Priorities in Tax Reform

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Outline

1. Introduction
2. Opportunities for immediate action
   - A wage tax trade-off
   - Big is beautiful – so is small
3. Longer term structural issues
   - Green and amenity taxes
   - Personal tax priorities
   - Corporate tax priorities

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Tax is about choices

Except for green taxes, taxing is costly. So . . .

- ‘Long clean lines’ of policy are valuable, but also come with costs.
  - ‘Real reform’ - getting top rate down – versus ‘tinkering’ of lifting thresholds
  - The argument for alignment of company and top personal tax
  - Dividend imputation was a ‘long clean lines’ reform
    - » perhaps worth trying, but it turns out, with large opportunity costs
- We must choose the lesser of evils.

Immediate prospects

The context

- Inflationary pressure
- Broader the base of our attack on inflation the less damage to any individual or sector
- We are using monetary and fiscal policy (to the extent possible within election promises)
- We should use savings policy (with default super)

We should also pursue a wage tax trade-off

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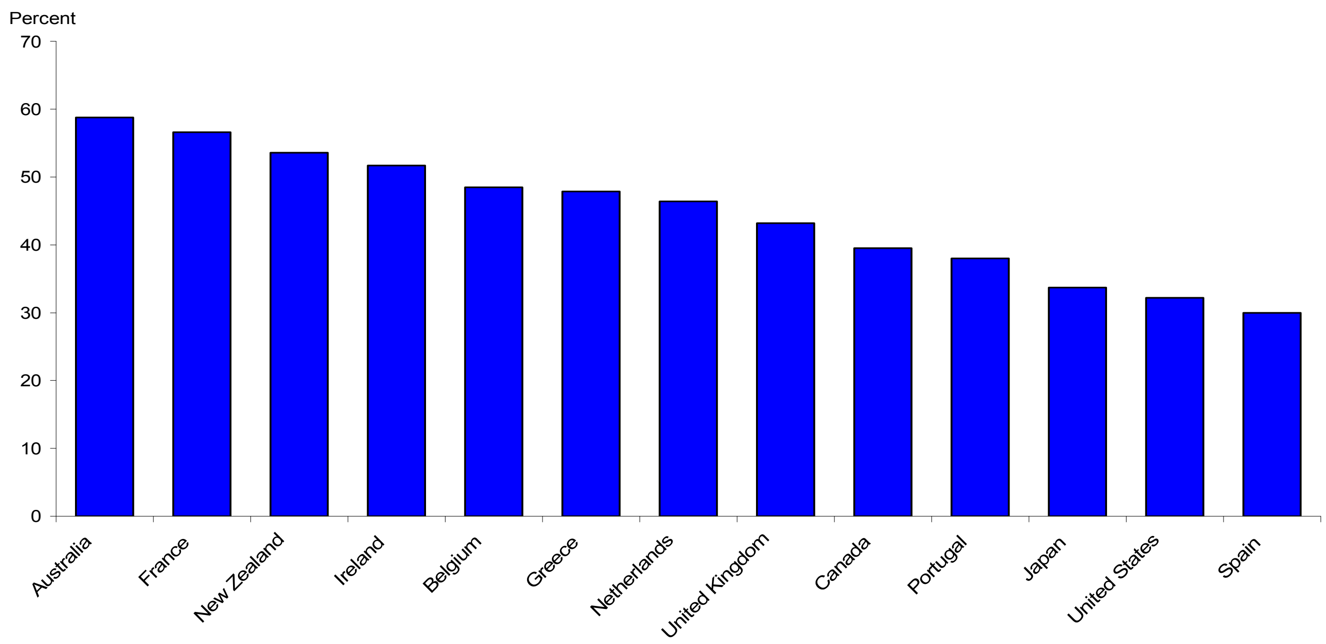
Wage tax trade-off

Adult Minimum Wages Relative to Full-time Median Earnings, Mid-2004: OECD Countries



Source: Wooden, M, 2005. Minimum wage setting and the Australian Fair Pay Commission

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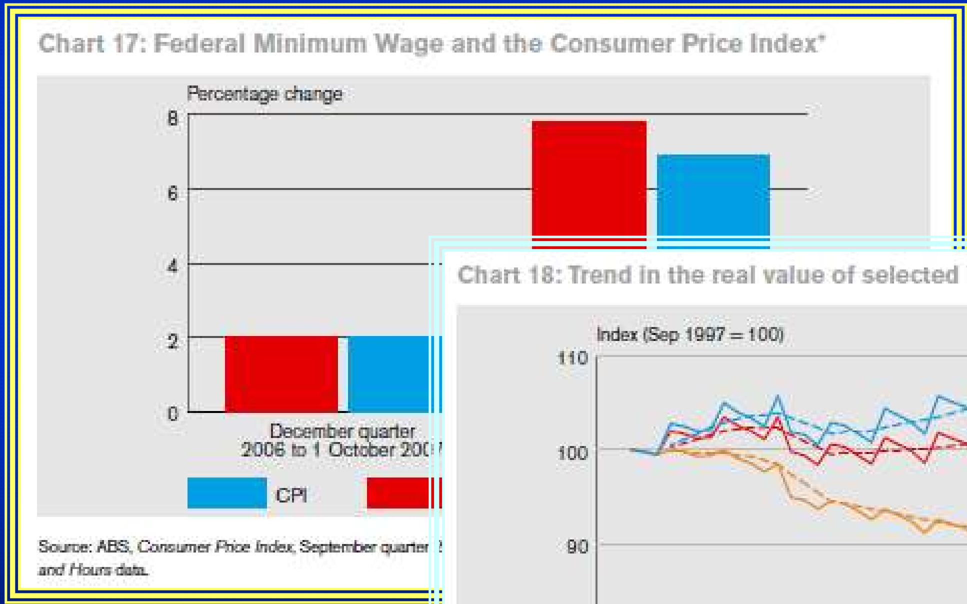
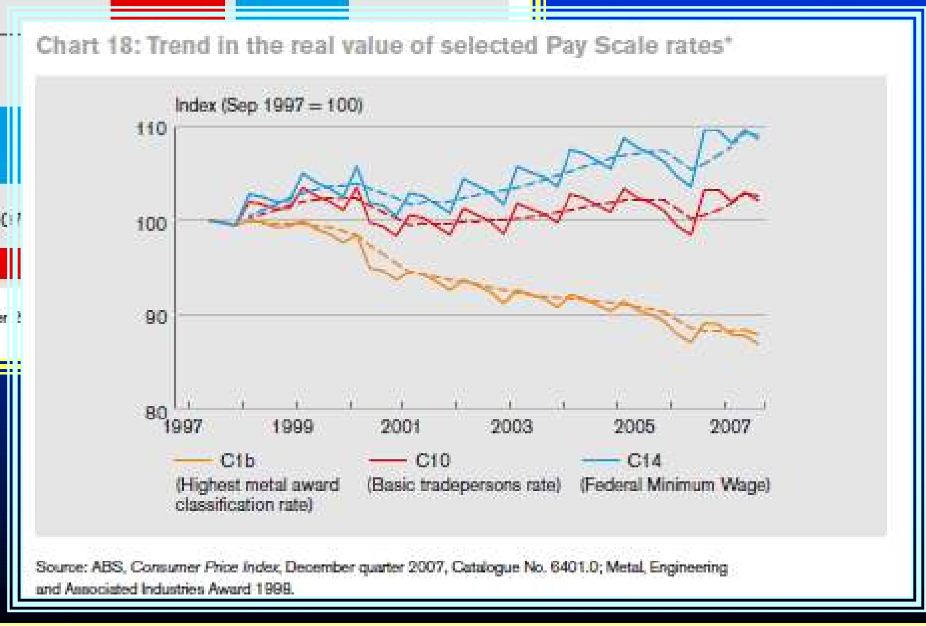
Wage tax tradeoff: FMW over time





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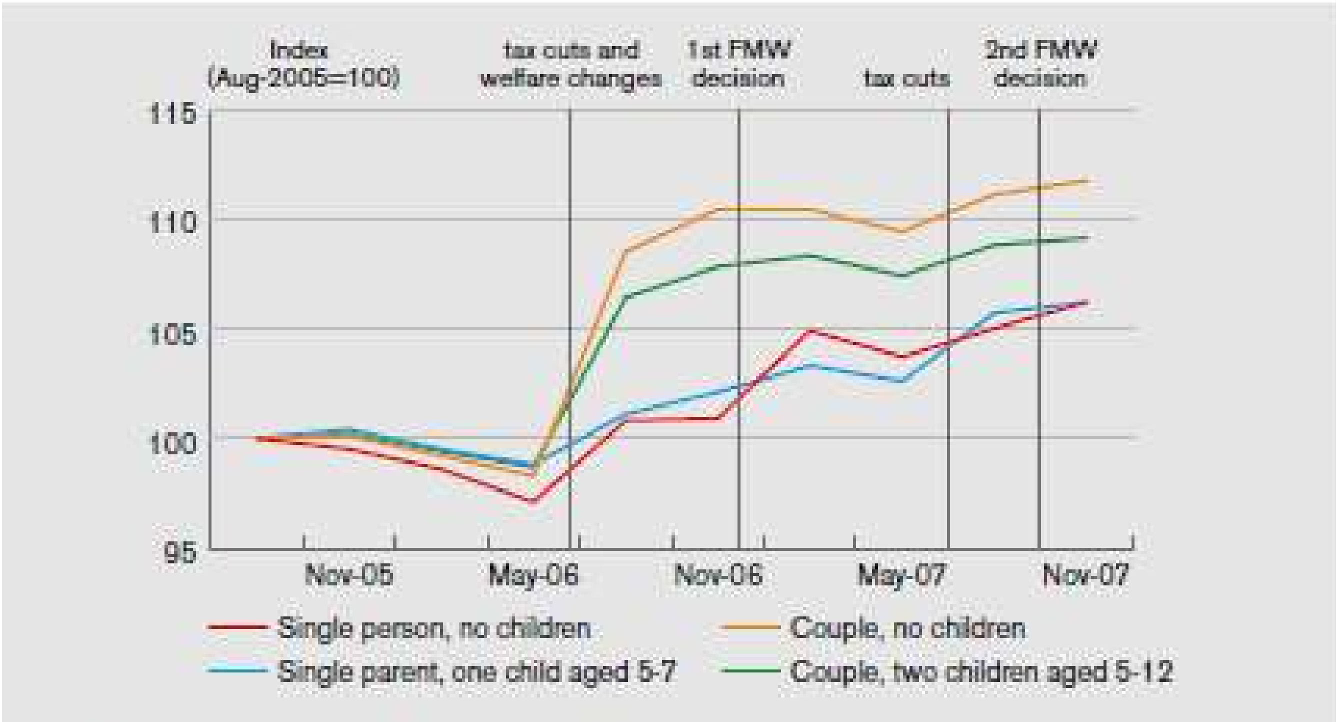
Wage tax tradeoff

- Proposed in 1999 (Five Economists Plan)
- Nominal freeze in the minimum wage
- In return for tax credits that would compensate *most* families for loss of real wage maintenance
- Rejected – though it wasn't clear why

Wage tax tradeoff

- We've spent tens of billions cutting tax and increasing transfers to minimum wage earners.
- Tax liabilities of low-paid workers were reduced in both July 2006 and July 2007,
- through increases in:
  - The LITO – from $235 to $600 (2006) and then $750 (2007) – raising the **tax free threshold from $7567 to $11,000**
  - The threshold at which the 30% rate cuts in from $21,600 to $25,000 (2006) and then to $30,000 (2007)
  - The Dependent Spouse Tax Offset from $1,655 to $2,100.

Wage tax tradeoff: Real household disposable income



Sources: AFPCS modelling; ABS, *Consumer Price Index*, Catalogue No. 6401.0, various.
Notes: Disposable incomes have been adjusted according to published changes in the CPI.

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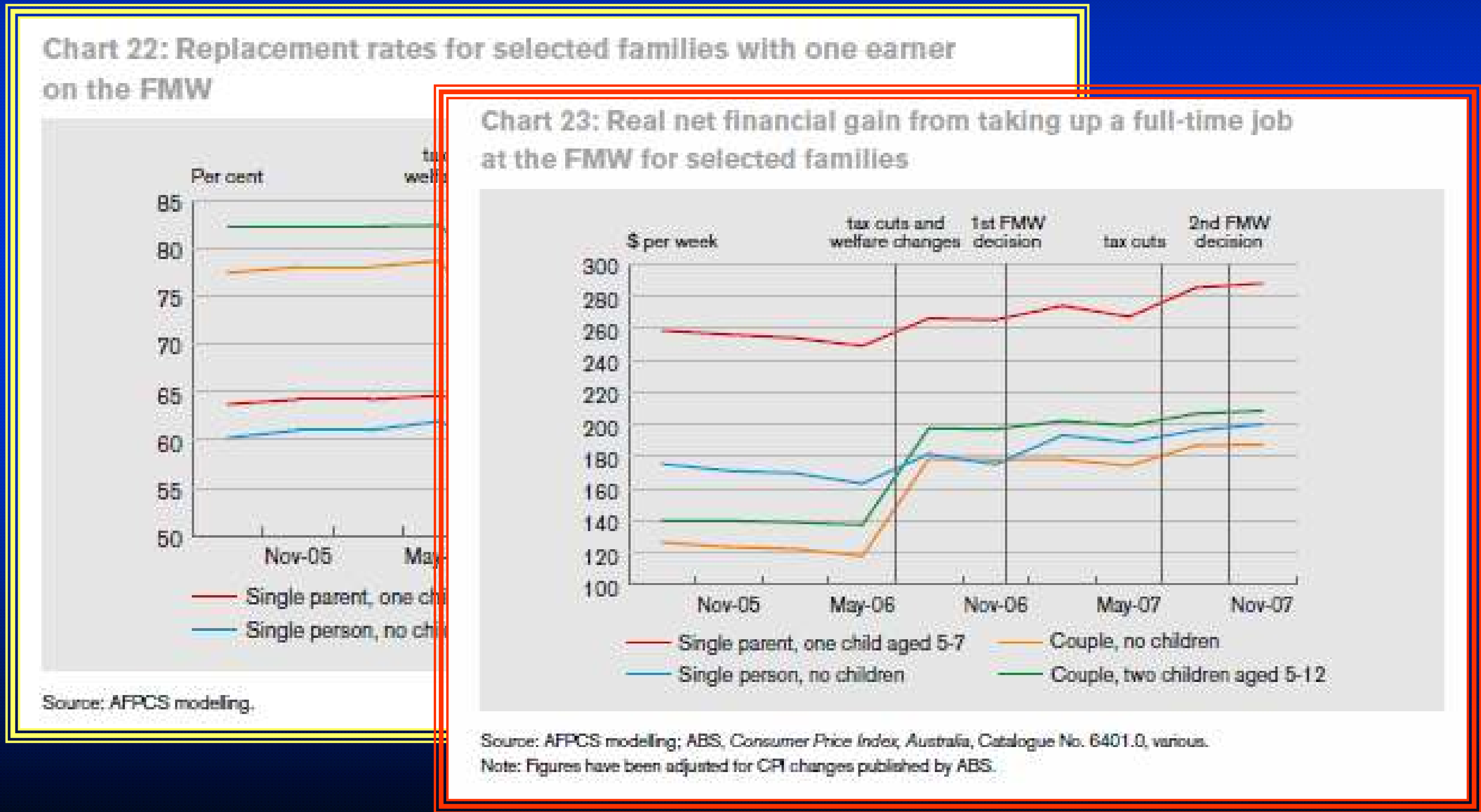
Wage tax tradeoff

– Foreshadowed changes 2008-10
  - **The LITO goes from $750 to $1,200 (2008) then to $1,350 (2009), then to $1,500 effectively raising the tax free threshold from $11,000 to $16,000.**
  - **Threshold for 30% rate goes from $30,000 to $34,000 in 2008 and $35,000 in 2009 and $37,000 in 2010.**

Wage tax tradeoff

- This string of rolling tax cuts creates the circumstances for a wage tax tradeoff
- AFPC should be well disposed to these arguments
- The changes have not just provided plenty of compensation for real minimum wage reductions.
- They've made substantial room for this by lowering replacement rates and EMTRs on moving from welfare to work

Wage tax tradeoff



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Wage tax tradeoff

- Was it too expensive in 1999?
- It's fiscal cost?
- Around $6 billion over three years
- The cost of the next three years tax cuts
- >$30 billion over three years

- What might have happened if WorkChoices had been sold as a wage tax tradeoff?

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Big is beautiful: So is small

- Tax is a complex adaptive system
  - We should start managing it like one
- With as much attention to small as large things
- Dear Mr Dawkins . . .
  - Thousands of small things
  - Artwork is depreciable at 1.5%
- New culture of TQM, and ‘wisdom of crowds’ required
  - Regular ‘continuous optimisation’ of tax system
- Prizes for best suggestions
  - from departments, accountants, the public
- Watch this space . . .

Longer term issues: green taxes, amenity taxes

- Most taxes harm efficiency.   Taxes on pollution and disamentity improve economic efficiency
- Serious revenue is available
  - Introducing congestion charging, could reap billions and replace much worse state taxes
  - Auctioning all emissions permits = tens of billions
    - With compensation for people, not businesses
  - Betterment taxes could help fund infrastructure

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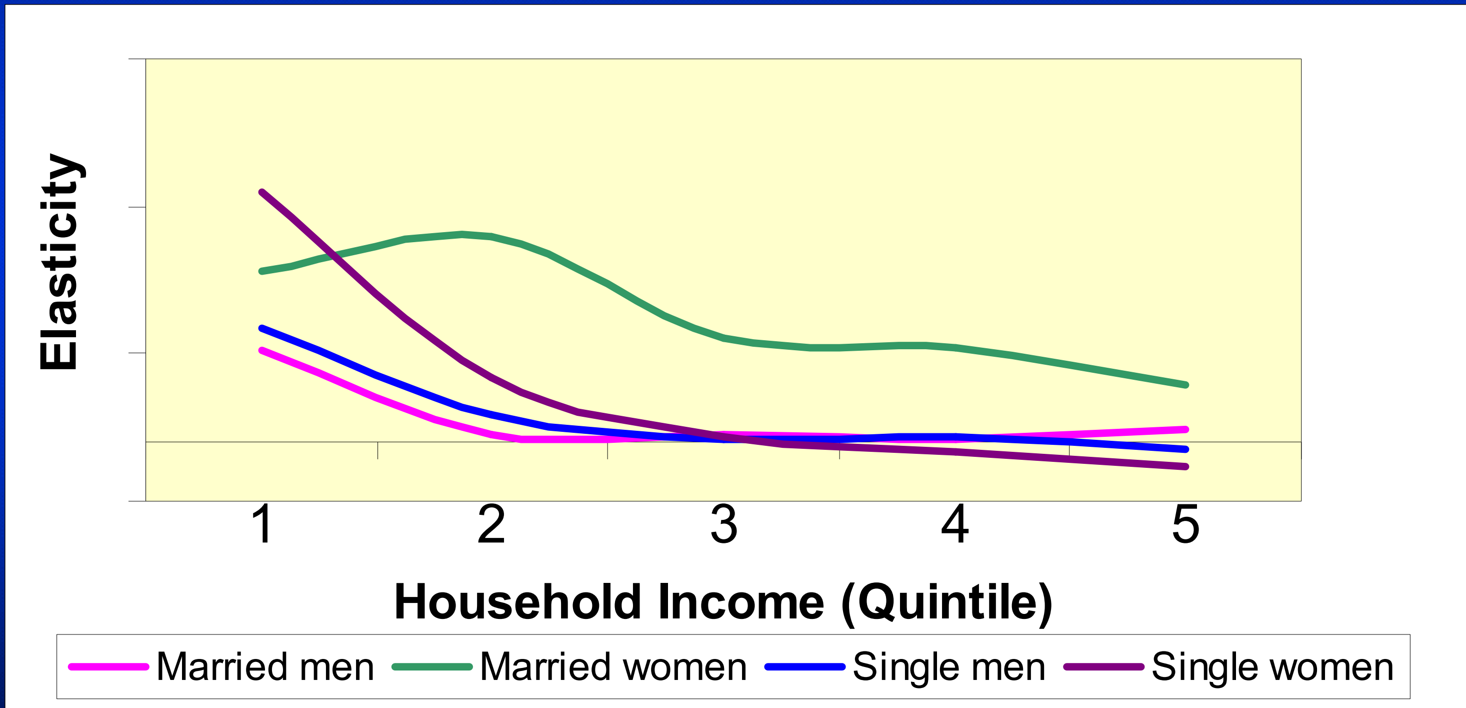
Longer term issues: Personal Tax

- Where we're cutting tax we should keep working on incentives at the bottom
  - This is where the biggest gains are from labour participation, equity, social inclusion and rebalancing our safety net
  - Further up the scale, Howard Government was right to lift thresholds rather than cut top rates
    - Little evidence that cutting top rate increases work effort – and it's expensive
    - If we're competing internationally for skilled labour we compete by lowering skilled workers' average taxation, not their top marginal rate.
  –

Labour supply response according to MITTS



Lifting thresholds versus cutting the top rate

TABLE 6: THE COSTS OF LOWERING THE TOP RATE COMPARED WITH LIFTING THE SECOND TOP THRESHOLD

Measure	Cost ($b)	Proportion of total (%)
Cut top rate	2.3	100
Lift top threshold to $200,000	0.6	26
Lift top threshold to $500,000	1.3	57
Lift top threshold to $1,000,000	1.5	65

Source: Access Economics Monitors

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Capital taxation

- Other things being equal it's more economically costly than taxation on personal exertion
- Why?
  - The implicit tax on saving compounds over time (the closed economy argument)
  - Capital is more mobile than people – even highly skilled people (the 'competing for capital' argument)

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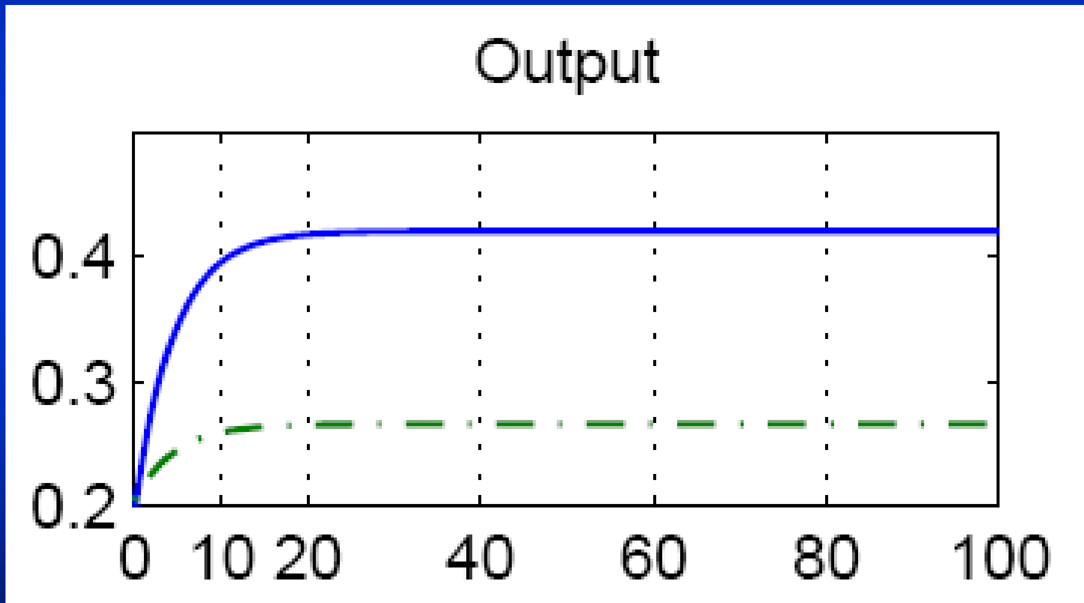
The closed economy argument

- Mankiw and Weinzierl's 'back of the envelope' model
- A simple neoclassical growth model of the US with plausible parameterisation and 25% tax on labour and capital
- In context of debates about extent of self funding of tax cuts
  - Where are various taxes on the Laffer Curve?
- Conclusions are that in the long run
  - Capital tax cuts are nearly 50% self funding through higher saving and investment compounding through time
  - Labour tax cuts are less than 20% self funding – through greater work effort

The closed economy argument



Source: Leeper and Yang, 2006

The closed economy argument

- Arguments only slightly weakened with
  - Non-infinite time horizon for household savings decisions
  - Recovery of lost revenue by alternative (distortionary) taxes.
- Arguments would be greatly strengthened if
  - Markets are imperfectly competitive or
  - Capital investment has positive externalities related to technology development and transfer as has been suggested by DeLong and others
  - The economy is open to capital flows

Tax cuts and growth - empirical evidence

- Lee and Gordon (2005)
  - Strong negative correlations between company tax rates and economic growth and
  - Little or no correlation between top personal tax rates and economic growth
- Hassett and Mather (2006) find
  - Strong negative correlations between company tax rates and wages and
  - Little or no correlation between personal tax and wages (against their AEI priors)

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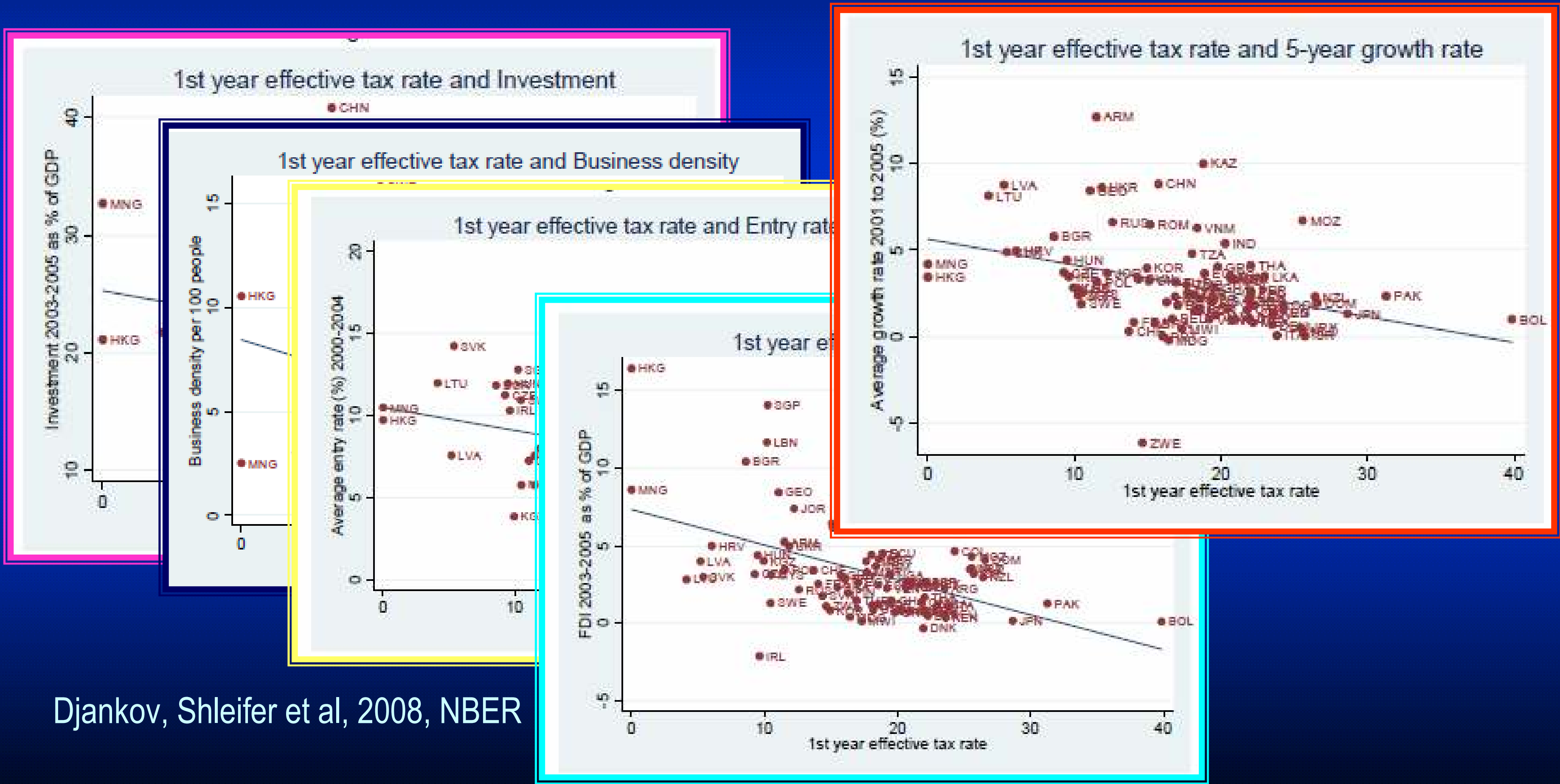
Company tax and growth - empirical evidence



Djankov, Shleifer et al, 2008, NBER

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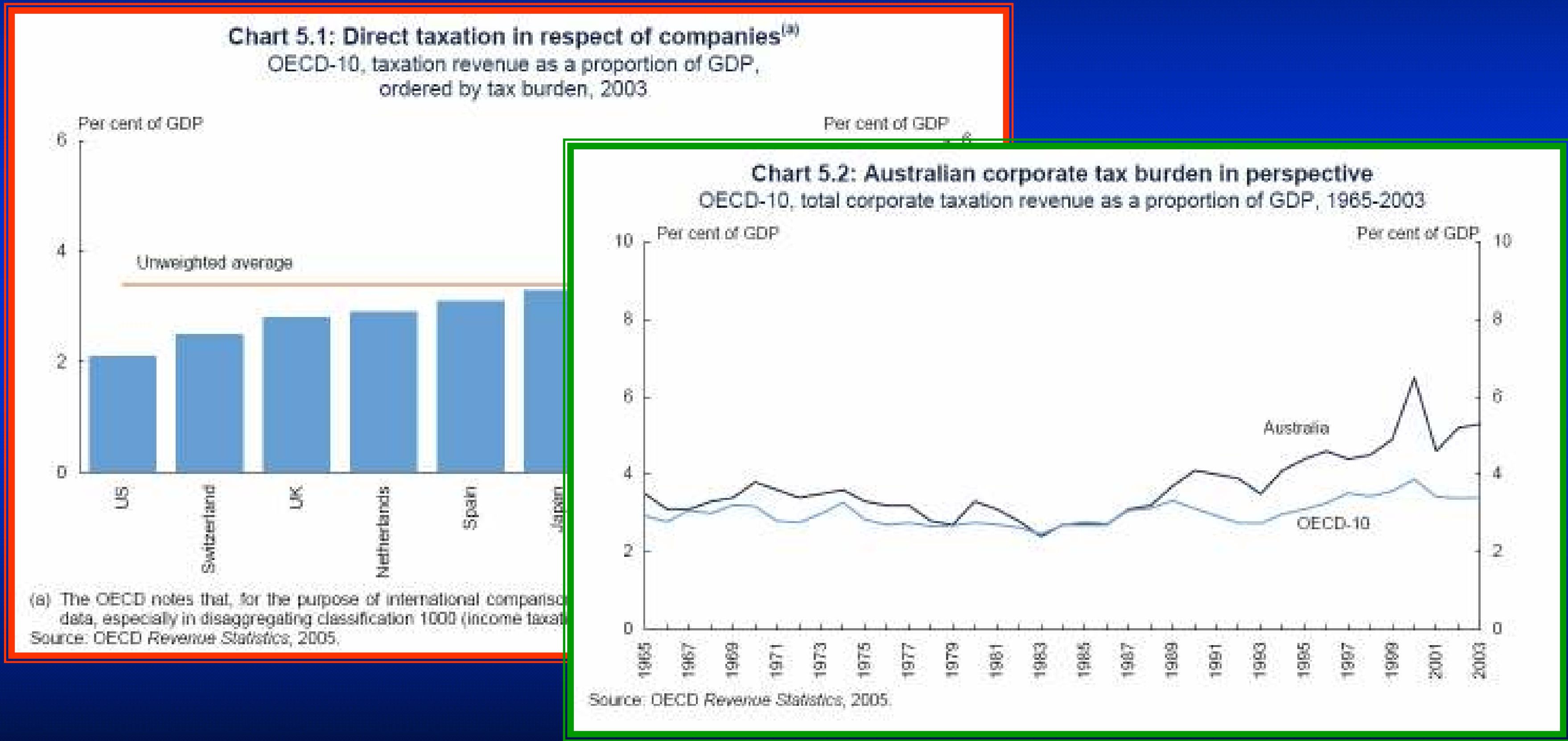
Company tax and growth



Source: OECD, 2004

The case for 'alignment' – company v personal tax

Practicality (anti-avoidance) suggests alignment

But economic theory suggest taxing different kinds of income differently

One can earn money in a company shielded from personal tax rate.

- But one can't enjoy it!

To spend money earned in a company owners and employees must be paid by company

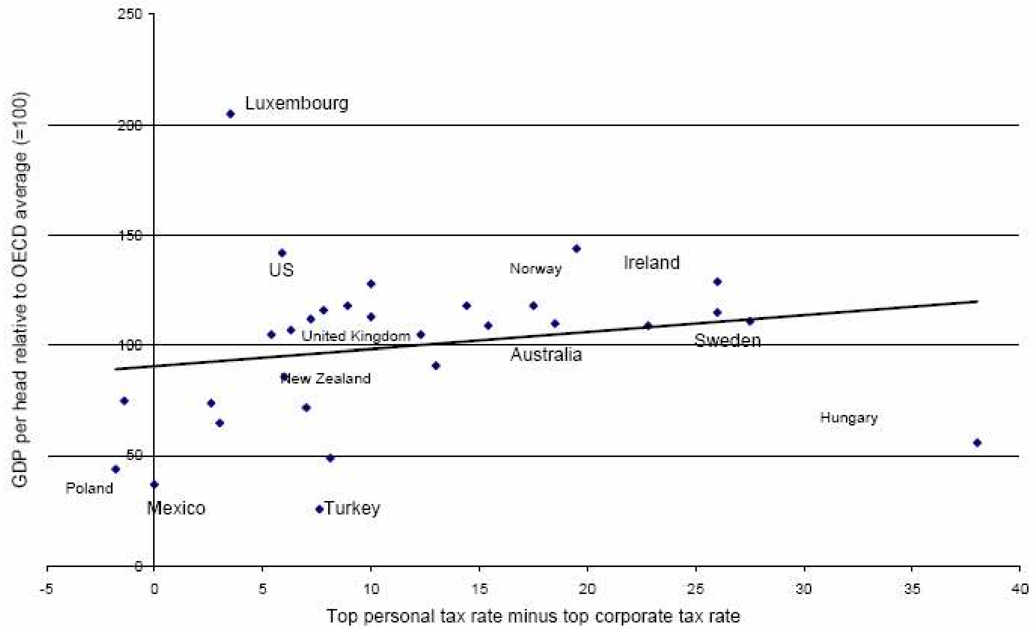
- Triggering personal tax liability

There is a tax deferral issue which, if it's a problem should be handled with appropriate anti-avoidance provisions

- As it is elsewhere and it was here – till 1987

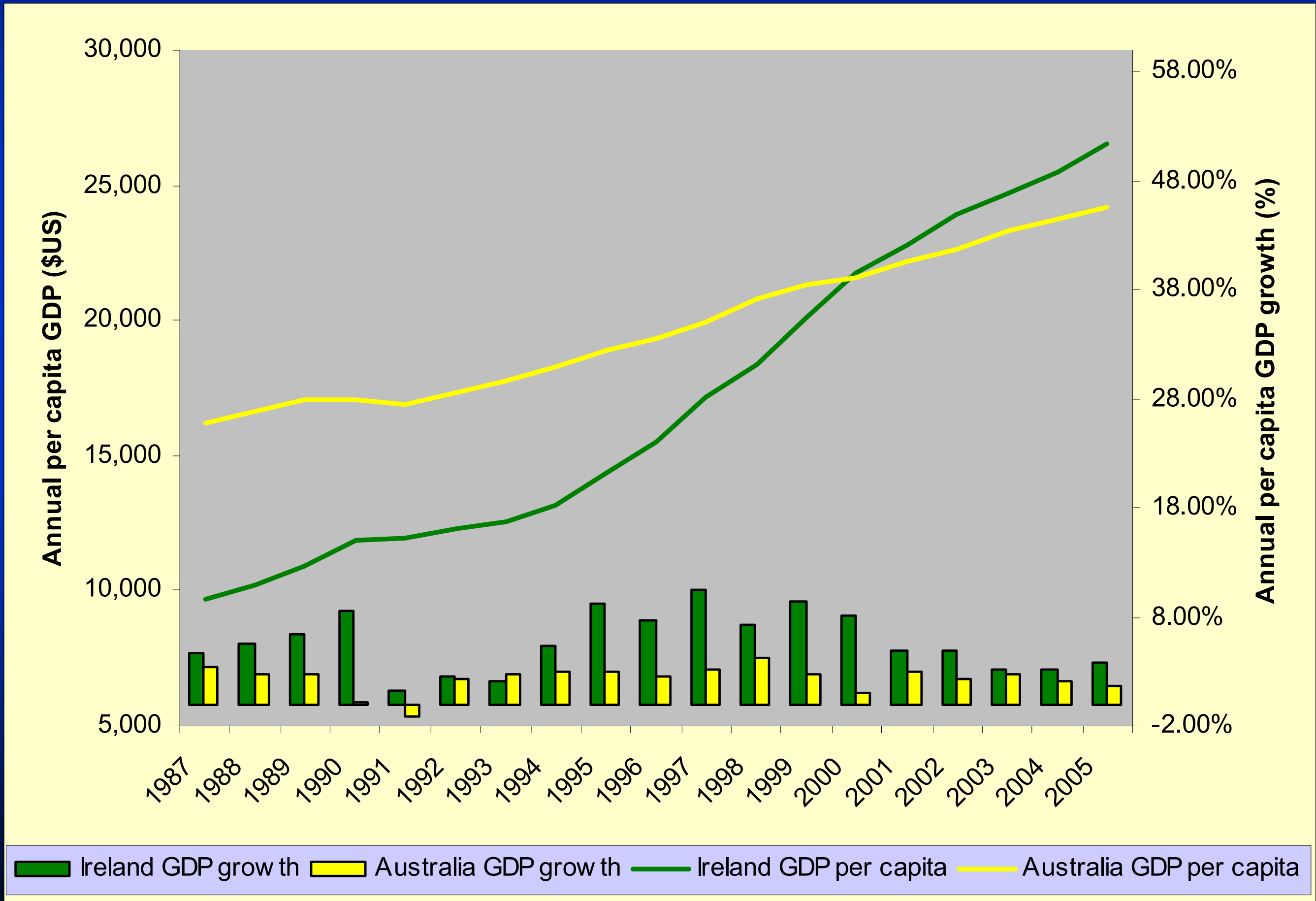
The case for alignment

FIGURE 2: GDP PER HEAD VERSUS GAP BETWEEN TOP PERSONAL AND CORPORATE TAX RATES, 2002



Source: Kingston, 2006a. Compiled from *OECD in Figures* 2005 edition; *OECD Purchasing Power Parities*, 2005

The case of Ireland



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The case of Ireland

Ireland's economic renaissance dates to 1987 when it aggressively courted foreign investment with tax cuts

Its out-performance is commensurate with Lee and Gordon's and Djankov, Shleifer's results

Ireland has a very large gap between top personal (42%) and company rate (12.5%)

Dividend Imputation

- We know it’s theoretical justification
  - To improve tax neutrality between debt and equity investment
  - To reduce double taxation of dividends
- But is it cost effective as a capital taxation expenditure?
- It now costs over $20 billion
- How much does it lower the cost of capital?

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Dividend Imputation – the theory of the marginal investor

Foreign investors are the marginal, more elastic investor

So they disproportionately determine share prices.

In fact Australian policy has

- Extended domestic shareholders' access to imputation credits
- Restricted pass-through of imputation to foreign shareholders.

– So the marginal (foreign) investor purchases Australian shares with diminished (or zero) regard to imputation.

– So the value of credits is poorly represented in share prices

- which determine the cost of equity capital

Dividend Imputation – the evidence

- Most reputable studies suggest that the value of imputation credits on the markets is 50 cents in the dollar or less.
- The most sophisticated econometric study by Cannavan, Finn and Gray (2004) suggests something close to zero valuation!
- Similar investigations of a tax credit scheme on dividends paid to UK pension funds yielded the same result.
  - Credits under-valued and so were not reflected in share prices and did not lower the cost of capital.
- Removing these tax credits showed second order effects on price. (Bond, Devereux and Klemm; 2005)

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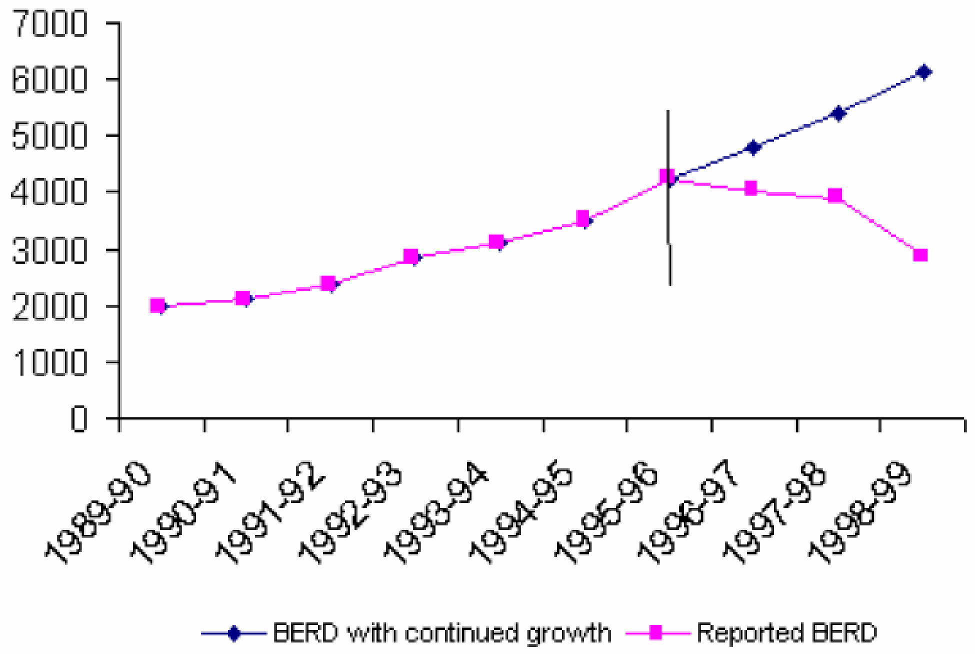
Dividend Imputation

Chart 1 Gross Australian Business Expenditure on Research & Development (BERD)
($ M)



Source: ABS: Research and Experimental Development: Business Enterprises, Australia, 1995-96, ABS Catalogue No. 8104.0, p. 6.

Revenue neutral reduction in company tax rate

- Accordingly we could ‘cash out’ an inefficient tax expenditure for an efficient company tax cut.
- Allows cuts of up to 11 percentage points
- Company tax could go as low as 19% even without behavioral responses
- Ireland cashed out its own dividend imputation system as lower company tax

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Revenue neutral reduction in company tax rate

- Likely effects
  - Abolition of dividend imputation would lead to a sale of Australian equities to foreigners. Because the market for foreign investment is so much deeper, this would have 'second order' price effects.
  - This is what happened when UK credits on dividends in pension funds were abolished (Bond, Devereaux and Klemm, 2005)
  - FDI would rise by nearly ¼ using latest elasticity parameter of -2.1.
  - Improved post tax return on foreign investment in Australian shares rises lifting share prices
    - This lowers the cost of capital.
    - Providing compensation for those whose effective tax rate on dividends rises.
    - Increases investment
  - Downside is higher effective rate of tax on dividends to Australian shareholders

Tax is about choices

'Long clean lines' of policy are valuable, but also come with costs.

Tax is about choosing the lesser of evils.

- Alignment or lower tax where it has the biggest effect
  - lower down where welfare to work decisions are made
  - lifting threshholds to make average tax competitive for professionals
  - lowering company tax
- Dividend imputation or more FDI and lower costs of capital

The economist's job is to say "this or that, not both. You can't do both". Kenneth Arrow, 1970

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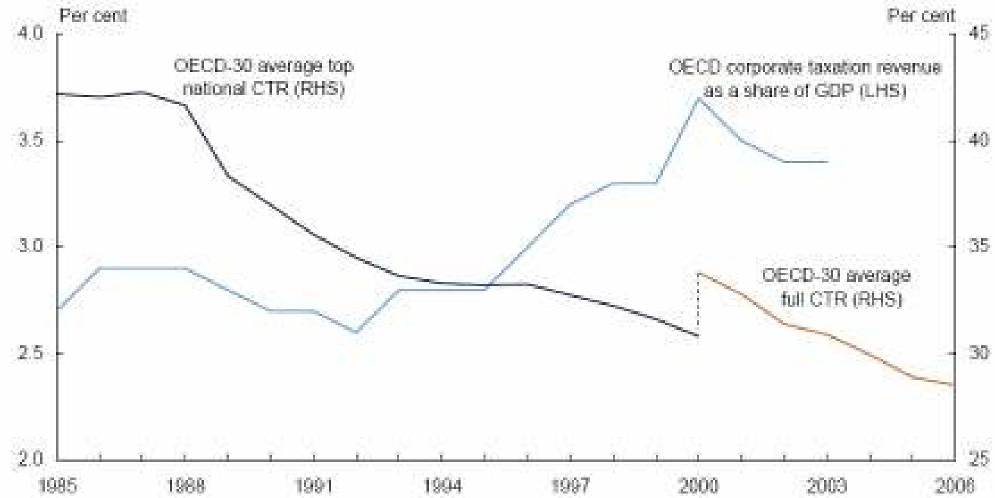
Chart 5.5: Historical trends in statutory corporate tax rates and corporate taxation revenue (unweighted)[a]

OECD-30, 1985-2006



(a) Rates are top national statutory corporate tax rates until 2000 and full corporate tax rates post 2000. Averages are unweighted.

Source: OECD Tax Database; KPMG (various years); OECD (2005); Deloitte (2006); various country websites.

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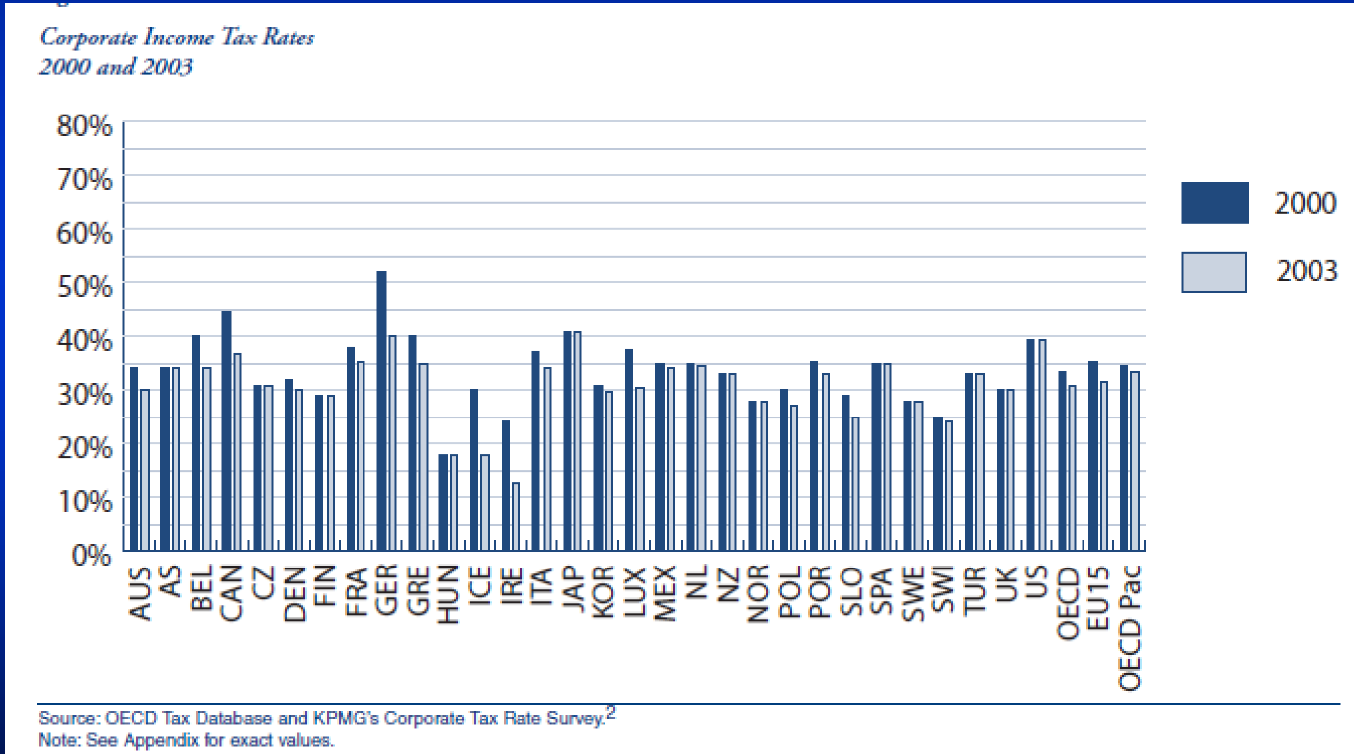
Three concepts in tax

1. Competitiveness
   - Tax competitiveness helps us access resources in competition with other countries
2. Participation
   - Brings idle resources into production
3. Productivity
   - Turns same inputs into more outputs

The open economy argument

- With a perfectly open economy (and some other assumptions) a capital tax is neither equitable nor efficient
  - Capital is withdrawn until the post tax return equals the previous untaxed return
  - This starves the economy of capital and so
  - The tax is borne by labour, not the foreign suppliers of capital
- If there are rents or non-finite horizons for savers and investors there may be a case for some capital taxation

Company tax and growth



Source: OECD, 2005