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13 April 2009

AFTS Secretariat
The Treasury
Langton Crescent
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By email: AFTSubmissions@treasury.gov.au

Dear Panel members,

Submission to the Review of Australia's Future Tax System

Your consultation paper raises the issue of vertical fiscal imbalance. Many of the submissions find vertical fiscal imbalance to be bad and should be fixed, but most do not propose how this should be achieved. Even those submissions that give some ideas for fixing vertical fiscal imbalance generally suggest some share of income tax but give no details. (I ignore those submissions that suggest fixing vertical fiscal imbalance by reducing state government expenditure, since there is good argument that there has been too little investment in areas of state government responsibility such as health and education.)

Has anyone provided a costed proposal? In case not and to promote discussion and analysis, this submission provides a costed proposal based on the revenues and expenditures of the three levels of government included in your consultation paper. Answers to some of the other questions raised by the Review are also provided.

The submission is in order of the questions raised by the Review.

For your consideration and publication.

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Denis J O'Hara
(by email)

1. Q3.3 - Property and Wealth

Does Australia's tax-transfer system appropriately deal with property and wealth?

Australia has no tax on inherited wealth, due to the States competing away their right to raise death duties. The States should pass the right to raise death duties (and if necessary inheritance taxes and gift taxes) to the Commonwealth. The Commonwealth should tax inherited wealth, for equity reasons and, if the USA is any guide (and it may not be), to promote philanthropy. I fully realise that such a move would be politically "courageous" (in the Yes, Minister sense), but one of the greatest sources of inequity in Australia is whether or not you are lucky enough to have rich parents. Even if it is necessary to set a minimum below which there is no estate tax (say $1m), the result would be improved equity over the current situation. It would probably also be politically necessary to exclude the family home and the family farm, despite the hit to efficiency and simplicity.

A side benefit to this would be the opportunity to align these arrangements with the taxes applying to certain superannuation assets on death. The submission of the National Institute of Accountants argues that the tax treatment of superannuation death benefits should be brought into line with how other assets are treated on death. I suggest that the Institute be careful what it wishes for!

2. Q5.13 - The Cost of Health and Aged Care

The cost of providing health and aged care to older Australians is currently met by government through the health sector. Should retirement income policy take into account projected increases in health costs for older Australians? If so, what would be the most effective mechanism and how might the transition to such a system be achieved?

As I understand it, the cost of health care as a proportion of GDP is expected to rise as economies advance. If this changing proportion was occurring in private expenditure, it would be of political note but with less political debate. This would require confining public expenditure on health to the "poor", and requiring most people to obtain health services from private sources, obviously including health insurance. This pushes health down the same path as we have taken with retirement income. The challenges include preventing rises in administration as a proportion of total health costs and preventing monopoly rent payments to health professionals and managers. In other words, we need to prevent some of the inefficiencies in the US health system.

In this approach, the Medicare surcharge is replaced by a compulsory health insurance premium. Because the premium is compulsory, there is no (incentive) reason for the private health insurance rebate. The premium should increase with age, because costs increase with age. The transition to such a system would no doubt take decades, as has been the case with private retirement income. Administration costs and monopoly rents can be avoided by tight regulation or a single monopsony health fund.

3. Q6.1 and Q6.2 - Foreign Investment

Can the tax system be structured to better attract investment to Australia in a way that increases national income, and if so how? For any given revenue outcome, what are the relative merits of broader base/lower rate (comprehensive income tax) or narrower base/higher rate (a narrow income tax or an expenditure tax) approaches? What changes, if any, to the tax system would improve the ability of Australian companies to operate internationally orientated businesses? How should the tax treatment of companies and shareholders be integrated in an open economy?

Is it these questions that have lead to the floating of the idea that dividend imputation be removed and the company tax rate reduced to encourage foreign investment? Where is the evidence that Australia needs to make foreign investment more desirable? In fact, is it not the case that Australia has never had any problem attracting foreign capital? The dividend imputation regime, in my view, perfectly integrates the tax treatment of companies and shareholders.

While I accept that "increased foreign direct investment can lead to higher labour productivity … through the introduction of new production techniques, knowledge, products, organisational synergies and process technologies" (p23), I suggest that increased FDI is hardly the only way of achieving such improvement. I suggest a better way of achieving such improvements, with improved equity, would be investing in education and skills development for the un(der)employed.

The consultation paper states that the removal of dividend imputation in the EU is for EU-specific reasons, and that the USA is taxing dividends at a lower rate to recognise company tax paid. I hope these words in the consultation paper indicate that this particular balloon has been well and truly, and justifiably, shot down.

4. Q8.2 - Administration of the Tax-Transfer System

In what ways might the administration of Australia's tax-transfer system be changed to better meet the needs of individuals and businesses? How might the process of personal income tax returns be simplified, including by removing the requirement for some taxpayers to lodge returns? Should the administration of the system be more integrated (across taxes and transfers and between jurisdictions)? How might advances in technology assist?

It would be better, in my view, if withholding taxes were applied to income such as interest and rent, along with other changes, with the aim of minimising the number of individuals and organizations that need to submit an income tax return.

It would also simplify administration for tax payers if all governments maximised their use of the ATO via service agreements. Such an arrangement would be easier to administer, and easier for tax payers, if the bases (but not necessarily the rates) of state and local government taxes were harmonised. Note, though, that harmonisation is not a pre-requisite for state and local governments to use the ATO as a service provider.

5. Q9.1 and Q9.2 - Federal Financial Arrangements

Noting the overall structure of Australia's federal financial arrangements, what changes, if any, should be made to the assignment of revenue raising powers and intergovernmental transfers in Australia? Given the widely held view in submissions that the current state tax arrangements need to be reformed, what changes should be made to state and local government own source revenue instruments? What scope is there for greater use of user charging to bring social, environmental or economic benefits?

I respectfully submit that the mismatch between own source revenue and costs for the governments of Australia is the biggest blight on Australia's taxation arrangements, and thus the greatest opportunity for this Review. In other words, I regard the importance of accountability as far greater than simplicity.

Business groups complaining about taxation complexity should be categorised as "they would say that, wouldn't they". In any case, businesses need to be able to handle multiple jurisdictions in order to be able to do business in multiple jurisdictions, and thus ability to handle multiple jurisdictions is good preparation for exporting and becoming multinational.

Even worse is the complaint from business groups about payroll tax, which is widely recognised as efficient tax, and with some economic equivalence to the GST. Any submission arguing for the abolition of payroll tax should be binned unless it also proposes a replacement tax for the States or the abolition of the States. If it proposes the later, it should be binned as unachievable.

As a side note, it would be very valuable for the Review to list the different taxes in the order in which the taxes satisfy the seven criteria (equity, efficiency, simplicity, sustainability and policy consistency). By doing so, hopefully future commentary from various interest groups would be more informed and less self-serving.

A number of submissions have suggested some form of tax sharing. For example, the submission from the Taxation Institute of Australia suggests a uniform income tax surcharge or a share of company tax. Based on the revenue and expenditure data provided in the consultation paper *Architecture of Australia's Tax and Transfer System*, state government expenditure is around $154b. Company tax raises a total of around $58b, so a share of this is well short of meeting state government needs. Personal income tax plus company tax raises around $176b, so a surcharge sufficient for all State government expenditure would need to be around 88%! That is a big "surcharge".

Based on the revenue and expenditure data provided, my big picture submission is as follows.

The Commonwealth obtains taxation revenue from company tax, GST, excise duty, superannuation taxes, customs duties, petroleum RRT, wine equalisation tax (or better an alcohol volumetric tax), agricultural levies and other federal taxes, raising a total of around $142b. To this is added revenue from probate, inheritance and gift taxes.

The States obtain taxation revenue from personal income tax, fringe benefits tax (levied on the individual not on the employer), payroll tax, motor vehicle taxes, gambling taxes and other state taxes, raising a total of around $150b. Stamp duty and insurance taxes are abolished, for efficiency reasons. Since state government expenditure is around $154b (and probably too low, given the lack of investment by state governments in health and education), the total tax take from these sources will need to be increased, preferably by removing exemptions to "broaden the base" of payroll tax. (Some of this may not be necessary if there is increased personal income tax flowing from abolishing stamp duty and insurance taxes. Access Economics, in their paper included with the submission of the Investment and Financial Services Association, estimates a personal income tax increase of $2.4b, company tax increase of $1.3b and GST increase of $0.8b.)

Local governments obtain taxation revenue from rates and land tax, raising around $13b. Since local government expenditure is around $24b, the total tax take will need to be increased, by removing exemptions to "broaden the base" of land tax. With legislative protection against gouging, this could include the States and the Commonwealth paying rates and land tax on their land holdings. Local governments which are not viable with this level of revenue must merge, not be bailed out by intergovernmental transfers.

6. Consequences and Reactions

Intergovernmental transfers are not so much abolished as unnecessary. There are no constitutional barriers to moving income tax back to the States (as the founding fathers originally decreed). It is no longer necessary to re-distribute GST back the States, as it truly is a Commonwealth tax. The Grants Commission is unnecessary.

In all likelihood, much of the Commonwealth public service currently duplicating functions that the constitution assigns to the States is also unnecessary. I predict that the IPA will be pleased with any reduction in the Commonwealth public service, but this is not my reason for proposing these changes!

It is the reaction of the politicians that will be the most interesting. Will state politicians step up and accept their responsibilities for both revenue raising and service delivery? House of Representative politicians will presumably reject such a reduction in their power over the States, and I predict that Senators will do likewise, confirming that they are members of their Federal party first and foremost and not representatives of their States.

I strongly suggest that the fight from Commonwealth politicians about the reduction in their power most strongly demonstrates the need for these measures.

7. Issues and Problems With These Recommendations

No estimate has been provided of the effect on all levels of government of the States and the Commonwealth paying rates and land tax on their land holdings.

The Review considers horizontal fiscal equalisation as outside its scope. I have not attempted to quantify the effect of my proposals on each state government and territory. Clearly such work is required before implementation. I suspect my proposals will favour the larger States, or more particularly given the growth of Queensland and WA, I suspect my proposals will cause problems for SA, Tasmania, probably the ACT and certainly the NT. It is also possible that SA and Tasmania would relish the opportunity to differentiate themselves if given the ability to raise their own revenue rather than relying on Commonwealth government transfers.

It is at least arguable that the States are not investing enough in health and education and local governments are not investing enough in asset maintenance and renewal. If this is true, the revenue raised by state and local governments will still be too low. Either the tax rates are increased or, more likely, the Commonwealth retains some power and influence, including economic flexibility, by funding investments in public infrastructure.

There would be on-going costs from individuals trying to artificially move to the state where they would pay the least income tax. Using withholding taxes and other measures to remove the need for individuals to submit income tax returns would reduce this problem (but not eliminate it, after all there is money involved, and tax money at that!).

When payroll tax was first handed from the Commonwealth to the States, the rules were reasonably uniform across jurisdictions. The States have since varied the rules for competitive political reasons. So why would this not happen in future with personal income tax? The reality is that it will. Accept it, and let the States accept the consequences of their decisions, instead of relying on federal government transfers to hide these consequences.

8. Power to Implement?

With the exception of the Commonwealth paying rates on its land holdings (via ex-gratia equivalent payments), implementation of my recommendations for local government revenue is entirely at the discretion of individual state governments.

In contrast, handing personal income taxation to the States is achievable by the Commonwealth government alone. (Of course, the Senate is no small issue.)

If the Commonwealth wants to keep its hands on all the levers and minimise some of the problems and issues raised above, it could:

- Implement withholding taxes on various investments such as interest and make other simplifications such that many individuals do not need to submit a tax return (or at least the tax return is prepared by the ATO and lodged unless changed by the individual).
- Maintain control of the ATO.

- Maintain control over income tax legislation, but automatically pass personal income tax collected to the state of residency of the tax payer.

- End all other transfers to the States and local governments. (Probably too much to hope for, but it is important that the States get the message that they are on their own.)

The Commonwealth maintains full economic flexibility over fiscal settings. It can even set different rates for different States, if it wants to and refuses to give this power to the States. This limits the hand back of revenue accountability to the States, but would stop complexity arising among the States and make Federal politicians feel like they are still in control.

9. Conclusion

The problem of vertical fiscal imbalance in the Australian federal system is fixable. The Commonwealth can end vertical fiscal imbalance between the Commonwealth and the States with one decision, similar to the decision to remit all GST revenue, only this time let us get a closer match of revenue and expenditure. Ending vertical fiscal imbalance with local government is also achievable, but requires action by state governments to pass more of their revenue raising capability to local government.