

Towards a tax and transfer system of human scale

Dr Ken Henry¹

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1 Chair – Australia’s Future Tax System Review Panel and Secretary to the Treasury. I would like to thank several members of the Secretariat to the Australia’s Future Tax System Review for assistance in the preparation of this address, including Rob Heferen, John Lonsdale, David Hazlehurst and Jason McDonald. I would also like to take this opportunity to thank all of the members of the Secretariat for their hard work and perseverance in a difficult year.

1. My working holiday

As people all around the world quickly learned – such is the reach of the electronic media these days – I spent July with my wife, Naomi, in the Epping Forest Scientific National Park in central Queensland, helping look after what may be the last 115 northern hairy nosed wombats left on the planet.

The care of our native wildlife is one of my passions. Another is tax policy. That, too, has occupied a fair bit of my time this year as we have been undertaking one of the most fundamental tax reviews ever attempted in this country.

Spending time on one's passions would normally be considered a good thing. In some respects, then, this has been a good year.

But of course in other respects it's been a dreadful year, especially for the global financial system, which has also consumed a lot of my time.

I don't wish, today, to provide a comprehensive accounting of the reasons for the global financial crisis. But I do want to identify three dimensions of it that are highly relevant to some other things that I want to talk about.

The first is the role played by complexity. The array of financial instruments deployed within the global financial system has become so complex that it defies understanding. It is not just that nobody understands the whole system; that's hardly surprising. What is worrying, though, is the very large number of senior finance sector executives who don't appear to understand the consequences of even their own decisions.

The second dimension is closely related. It has to do with risk and uncertainty. Complex financial instruments have been traded globally in ways that were thought to provide a more comfortable sharing of risk. What they've shared instead is fear. People now not only don't know who they can trust, they don't even know who they need to be able to trust.

And the third dimension I want to identify is the role played by regulation and, more broadly, governance systems. For decades to come, policy makers are going to be asking why those with sufficient authority didn't stand up and declare, in simple language, that this just doesn't make sense.

Today, I will be talking about tax. In doing so, I'll be reflecting on those themes of complexity, risk and governance that lie at the core of the global financial crisis.

But first, back to Epping Forest. While there I also spent some time working over drafts of the Treasury's tax and transfer architecture paper released in August.

Having spent a lot of my professional career in the tax policy business, I'm acutely aware of the extraordinary complexity in our system, especially when tax is combined with transfer payments. I can probably take responsibility for some of that complexity. Even so, on reading the Treasury paper, it was a revelation to me that Australia's system now has no fewer than 125 taxes. It turns out that there are more taxes in Australia than there are northern hairy nosed wombats. Clearly taxes are not an endangered species. The Treasury paper also detailed how there are approximately 5,700 pages of income tax legislation, and that almost three-quarters of individual Australian taxpayers apparently need a registered tax agent to prepare their tax return.

On the first night of our trip home from Epping Forest, Naomi and I stopped at Jericho, a small town to the south-west of the park. While waiting for dinner – it was Thursday pizza night at the pub – we sat in the bar for a drink. A local businessman, let's call him Jim, came up to have a chat.

'So, what do you do for a living?' he asked. I was going to say 'I'm a wildlife protection officer', which was sort-of true. But I said: 'I work for government, in Canberra.' Perhaps I sounded a bit defensive – I didn't mean to – because he responded: 'That's alright mate, somebody has to.' And then he added 'Just so long as you don't have anything to do with tax.'

Well, discretion is part of my job description. Even so, we ended up having a long and – I think – insightful discussion about the complexities of the tax system that ordinary Australians have to deal with.

One of the points of discussion sticks in my memory. Jim, an experienced businessman, had, at one point, owned a number of cattle stations. In the course of numerous discussions with a couple of tax auditors following a dispute, eventually settled in his favour, he learned more than he had ever wanted to know about our tax system. 'Do you know', he said, 'that something as ordinary as fencing wire can be treated several different ways for tax purposes?' He explained that it might be immediately expensed. Alternatively, it might have to be depreciated. Then again, perhaps it should be treated as trading stock. Why was it treated one way under income tax but another way under the GST? 'Isn't fencing wire just fencing wire?' he asked.

The views of practical people like Jim can be too easily dismissed by policy experts. After all, 'common sense' can often mask vested interest and produce unintended consequences.

Yet it's been my experience that the bar room conversations of practical people can sometimes contain more wisdom than high-brow policy seminars. This proved to be such an occasion, with Jim going on to explain his preference for being taxed on the

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difference between his cash incoming and outgoings. He thought that this would make a lot more sense than the complex and uncertain system currently in place. As it happens, there's a lot of academic discourse on the merits of a 'cash flow' tax as one way to simplify the tax system – not that I mentioned this to Jim – but I had never seen it argued so well, nor with such understanding. And so without endorsing it, this proposal is clearly one of a number the Panel will need to consider.

2. The personal cost of complexity

Even though our discussion was long, I reflected later that Jim had just scratched the surface of the complexity of our tax-transfer system.

The conversation got me thinking about how seldom policy people approach issues from the perspectives of everyday citizens. And on the long drive south from Jericho, I pondered how the tax-transfer system, in its entirety, might look to someone like Jim.

At some point on that long drive home, it occurred to me that our tax-transfer system, designed for humans, now vastly exceeds human scale.

In establishing his business, for instance, Jim would have needed to consider critically important tax factors in deciding whether to operate as a sole trader or a partnership, a fixed or non-fixed trust, or a company. Each is taxed in a different way. To get the best tax outcome he may well have been advised to use more than one legal entity. Assuming he needed external finance, the differing tax treatments of debt and equity would also have come into play. He would have had to think about superannuation and how his business might provide for his retirement.

Depending on the type and nature of the business, Jim would have faced other obligations. For example, if using a company, he would have needed to keep various additional accounts to comply with dividend imputation arrangements. He would have needed also to avoid falling foul of rules about non-commercial losses and distributions to associated entities. He might have become acquainted with the latter by perusing the 190 page manual dedicated solely to this topic.

And, although Jim's children were grown up and had long since left home, I thought about the tax implications for them of starting a family. Did they know, for instance, that if mum returns to work after having children, Family Tax Benefits Part A and B might be reduced, though the Government covers some of the costs of childcare? Or that the Government provides two separate child care payments – each with different entitlement arrangements and payment rates? Or, further, that the Family Assistance Office must be notified of any changes in family income, which determines entitlement to the Family Tax Benefit and Child Care Benefit, and can indirectly affect Child Care Tax Rebate?

I thought also about how, as Jim and his wife near retirement, they will have significant decisions to make about how to invest their savings. Age Pension eligibility and income tax liability each year depends on the form assets take, so they will need sound advice on what investments they should choose. Depending on whether their savings are invested in their own home, superannuation, or certain types of annuities, they may or may not be able to access the Age Pension and the other concessions and supplementary payments available to pensioners.

By this stage I was thinking how much simpler life had been in the donga back in Epping Forest.

And in reflecting on that disjunction, a proposition formed in my mind: perhaps it's fair to expect Jim to have to hire a tax expert while establishing a business, but surely not when engaging in the normal activities of family life. Australians should not need to consult an accountant to decide whether to return to work or put their kids in childcare. Their retirement planning, too, should be a lot easier.

As well as complexity there's another issue related to tax that confronts people like Jim: uncertainty – or more broadly, risk. As Jim said, 'How is someone like me meant to know what to do with fencing wire in my tax return? And if I get it wrong, I could be in a lot of trouble.'

Dealing with risk also takes time and resources. Like complexity, risk is costly.

One manifestation of this cost is the use made of tax agents. Fundamentally, tax agents are engaged by ordinary taxpayers to manage complexity and risk.

In the 2005–06 income year, around 11½ million Australians lodged tax returns. Of these, 73 per cent – some 8½ million returns – were submitted by tax agents. This reliance on professional help is much greater than in other countries: in New Zealand, only 30 per cent of returns are submitted by tax agents. The cost of managing the tax affairs of Australians is significant, and it's growing. We should be reducing that cost as a matter of urgency.

3. The social cost of complexity

Jim was well aware of some of the direct costs to him of complexity in the tax-transfer system. But there are further indirect complexities that affect him as well. These are hidden in the administration and business compliance costs of the tax-transfer system, which find their way into the prices of everything he buys.

Complexity has macro consequences too. These fall into two broad camps. First, an excessive level of complexity wastes resources. It makes it difficult for taxpayers and transfer payment recipients to make optimal decisions. It diverts resources from more

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valuable uses; many high-achieving tax agents could be school teachers, for example. It wastes time that people could spend with their family, volunteering in their community, relaxing with friends and – of course – caring for northern hairy nosed wombats.

Second, complexity undermines social goals for the tax-transfer system. It provides opportunities for sharp planning practices that undermine the fairness of the system. But it may do more harm than that. Undue complexity serves to alienate Australians from the tax and transfer system, undermining the trust the system needs to operate successfully. Remember how Jim hoped I wasn't a tax official! A simpler tax system will be a more trusted system that generates greater public support and reduces avoidance.

This system complexity acts like an additional tax, but the worst kind of tax: a tax that provides no revenue, is indiscriminate in whom it affects and serves little social value. So why do we have it?

Ideally, we'd like to reduce this complexity, although it's naive to think that we can remove all of it. Part of the complexity in the tax system reflects complexity in the real world, which is becoming more complicated by the day as globalisation and individual opportunity increase. Complexity is not an intended outcome of greater economic freedom, but it may be an unavoidable consequence. And a complex world constrains how simple a nation's tax system can be.

On the other hand, some of the complexity in real life reflects the efforts of individuals and businesses attempting to escape complexity in the tax system. If governments respond by imposing additional tax complexity, a vicious circle is created.

So what do we do about it?

I think there are two things.

First, governments need to sit back regularly and think about the transaction costs of the system as a whole, with an eye to reforms that can not only simplify the tax system but meet other economic, social and environmental objectives.

And second, we should look at the tax and transfer system from the perspectives of the citizens for whom it has been designed.

I'll return to these points in a moment.

4. The optimal taxation of capital

I've noted that there are dimensions of complexity that are of macro significance. One key example where the Panel is still developing its views is the taxation of income from savings and investment. Capital income taxation affects individuals' decisions to save or defer consumption. And, for workers who save part of their earnings, taxing savings also reduces the return from working. Capital income tax settings also affect our ability to tax other income, notably labour income. They affect resource allocation within the economy, investment levels, risk taking, innovation and entrepreneurialism – all of which drive productivity and long-run growth.

Let's drill down for a moment to the implications of taxing investments.

Ultimately, all of us, not just shareholders, may pay the cost of company and other capital income taxes. In an open economy like Australia's, taxes on investment income can increase the cost of capital and reduce investment, which in turn can reduce the level of capital per worker, affecting labour productivity and, eventually, real wages.

Of course, capital is not perfectly mobile and there are other complications to factor in. The Review Panel needs to understand better the economic incidence and distributional effects of capital taxes. Nevertheless, we do expect that, in an open economy like ours, an increase in taxes on mobile capital will reduce investment and national income in aggregate, affecting wages and jobs.

The Treasury's architecture paper pointed to the fact that company tax rates have been declining worldwide, and that Australia has a relatively high reliance on capital income taxes. Not surprisingly, some of the commentary following the architecture paper's release suggested the Treasury was pointing to the need to cut the statutory company tax rate.

However, the policy options are richer than simply cutting the company tax rate.

The strength in company tax revenues in recent years reflects, at least in part, cyclical factors and the resources boom. There is a good case, relative to other tax bases, to tax super-normal profits – what economists call 'economic rents'. To date, the company income tax has been our primary means of doing so. If it is to continue to play that role, then the case for reducing the company tax rate is weakened.

If we were to adjust business tax arrangements to try to attract a greater share of global investment, we would ensure that firms have minimal incentive or opportunity artificially to shift profits offshore; we would want to recognise the impact of tax on the global location of mobile or marginal investments; and we would want to continue to tax economic rents, as these are, by definition, immobile and unresponsive to tax.

These textbook principles are relatively uncontroversial in academic discourse, but they are hard to implement in practice, mainly because even revenue-neutral changes benefit some while imposing costs on others, with attendant political pain. Australia, like most countries, has a way to go before we achieve perfection.

5. What are the next steps?

Progressing tax system design isn't easy. But I'm optimistic. Certainly, it will be more feasible if we have a sensible discourse. Recognising that, the Review Panel has committed to a few ground rules: first, we must remain open to new ideas; second, the review is both too complex and too important to rush; and third, we cannot make good progress without engaging the community.

The steps in the review process are these. In August, as I have noted, the Treasury released its architecture paper, to seed debate. Next month, the Review Panel will release a consultation paper. That paper will summarise what we've heard so far from the community, identify some key issues, draw out the choices that emerge from our analysis of the issues, and seek views on a range of more specific questions. Following the release of the consultation paper, there will be a second, longer consultation period of perhaps six months. During that time, there will be many opportunities for engagement – public meetings, round table discussions, and a tax policy conference in June.

We're going to see a first in Australia: ordinary Australians like Jim will be given the opportunity to put their commonsense view directly to people like me – and not just at the pub. The tax system is for the benefit of every Australian and it follows that every Australian should be able to debate its design.

In the second half of next year we will be writing up our report, due to the Government by December 2009.

6. Why should people be interested?

If Jim were here today, he would know that I agree with him that our tax-transfer system is simply too complex for users. That complexity is costly. We don't know how costly, but we have good reason to think that what you see is only a small part of it. System complexity also exposes people to risk. And, again, in most cases that level of risk should be regarded as unacceptable.

Back in Jericho, Jim tested me on a few questions that had been bugging him. If Jim were here today, I would want to test him on a few questions that have been bugging me.

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First, do you want so many taxes and transfers? Is the added complexity of so many instruments trying to do the same thing worth whatever the benefits may be?

Second, is there a better mix of taxes and transfers that would improve resource allocation?

And third, have we got the right balance of government tax and transfers over a person's lifetime? We don't really know the impact of the tax-transfer system over a person's life-span despite its obvious influence on decisions to work, save, have children, invest and retire. We should know these things.

The Review Panel has been tasked with a 'root and branch' review, not just the 'pruning and shaping', of the tax and transfer system. Its deliberations involve a comprehensive examination of the structure of the system for the long term and its effects on individuals, businesses and Australia's macroeconomic performance.

We will be looking for ideas that address system complexity and deliver superior economic, social and environmental outcomes.

Our goal is to identify enduring reform directions for the tax and transfer system; to craft an architecture that might support multiple reform packages over many years.

If we are going to find that architecture, and give it human scale, we are going to have to be a lot more imaginative, a lot more creative, and we are going to have to get much better at seeing things from the perspectives of people like Jim.

Thank you.

