6 The mix of taxes on work, investment and consumption

Outline

This section examines the mix of taxes in Australia on labour income, capital income and consumption and compares this with outcomes in other OECD countries.

Key points

- Most countries have a tax system based on a mix of taxes on labour income, capital income and consumption.
- Australia's tax mix is slightly skewed toward direct taxes on labour income. This accounts for around 40 per cent of tax revenue. Taxes on capital income account for about 33 per cent, while taxes on consumption account for 27 per cent.
- Compared with other OECD countries, Australia has a low share of tax revenue from labour income and the highest share from capital income. In part, this reflects the relatively greater contribution of corporate income taxes to total tax revenue.
- As a share of GDP, the total tax burden in Australia on capital is around 11 per cent (the fourth highest in the OECD). The total burden on labour is 12 per cent (the fourth lowest in the OECD), and the total burden on consumption is 9 per cent (also the fourth lowest in the OECD).

Most countries have a tax system comprising a mix of taxes on labour income, capital income and consumption. A key issue when considering the mix of taxes is whether some forms of tax impose larger efficiency costs than others. A key theme in tax literature over the past 30 years has been whether tax systems should be based on the concept of comprehensive income or the taxation of expenditure (see Box 6.1).

The OECD (Johansson et al 2008) has recently undertaken a cross-country study of the effects of different taxes on economic growth. The indications from this analysis are that property taxes have the least detrimental impact on growth, followed in order by taxes on consumption, taxes on labour income and taxes on capital income. The OECD analysis only looks at the issue of the tax mix from the perspective of economic efficiency. Considerations about the distributional impacts of the tax structure also need to be taken into account when considering the findings of that study. Further, as the authors note, the general findings of the study need to be considered carefully within the context of each country's tax system and broader economic structure.

Box 6.1: The income tax versus expenditure tax debate

A key debate is whether tax systems should be based on the concept of comprehensive income ('Haig-Simons' income, defined as consumption plus the change in the real value of net assets) or the taxation of expenditure (which excludes saving from the tax base).

- The comprehensive income base referred to by economists is based on real income — that is, the inflationary elements should be excluded from taxation.
- Two types of expenditure tax have been identified in the literature — the so-called pre-paid expenditure tax based on direct taxation of labour income with an exemption for saving and the so-called post-paid expenditure tax based on the taxation of a direct measure of expenditure or of goods and services. Apart from the point of taxation, a key difference between these two approaches is the generally accepted view that only under a post-paid expenditure tax are the returns to pure economic rent and good luck taxed.

Proponents of the expenditure tax argue this approach delivers greater economic efficiency because taxing the return to saving under an income tax results in future consumption being taxed more heavily than present consumption. This reduces the incentive of individuals to save, which can in turn reduce the level of investment in the economy, the size of the capital stock and the return to labour. It can also affect equity issues, by increasing the level of tax on those that wish to save for items such as education and retirement. Proponents of an income tax have generally argued that the efficiency gains from an expenditure tax are diminished by the need to levy the tax at a higher rate to achieve a given revenue target and that an income tax is more equitable because the distribution of wealth is greatly skewed.

Since the Meade Report (1978), where the arguments in favour of expenditure taxes were considered clear, more recent literature has cast doubt on the premise that expenditure taxes are necessarily superior to income taxes. However, the view of the literature is that capital income should be taxed at a lower rate than labour income solely from the perspective of efficiency considerations (Diamond and Banks 2008).

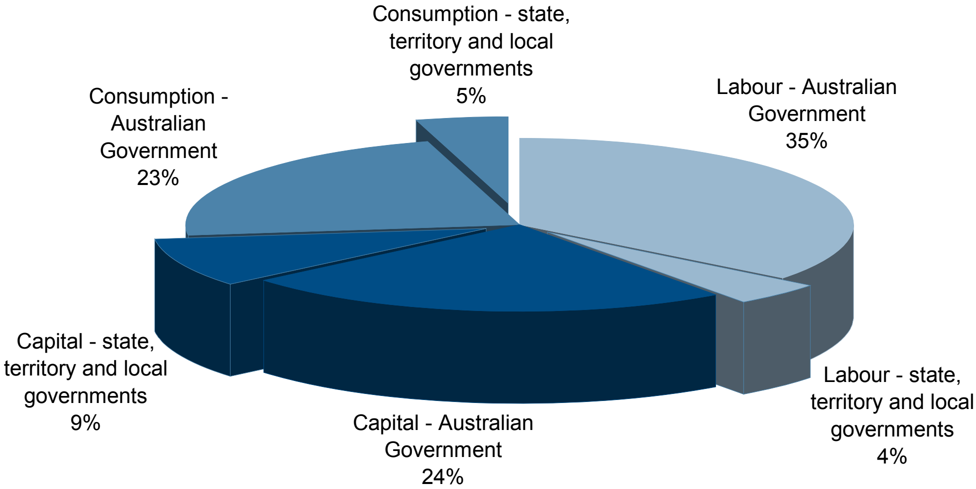
A second key theme in the tax literature has been concerned with the definition of the tax base, particularly in terms of its comprehensiveness. It is generally accepted that within any appropriately defined base, a broad tax treatment will impose fewer efficiency costs on the economy, because of the neutral treatment of alternative sources of income or expenditure and a lower average tax rate for a given revenue objective. In practice it is extremely difficult to assess the comprehensiveness of a tax base defined as broadly as labour income, capital income or consumption. Where different rates are applied to different goods, a judgement needs to be made as to whether these represent different sub-components within the labour, capital and consumption tax bases, or deviations from the comprehensive base. There are parallels between this and the benchmark issues surrounding the identification of tax expenditures (see Box 2.7).

6.1 Australian government and state taxes on labour, capital and consumption

Australia's tax mix is slightly skewed towards the direct taxation of labour income, accounting for around 40 per cent of revenue raised (Chart 6.1). This includes taxes on salary and wages and fringe benefits, taxes on superannuation contributions and payroll taxes. Taxes on capital income account for around a third of revenue, while taxes on consumption account for slightly more than a quarter. Taxes on capital include company tax, taxes on individual capital income (interest, dividends, capital gains and some business income), the petroleum resource rent tax, crude oil excise and taxes on property such as land taxes and stamp duties on conveyances. Taxes on consumption include the GST, excises on tobacco, alcohol and fuels and other taxes on consumer goods.

The allocation of revenue according to capital, labour and consumption differs between the two levels of government (Chart 6.1). At the Australian Government level the contribution from taxes on labour is around 50 per cent higher than the contributions from taxes on capital and consumption. At the state government level, the contribution from taxes on consumption and labour are roughly equal, while taxes on capital are around 50 per cent higher.

Chart 6.1: Tax revenue from labour, capital and consumption
Australian Government and States — 2006-07



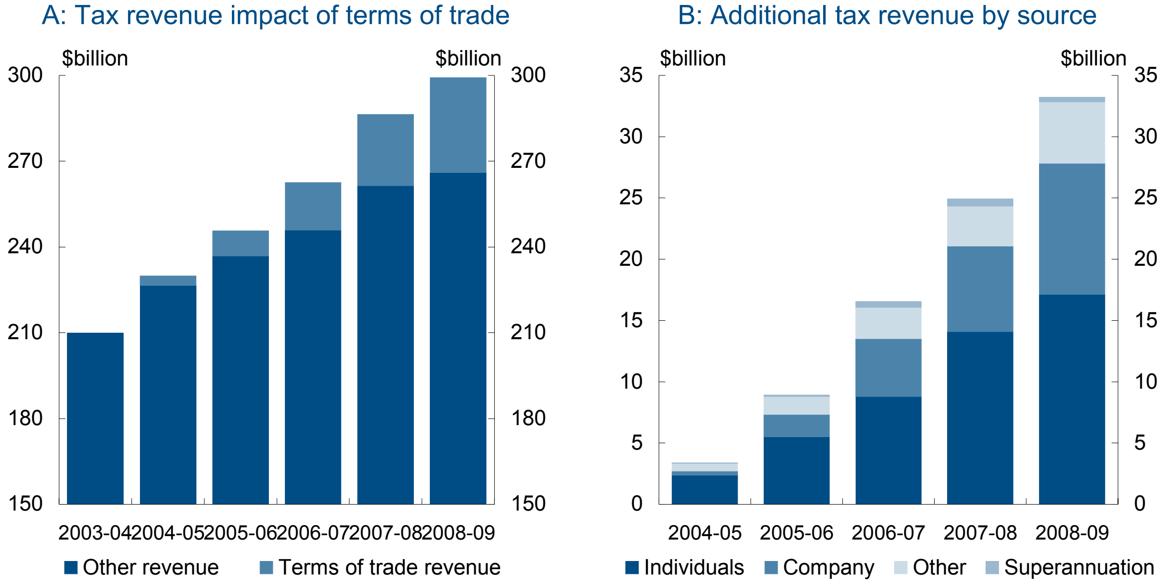
Source: ABS (2008a); Australian Treasury estimates.

Australian Government tax mix — recent history

The boom in the terms of trade is estimated to have generated around $87 billion in additional revenue over the five years to 2008-09 (Australian Government 2008a). Around $33 billion is expected to accrue in 2008-09 (Chart 6.2).

The components of this estimated increase in revenue are shown in Panel B of Chart 6.2. In 2008-09, company tax revenue is estimated to be $10.7 billion, or 14 per cent, higher than would otherwise be the case. This reflects higher company profits flowing from increased bulk commodity prices. Personal tax collections have also increased as a result of higher income tax payments from individuals arising from higher wages and employment.

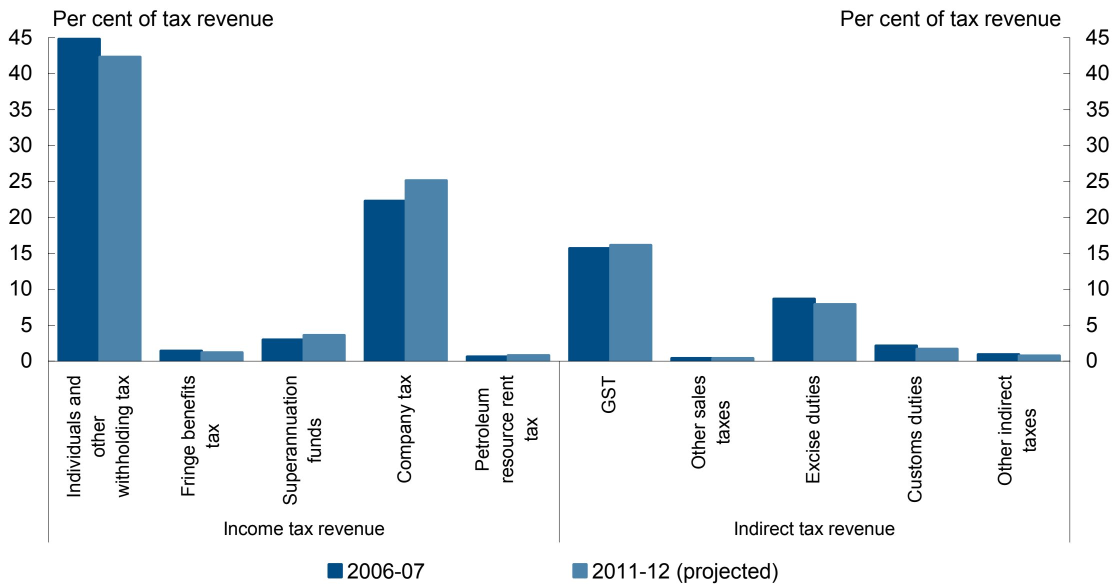
Chart 6.2: Estimated increase in tax revenue due to the terms of trade boom



Source: Australian Treasury estimates, Australian Government (2008a), Statement 5, see Box 2.

Relative to 2006-07, the Australian Government share of revenue from individuals' income and fringe benefits tax is projected to decline, to be around 43.5 per cent by 2011-12 (Chart 6.3). This reflects the recent and announced future cuts in the personal income tax scales. Company income tax is expected to account for a higher share of Australian Government tax revenue in 2011-12 than in 2006-07, along with taxes on superannuation funds and resource taxes. GST revenue is also projected to increase slightly as a share of Australian Government revenue, but overall, indirect taxes are expected to decline slightly in importance.

Chart 6.3: Shares of Australian Government tax revenue in 2006-07 and 2011-12



Source: Australian Government (2008a).

6.2 Taxes on labour, capital and consumption — Australia in the OECD

Chart 6.4 shows the balance of taxes on labour, capital and consumption in OECD countries. In this chart, taxes on labour include taxes on labour income, social security contributions and payroll taxes. Taxes on capital include company tax, taxes on personal capital income and property taxes.[1] Taxes on consumption include value added taxes (like the GST) and excises, as well as taxes such as motor vehicle stamp duties and gambling taxes.

The position of a country in the chart shows its relative reliance on revenue from the taxation of labour income, capital income or consumption. A position on the vertical axis in the centre of the chart represents an equal weighting between revenue from taxes on labour and taxes on capital. To the left of the vertical axis, relatively more revenue is derived from labour taxes than capital taxes while the converse is true to the right of the vertical axis. The closer the country is to the horizontal axis, the lower its reliance on taxes on consumption. For example, the United States (Point 'USA' in Chart 6.4) derives a greater share of its revenue from taxes on labour income than from taxes on capital income and has the lowest share of revenue derived from taxes on consumption.

Compared with other OECD countries, and the OECD-10, Australia has a relatively low reliance on tax revenue from labour, representing around 37 per cent of tax revenue by this measure. In other OECD countries, the reliance on labour taxation is significantly greater. This reflects the significant use of social security contributions in other countries, which are levied on wages, salaries and similar income. Social security contributions represent a significant source of revenue for many OECD countries. For many, this is a larger source of revenue than personal income taxes, in some cases contributing up to 40 per cent of total tax revenue. Australia's closest taxes are the payroll taxes levied by the States, which account for around 5 per cent of tax revenue.

Australia's reliance on consumption taxes, such as the GST and excise, is around the middle of the OECD-10 countries but at the lower end of the OECD as a whole.

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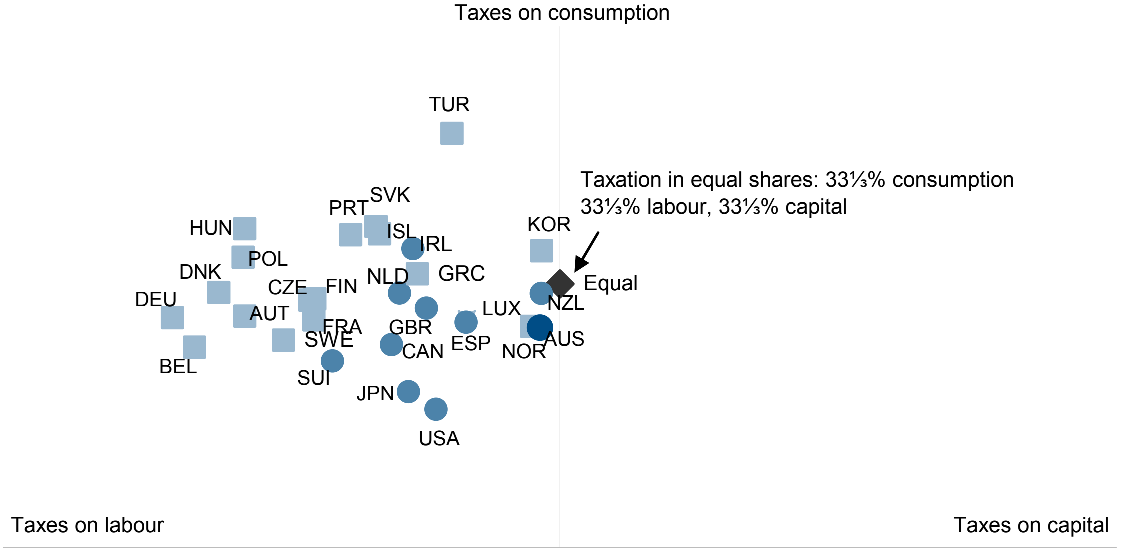
1 There are some differences in the classification of taxes on capital income and labour income between Charts 6.4 to 6.6 and Chart 6.1, due to differences in available data.

Chart 6.4: Estimated tax mix, Australia (dark dot), OECD-10 (light dots) and other OECD countries (squares) — 2005[(a)]



(a) Does not include Mexico. For Korea, Iceland, Switzerland and Turkey the share of personal income tax revenue derived from capital has been estimated using the average share of other OECD countries.
Source: OECD (2007a); Eurostat (2008), national governments; Australian Treasury estimates.

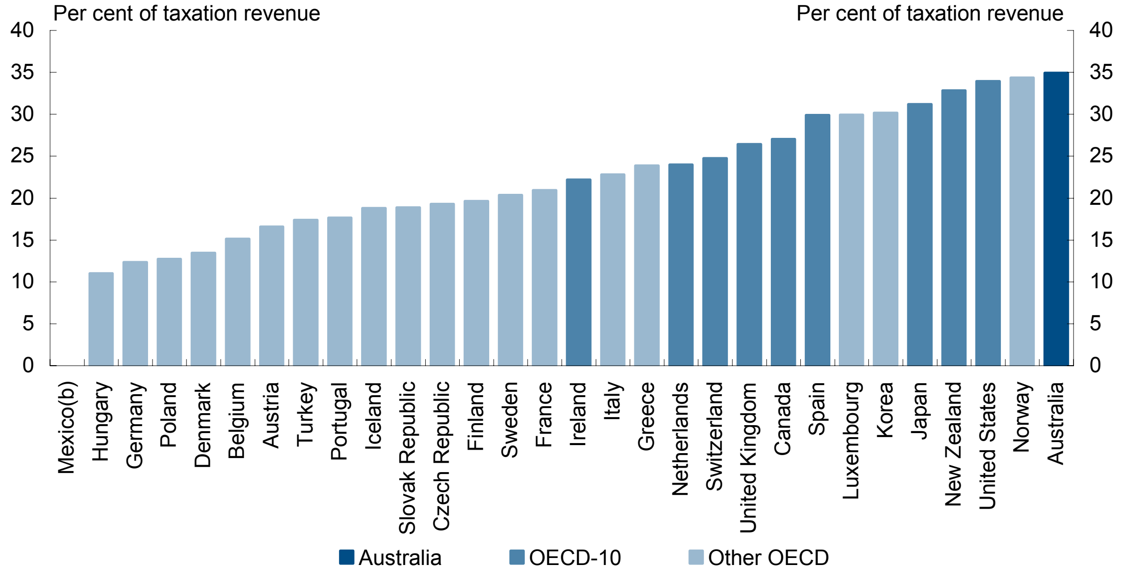
Chart 6.5 provides a perspective on the relative weight given to capital taxation in Australia. It is a surprising result in a globalising world with increasingly mobile capital flows for a small open economy to have the highest weight given to the taxation of capital income.

This overall result for Australia flows from a combination of the relatively high contribution of company tax to total tax compared with other OECD countries (driven by a relatively broad base and Australia's superannuation arrangements), a relatively high share of tax revenue from property, and relatively high taxation of personal capital income. The contributions of company and property taxes to total tax revenue are discussed in Section 5 and shown in Charts 5.5 and Chart 5.7. A comparison of top personal tax rates on capital income is also included in Section 5.

The relative contribution of taxes on labour, capital and consumption is indicative of the distribution of the tax burden but it does not necessarily give an indication of the absolute size of the tax burden on labour, capital or consumption. While Australia's reliance on capital taxes as a share of total tax revenue is the highest in the OECD (Chart 6.5), the total tax burden, measured in terms of tax to GDP, is relatively low (Chart 6.6).

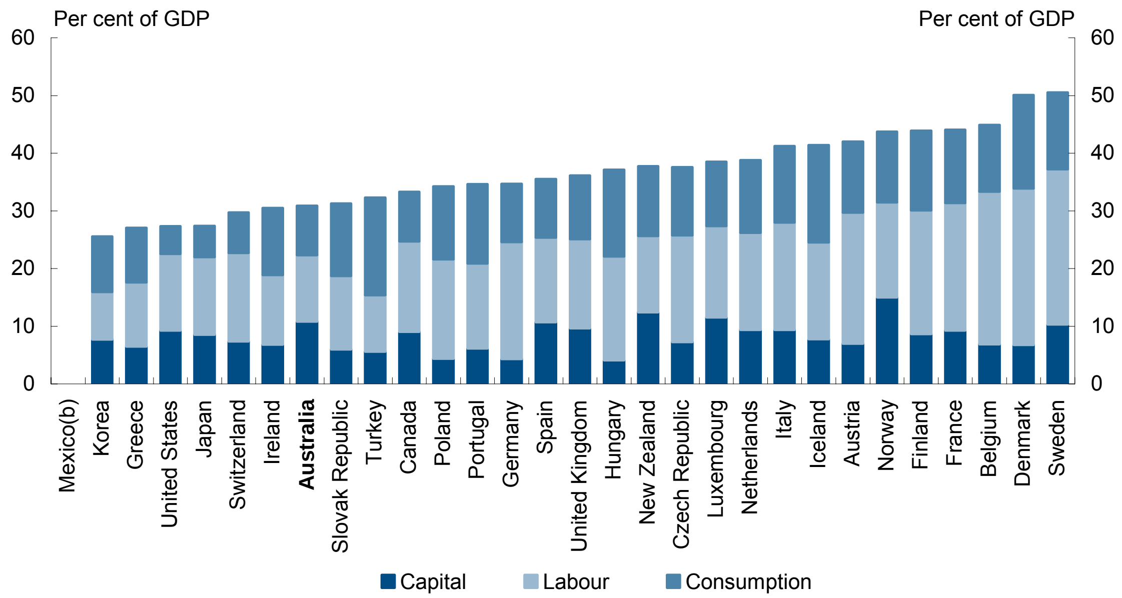
Nevertheless, as a share of GDP, the total tax burden on capital is around 11 per cent, which is the fourth highest in the OECD. The total burden on labour is around 12 per cent of GDP (the fourth lowest in the OECD) and the total burden on consumption is around 9 per cent of GDP (also the fourth lowest in the OECD).

Chart 6.5: Estimated capital taxation revenue in 2005[(a)]
OECD-30 and OECD-10 countries



(a) For Korea, Iceland, Switzerland and Turkey the share of personal income tax revenue derived from capital has been estimated using the average share of other OECD countries.
(b) Data for Mexico not available.
Source: OECD (2007a); Eurostat (2008), Treasury estimates.

Chart 6.6: Estimated contribution of capital, labour and consumption taxes to total tax burden — OECD 2005[(a)]



(a) For Korea, Iceland, Switzerland and Turkey the share of personal income tax revenue derived from capital has been estimated using the average share of other OECD countries.
(b) Disaggregated data for Mexico not available.
Source: OECD (2007a); Eurostat (2008), national governments; Australian Treasury estimates.

Chart 6.4 and Chart 6.6 indicate the relative contribution to tax revenue from taxes on labour income, capital income and consumption. However, differences in the weightings do not necessarily imply differences in tax competitiveness across countries. The amount of tax revenue derived from a particular base and its relative contribution to total revenue will be a product not only of the rate of tax and the comprehensiveness of the tax base but also of size of the activity of the base to which the tax applies. For example, while Australia has one of the highest levels of corporate tax as a percentage of GDP among OECD countries, and this ratio has increased in recent years, the average effective rate of tax on corporate income, which is a better measure of competitiveness, has not increased markedly (Chart 6.7). The increase in the corporate tax to GDP ratio has been due primarily to strong growth in corporate income, particularly in the resource sector. However, there is no readily available data on how average effective rates of tax on corporate income have moved in other OECD countries. These may or may not have shifted downwards relative to Australia in line with the reductions in the statutory company tax rate.

Chart 6.7: Measures of the effective corporate tax rate in Australia

Source: Australian Treasury estimates.