SUBMISSION ON INFLATION AND THE AUSTRALIAN TAX SYSTEMS

INTRODUCTORY

This submission is made in my personal capacity. It has regard to my experience as an actuary, company director, investor and executive director of the Life Insurance Federation of Australia (1975-1986). I have also written numerous books and articles on investment, business, retirement and taxation issues.

SUMMARY

This submission comments on inflation (architecture paper 3.1, 7 and 8.2).

In particular, it focuses on four areas calling out for reform, discussed under the following headings:

BACKGROUND

A major defect of the current taxation systems in Australia (and also in many other countries) is that there is no recognition of inflation.

Inflation affects the Australian income tax system in a number of different ways. In particular, dollar amounts mentioned in the tax legislation - deductions, tax offsets, limits, thresholds, even penalties - all rapidly become out of date as the value of the dollar becomes eroded.

If a given level was appropriate at the time of its introduction some years ago then it will certainly no longer be appropriate today.

PERSONAL INCOME TAX

The effect of this which is most obvious to the general public surfaces in the progressive scale used for personal income tax. For example, wage earners whose income moves up in dollar terms in line with changes in the cost of living - so that their "real" wages remain unaltered - could reasonably expect that their tax would move up correspondingly, in other words, that the tax as a proportion of taxable income would remain unaltered.

But the tax scale in current use, designed on a "zero inflation" assumption and with regard to "ability to pay" considerations, involves the philosophy of collecting more cents in the dollar from large incomes than from small ones. This principle, reasonable enough when real incomes increase, is totally inappropriate when real incomes stay constant with nominal incomes increasing.

This phenomenon is commonly referred to as "bracket creep". Government revenue in real terms can as a result increase each year without Parliament ever having to make a deliberate decision to increase tax rates. The zero inflation assumption in the legislation is quite unrealistic.

For example, consider a typical worker on $55,838 a year ($1073.80 per week), being average weekly earnings for the March quarter of 2007. If that worker then gets a 10 per cent pay rise to $61,422 (whether by way of promotion or because of award changes), then that person's tax bill goes up, not just by 10 per cent, but rather by 14.43 per cent from $12,189 to $13,948. At whose expense is the government achieving some of its much vaunted budget surplus?

Looked at another way, if that worker's employer wanted to increase the worker's net take home pay by 10 per cent from $43,649 to $48,014, then the employer would need to increase the worker's gross pay by some 11.41 per cent from $55,838 to $62,210. This would, of course, also increase the employer's oncosts (for payroll tax, workers' compensation, superannuation, and so on) by at least the same proportion.

CAPITAL GAINS AND LOSSES

It also follows that if capital gains are to be subject to income tax then such gains should be measured as the difference between the proceeds received on the disposal of an asset and its indexed cost price where this is a lower figure.

In the same way if capital losses are to be allowed as income tax deductions - desirable in the interests of equity - then such losses should always be measured as the difference between the proceeds received on the disposal of an asset and its indexed cost price where this is a higher figure.

SOME HISTORY

In 1983 the then Federal Government introduced the half-yearly automatic indexation of excise duties, showing that it was willing to recognise inflation where this benefited overall tax collections.

The indexation concept in situations favouring citizens has, to be fair, also surfaced in some more recent legislation - for example, in relation to capital gains tax on its introduction in September 1985 - but even that aspect of this legislation was subsequently repealed in 1999 and it had not dealt evenly with capital losses. By and large indexation is still the exception rather than the rule and anomalies abound.

The most objectionable aspect of the tax system discussed above is not that it produces more revenue for the government but that it does so surreptitiously and dishonestly. Obviously, if the people want more services then these will have to be paid for in some manner.

A frank and open announcement that taxes need to go up in order to finance the government's programs may be less appealing electorally than subterfuge, but it would at least enable the community to debate its priorities in a meaningful way. In any case, not all voters are stupid - they may not realise just how they are being hoodwinked, but they know (from their pay packets) that they have been taken for a glorious ride somehow.

A separate problem arises in relation to the correct calculation of business income (or profit) for income tax purposes. As discussed below, it is necessary on the grounds of equity to ensure that only real rather than nominal gains are made subject to tax levies.

A former Liberal/National Party Federal Government in its first budget after being returned to office in 1975 gave recognition to these factors and proudly introduced tax indexation. The then Treasurer, Mr Lynch, in his formal August 1976 Budget Speech praised the new system in the following terms:

"It represents perhaps the most significant reform of the personal income tax system in our time."

However, the legislation introduced at that stage, providing for a mere 50 per cent trading stock value adjustment, did not really deal adequately with the taxation of business transactions under inflationary conditions, a point discussed in greater detail below.

Despite this, the measures were in the right direction and the move was therefore widely welcomed. A first step appeared to have been taken towards ensuring that only actual profits - rather than illusory profits - were to be subjected to tax.

As the then Prime Minister, Mr Fraser, pointed out at the time, tax indexation was meant to keep governments honest, forcing them to go to Parliament whenever they wished to increase tax collections.

He said that governments would no longer be able to rely on a graduated scale of personal income tax in order to produce increased yields each year without this being obvious to the majority of the electorate. The phenomenon, usually called "fiscal drag", was in effect being outlawed.

In subsequent years the Coalition Government became less enthusiastic about automatic tax indexation and eliminated it in stages. Indexation completely disappeared after 30 June 1982. The desire to gain electoral mileage from making tax reductions by specific enactment and a wish to keep budget deficits low both seemed then to be more important than having an equitable tax system.

The Coalition chose to ignore its own philosophy as summarised above. That Government completely rejected the obvious and important principle that the correct way to increase total personal income tax collections (if that is felt necessary) is to increase the rate of tax in the dollar rather than to abandon or downgrade indexation.

THE FOUR PRINCIPAL AREAS REQUIRING REFORM

There are actually four main areas crying out for reform:

* Wage earners and other individuals whose incomes rise to broadly reflect changes in the cost of living experience "bracket creep".

* Recipients of interest pay tax on the full nominal amount of interest without any offset for the loss of purchasing power on their capital investment. Correspondingly, in a business context borrowers get a tax deduction for the nominal rather than the real amount of any interest and thus make windfall profits.

* Depreciation on fixed assets is for tax purposes based on their historical cost, rather than, as in logic and equity it should be, on their current replacement value.

* Businesses buying and selling goods are taxed on profits calculated as the excess of the sales prices of items over their historical cost, rather than on the actual cost of items purchased as replacement stock.

In addition, because the above anomalies also lead to misleading bookkeeping, it is quite possible for investors to have to pay tax on what are really illusory profits.

These aspects are further discussed below.

BRACKET CREEP

It is obviously undesirable that each 10 per cent wage rise for workers should automatically produce a rise in their tax bill of around 20 per cent.

The indexation of tax brackets in the sliding scale used in many tax systems would help to keep governments honest, forcing them to go to Parliament whenever they wished to increase tax collections.

Tax indexation, by eliminating such windfall gains to the authorities, would also act as a useful device to strengthen the resolve of governments to fight inflation.

The correct way to increase personal income tax collections if this ever becomes necessary is to increase the rate of tax in the dollar openly, by legislation, rather than to rely on bracket creep.

Automatic indexation of the scale used for personal income tax should now be brought in.

Similar remarks apply to certain state taxes, such as land tax, which involve a sliding scale.

THE TAX ON INTEREST - THE PROBLEM

Real interest rates after tax (that is, nominal rates after tax less the rate of inflation) can easily be negative, meaning that fixed interest depositors and other holders of net monetary assets effectively get "fined" for saving. It is little wonder then that some people prefer to spend rather than to save under this scenario.

Part of the nominal interest payments which bear income tax under the current tax regimes of most countries are really payments in the nature of capital, doing no more than preserving the spending power of the lender's original savings.

Only the balance of the interest above the inflation compensation element - the so-called "real" interest rate - increases the lender's wealth and so can be regarded as a "profit" contribution which should in equity be treated as subject to income tax.

To tax more than this is quite immoral and amounts to a selective wealth tax, confined to monetary assets, and thus weighted against the poor.

Correspondingly, where interest paid by borrowers is deductible as an expense incurred in the earning of assessable income, logic demands that only the real interest and not the nominal interest should be claimable.

Any change to the tax treatment of interest should clearly cover both lenders and borrowers - a point often overlooked in the discussion of this subject. Using real interest for tax purposes in commercial transactions would, of course, be revenue neutral, provided that lenders and borrowers were both on the same marginal tax rate.

Obviously the authorities would also be concerned at some possible side effects if a change towards taxing only real interest were suddenly to be made.

The public sector is typically a net borrower from the private sector. The public sector is not itself a taxpayer, so that the total cost of the tax benefits to lenders could exceed the total value of the lower tax deductions for borrowers. Thus tax rates would need to rise elsewhere in the system in order to produce the same total amount of revenue - and such an increase would clearly be unpopular.

This is, no doubt, one of the reasons for the reluctance of governments throughout the world to face the issue.

Equally seriously, interest rate levels on all existing loans naturally reflect the current tax regime. A change to the rules would result in lower interest rates in future. In the absence of special arrangements, this would affect the market value of all listed fixed interest securities.

Without this, all existing lenders would, in effect, get windfall gains from the changeover, as they would keep their high gross returns and also receive tax relief. Correspondingly, all existing borrowers would incur windfall losses.

THE TAX ON INTEREST - A SOLUTION

To overcome this, the tax legislation should recognise two classes of loans, say "A" and "B". For Class "A" loans interest would be taxed under the present rules. For Class "B" loans interest would be treated under new rules, drafted to ensure that only the "real" component was taxable/deductible.

Existing loans would all become Class "A" loans. Future loans could be either Class "A" or Class "B", at the nomination of the borrower at their commencement. Market forces would obviously ensure that the latter commanded much lower interest rates than the former - a feature which would be of great benefit to many users of borrowed funds, including small businesses.

This dual system would admittedly involve some loss of revenue, as under freedom of choice people will always select the more tax-efficient alternative for them.

DEPRECIATION

A depreciation value adjustment to reflect the increased cost of replacing fixed assets at a time of inflation should also be introduced.

There are several different formulae for calculating depreciation each year, but the idea in each case is that by the time the value of a depreciating asset has become zero enough money will have been taken out of the profit otherwise available for distribution to enable a replacement asset to be acquired.

When, as at present, the tax law requires the tax deductions to be calculated by reference to only the historical cost of an asset, when due to inflation the cost of an equivalent replacement asset is higher, then the amounts taken out of profits using this basis will be inadequate.

STOCK VALUES

Consider an item purchased wholesale by a merchant for $100 and sold retail for $120. The gross profit on which tax would be assessed would thus be $20.

But in business a true profit does not arise unless the value of one's assets at the end of a cycle exceeds the value of one's assets at the beginning of the cycle, apart from cash brought in or taken out.

Immediately before the above-mentioned sale the merchant owned one item.

Immediately after the sale the merchant owned $120 cash. If as a result of inflation it required $110 to purchase a replacement item to have on hand as trading stock then the cash owned would fall to $10.

As the number of items (namely, one) has not changed the value of the merchant's assets over this cycle has increased by only $10 and to tax the merchant on an apparent profit of $20 is clearly unfair.

CHOICE OF INDEX

Consideration should also be given to introducing a more appropriate index for tax indexation purposes than a consumer price index, as sometimes suggested.

The most suitable single index would appear to be one based on average weekly earnings, as that would have maximum regard to inflationary movements in taxable incomes.

THE TAXATION OF BUSINESSES

For all commercial transactions it is most important that the tax base should be correctly chosen so that only real profits are assessed.

As indicated above, a business enterprise cannot be considered to have made a true profit unless the net worth of the proprietor at the end of an accounting period exceeds the proprietor's net worth at the beginning (apart from moneys put in or taken out).

The taxation of illusory profits amounts to a levy on capital and not on income.

An inequitable tax system also encourages companies to adopt inadequate bookkeeping procedures and in effect to pay dividends out of capital. In this way a nation's capital base is being eroded, leading to serious long term consequences for the nation.

BOARDS OF DIRECTORS

Many company directors seem unwilling to adopt inflation accounting on the grounds that taxation is levied on conventional profits and that no change in presentation is appropriate until the tax legislation is amended.

This is a "back to front" argument. Governments would be much more likely to correct the tax injustice of their present systems if the published profit results of business enterprises demonstrated the unfairness of the high rate of tax per dollar of real profits being paid by many businesses.

INEQUITIES IN THE PRIVATE SECTOR

Inflation affects different industries in different ways and the tax approach in current use is also quite inequitable as between different industries, particularly in regard to depreciation and stock values, as discussed above.

A trading stock value adjustment would not be an arbitrary tax concession - it would be a genuine attempt to achieve tax neutrality.

If a government feels that it must raise a particular sum of money from company taxation then it should adjust the rate of tax rather than persevere with an incorrect tax base.

MORE HISTORY

The then Treasurer, Mr Howard, when announcing the withdrawal of the trading stock value adjustment on 24 May 1979, criticised the business community in the following terms:

"There is evidence that many businesses, taking the view that the stock valuation adjustment was an outright tax concession, have applied benefits from it to increasing reported profits."

There is little doubt that he was fully justified in this harsh criticism.

However, other points made at the same time (namely, that the adjustment was no longer necessary because business liquidity had improved significantly and because the rate of inflation was falling) were not valid then and are not valid now.

It was unfortunate that far too many companies had chosen to boost their published net profit results by taking full advantage of the lower tax derived from a correction to conventional profits, while not being willing to make the corresponding downward adjustment to the gross profit figures themselves - an inexcusable inconsistency.

The trading stock value adjustment had not been a tax concession, despite political rhetoric to that effect. It had been a deliberate attempt to achieve tax neutrality.

In his 24 May 1979 speech to Parliament, Mr Howard also claimed that "this concession was not available to a significant section of the business community". Perfectly true: an adjustment designed to compensate for the impact on profits caused by the holding of trading stock should from its very nature not be available to businesses not holding such stock.

The former Treasurer had apparently lost sight of the considerations of equity which had induced his predecessor to institute this reform in the first place.

THE OVERALL EFFECT

When a private organisation quietly rips off the public to the extent of a few million dollars this can attract media attention for weeks. If, on the other hand, the Commonwealth Government takes the community for a ride to the extent of more than 10,000 times such a figure every year then there are no headlines - presumably because it is all done by sleight of hand.

The Government's method is actually crystal clear. It uses a taxation system which pretends that a major fact of life - namely, rampant inflation - just does not exist.

STATE TAXES

Some State Governments have been more ready to recognise inflation in their tax systems, although this is generally done by ad hoc legislation each year rather than by an automatic formula.

For instance, the sliding scale used for levying land tax in Victoria is adjusted each year and this is possibly intended to ensure that on average the ratio of tax to the value of the land content in each property will stay constant from year to year.

However, the approximations used in the equalisation factors, which treat all land values in any one municipality as increasing at the same pace, can admittedly be inequitable to individual landowners (in either direction).

Again, monetary penalties in recent Victorian legislation have been expressed in "penalty units" rather than in dollars. Each unit is worth $100, indexed.

Some business taxes levied by State Governments are particularly harmful in the inflation context - notably payroll tax, which increases the cost of labour and which is inevitably passed on in the form of higher prices.

Similarly, motoring taxes feed into all transport costs and thus affect virtually all goods. This is particularly severe for Australia as a country with large distances separating small markets.

Taxes imposed on businesses as distinct from those levied on individuals may be less damaging to governments in an electoral sense, but such taxes also tend to be far more inflationary.

SOME FURTHER OBSERVATIONS

Australian taxpayers earning income derived from overseas sources are required to present their tax returns in Australian dollars, using appropriate rates of exchange to convert any foreign currencies involved.

Would it not be equally logical to require taxpayers to convert Australian dollars of earlier years into current value Australian dollars?

CONCLUSION

The authorities need to face reality - inflation cannot be eliminated. It is therefore most important that the effects of inflation should be made as tolerable as possible for the whole community.

Reforms on the lines discussed above are long overdue.

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Nick Renton AM