Tax Discussion Paper – March 2015 Submission

Historical Overview

There was a time when Australia had a far simpler taxation system, one with lower rates and greater incentives for work and productivity. Taxes were introduced on income from personal exertion by the Australian colonies between 1884 and 1902. South Australia was the first to introduce a tax on income in 1884 at a rate of 1.25%. After an initial attempt in 1886, New South Wales introduced an income tax of 2.5% in 1895. In 1902, Queensland levied a tax at rates up to a maximum of 5% on income from personal exertion. Finally, Western Australia introduced an income tax of 1.66% in 1907. Of course, simplicity and incentives for work were even greater before these taxes were introduced.

Facing the cost of war the Federal government decided to introduce a tax on income from personal exertion at rates from 1.25% to around 13% for amounts below £7,600 ($732,492[1]), and 25% after that. The income of companies was taxed at a flat rate of 7.5%. Upon the introduction of the Act, the Attorney-General said, "This Bill, of course, is frankly a War measure designed to meet the present circumstances … No doubt this Bill reaches the high-water mark of income taxation, but it does not do so without ample warrant".[2] The war is now over but the tide of taxation has not receded.

From 1915 until 1942, both State and Federal governments levied income tax. Amid the expenses of another world war, in 1942 the Commonwealth passed four Acts as part of the 'Uniform Tax Scheme'. These Acts raised the Commonwealth income tax and, through section 96 of the Constitution, granted an amount of money to the States (approximately equal to what they would have received from their own income tax) on the condition that they would not levy an income tax. Commonwealth exclusivity in the field of income tax was to be temporary.[3] No word yet on the end date.

Centralisation, Higher Taxation and Greater Complexity

Through the demands of war and the centralisation of power, government spending has risen and with it has come a higher level of taxation and subsequent greater complexity. In making representations to their elected representatives, rather than argue for a lower tax rate for everyone, interest groups are far more likely to argue for special deductions, exemptions or subsides, adding to complexity and requiring more taxation from the rest of the public. As the tax rate becomes higher, special concessions become far more profitable for the interest group. Since each concession represents only a small portion of the budget, an interested politician is likely to lend a listening ear. Economist Milton Friedman explained how special interests prevail in a democratic system as the concentrated interests of the few overwhelm the diffuse interests of the many.

> *"The benefit an individual gets from any one program that he has a special interest in may be more than canceled by the costs to him of many programs that affect him lightly. Yet it pays him to favor the one program, and not oppose the others. He can readily recognize that he and the small group with the same special interest can afford to spend enough money and time to make a difference in respect of the one program. Not promoting that program will not prevent the others, which do him harm, from being*

[1] In 2014 dollars according to the Reserve Bank of Australia's Pre-Decimal Inflation Calculator
[2] Woellner, Barkoczy & Murphy (1999) *Australian Taxation Law 2000*, 10th edition, CCH Australia
[3] Bizioli, Gianluigi & Sacchetto, Claudio (2011) *Tax Aspects of Fiscal Federalism*, IBFD, p. 158

adopted. To achieve that, he would have to be willing and able to devote as much effort to opposing each of them as he does to favoring his own. That is clearly a losing proposition."[4]

The process of this tax discussion paper is also affected by these incentives. A member of the public will not likely make a contribution unless there is a highly concentrated interest to serve. It is likely that the contributions received will argue for special deductions or exemptions, adding yet more complexity to the existing taxation system.

A brief survey will show how complexity has arisen in our present taxation system. To prevent leakage from high rates of income tax, the federal government introduced fringe benefits tax as well as high rates of tax on undistributed trust income and the unearned income of minors. Before capital gains tax, a taxpayer could avoid income tax by investing in an asset that appreciated in value rather than delivered a flow of income. For this tax, the government has introduced new methods of calculating gain plus rollover relief, concessions and exemptions. With high personal and company tax rates, dividend imputation was introduced to eliminate double taxation of dividends. In the last budget, the federal government introduced more complexity with differential rates of company tax for companies with turnover of less than $2 million as well as a 5% discount on tax payable for unincorporated enterprises up to a cap of $1,000. Meanwhile, the ATO is embedded inside dozens of multinational firms[5] to find out how they are avoiding a company tax rate that is uncompetitive on the world market.

An Aim for Lower Tax

The aim of the tax review is to have "a better tax system that delivers taxes that are lower, simpler, fairer"[6] with greater incentives for workforce participation and productivity. Given the complexity that high rates of tax generate, this aim is more likely to be fulfilled when taxation is lower. This in turn requires lower spending. But how can the government cut spending when the public has such high expectations of government and when the aggregation of special interest groups are arguing for subsidies. Is anyone really going to volunteer that subsides or special consideration be withdrawn from their own situation or line of business? No! Clearly, lower taxation and government spending will be very difficult to achieve.

Recommendations for Lower Spending and Taxation

In order to achieve this, the balance of incentives must be tilted towards lower spending and lower taxation. This submission proposes this be done using two approaches: the indexation of personal income tax brackets, and the devolution of taxation and spending power from the federal to state governments.

Indexation of Income Tax Brackets

With progressive income tax brackets, a government can increase tax revenue over time through 'bracket creep'. As income rises, the same amount of income is taxed at a higher rate. This process lowers the incentive to work over time as income earners are able to keep less of their income. Bracket creep is also an automatic tax increase without the requirement of legislation. It enables politicians to avoid the political cost of announcing tax increases, and lowers scrutiny on government spending. In order to avoid the problems of bracket creep, income tax brackets could be indexed to the higher of consumer price index or earnings.

---

[4] Friedman, Milton & Rose (1980) *Free to Choose*, Harcourt Brace, p. 294.

[5] The Hon Joe Hockey MP, *Integrity in our tax system*, Media Release, 8 April 2015, http://jbh.ministers.treasury.gov.au/media-release/024-2015/

[6] Commonwealth of Australia, *Tax Discussion Paper*, March 2015, pp. iii, 1, 2, 5, 14.

Devolution of Taxation and Spending Power

At the moment, state governments compete with each other in the areas of payroll tax, stamp duty, land tax and workers' compensation premiums. States aim to keep spending tight and ensure they are getting value for money so that they can offer lower tax environments to encourage business to create jobs and be productive in their state. Where a business sees opportunities in another state, and the tax environment is more favourable to productive activity, it is relatively easy for the business to move.

While the tax system of the Commonwealth competes in an international market, it is more difficult for an Australian citizen to move. If Australians think that Commonwealth taxes are too high, they must leave for another country and perhaps obtain a whole new citizenship. This could take years and may be an uncertain prospect. Compared to a state, the Commonwealth government has less incentive to temper their taxation and spending because it is more difficult for citizens to leave for a different country than to move to a different state. Economist Hans-Hermann Hoppe explains how the geographic size of a government's territory relates to taxation and regulation.

> *"Smallness contributes to moderation, however. A small government has many close competitors, and if it taxes and regulates its own subjects visibly more than its competitors, it is bound to suffer from the emigration of labor and capital and a corresponding loss of future tax revenue. … the larger the territories, the fewer and more distant the remaining competitors, and thus the more costly international migration—the lower a government's incentive to continue in its domestic liberalism will be. … Thus relieved of the problem of emigration, a fundamental rein on the expansion of government power is gone."*[7]

This is part of the reason why state governments might be reluctant to have taxation and spending power devolved to them. States can use the Commonwealth as a form of tax cartel without having to compete with each other or take responsibility for lack of funding. This also points to the potential consequences of the Commonwealth entering into international agreements to ensure tax compliance. It may result in higher taxation for all countries involved.

In order to tilt the balance of incentives towards lower spending and lower taxation, the Commonwealth could devolve entire policy areas to state governments. This might involve the lowering of the Commonwealth income tax to allow room for state governments to levy their own income tax so that they can fund services out of their own revenue, rather than requiring grants from the federal government with strings attached. Where to start?

In 2015-16, the Commonwealth will provide the states with $50.0 billion in specific purpose payments (tied grants) and $57.7 billion in general revenue assistance (GST entitlements), a total of $107.7 billion.[8] According to the budget documents, "The Commonwealth provides payments to the states for specific purposes in areas administered by the states. These payments cover most functional areas of state and local government activity, including health, education, skills and workforce development, community services, housing, Indigenous affairs, infrastructure and the environment."[9] As state and even local governments administer these policy areas, there is no reason why the states should not raise revenue for them. For 2015-16, the Commonwealth Budget estimates $194.26 billion of income tax on individuals and $69.8

---

[7] Hoppe, Hans-Hermann (2001) *Democracy—the god that failed*, Transaction Publishers, pp. 110-112

[8] Commonwealth of Australia, Budget Paper No. 3, *Federal Financial Relations 2015-16*, p. 1.

[9] Ibid, p 7.

billion in company tax.[10] The Federal government could therefore cut income taxes by around 25.7%[11] in order to leave room for the states to levy their own income tax (or other mix of taxes) to fund these policy areas. The Commonwealth might also take the opportunity to include a lower company tax as part of the tax reduction. This would reduce compliance costs and may see multinational companies shifting their profits to Australia. This change could be the first step in further devolution of additional responsibilities from the Commonwealth to state governments following a similar pattern.

While this proposal may seem more complex as both Commonwealth and state governments levy income tax, given competition between states, less tax would be paid overall and citizens would receive more value. The Commonwealth may even reduce the complexity of its own taxes as the incentives for special deductions, exemptions and subsidies fall. The price of uniformity across the country is higher tax and more complexity within a unified Commonwealth tax system.

Conclusion

These policy recommendations would represent major developments in tilting the balance of incentives towards lower spending and lower taxation. The devolution of taxation and spending power to the States would be an historic development in the history of federal financial relations. A large financial shift such as the obvious one suggested may be just the trigger to enable states to raise more of their own revenue and be more independent of the Commonwealth government. As state governments find value for money in these policy areas, change policy preferences to suit the desires of their own people, and lower taxes, Australians may also find greater opportunity with a lower, simpler and fairer tax system with greater reward for work.

Danny Haynes
Principal
Action Economics

[10] Commonwealth of Australia, Budget Paper No. 1, *Budget Strategy and Outlook 2015-16*, pp. 4-19
[11] $50 billion in specific purpose payments as a proportion of income tax receipts of $194.26 billion.