

Submission on the Tax Discussion Paper

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As we begin the 21st century, new dilemmas confront our society and our planet. Unprecedented levels of consumption co-exist with extreme poverty. Through new technology we are more connected than we have ever been, yet civic engagement is declining. Environmental neglect continues despite heightened ecological awareness. A better balance is urgently needed.

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Introduction

The Tax White Paper is an opportunity to look at areas where the tax system is failing and how to improve it. There are many ways Australia can tax smarter and reduce distortions that the current tax system creates.

The Australia Institute has identified a number of areas for reform, outlined in our recent paper *It's the revenue stupid: Ideas for a brighter budget*.¹

These proposals have the potential raise billions of dollars in additional revenue which could reduce the budget deficit, increase spending in areas of greater need or allow the government to reduce inefficient, complex or inequitable taxes. These proposals also help address distortions in the taxation system.

The proposals for reform include changes to superannuation tax concessions, restricting negative gearing to new properties and scrapping the CGT discount. Finally, we also propose the introduction of a minimum average rate of tax based on total income which we called a 'Buffett rule' after a similar proposal in the United States. It also includes a discussion on Franking credits and financial transaction tax and a super profits tax on banks.

Superannuation

Super tax concessions are increasingly being used by high income earners as a tax minimisation strategy. This works against the progressive nature of the income tax system in Australia. This was not the original purpose of super tax concessions. They were designed to encourage people to save for their retirement so they would be more self-reliant and less dependent on taxpayer-funded aged pensions.

Super tax concessions are, however, failing to substantially reduce the portion of retirees receiving the aged pension. According to the Intergenerational Report, 80 per cent of those who are of eligible age are receiving either a full or part pension and this is predicted to still be the case in 2050. Worse, almost \$18 billion (60 per cent) of super tax concessions are going to the top 20 per cent of income earners. These are the people most likely to be a part of the 20 per cent not receiving an age pension. There is no economic justification for this concession accruing to people who are unlikely to ever claim a pension. This means that about \$18 billion of tax revenue is foregone each year on tax concessions which are unnecessary to those receiving them.

Reform of super tax concessions is long overdue and should start from the principle that the only justification for a concession is if it reduces long term impacts on the budget. Otherwise the benefit of the tax concession is entirely private – hardly a prudent use of taxpayers' money.

The proposed reform would see super tax rates rise with income so that the benefit was greatest for low and middle income households. Growing the super balances of these households is likely to have the largest long term impact on the budget by reducing their reliance on the age pension. High income households would see a smaller super tax concession as they are less likely to need an age pension. Our proposed new super tax rates are set out in Table 1 below.

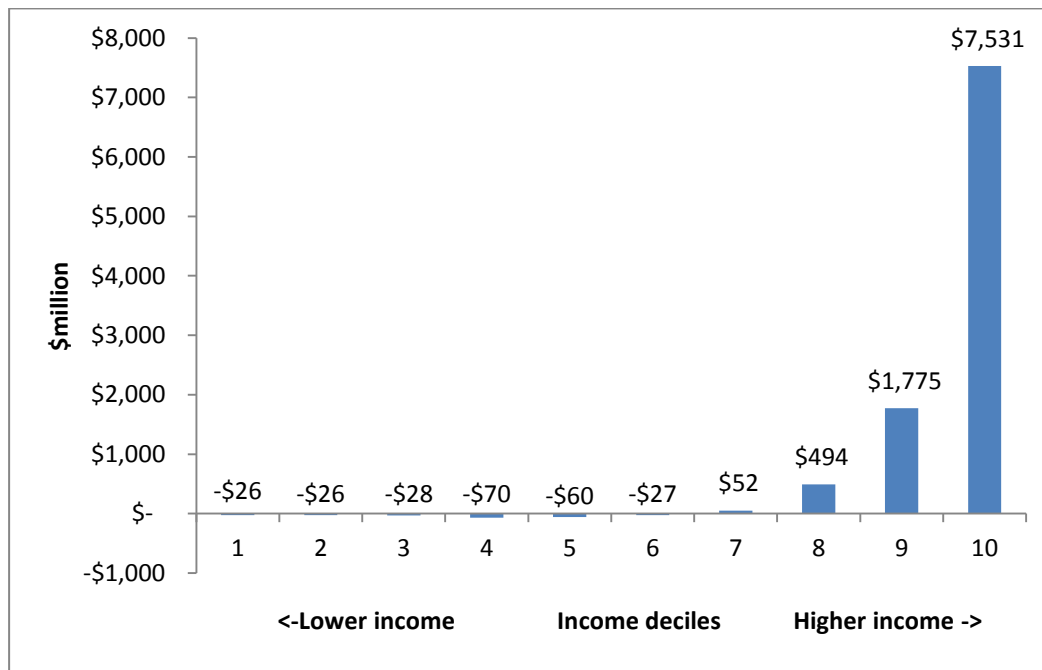
¹ Grudnoff (2015) *It's the revenue stupid: Ideas for a brighter budget*, The Australia Institute, available at <<http://www.tai.org.au/content/its-revenue-stupid-ideas-brighter-budget>>

Table 1 – Proposed super tax rates

Annual Income	New tax rate	Old tax rate	Difference
\$0 to \$37,000	0%	15%	-15%
\$37,001 to \$80,000	10%	15%	-5%
\$80,001 to \$180,000	22%	15%	+7%
\$180,001 to \$300,000	45%	15%	+30%
Above \$300,000	45%	30%	+15%

These new super tax rates will reduce the distortion in tax policy where the tax concession is going predominately to high income people for a dubious long term benefit to the budget.

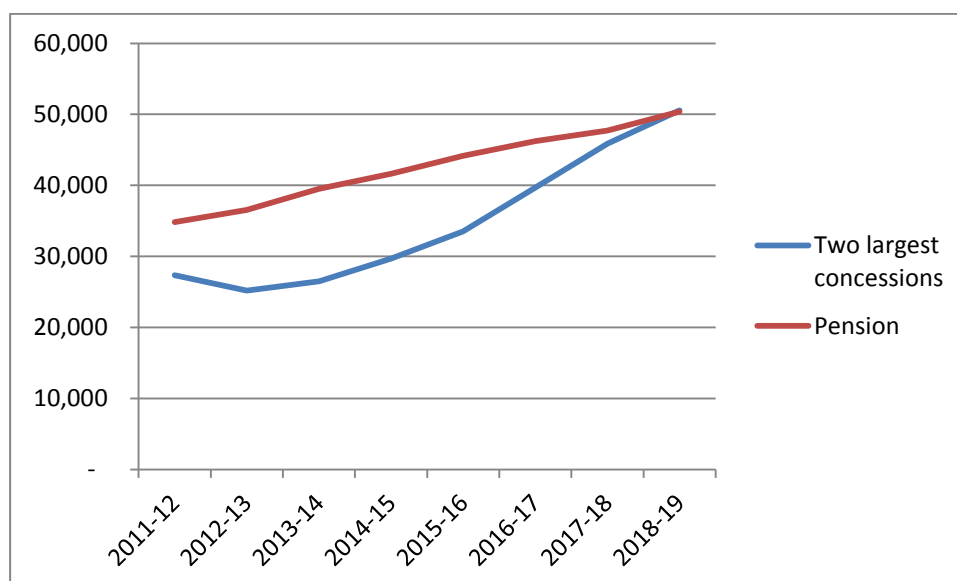
The new super tax rates will also see 60 per cent of households paying less tax on their super. High income households would gain less of the benefit of super tax concessions and overall the policy would reduce super tax concessions – and raise tax revenue - by \$9.6 billion. The income distribution of impacts of changes to super tax concessions are shown in Figure 1.

Figure 1 - Distribution of impacts of changes to super tax concessions by household income

Source: NATSEM modelling in Grudnoff (2015) *It's the revenue stupid: Ideas for a brighter budget*,

Super tax concessions are growing rapidly. The two largest concessions, on contributions and on fund earnings, are expected to be greater than the cost of the pension in 2018-19 as shown in Figure 2.

Figure 2 – Two largest super tax concessions and the age pension



Source: Tax Expenditure Statement, Budget papers 2015-16

Super tax concessions are unsustainable and need to be altered. They should be altered to help people become less reliant on the taxpayer in retirement and not as a vehicle for tax minimisation and estate planning.

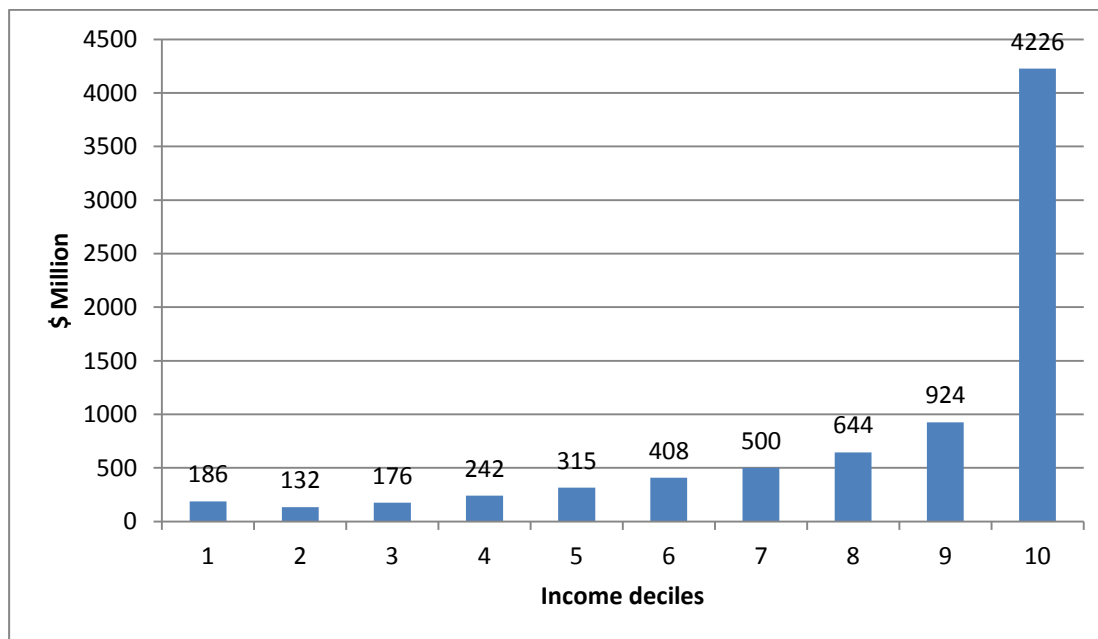
Negative gearing and the capital gains tax discount

The combination of negative gearing and the capital gains tax (CGT) discount is distorting the Australian residential property market, encouraging speculative behaviour and being used by predominately high income households as a tax shelter.

Modelling commissioned by The Australia Institute shows that these tax perks are costing tax payers \$7.7 billion per year.

The modelling also shows that the majority of the benefits of negative gearing and the CGT discount are not going to middle Australia but rather to high income earners. 56 per cent goes to the top 10 per cent of income households and 67 per cent goes to the top 20 per cent. By comparison relatively little flows to low income households with just four per cent going to the bottom 20 per cent of households. The bottom half of Australian households only get 13 per cent of the benefits.

Figure 3 – Income distribution of negative gearing and the CGT discount



Source: NATSEM modelling in Grudnoff (2015) *It's the revenue stupid: Ideas for a brighter budget*,

Negative gearing and the CGT discount act as a strong incentive for Australian investors to invest in residential property. This has the effect of pushing up proportion of housing finance that is going to investment properties, in turn increasing house prices and lowering rates of home ownership. These tax perks encourage investors to make a loss and to focus not on rental returns but on capital gains.

The proportion of investment loans in total housing finance has grown from 16 per cent 23 years ago to 40 per cent in 2014, according to the ABS. A larger proportion of residential investment properties are showing up as more and more low and middle income households being forced to rent. Low and middle income households are being squeezed out of the property market.

This type of speculative investment makes the property market more susceptible to bubbles; it also makes it more difficult for the Reserve Bank (RBA) to conduct monetary policy. While the domestic economy is weak the RBA is reluctant to lower interest rates further for fear of pushing up already inflated house prices in Sydney. A focus on capital gain means that rising house prices draw in more speculators which could further inflate prices.

A good tax is efficient and equitable. Negative gearing and the CGT discount fail on both those criteria. These two tax policies are highly inefficient as they distort the residential housing market by encouraging speculation and make it more susceptible to asset bubbles. They are inequitable as they make it more difficult for lower income Australians to buy their own home. The benefits also overwhelmingly flow to high income households.

These are taxes that are ripe for reform. The Australia Institute proposes reforms that

- End the CGT discount
- changing negative gearing on residential investment property to
 - Only apply to newly built housing
 - Only be deductible for 10 years after purchase of new housing
 - Grandfather existing negative gearing for five years

These reforms would raise \$7.4 billion in revenue predominately from high income households. It is also likely to reduce pressure on house prices in the second hand property market. Grandfathering provisions to five or ten years could also be introduced to avoid any sudden changes in the property market.

By restricting negative gearing to new houses the policy might also encourage the construction of new housing and bring new housing stock to the market.

The original purpose of the CGT discount was to tax only real capital gains. The 50 per cent discount replaced a more complicated process for removing inflation. This does make the capital gains tax different from other taxes, in that it is attempting to tax only the real gain. Other government taxes do not attempt to do this.

Negative gearing is making housing less affordable and making the residential property market more susceptible to housing price bubbles. Reform in this area could bring more housing stock to the market, make housing more affordable and raise government revenue.

Buffett Rule

The idea of a Buffett rule is to ensure that very high income earners are not able engage in aggressive tax minimisation. A Buffett rule would create an average minimum rate of tax that high income earners could not go below. It acts like a tax floor for people earning more than \$300,000 per year, the top one per cent of taxpayers. The tax rate would be set at 35 per cent, just below the average tax rate paid by someone on \$300,000 a year.

Aggressive tax minimisation undermines the progressive nature of the income tax system. Very high income earners pay large sums of money to tax advisors to find them tax loopholes. This is a sensible from their individual point of view as the tax advisor can save them more money than they charge in fees. It is not efficient from the point of view of the economy as resources are being wasted circumventing the tax system.

It is also inequitable since lower income households cannot restructure their incomes to take advantage of the tax loopholes and do not have the funds to pay for the advice.

The Buffett rule does not change the deductions that very high income earners can make. Instead it simply puts a limit on how low very high income earners can reduce their taxable income. It would have the effect of reducing the value of tax advice as additional deductions after a certain point are worthless.

This would have the effect of reducing the value of finding tax loopholes since tax deductions after a certain point would be worthless. It would also overcome to some extent the cat and mouse game that the government and the Australian Tax Office (ATO) play with some high income tax payers and their tax advisors. This is the process where the government and the ATO try to close tax loopholes and tax advisors try to find new ones. This is a very inefficient use of resources.

Our research and NATSEM modelling estimates that if a Buffett rule set on people with an income above \$300,000 and set at a rate of 35 per cent then it would raise \$2.5 billion per year, all from very high income earners.

Franking credits

The way in which Australia deals with franking credits is based strongly on theory, but at the same time it is a system that the rest of the world has rejected. Its good theoretical underpinnings combined with its obscurity helps explain why it has survived for so long.

Franking credits are a way to deal with concern that dividends from businesses are not taxed twice. So when a company earns a profit it is taxed at 30 per cent after deductions. But dividends paid out to shareholders turn into income for those shareholders. Income is subject to income tax and so the dividends are taxed again according to the 'double taxation' view.

To avoid this double taxation the tax office allows businesses who have already paid tax on their dividends to also create franking credits. This is basically a note that comes with the dividend that says this income has already been taxed at 30 per cent. Shareholders when they do their tax receive a credit for the income deemed to have been paid on their behalf by the company.

Of the 34 OECD nations Australia is one of only four nations that calculate franking credits in this way. About 24 other OECD nations have hybrid franking credit systems that return some of the corporate tax paid on the dividends to the shareholder. Six OECD nations return no corporate tax paid on dividends to shareholders.

Australia goes further and provides a refund of any unused franking credits. If the shareholder pays no tax, such as a superannuation fund for over 60s in the pension phase or someone who has reduced their taxable income below the tax free threshold, then the tax office will pay out the value of the franking credit to the shareholder. Of all the OECD nations, only Australia is so generous to shareholders.

The international evidence shows that Australia is extremely generous when it comes to franking credits. But which Australians does this mean we are being generous to? NATSEM have modelled for The Australia Institute the amount and distribution of franking credits.

Franking credits to households (excluding franking credits earned in superannuation funds and trusts) are worth almost \$10 billion per year. They flow overwhelmingly to high income earning households as Table 2 below shows.

Table 2 – Income distribution of franking credits

Decile	Franking credits received by households (\$m)	Proportion of total households
1	\$59	0.6%
2	\$105	1.1%
3	\$28	0.3%
4	\$71	0.7%
5	\$192	1.9%
6	\$266	2.7%
7	\$296	3.0%
8	\$593	6.0%
9	\$913	9.2%
10	\$7,404	74.6%
Total	\$9,926	100.0

Source: STINMOD 2014-15 Financial year estimate

The Australian Tax Office (ATO) statistics show more detail of very high income earners. The ATO statistics reports those who receive franking credits on an individual basis. This is different from the above NATSEM modelling that works on a household basis.

Table 3 shows very high income earners and the proportion of franking credits they receive. It shows that people earning more than a million dollars a year receive 17 per cent of franking credits and about half of all franking credits go to those who earn more than \$180,000 a year.

Table 3 – Very high income earners proportion of franking credits

Incomes above	Proportion of taxpayers	Proportion of franking credits
\$1,000,000	0.08%	17.1%
\$500,000	0.3%	27.2%
\$250,000	1.3%	42.2%
\$180,000	2.2%	48.8%

Source: ATO tax statistics

The Australian system of franking credits is one of the most generous in the world and there does not appear to be any strong case for this. Franking credits not only distort investment decisions by making franked dividends more desirable than unfranked dividends, most of the benefit flows mainly to high income earners. It also means that in the case of the refund on unused franking credits some company profits are going untaxed.

Financial Transaction Tax

High-frequency traders (HFTs) use powerful computers to trade large volumes of assets at very high speeds, completing transactions in a fraction of a second. High-frequency trading (HFT) involves the buying and selling of large volumes of securities such as stocks or derivatives for very short periods of time - often for only fractions of a second. HFT uses sophisticated computers and algorithms designed to capitalise on millisecond-long discrepancies in stock prices. HFTs are able to buy up the shares that normal investors have ordered, pushing up the price, before selling at the higher price to normal investors, who are unable to process their orders at such speeds.

A Tobin tax (also known as a Financial Transactions Tax, or FTT) would reduce the volatility of capital markets that HFT creates, as incentives to trade large volumes exacerbating minor markets movements are reduced by the tax. A Tobin tax could also work to keep more investors on public exchanges and away from less transparent “dark pools”. This would improve transparency and the price formation function of capital markets. In doing so, a FTT similarly raises revenue, improves average investor returns, and lowers the risk associated with excess liquidity.

Using conservative estimates using conservative assumptions on tax elasticity, regulatory cost impositions and evasion rates, The Australia Institute has estimated a tax levied at rates between 0.01 and 0.4 per cent depending on the instrument would raise \$1 billion to \$1.4 billion a year. Its design is based on a similar structure to that proposed by the European Commission. Crucially, this would also dampen speculation and reduce the prevalence of “front-running” in the capital markets, allowing longer-term institutional investors and self-managed super funds greater access to market information, increasing profitability and eliminating financial scalping by up to \$1.9 billion a year.

Bank super profits tax

According to IMF figures which give the share of the market accounted for by the top four banks in each country examined, Australia has the most concentrated banking industry among the developed economies of the world. The latest figures show that the big four banks account for 80 per cent of bank assets in Australia. Recent profit figures for each of the big four are given in table 4.

Table 4 – Profit of the big four banks in Australia

Bank	After tax (\$m)	Before tax (\$m)
ANZ	\$7,283	\$10,308
Commonwealth Bank	\$8,650	\$11,997
National Australia Bank	\$6,802	\$7,955
Westpac	\$7,625	\$10,740
Total	\$30,360	\$41,000

Source: Annual reports

Big banks act as a sort of tax collector by overcharging for access to the payments system which is basically a utility. In addition banks tend to charge whatever the market will bear. Economies of scale, technology and other innate advantages of the big banks are used for their own advantage rather than passing cost savings on to their customers.

As a result the big four banks earn pre-tax profits of \$41 billion or an average return on equity of well over 20 per cent. This is well over the profitability that would occur in a competitive industry and is reflected in the fact that bank stocks trade at a substantial multiple of their book value or the value of shareholders' funds. Super profits worth some \$18 billion are generated by the big four banks.

For the mining industry super profits were defined as a return equal to the 10 year bond rate plus seven per cent. At the moment that would imply a rate of less than 10 per cent. This reflects the abnormally low interest rates at the moment. On the other hand a seven per cent premium seems a bit high for what is effectively a utility with predictable cash flows from year to year. Hence 12 per cent seems a justifiable figure and certainly includes a good conservative allowance in favour of the banks.

As a tax on the super profits earned by banks there is no reason for the banks to change their behaviour in any way and that will be reinforced by the limited competition big banks get from the smaller banks. As such a super profits tax is favoured by economists as it does not change behaviour or distort the market.

A tax surcharge of 30 per cent on all profits of the big four banks above a threshold 12 per cent pre-tax rate of return on equity would have raised \$5.7 billion in 2013-14 and can be expected to increase substantially in years to come.

Conclusion

The release of the government's 2015-16 budget shows that much of the move back to surplus over the medium term will come from bracket creep. This is likely to impact on low and middle income households more heavily.

There are things the government can do to improve this situation by targeting areas of revenue that reduce distortions and raise revenue in a more equitable way. This submission has suggested a number of ways to achieve this.