28 per cent over the next ten years. The bracket creep effects, as described here, operate in addition to other tax changes introduced by government, such as the deficit levy which means that people earning $200,000 will pay an extra $400 per annum in tax.

Disconcertingly, analysis of the 2015-16 federal Budget indicates that approximately 80 per cent of the increase in revenue outlined over the next four years will be generated directly from bracket creep effects.[68]

Genuine political attempts to eliminate bracket creep from the Australian income tax system, or to return the proceeds of bracket creep back to taxpayers, have been few and far between (Box 4).

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[66] Hielke Buddelmeyer, Peter Dawkins, John Freebairn and Guyonne Kalb, 'Bracket Creep, Effective Marginal Tax Rates and Alternative Tax Packages', https://melbourneinstitute.com/downloads/reports/webreport.pdf.

[67] Samantha Maiden, 2014, 'Tax cheat: Bracket creep on track to rob Australian workers of $25 billion', The Australian, 1 November.

[68] Jacob Greber, 2015, 'Federal Budget 2015: Bracket creep accounts for 80pc of revenue rise', The Australian Financial Review, 13 May.

Box 4: The Fraser tax indexation system: A policy innovation cut short[69]

In the 1975 election opposition leader Malcolm Fraser promised a reform of the personal income taxation system centred upon indexing the rate thresholds in accordance with changes in the consumer price index (CPI):

'[w]e will reduce the tax burden. We will put an end to Labor's tax rip off. ... We will fully index personal income tax for inflation over three years. This reform will reduce the pressures for excessive wage demands.'

The Fraser government introduced indexation in 1976 as part of its initial attraction to the idea of small government, but soon diluted it by discounting and then arbitrarily halving the CPI for indexation purposes. It was abandoned altogether after six years, during which time the cumulative indexation of thresholds was less than half the increase in the CPI.

A political rationalisation for the abandonment of tax indexation was provided in an editorial by The Sydney Morning Herald in early 1982:

'[t]ax indexation, particularly in its greatly watered down form of latter years, delivered modest weekly tax cuts, beginning on July 1 every year. The cuts were so small, and took effect so early in the government's three-year term, that taxpayers tended to have forgotten about them by the time the election arrived. The government reasoned that it would be much better to abandon indexation, let inflation work its magic on income-tax collections, and then, when the next election was firmly in view, announce a thumping tax cut.'

The subsequent lack of income tax indexation again afforded governments with greater fiscal discretion to either provide 'shock and awe' tax cuts that barely returned the proceeds of bracket creep, as was the case during the Howard years, or to claim windfall revenue gains as inflationary effects pushed the earnings of workers into higher tax rate brackets.

In either scenario, such policy actions enabled the government to take advantage of fiscal illusion besetting average citizen-voters within the political system.

Whilst the Australian pro-tax lobbies have proclaimed the more recent Howard-era income tax cuts as fiscally profligate, in fact the post-2000 tax cuts offered by the former government barely covered for the effects of bracket creep, let alone made seismic inroads into lowering and flattening the income tax structure.

With the impetus for income tax reductions waning, bracket creep effects are likely to be felt even more acutely by the taxpaying public in the short to medium term, as outlined in the Tax Discussion Paper. According to the Paper, the percentage of taxpayers in the top two tax brackets (that is, with taxable income exceeding $80,000; and excluding Medicare Levy and Temporary Budget Repair Levy) is projected to increase from 27 per cent to 43 per cent over the next decade.[70]

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[69] Robert Carling, 2014, 'Inflation must be in the tax review', The Australian, 16 May; Hon Malcolm Fraser MP, 1975, Election Speech, 27 November, http://electionspeeches.moadoph.gov.au/speeches/1975-malcolm-fraser; 'Tax perils', The Sydney Morning Herald, 2 February 1982.

[70] Commonwealth of Australia, 2015, *Re:think - Better tax system, better Australia*, Tax discussion paper, March, p. 22.

4.5 Principles for reforming Australian personal income taxation

For too long the income tax system has served as a key mechanism through which government can invoke fiscal discrimination against classes of taxpayers, at the great cost of promoting more efficient market arrangements and to the detriment of the integrity of the tax system as a whole.

A key proposal to reduce the extent of fiscal discrimination, through income taxation, would be to eliminate the top base income tax rate of 45 per cent. Leaving other rates unchanged for the time being, this would reduce the top tax rate down to 37 per cent and providing a basis for further flattening of the income tax scale.

In addition to reducing the top base rate of personal income tax, **the commonwealth should eliminate income tax surcharges masquerading as specific-purpose 'levies.'** These include the two per cent Medicare Levy (including NDIS Levy of 0.5 per cent), Medicare Levy surcharge for those on higher incomes without private health insurance, and Temporary Budget Repair Levy of two per cent (on incomes over $180,000) applicable in the 2015-16 and 2016-17 financial years. Abolishing these levies would roughly save taxpayers about $11 billion per annum.[71]

To avoid the forcible reduction in disposable incomes of Australians resulting from bracket creep, promote labour force participation, and inject more honest federal budgeting standards, **the government should reintroduce indexing income tax thresholds**. Indexation will deprive the public sector of an instant growth source of revenue, which tends to be less perceptible to average taxpayers. However, the implementation of this reform should encourage a much greater political focus upon the need to reduce overextended governmental expenditure.

5 Corporate income taxation issues

5.1 The company tax rate in Australia is too high, and is a deterrent to greater investment

At present all taxable income (including retained earnings and capital contributed by shareholders) earned by corporations are taxed at a rate of 30 per cent, with no tax-free threshold applicable. As explained previously, dividend imputation ensures that company tax effectively acts as a withholding tax on company profits that represent a return to either the savings of Australian investors of the labour of owner-operators of businesses that operate through companies.[72]

The statutory corporate income tax rate applicable in Australia remains higher than either the OECD member-country or global average rates of tax on companies, and is in the top echelon of countries with regard to the taxation of capital (Figure 13). As a consequence of more intense global competition for mobile capital owners, corporate tax rates had declined at a significant pace since

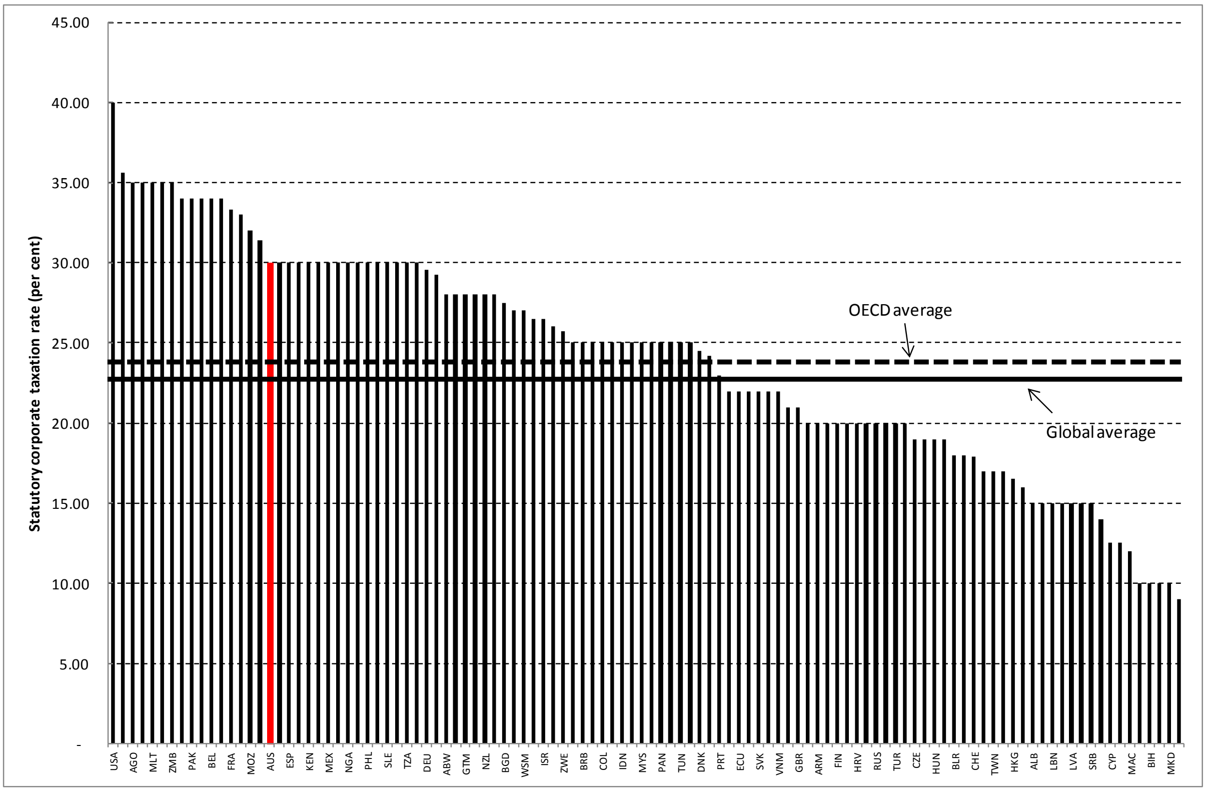
[71] Estimates based on taxation statistics published by the Australian Taxation Office, and estimates of 'deficit levy' revenue presented in 2014-15 Budget.

[72] Australia's Future Tax System Review Panel, op. cit., p. 150.

the 1980s.[73] Australia's company tax rate declined from 46 per cent in 1980 to 30 per cent in 2001, although it did increase periodically during the 1980s and 1990s.[74]

However, as the Figure indicates, despite previous tax-cutting reform episodes Australian company taxes have remained markedly higher than average corporate tax rates for the world and the OECD.

Figure 13: Top corporate income tax rates, global, 2014



Source: KPMG, 'Corporate tax rates table', http://www.kpmg.com/Global/en/services/Tax/tax-tools-and-resources/Pages/corporate-tax-rates-table.aspx.

There is a voluminous empirical economic literature which suggests that the corporate tax burden should be lower, rather than higher. Young Lee and Roger Gordon found a consistently negative relationship between corporate tax rates and economic growth. A ten per cent decrease in the corporate tax rate can be expected to increase subsequent economic growth by between one and two per cent. In a 2008 World Bank draft paper, Simeon Djankov and his colleagues reported that higher corporate taxes reduce aggregate investment and entrepreneurial activity, and increase the size of the shadow economy.[75]

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[73] Stephen Moore, 2009, 'The World Discovers the Laffer Curve', in Heritage Foundation, *2009 Index of Economic Freedom*, Washington DC.

[74] Information supplied by the World Tax Database, maintained by the University of Michigan. http://www.bus.umich.edu/otpr/otpr/default.asp.

[75] Sinclair Davidson, 2008, 'Corporate tax needs attention now', The Australian Financial Review, 7 August.

Several studies have investigated the economic impacts of taxation structures, and the general consensus appears to be that corporate taxes are particularly harmful to growth. According to Jens Arnold and other researchers, '[c]orporate income taxes can be expected to be the most harmful for growth as they discourage the activities of firms that are most important for growth: investment in capital and in productivity improvements.'[76]

When assessing the evidence with regard to the economic effects of corporate income taxes, due regard must be given to the fact that decisions to establish and maintain capital structures are also undertaken spatially. The implication of this point is that mobile capital investors must consider the after-tax rates of return on their ventures, and interjurisdictional differentials in corporate tax burdens can influence the decisions of such investors as to where to invest.

A meta-survey of the empirical literature by Mooij and Ederveen found most studies reported a negative relationship between taxation and foreign direct investment (FDI). According to Table 6, although there are variations in results according to the types of econometric techniques employed, the average tax semi-elasticity values indicate that a one percentage point increase in the corporate tax rate reduces the rate of FDI by about four percentage points.[77]

Table 6: Summary statistics of empirical studies of the sensitivity of foreign direct investment to corporate income tax

	Semi-elasticity			**Ordinary elasticity**		
	Mean	**Median**	**Standard deviation**	**Mean**	**Median**	**Standard deviation**
Time series	-2.61	-2.75	6.03	-1.23	-1.28	2.87
Cross section	-7.16	-4.24	6.92	-0.85	-0.78	0.44
Panel	-2.73	-2.41	2.69	-0.78	-0.66	0.75
Discrete choice	-3.43	-2.80	6.42	-0.30	-0.19	0.51
All	-3.72	-2.91	5.92	-0.75	-0.57	1.55

Source: OECD, 2008, *Tax Effects on Foreign Direct Investment - Recent Evidence and Policy Analysis*, OECD Tax Policy Studies, No. 17.

5.2 The company tax load is borne by larger firms, and progressivity could create new problems

On a statutory basis the commonwealth government presently imposes a flat rate 30 per cent tax rate on assessable incomes generated by a corporation. However the existence of the likes of tax offsets, foreign tax credits, franking deficit tax offsets, and other credits ensures that the effective rate of tax which a given company may pay is not necessarily consistent with the flat statutory rate.

[76] Jens Matthias Arnold, Bert Brys, Christopher Heady, Asa Johansson, Cyrille Schwellnus and Laura Vartia, 2011, 'Tax Policy for Economic Recovery and Growth', *The Economic Journal* 121: F59-F80, p. F71.

[77] Ruud A de Mooij and Sjef Ederveen, 2005, 'Explaining the Variation in Empirical Estimates of Tax Elasticities of Foreign Direct Investment', Erasmus University, Tinbergen Institute, Discussion Paper 108/3.

Analysis of Australian Taxation Office data by economist Sinclair Davidson indicates that the corporate effective tax rate adheres to a distribution akin to a progressive tax system, in which smaller firms bear a consistently lower effective tax rate than do larger firms.[78]

Table 7 shows the distribution of revenues collected from larger firms paying more than $1 million in net company tax annually. Larger companies comprise about half of one per cent of the total number of firms in Australia, yet in 2011-12 they paid about 74 per cent of net corporate income tax (facing an effective tax rate of 26.63 per cent).

Table 7: Distribution of large firms and net corporate income taxes paid, per cent

	Proportion of firms	Proportion of net income	Proportion of net company tax	Effective tax rate
2001-02	0.35	56.09	69.79	22.41
2002-03	0.37	63.39	70.54	22.27
2003-04	0.39	67.06	70.20	25.54
2004-05	0.38	70.11	72.59	25.68
2005-06	0.44	73.11	75.60	25.36
2006-07	0.52	74.42	77.80	25.57
2007-08	0.53	72.52	76.26	24.56
2008-09	0.44	72.50	78.60	25.49
2009-10	0.45	70.69	75.29	26.70
2010-11	0.50	75.00	78.06	24.67
2011-12	0.49	75.11	73.54	26.63

Source: Sinclair Davidson and Chris Berg, 2015, Submission to Senate Inquiry into Corporate Tax Avoidance, Institute of Public Affairs.

In the 2015-16 Budget the commonwealth government announced a two-tiered corporate income tax rate structure.

For a small business, with an aggregated annual turnover of less than $2 million per year, the tax rate will be reduced from 30 per cent to 28.5 per cent from 1 July 2015. Companies with a turnover of $2 million or more will continue to be subject to the 30 per cent rate. The proposed change to the company tax heralds something of a return to arrangements maintained from 1948 to 1972, in which multiple rates of tax applied from 42.5 per cent to 47.5 per cent.[79]

A concern with this policy is that the imposition of a lower company tax rate for smaller businesses could encourage some establishments, at least those expecting to exceed the tax threshold, to

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[78] Sinclair Davidson, 2008, The Faulty Arguments Behind Australia's Corporate Income Tax, Centre for Independent Studies, Policy Monograph No. 87.

[79] In 1940 the commonwealth government imposed an undistributed profits tax on public companies, an arrangement which persisted until the late 1970s. Sam Reinhardt and Lee Steel, 2006, 'A brief history of Australia's tax system', *Economic Roundup* (Winter): 1-26.

artificially restructure their affairs to ensure their levels of taxable income remain below $2 million.[80] Such practices might be reflected through, say, the suppression of sales, purchasing excessive levels of inputs, or incurring additional expenses simply to attain a lower company tax liability.

In the absence of policy changes the likely effect of reintroducing progressivity into the corporate income tax regime is the maintenance of a system in which larger firms bear the great burden of company tax liability whilst smaller firms are further discouraged from growing, via the provision of valuable outputs to consumers in competitive markets, in an effort to avoid greater tax penalties.

5.3 The burden of high company taxes are borne by workers, as well as firms

Whilst there is no question that the statutory incidence of corporate taxation is borne by the firm which generates taxable income subject to the company taxing base, there appears a lack of sufficient recognition within political circles that the burden of the high and uncompetitive Australian company tax system is dispersed through society.

The key insight of taxation incidence theory is that adjustments made by taxpayers ensure that the final economic burden of taxation may not rest with those deemed statutorily liable to pay tax. For example, the cost of corporate tax in the long run may be passed onto consumers through higher prices, or to shareholders in the form of reduced dividends, or to the firm's own employees through reduced wages. This is reflective of the oft-quoted statement that 'companies don't pay corporate tax, people do.'

To illustrate the potential distributional effects of corporation income tax changes, a recent Treasury study simulated the effects of a small reduction in the company tax rate. It found that, in the long run, about one-third of the benefit of reduced tax accrues directly to the owners of capital, whereas two-thirds flows to households through rising real wages. According to the authors of the study:

> 'these results suggest that there may be larger welfare gains available from cutting the company tax rate than from other major revenue sources and that in the long-run, only a minority of the welfare gains will accrue to the owners of capital, with the majority shared more broadly through the community.'[81]

It is important to further clarify the basis for the economic incidence of corporate taxes partially falling upon worker's wages, as set out in iconic conceptual papers by Christophe Chamlee and Kenneth Judd.[82]

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[80] Joanna Mather, 2015, 'Two-tiered business tax hint concerns ACCI', The Australian Financial Review, 16 April.

[81] Xavier Rimmer, Jazmine Smith and Sebastian Wende, 2014, 'The incidence of company tax in Australia', Economic Roundup (Issue 1): 33-47, p. 43.

[82] Kenneth L Judd, 1985, 'Redistributive Taxation in a Simple Perfect Foresight Model', Journal of Public Economics 28: 59-89; Christophe Chamley, 1986, 'Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives', Econometrica 54 (3): 607-622.

In modern economies labourers contribute to production processes with the aid of heterogeneous capital, such as machinery and equipment, which in turn help them become more productive workers. Other things being equal, more productive workers are able to earn more income in the longer term. According to the Chamley-Judd thesis, a reduction in company taxes increases the available capital stock enabling workers to earn higher wage levels; conversely, an increase in the rate of corporate income taxes reduces capital stocks and reduces wages growth over time.

The notion that, from the viewpoint of optimal taxation theory, the optimal rate of taxation on capital is, in effect, zero is exemplified in the following statement by economist Garett Jones:

> 'Any tax on capital is a bad idea in the long run, and that the overwhelming effect of a capital tax is to lower wages. A capital tax is such a bad idea that even if workers and capitalists really were two entirely separate groups of people—if workers could only eat their wages and capitalists just lived off of their interest like a bunch of trust-funders—it would still be impossible to permanently tax capitalists, hand the tax revenues to workers, and make the workers better off.'[83]

5.4 Principles for reforming Australian corporate income taxation

Given the uncompetitive rate at which Australian corporate income taxes apply, the adverse impacts of company tax upon productive economic conduct, as well as the malign distributional effects of corporate taxes, it is imperative that the commonwealth significantly reduce the burden of this form of taxation.

The impending resumption of corporate tax progressivity provides an opportunity for **the commonwealth government to further reduce the prospectively top tax rate of 30 per cent to 28.5 per cent in the short term, and then reduce the uniform tax rate of 28.5 per cent even further as circumstances permit**. This initiative will ensure that Australia's lack of tax competitiveness is redressed, improving our relative attractiveness as a destination for mobile capital in the process.

6 Indirect taxation issues

<u>Goods and services tax</u>

6.1 The GST is not an economically harmless tax

Based on a core foundation of orthodox (neoclassical) taxation theory that the imposition of taxes should impose the lowest efficiency burdens upon economic activity as possible, economists have long lauded the relatively high efficiency properties of consumption taxes. The rationale for favouring consumption taxation, such as the GST, on efficiency grounds was explained by the Henry Tax Review as follows:

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[83] Garett Jones, 2014, 'Living with inequality', Reason, 26 April, http://reason.com/archives/2014/04/26/living-with-inequality.

'A broad-based consumption tax is one of the most efficient taxes available to governments ... For a small open economy, investment is likely to be more mobile than consumption, suggesting economic growth is likely to be higher by shifting away from taxes levied on investment. Further, a single-rate consumption tax does not distort the timing preferences of consumption for individuals. The same tax is paid regardless of whether a person consumes now or in the future, imparting no bias for or against saving.'[84]

For similar reasons, and with the intent to ameliorate the degree of tax avoidance activities that potential taxpayers could undertake, it is presumed that the imposition of low rate consumption taxes, but on a wide base of goods and services, would also rate highly from the point of view of the economic efficiency criterion.

Using 'computable general equilibrium' simulation models of the Australian economy, consultants have previously estimated that the deadweight costs of the GST are relatively low and certainly so in comparison with some state taxes.[85] A study commissioned for the Henry Review found the 'marginal excess burden'[86] of the GST was eight cents per dollar of revenue collected, and this in turn was ten times smaller than the likes of state and territory gambling taxes.[87]

But it would be a mistake to infer from this that the GST is economically costless in effect. This is simply not so: 'consumption taxes may be less distorting than progressive income taxes, but that doesn't mean they are a free lunch: when added to an already high income tax, they cause serious economic harm. Moreover, that harm is magnified if their effect is to encourage public sector profligacy.'[88]

Even if the extension of the GST base reduces the marginal excess burden of the tax to some degree, other things being equal, it will still retain the potential to distort private sector economic activities and, thus, compromise our growth potential in the longer term. This is confirmed by a recent study conducted for CPA Australia, which presented modelling results of various tax reform scenarios including extending the present 10 per cent GST onto a broader base. The report states:

'In the absence of other compensating measures, greater GST revenue would have a negative impact on output (GDP) because it would increase the average tax rate on the economy, increasing prices for goods and

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[84] Australia's Future Tax System Review Panel, 2010, *Australia's Future Tax System: Final Report*, Commonwealth Department of the Treasury, Canberra, p. 273-274.

[85] KPMG Econtech, 2010, CGE *Analysis of the Current Australian Tax System, Final Report*, http://taxreview.treasury.gov.au/content/html/commissioned_work/downloads/KPMG_Econtech_Efficiency%20of%20Taxes_Final_Report.pdf.

[86] The marginal excess burden was calculated in the consultancy report as the ratio of the loss in consumer welfare relative to net gains in government revenue, associated with small tax increases.

[87] A subsequent study by KPMG Econtech found the marginal excess burden of the GST to be slightly higher, at ten cents in the dollar. KPMG Econtech, 2011, *Economic Analysis of the Impacts of Using GST to Reform Taxes*, http://www.cpaaustralia.com.au/~/media/corporate/allfiles/document/professional-resources/taxation/kpmg-econtech-final.pdf.

[88] Henry Ergas, 2015, 'Extending GST to health and education would boost public sector unions', The Australian, 10 January.

services and providing disincentives to supply of labour through the reduction in real take home wages. This effective is relatively strong in the earlier years.'[89]

An important matter which is not adequately captured in neoclassical simulation 'toy models' of the Australian economy is the potential effects of taxation changes upon the structure of capital, an insight covered in detail by the market-process approach of Austrian economics.

In general terms it is surmised that the imposition of a broad-based consumption tax reduces the rate of return on investments tied into the production of goods with a more rapid turnover rate. This, in turn, skews the capital structure away from shorter term investments, say devoted to the production of consumption goods, and towards longer term investments.[90]

Extending the GST to those parts of the Australian economy presently exempted from the tax, or at least enjoying some concessional status under the GST regime, is likely to have some detrimental effect by way of artificially deranging the capital structure.

Producers of goods and services caught under a wider GST net might tend to reduce their utilisation of heterogeneous capital more suited to supplying less complex consumptive conveniences, relative to taking up capital for the purpose of production with a longer time frame. The implied reduction in shorter term consumption possibilities would not come without some cost, perhaps even a heavy one, to the everyday Australian consumer.

6.2 The GST also rates poorly on equity grounds

During the debate leading to the introduction of the GST it was widely acknowledged that one of the drawbacks of the tax was to be its disproportionate effect upon people on relatively lower incomes. Although the Howard government, in a ready acknowledgement of the GST's inherently regressive character, significantly extended the welfare state to compensate various constituencies against adverse price and wealth effects, this was insufficient to assuage some influential political figures about equity concerns:

'The question is whether compensation is adequate … the question now in my mind is whether it is inherently regressive to such an extent that it should not be supported. ... I've always been conscious of the fact that the true test of a civilised society is in how it regards and treats its most vulnerable. But I don't claim here a monopoly on moral judgments in respect of this. I just happen to believe that the inherently regressive nature of the GST does not achieve that test. ... And the question that I have to ask myself is whether I'm going to be a party to imposing an impersonal, indiscriminate tax on my children, my grandchildren, and their children for generations to come. I cannot.'[91]

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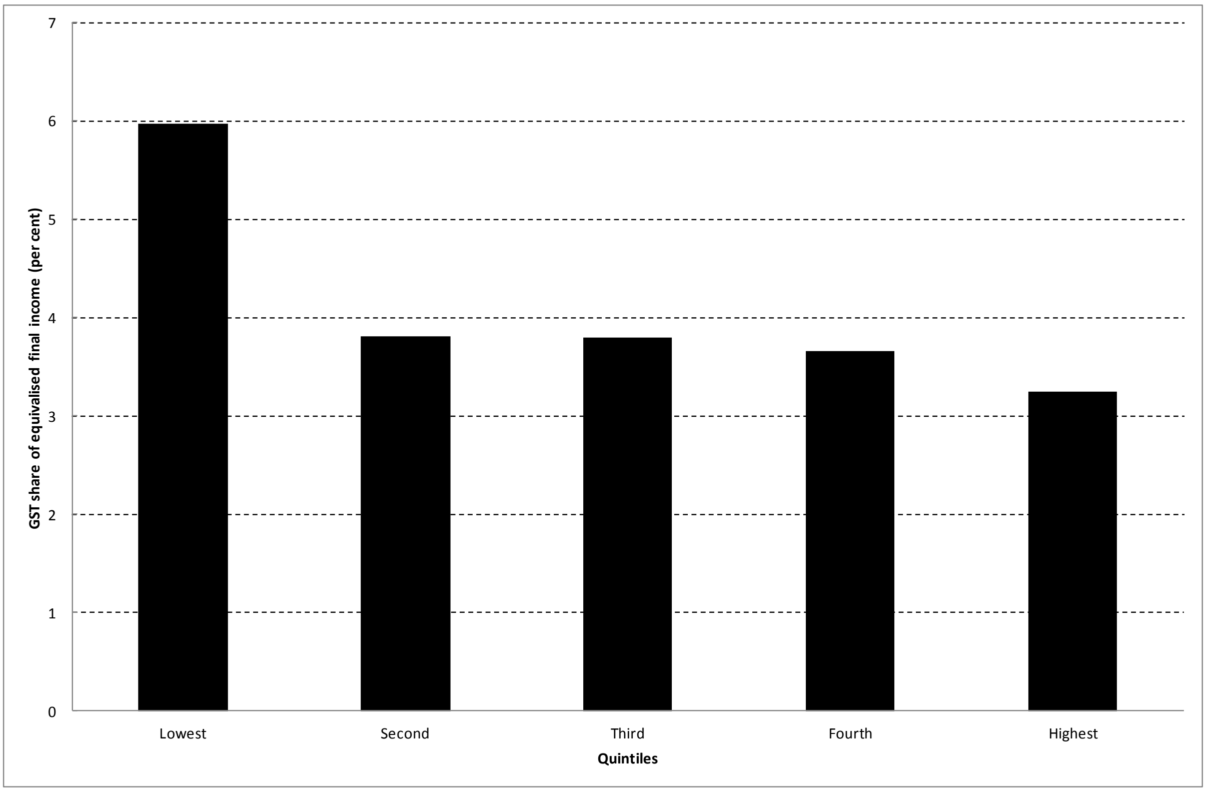
[89] KPMG, 2015, *Tax Reform in Australia - The Facts*, Study commissioned for CPA Australia, p. iii.

[90] Mason Gaffney, 2013, 'Europe's Fatal Affair with VAT', http://www.masongaffney.org/essays/Europes_Fatal_Affair_with_VAT_071713a.pdf.

[91] Senator Brian Harradine, 1999, http://australianpolitics.com/1999/05/14/senator-brian-harradine-opposes-the-gst.html.

The regressivity of the GST, as it is currently applied, is confirmed by ABS analysis of the distributional effects of taxes and government benefits (Figure 14). According to the Figure, the average household in the lowest (equivalised) income quintile pay about six per cent of their final income in GST, falling to about three per cent for those in the highest quintile.

Figure 14: Goods and services tax as proportion of household equivalised final income



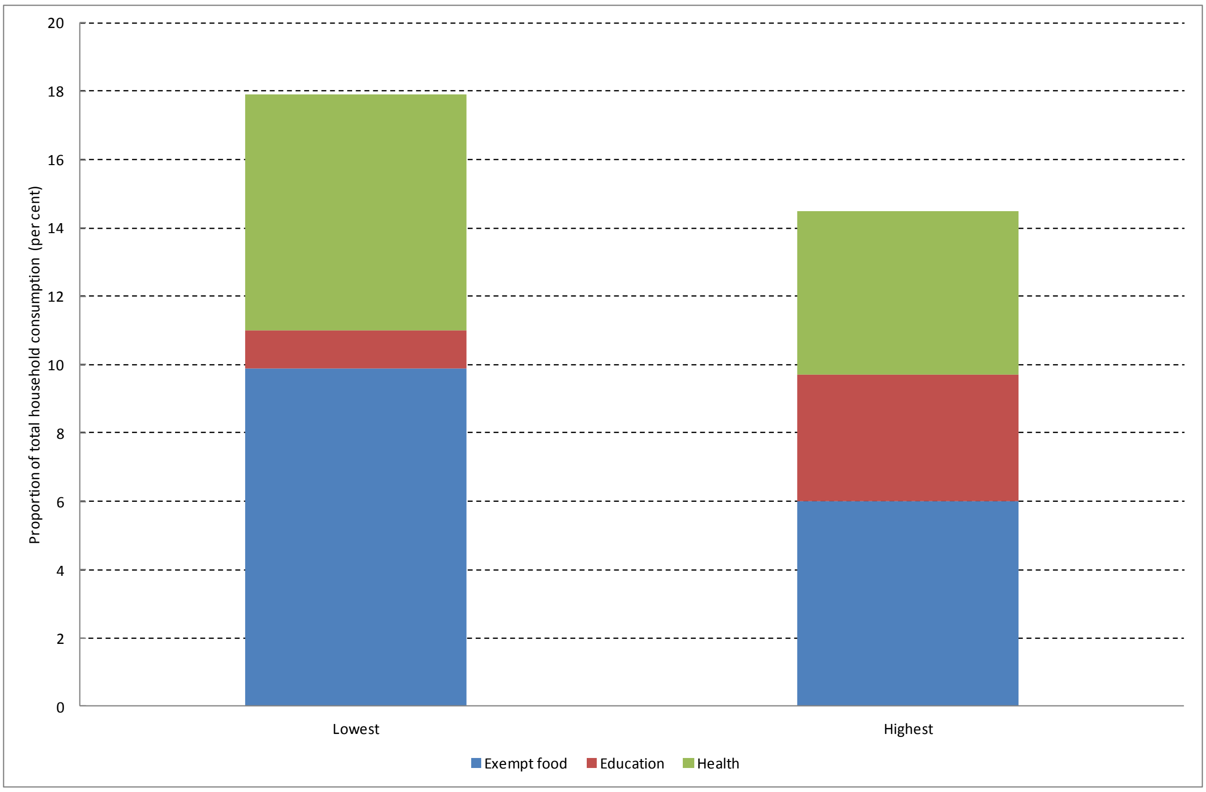
Source: ABS, Government Benefits, Taxes and Household Income, Australia, cat. no. 6537.0.

Some tax reform proponents have suggested the GST be extended to presently exempted goods and services. The impact of the GST, under this scenario, is likely to be felt more heavily by individuals and families on lower incomes (putting aside the effect of welfare compensation schemes on household budgets). This is because they tend to save less, in relative terms, implying a greater share of their incomes is absorbed by consumption activities.

As shown in Figure 15, households in the lowest income quintile spend a considerably greater proportion of their incomes on certain goods and services nominated for inclusion in the GST base, such as fresh food, education, and health care.[92] This suggests that an extension of the GST would more detrimentally affect the budgets of lower income earners.

[92] The Figure refers to spending by households in the lowest and highest income quintiles only, excluding second, third, and fourth household quintile expenditures. For the excluded groups, the proportion of consumption on exempted (fresh) foods, education, and health care services was roughly consistent at between 14 to 16 per cent in 2011-12.

Figure 15: Household consumption on selected GST-free goods and services, proportion of total, 2011-12



Source: ABS, Household Expenditure Survey, cat. no. 6503.0.

6.3 Businesses have become glorified GST collectors

As explained by the 2008 Board of Taxation review into the GST legal framework, the GST is a transaction-based multi-stage tax imposing obligations on registered suppliers and recipients to account for and remit GST and an entitlement to claim input tax credits throughout each stage of the supply chain. These arrangements bring to bear a host of compliance costs borne by business to conform with relevant GST payment procedures, such as:

'acquiring the necessary knowledge of the tax system; compiling records; dealing with the Tax Office; evaluating the effectiveness of alternative transactions or methods of complying with the law; and collecting and remitting taxes.'[93]

Since its implementation by the Howard government in 2000, there have been frequent complaints especially by smaller sized businesses about GST compliance costs. Indeed, available evidence illustrates that complying with the GST appears as one of the more fraught aspects of everyday activity with which business managers and owners must contend.

[93] Board of Taxation, 2008, *Review of the Legal Framework for the Administration of the Goods and Services Tax*, Report to Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, Commonwealth of Australia, Canberra, p. viii.

According to a study published in the *Australian Tax Forum* journal, it has been estimated that more than half the time surveyed small business take to comply with tax obligations was spent on the GST.[94] Overall, business staff spent 493 hours on average during 2009-10 dealing with different taxes with 287 of those hours spent dealing with GST matters. As Table 8 illustrates, the significant amount of time spent complying with the GST is commonplace across all businesses.

Table 8: Mean annual hours spent complying with selective taxes, businesses by annual turnover, 2009-10

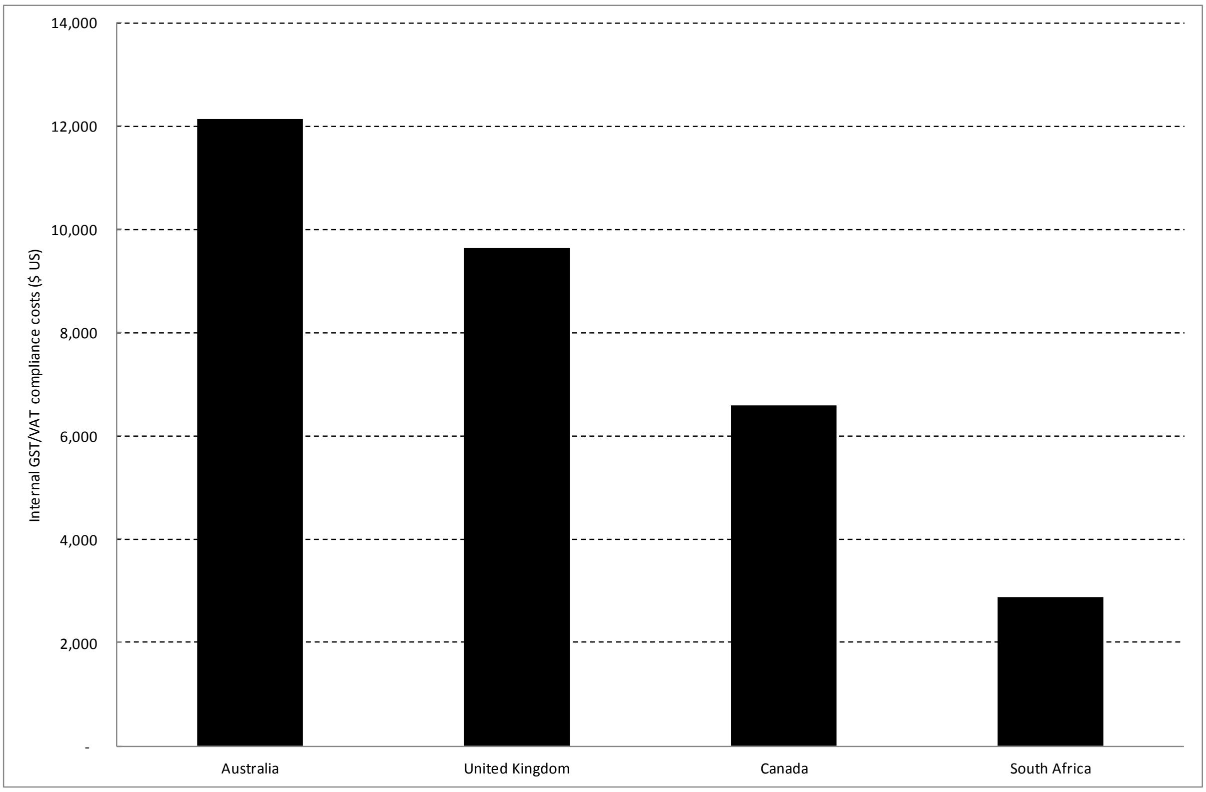
	< $1 million	$1 million - $3 million	$3 million - 6 million	$6 million and above
GST	112	354	319	334
Income tax	59	117	109	129
Payroll PAYG	29	81	65	109
Capital gains tax	2	5	12	5
Fringe benefits tax	1	17	19	59
Total	204	574	525	637

Source: Philip Lignier and Chris Evans, 2012, 'The rise and rise of tax compliance costs for the small business sector in Australia', *Australian Tax Forum* 27 (3): 615-672, p. 630.

In a 2012 paper the compliance costs of several taxes borne by small business were compared between Australia, Canada, South Africa, and the United Kingdom. The compliance costs of managing GST liabilities were found to be significant higher than for other countries in the sample (Figure 16).

[94] Philip Lignier and Chris Evans, 2012, 'The rise and rise of tax compliance costs for the small business sector in Australia', *Australian Tax Forum* 27 (3): 615-672.

Figure 16: Internal compliance costs of GST/VAT, selective countries, $US



Source: John Hasseldine, Chris Evans, Ann Hansford, Philip Lignier, Sharon Smulders and Francois Vaillancourt, 2012, 'A comparative analysis of tax compliance costs and the role of special concessions and regimes for small businesses in Australia, Canada, South Africa and the United Kingdom', Paper presented to US National Tax Association Conference, November.

Proponents of tax reform have pointed to the potential administrative and compliance cost savings associated with GST base extension. As noted in the final report of the Henry Tax Review, 'compliance costs increase when different supplies are given different tax treatments. While most supplies are taxable, some supplies are GST-free, or input-taxed.'[95]

However, any cost savings associated with these aspects of broadening the GST, which are perhaps modest in scale, have to be balanced against the increases in costs to be borne by businesses (currently GST registered or not) meeting obligations of paying tax on goods and services previously exempted from GST.

For example, the eBay Australia submission to the 2011 Productivity Commission inquiry on the retail trade referred to the potential increases in compliance costs upon some small businesses if the GST low-value import exemption threshold were scaled back or removed:

'For GST purposes, a small seller has turnover of less than $75,000. These sellers do not have to register for, or pay GST. The tax system operates such that even where GST is payable on an import due to it being over the current low value import threshold, the small business would obtain a GST refund for this import and there would be no additional GST collections by the federal government. So for GST registered businesses there

[95] Australia's Future Tax System Review Panel, op. cit., p. 288.

would be no additional GST collected by the commonwealth, yet there would be other impacts on small business, whether above or below the threshold. The majority of businesses that have taken advantage of online retail are small to medium businesses who have a more flexible business model. Therefore, any change to the GST threshold will create an undue administrative burden on small to medium businesses with little or no resulting financial benefit to the government or the economy.'[96]

In the absence of policy efforts to radically simplify the administrative procedures pertaining to the GST, an extension of the base to child care, education, health, low-value imports, and the like, will simply enlarge the aggregate GST compliance burden borne by participants in the Australian economy.

6.4 Principles for reforming Australian GST

One of the more ingenious aspects of the GST policy design mechanism enacted by the former Howard government was the introduction of arrangements which would make it difficult for government to unilaterally change the base or rate of the GST, as has so often occurred in other developed countries over the last few decades.[97]

The original Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations (IGA) stated (Part 3: 32-36) insists that changes to the GST base and rate can only be implemented by the unanimous approval of commonwealth and state governments together with legislative ratification by the federal parliament. These arrangements have been maintained in a revised IGA signed in 2008, and remain in force to this day.

This inducement of an Australian form of 'Madisonian friction' - in which the respective and competing interests of federal and state, Labor and Liberal, Senate and House of Representatives, consumer and ATO, citizen and state must be reconciled - has served Australian consumers and taxpayers very well to date. The arrangements have blocked consumption tax increases regularly seen elsewhere, but these are now under great pressure with the commonwealth advocating an extended GST base, seemingly with the tacit approval of the states.

In the 2015-16 Budget the commonwealth government announced it would broaden the GST to digital goods and services purchased from overseas from 1 July 2017, in a measure expected to yield $350 million in additional revenue over four years (with all funds transferred to the states and territories).

With the costs associated with downloading films, music and other digital products already relatively higher in Australia than in most other developed countries,[98] **the government should abstain from implementing the so-called 'Netflix tax' and recoup the loss in revenue through spending reductions**.

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[96] Allen Consulting Group, op. cit., p. 34.

[97] Mikayla Novak, 2014, 'Revenue lobbyists should leave GST alone', ABC Drum, 11 April.

[98] Parliament of Australia, 2013, *At what cost? IT pricing and the Australia tax*, House of Representatives, Standing Committee on Infrastructure and Communications.

In recent months pro-revenue lobby groups have called for extending the GST to economic and social activities currently subjected to no tax, or to tax concessional status. In response to these pressures to magnify cost of living pressures for Australian individuals and families, **the commonwealth should also explicitly affirm its intention not to extend the GST to other items currently exempted from taxation, including education, health care and medical services, and other low-value imported goods**.

8 Conclusion

The pro-tax lobby may argue that Australia is a low tax economy, but this is only true when compared with a group of high tax economies in continental Europe and, even then, several applications of Australian tax laws compelling people to expend their monies in certain ways also need to be contemplated when making international comparisons.

In reality, when comparing Australia against a larger sample of economies, and ensuring that financial effects akin to European social security contributions are added to the measure of the Australian tax take, it becomes clear that this country is a high taxing one, especially for this East Asian region, if not the remainder of the world, against which we increasingly compete.

The Australian tax system remains skewed towards direct taxation, mainly accounted for by personal income taxation set at very high top marginal rates and an uncompetitive company tax regime.

The highly progressive nature of our regime of direct taxes means that relatively few Australian individuals and corporates are doing the heavy lifting on tax, leading many other Australians to become less sensitive to the spiralling costs of maintaining our large government.

The Australian indirect taxation regime may have been partially renovated in the early 2000s, following the introduction of value-added taxes by European countries from the 1950s, however the resulting GST remains inequitable, costly to maintain, and a drag upon economic performance. The GST burden is threatened to increase over the next few years, as governments perceive the emergence of digital technologies and 'sharing economy' services as revenue targets.

The release of the latest federal budget, and state and territory budgets thus far, clearly outlines the fiscal challenge facing governments at all levels. What is required of commonwealth, state and local governments is that they reduce wasteful spending, to repair their budgets and boost long term economic growth, rather than lift taxes.

Increasing taxes is simply a recipe for constricting the freedom of individuals to keep and use their own monies as they see fit, and a program to subdue economic growth and improved living standards in the longer term.