Tax Reform: An Unfinished Agenda?

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1. Introduction

The past twenty years have seen major taxation reforms, but also the present system is easily criticised because of its inefficiency, inequity, complexity and revenue risk. In the mid 1980s extensive income base broadening measures were used to fund lower and flatter personal income tax rates, and the imputation system for company tax replaced the classical system. A fairly broadly based consumption tax, the GST, was introduced in 1999 to replace a number of narrow base and variable rate indirect taxes. A part of the GST revenue and new income base broadening measures were used to lower personal income tax rates, and a lower corporate tax rate was funded by business income base broadening measures. However, the many special exemptions and deductions, together with the hybrid or differential tax treatment of different saving and investment options and of different business structures, mean that neither the income or GST tax bases are comprehensive. Most State taxes and the special purpose Commonwealth excise taxes have not been reformed. At the same time, the competitive pressures of the global economy are raising new questions about an appropriate tax system, in particular because of the greater international mobility of capital and skilled labour. While a lack of political commitment to yet more major tax reform cannot be ignored, nor should the opportunities to reduce distortions and inefficiencies and to lower tax compliance costs for minimal redistributive changes be ignored either.

Taxes provide the principal way in which governments gain access to scarce national resources for collective use by society. These uses include expenditure on defence, law and order, education, health, and so forth to correct perceived market failures. Taxation on one hand, and social security payments and provision of some services at below cost on the other hand, are used for redistributional and equity

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reasons. In 1999-2000 the Commonwealth, States and Local governments collected $196 billion. These revenues are equivalent to 31% of GDP and amount to $10,243 per Australian.

This paper describes some of the distortions and inefficiencies of current taxation arrangements which reduce productivity and output, and it looks at reform options to achieve greater neutrality and efficiency without requiring major changes in aggregate revenue collected and in overall progressive incidence of Australian taxes. The next section provides a sketch of current arrangements and their implications for efficiency, equity and simplicity. Then, reform options are considered under two artificial headings. Section 3 looks at old and on-going tax reform debates. These include: size of the tax burden; exemptions, deductions and measurement of tax bases; the tax mix between income and consumption; Commonwealth and State financial relations about vertical and horizontal fiscal imbalances; tax rate schedules and means testing of social security benefits as they affect effective marginal and average tax rates; individual versus family tax bases; and, administrative and compliance arrangements and costs. Section 4 looks at what I categorise as largely untouched reform areas and emerging debates. Topics covered are: State indirect taxes; greater international factor mobility and optimal taxation ideas: and, special purpose indirect taxes. A final section provides some tentative thoughts on progress towards further taxation reform.

2. Current Taxation

This section describes current Australian taxation in terms of tax system, tax bases and tax rates, and it comments on the efficiency, equity, simplicity and revenue raising properties. More detailed reviews include Pender (1997), Head and Krever (1997), Abelson (1998), Costello (1998) and Smith (2001).

Income Taxation

Income taxes collected by the Commonwealth represent just under 60% of total taxation revenue. They are fairly comprehensive for labour income, with the main concessions being for remuneration taken as superannuation and the self-employed are better placed to claim allowable deductions than employees. Mixed tax systems resulting in different effective tax rates apply to different forms of capital income and income earned on land. The taxation of capital income, or the returns on saving and investment, has been described as a hybrid or mongrel system. For example, essentially an expenditure base is applied to owner occupied housing (no tax or imputed rent or capital gains) and to business investment in human capital and R & D (expenses immediately deducted and tax on extra earnings only when realised); capital gains are taxes concessionally at half the rate and only on realised gains; other savings options receive a nominal income tax treatment including savings in financial instruments, and most business investment; however, effective tax rates vary for corporations according to funding source (debt, new equity and retained earnings), payout strategy (domestic shareholders, overseas shareholders, retained earnings, and so forth) and source of activity (Australia or overseas); and the taxation of superannuation is a mixed (partly income and partly expenditure based) system. As a result, different saving and investment choice options and different business strategies face effective tax rates which vary by tens of percentage points (Pender and Ross, 1993). Table 1 provides an update of the Pender and Ross calculations for 2001. Since there is no rationale on market failure reasons for the different effective tax rates, the current hybrid taxation of saving and investment options distorts the composition of Australian investment and saving, and it adds to complexity and tax compliance costs.

While much of the extensive tax reforms of 1985 and the late 1990s were to remove or reduce the number and magnitude of special exemptions and deductions which erode the income tax base, many remain and some new ones have been added. Important base broadening measures included the fringe benefits and capital gains taxes introduced in 1985 and subsequent revisions, removal of the savings rebate and administrative changes in 1999, and a return from accelerated to economic depreciation for medium and large businesses in 2000. Treasury (eg. Treasury, 1997) identify special exemptions and deductions from a comprehensive income tax base as tax expenditures amounting to about $8 billion of foregone revenue in 1999-00 if expenditures for social security and welfare are ignored. The tax concession for private medical insurance introduced in 2000 is a recent addition to the list. Unless justified by market failures, the tax concessions create distortions and a loss of efficiency, they add to complexity, and often they are of more value to higher income earners and reduce effective progressivity of income taxation.

Australia's income tax system is progressive in terms of individual incomes, and a number of allowances are included for dependent spouses and children, to meet social equity goals. In practice the extent of progressivity is less than indicated by the statutory tax rate schedules because the benefits of the hybrid tax system on capital income and other concessions from a comprehensive income base are exploited by and are of greater tax reduction value for, those on higher incomes.

General Consumption Taxation

General consumption taxation is taken to include a number of Commonwealth and State taxes levied on expenditure with the primary purpose of general revenue raising and not to deliberately alter expenditure patterns. These include the GST collected by the Commonwealth but then directly re-allocated to the States, State payroll taxes, and a number of State stamp duties including conveyance fees, taxes on insurance, and other stamp duties. In total these taxes collect about 23% of total taxation revenue, with the GST collecting about 14%.

The GST, introduced in 1999 at a 10% rate on a broad but far from comprehensive private final consumption expenditure base, is the closest to a broad based consumption tax. Major categories of expenditure exempt from the GST are basic food, health, education and charitable expenditures. Debate on the merits of exemptions, particularly as a better means to achieve progressivity relative to more direct but perhaps less certain offsetting increases in social security benefits and pensions and lower income taxation, is still on-going. There also is debate about further exemptions which would narrow the GST tax base. Introduction of the GST in conjunction with the Business Activity Statement (BAS) to improve business income tax as well as GST compliance clearly has raised business taxation compliance costs (Tran-Nam, 2001), although the level of complaint has declined with greater familiarity with the new system.

States collect nearly $9 billion a year from payroll tax. In principle a broad based payroll tax (which falls on labour income and exempts capital income) has similar long term effects as a broad based consumption tax (which exempts income spent on saving and investment that generates capital income), although there are different exchange rate implications (payroll is an origin based tax and GST a destination based tax) and transition adjustment effects (GST falls on past savings when spent while payroll tax exempts past capital income((Freebairn, 1993 and Ryan, 1995). Australian payroll taxes fall on less than a half of the potential taxable base, particularly because of the exemption of small firms (with payrolls of less than $555,000 in Victoria to less than $850,000 in Queensland) and also because of various forms of interstate firm location incentives. The top marginal payroll tax rates vary from 4.75% (Queensland) to 6.85% (ACT). The exemptions lower revenues collected, distort the mix of business structures and to a lesser extent the mix of products produced, they aggravate tax distortions to work versus leisure decisions, and they have questionable redistributive effects given that most of the final incidence will be on employees of large firms.

The States have a varied collection of stamp duties which were initially introduced in the first half of the twentieth century. The more important revenue earners are conveyance duties on the transfer of ownership of commercial and residential property, fees on motor vehicle transfers, and duties on insurance premiums. There also are in some States stamp duties on mortgages and loans, cheques and credit card transactions, hire purchase, off-market share transfers, life insurance premiums and bank debits (see NSW Treasury, 2001, for details). Taxable sums and tax rates vary across the States. Stamp duties are narrow based indirect taxes falling on selected business inputs and final consumption transactions. They represent an additional expenditure tax on top of the GST and payroll taxes. While pre-1999 there might have been a second best argument for stamp duties to balance the taxation of goods under the wholesale sales tax (WST), replacement of this tax with the GST makes such an argument redundant. For example, insurance premiums now face a 10% stamp duty plus a 10% tax on tax GST. With property conveyance duties and motor vehicle stamp duties levied only upon changes of ownership they effectively restrict efficiency improving ownership transfers from lower value to higher value uses; by contrast, an annual land tax or vehicle registration fee would collect the same revenue without distorting ownership and use decisions.

Special Purpose Indirect Taxes

A part of the motivation for Commonwealth excise taxes on petroleum, alcohol and tobacco products and for State taxes on motor vehicles and gambling is to correct market failures and thereby raise efficiency as well as to collect revenue. These special purpose indirect taxes represent nearly 15% of all tax revenues, and they are regressive in their incidence.

Despite the potential corrective market failure arguments for special purpose indirect taxes it is doubtful, or at best a happy coincidence, that the current Australian tax bases and rates even approximately internalise the market failures. In part, special taxes on motor vehicles and petroleum products might be justified as a form of user fee for government provided road infrastructure, or as a tax on external costs associated with congestion and pollution. The correlation between fuel use and road damage is crude, but the exemption for off-road use fuel has some logic, and differential registration fees between cars, small trucks and large trucks pay some reference to road damage caused. Congestion taxes would need to be targeted on peak-hour major city traffic. Taxes to counter greenhouse gasses pollution would need to target all fossil fuel burning, including fossil fuel electricity generation and off-road petroleum use as well as on-road petroleum use.

Special indirect taxes on the "sin products" alcohol, tobacco and gambling might be argued as a way to raise private costs to reflect the external costs placed on society in terms of alcohol abuse, extra medical and social outlays, passive smoking and problem gambling. Then, for example, why not impose an alcohol tax on wine along the lines of beer and spirits rather than the present product price ad valorem wine equalisation tax, and why are the tax rates on different forms of gambling conducted in the same venue, let alone across venues, so different?

There may well be other products generating external costs in production or consumption which should be the subject of special externality correction indirect taxes. Taxation reform to improve economic efficiency should use as a tax base a measurable sum close to the externality and a rate to reflect the marginal external cost.

Wealth Taxation

Taxation of wealth is not an important component of the Australian system. Land tax collects less than $2 billion a year and is restricted primarily to land holdings in the CBDs, with primary production land and most owner occupied residential land exempt.

Local government rates which are levied on measures of the unimproved value of residential and non-residential properties are better interpreted as a crude form of user fees for services provided than as a wealth tax per se. This, of course, begs the question of whether more direct and explicit user fees would be a better option.

3. Old and Recurring Tax Reform Topics

This section considers some of the taxation reform topics which (a) either have been subject to reform over the last twenty years or have been suggested for reform and (b) are likely to arise again in designing a tax system which is more neutral and less distorting, which better meets society vertical and horizontal equity goals, which has lower tax compliance and administrative costs, and which secures future revenue flows. Inevitably the list is arbitrary and coloured by personal prejudices, and there is overlap across the topics.

Size of the Tax Burden

One imagines there always will be debate as to whether taxes and what they are used for in government expenditure are too high or too low. It is an unresolvable debate involving politics, sociology, ethics, economics and other disciplines.

Definition of the tax burden itself is a slippery concept. For example, tax expenditures artificially reduce the measured tax paid to GDP ratio, as illustrated by the 1999 policy to give a 30% deduction for private health insurance as an alternative to the tax increase to fund more public hospital outlays. Another measurement question is whether to focus on statutory tax rates or effective tax rates where the latter is more comprehensive by allowing for the taxable sum. To illustrate, corporate tax paid was roughly revenue neutral pre-Ralph with a 39% statutory rate but on a base reduced by accelerated depreciation and other deductions and post-Ralph with a

30% statutory rate on a more comprehensive base with economic depreciation. Third, some argue the compulsory 9% superannuation levy should be included in Australian taxation for comparability with the northern hemisphere OECD countries inclusion of social security taxes. But, here, and no doubt also in Europe and North America, compulsory superannuation levies and social security taxes are partly offset by reductions in voluntary private superannuation and other savings for retirement. Then, only crude and cautious comparisons of tax burdens across time and between countries can be made.

In terms of international comparisons of tax paid to GDP ratios, Australia is at the lower end when compared with OECD countries and our rates are higher than countries in North East Asia.

From an economic perspective, discussion of an appropriate overall tax burden requires assessment of the social benefits derived from government expenditure it finances relative to the distortionary costs of taxation. Markets work better with a government provided and monitored institutional system regarding property rights, and government expenditures are one option to correct for market failures associated with externalities and public goods. The needs for taxation and for expenditure on social security to meet equity goals is more a social and political debate than a resolvable economic question. Inevitably taxation distorts economic decisions, including work versus leisure, consumption today versus tomorrow, product mix purchase choices, between production methods, and so forth. These distortions mean losses of potential national productivity. Even accepting such a framework, uncertainty about key parameters and elasticities inevitably means debate on an appropriate tax burden will continue to be inconclusive.

Tax Mix

A regular feature of recent Australian tax reform debate has been to shift the tax burden away from income to consumption, and the 1999 reforms involved a small shift with about two percentage points of the GST revenue funding lower income tax rates. Effectively, a consumption for income tax mix change reduces the tax burden on saving and investment, and it shifts the burden away from capital to labour. Such a tax mix change can be achieved by one or a combination of greater reliance on a GST or on a payroll tax, or by providing more and larger deductions for income taxation falling on the returns to saving and investment.

There is an extensive, and generally inconclusive, literature reviewing the comparative efficiency, equity and simplicity properties of an income base versus a consumption base (see for example Goode, 1997, and Zodrow, 1997). In terms of efficiency, a consumption base removes distortions to intertemporal choices affecting saving and investment, but the required higher tax burden on labour income aggravates distortions to work versus leisure choices. When, as in Australia, the income tax system treatment of different saving and investment choice options is a hybrid system, lower income tax rates funded by a tax mix change reduce the magnitudes of the distortions to the composition of saving and investment. With a direct expenditure tax system, a progressive tax rate schedule can be applied to achieve progressivity in the same way as for an income tax system. But, if the tax mix change is achieved via indirect taxes such as a GST or payroll tax the replacement indirect tax comes with a flat rate structure.

In 1993 in particular, but also since then, there were proposals to replace payroll tax with a GST. As noted earlier, for comprehensive GST and payroll tax bases, the longer run incidence and incentive effects of the two taxes are similar. Current Australian GST and payroll tax bases are far from comprehensive, and more so in the case of payroll tax. Then, if removal of the small business and other exemptions is considered politically impossible, a weak second best case might be made to replace the payroll tax with a higher rate GST. On the other hand, if both bases were to be broadened there are some practical complementaries in using both a GST and a payroll tax. A payroll tax is difficult to apply to the labour income component of self employed income, and a GST is difficult to apply to the value added component of financial services.

Deductions and Exemptions

The reality of a democracy includes political pressure groups advocating the maintenance of "special" exemptions and deductions which reduce the tax base, whether it be income, consumption, land or other, and others advocate new and larger tax concessions. Broad and comprehensive tax bases with minimal exemptions and deductions have good tax design criteria advantages; continuity and security of revenue flows; lower tax rates to achieve a revenue target; lessened incentives and rewards for tax avoidance and for lobbying; neutrality of taxation of related choice options and smaller deadweight costs of taxation; horizontal equity; a firmer building block for vertical equity; and simplicity. While much of Australian tax reform in 1985 and the late 1990s involved significant movement toward broader and more comprehensive income and consumption tax bases, there remain opportunities to further reduce the list of allowable deductions.

Different exemptions and deductions for different types of saving and investment which underlie the hybrid system of capital income taxation are a significant source of inefficiency, inequity and complexity. These include the mixed and complicated taxation of superannuation, concessions with capital gains taxation, the favoured treatment of owner occupied housing and the differential treatment of unincorporates, trusts and corporations involved in the same type of product production activity. Studies for the US indicate significant efficiency gains from reduced distortions to the composition of aggregate investment by shifting away from the hybrid system to either a comprehensive income base (ie. tax everything as we do interest income) or a comprehensive expenditure base (ie. either by not taking capital income or by allowing all investment outlays as fully deductible at the point of expenditure) - see for example, Jorgenson and Wilcoxen (1997), Hubbard (1997) and Auerbach (1997).

Efficiency, equity, simplicity and the capacity to lower tax rates on an enlarged income tax base could be achieved by removing many of the special exemptions noted in Treasury Tax expenditure documents. For individuals these include; the 30 percent private medical insurance rebate; selective deductions for some work related expenses but not for others; special rates for lump sum payments; capital gains tax concessions including pre-September 1985 assets, own homes, and generous roll-over provisions for small business. For businesses there remain special income tax concessions for primary production and mining, and debate over the size of the rebate for R & D expenditures is likely to continue.

Still unresolved is the appropriate taxation of trusts and private companies, with the government proposals to tax trusts like companies in 1998 still under consideration. Ideally, for reasons of equity, efficiency and simplicity the tax burden should be neutral as to whether a business operates as a public company, private company, trust, partnership or self employed, and this should not distort employee and employer decisions about whether to be an employee or self employed.

With reference to the GST tax base, most of the political pressures have been to further erode the base, for example government decisions on alcohol and petroleum products and Labor Party proposals on health, education, and others have floated energy and extension of the list of eligible food items to be exempt. Extending the list of deductions brings inefficiencies and new complexities, generally they would worsen horizontal equity, and vertical equity gains are less effective than more explicitly and directly working through the income tax and social security systems.

Current GST taxation of insurance is excessive with both a 10% GST and a 10% stamp duty on premiums. Ideally, only value added rather than gross turnover should be subject to the GST, that is the cost of providing the intermediary services rather than the premium which largely is a transfer payment. The present GST taxation of insurance premiums is similar to taxing interest payments. For other financial services this problem is ameliorated by input taxing financial services, and this would seem a desirable option for insurance.

The State payroll tax base could be more than doubled in size by removing the small business exemption. Grafting an enlarged payroll tax onto either the existing Commonwealth PAYG tax base or the existing State workers' compensation base would save administrative and compliance costs for existing payers and involve minimal additional costs for new payers. Costs of the payroll tax distortions between small and large business would be removed, the extra revenue could be used to fund the removal of other distorting State taxes, including stamp duties, or a lower rate could be set to collect the same revenue, with the lower rate reducing the efficiency costs of distortions to work versus leisure decisions. Removal of a number of other special exemptions from State payroll tax, such as for decentralisation or for internationally mobile firms, should be considered as ways to achieve a more comprehensive, broader and more transparent payroll tax base.

Land tax bases in Australia are narrow. Even ignoring the politically sensitive areas of primary production and owner occupied residential land, the business land tax base is eroded by as much as a half by exemptions, especially for small parcels of land. The vertical equity arguments for a progressive land tax rate schedule are weak. In particular, most of the large blocks of land in the CBDs ultimately are owned by contributors to superannuation funds, property trusts and the shareholders of large finance corporations. Many of these ultimate landowners are not particularly wealthy, and clearly the equity link between land parcel and ultimately owner is extremely mixed. The desirability of a more comprehensive based land tax, together with the final incidence of the tax associated with ownership patterns, favours a broad base with a flat rate to achieve neutrality and simplicity with the taxation of land.

Commonwealth - State Financial Relations

Options for reform of Commonwealth - State financial relations often are centred on the issues of vertical fiscal imbalance (VFI) and horizontal fiscal equity (HFE). The States now collect a third or less of their expenditure outlays from own taxation if the GST collected from the Commonwealth is excluded, and just over a half if the GST which is automatically redistributed to the States, but whose base, rate and redistribution formulae are largely beyond their control, is included as a State Tax. Most Commonwealth grants and the GST revenue are allocated to the States to achieve HFE, whereby allowance is given for the relative spending needs and taxable capacities of the different states. Effectively, VFI means the States depend on Commonwealth grants and the GST for most of their funds, and HFE means taxes collected from NSW, Victoria and WA are redistributed to other States.

There are different views on the importance of VFI. The most common view is summarised by Fitzgerald (1998) who concludes VFI is "...dysfunctional in terms of both democratic accountability to electorates and good public sector management". As a counter view, if State governments use Commonwealth transfers for inframarginal expenditures, and at the margin State taxes fund the extra or marginal dollars spent on education, health, etc., then accountability and good economic management can follow. At question between the two views is the rationality of the electorate and State policy.

There are several options to reduce VFI. The States could do much to increase their own revenues by broadening both the payroll tax base and the land tax base, and they could make more use of user pay fees for government provided services, including road infrastructure. Alternatively, as favoured by Fitzgerald (1998), the Commonwealth would vacate some of the income tax and leave room for a State income tax component. Raising the GST is another option.

Debates about the need for and magnitude of HFE are primarily about equity and fairness issues. To the extent redistribution between the States distorts the wealth maximising location of economic activity there are efficiency losses, however the magnitude is yet to be quantified.

Other Issues

There would seem to be a general consensus that the individual, rather than the family, should be the main taxable unit, and that taxation of business is no more than a withholding tax for income going to individuals or investors. Even so, some of the tensions over the taxation of trusts, private companies and partnerships arise from the greater ease of splitting labour income and capital income between family members; and the relatively low corporate tax rate favours investors via delaying the full marginal tax rate burden on retained earnings. Also of importance is that while the income tax system is individual based, the social security means benefit tests are primarily family based. As well as the inconsistencies, the interface of welfare support and income taxation give rise to high effective marginal tax rates for many low and middle income earners. Reform attempts to reduce poverty traps can hardly avoid the murky area of whether the individual or family should be the key tax unit.

No tax reform proposed can ignore discussion of tax rates. The absence of automatic indexation of the tax brackets for inflation, even at today's low rates and projected two to three percent band, provides governments with a fiscal benefit of a rising income tax revenue to GDP ratio. Social views on redistributional equity will dominate discussion of future changes in the degree of progressivity of the personal income tax rate schedule.

Tax compliance costs in Australia are high absolutely and relatively to some comparable countries (Pope, 1995, Evans et al, 1997, and Tran-Nam, 2001). Compliance costs use resources which otherwise could be used to produce goods and services to raise consumer wellbeing, they tend to be regressive in their incidence, and they vary by type of tax. Reforms to lower compliance costs would focus on tax design issues, and here broad, comprehensive tax bases with minimal exemptions and special deductions are desirable, and reform also could focus on tax administration.

4. Emerging Tax Reform Topics

This section considers three sets of issues or areas of taxation which have not been the focus of extensive discussion in recent tax reforms but which seem likely to be high on the agenda over the next decade. In the case of State taxes, especially stamp duties, and Commonwealth excises which now incorporate State business franchise fees, they largely escaped the reformer's scalpel of the last twenty years. The issue to which we turn now concerns globalisation and greater factor mobility

Greater International Factor Mobility

Globalisation has tended to increase the mobility of capital and skilled labour, both for overseas people and businesses placing their resources in Australia and for Australians investing their savings and skilled labour in Australia or internationally. In economic terms, this means the elasticity of supply of capital and skilled labour to Australia is becoming more and more elastic with the rest of the world becoming a closer substitute location. However, observations that saving and investment by country are highly correlated, that there are sustained real interest and equity return differentials across countries, and that country investment portfolios are heavily specialised in domestic securities indicate the extreme case of perfectly elastic factor supply elasticities is unrealistic. Suggested rigidities to the free flow of international capital include asymmetric information, regulations, high transaction costs and exchange rate risks (Gordon and Bovenberg, 1996). Even so, by contrast, the factor supply elasticities for natural resources, including land, and for unskilled labour are highly inelastic. Optimal taxation theory implies Australia could gain by lowering tax rates on the highly elastic factors, capital and skilled labour, and increase them on the inelastic factors, natural resources and unskilled labour.

To illustrate, consider the extreme case where capital (and skilled labour) are in perfectly elastic supply and land (and unskilled labour) are in perfectly inelastic supply. Here I report the intuition behind more formal analysis by, for example, Gordon (1986), Razin and Sadka (1991) and Gordon and Bovenburg (1996). A broad based income tax with equal tax rates on the different factors would in its final incidence redistribute the initial incidence on the internationally mobile factors to the inelasticity supplied immobile natural resources and unskilled labour factors. To earn the optional after-tax international return on capital, the pre-tax return for Australian located investment would have to rise by the domestic tax rate. This higher pre-tax return is achieved by less capital, both from domestic and overseas sources, per unit of fixed supply domestic natural resources and unskilled labour. The inelastically supplied domestic factors bear the final incidence of tax on capital as a fall in their pre-tax return caused by less capital and skilled labour per unit of natural resources and unskilled labour.

Now, consider the effect of adopting the optimal tax model recommendation to shift the statutory tax burden away from the internationally mobile factors to domestic inelasticity supplied factors. Removal of the tax burden on capital and skilled labour encourages the Australian location of these factors. In turn, the higher ratio of capital and skilled labour to the fixed supply of Australian natural resources and unskilled labour increases their pre-tax return. Further, the pre-tax return may rise more than enough to offset the initial tax burden increase so that the after tax return to Australian natural resources and unskilled labour increases. That is, lowering the tax burden on internationally mobile capital and skilled labour can be a win-win improvement for all Australians.

How then might a tax mix change lowering the tax rates on internationally mobile capital and skilled labour be achieved? General tax rates can be reduced by lowering the total tax take, and by removing special deductions and exemptions to achieve comprehensive tax bases. The narrow land tax base in particular could be increased significantly, at least doubled for business, and more could be made of resource rent taxes. Lower tax rates on capital generally can be gained by shifting the tax mix from income to consumption via more emphasis on the GST and/or payroll tax. Lowering taxes on selected capital flows, for example the corporate rate or capital gains tax, but not on other saving and investment options, for example unicorporated business and superannuation, is likely to cause greater efficiency losses by further distorting the composition of aggregate investment.

Also important in any future assessment of the taxation of internationally mobile capital and skilled labour are withholding taxes, Australian credit for foreign taxes paid, and international tax agreements.

State Stamp Duties

Perhaps the most troublesome outcome of the Coalition Parties - Democrats compromise tax reform package of 1999 was that a number of State stamp duties initially proposed to be replaced by the GST were dumped. The FID and stamp duties on marketable securities were removed in July 2001, and the debits tax is due to go in July 2005. However, other stamp duties remain. Stamp duties bring inefficiencies, at best they are proportional taxes, they are horizontally inequitable, and they are complex and a source of confusion, especially for new investors (see Harvey et. al., 2001).

Stamp duties on the transfer of commercial property, residential property and motor vehicles are distorting transaction taxes. They impose a tax wedge on productivity enhancing transfers of land, location and vehicles from lower valued uses to higher valued uses. As well as the static deadweight cost, these stamp duties act as a deterrent to change and innovation because they favour the status quo. The transfer distortion costs could be avoided by revenue neutral packages which: replace commercial property conveyance duties with an annual business land tax; replace conveyance duties on residential property with a progressive residential property annual tax, say on the rates base, to retain vertical equity; and, augment annual car registration fees to replace vehicle transfer duties.

With the introduction of the GST as a broad based consumption tax, remaining stamp duties on insurance, unquoted marketable securities, mortgages, rental agreements and non-residential leases represent double taxation of selected items. Since there are no market failure arguments for these additional specific taxes on these selected products they distort product choice consumption decisions. Further, as some of the stamp duties initially fall on selected business inputs they also distort production method decisions and lead to tax on tax cascading. The double taxation of insurance premiums with 10 percent GST and 10 percent stamp duty is particularly distorting because of the importance of business input taxing, and because the tax base in both cases is the premium rather than the intermediation services provided value added component of the premium. Replacement revenues for these stamp duties could come from a higher GST rate, or from extra revenues collected from broader payroll and/or land tax bases discussed above.

Special Purpose Indirect Taxes

In principle good economic efficiency arguments can be advanced for special and relatively high indirect tax burdens on selected products for reasons of market failure.

Ideally, the tax base would be the most direct measure of the production or consumption activity creating external costs, and the tax rate would be equal to the marginal external cost. To date, the design of excises (now including State business franchise fees) on petroleum, alcohol and tobacco products, the wine equalisation tax, vehicle transfer duties and vehicle registration fees, and taxes on gambling have been more ad hoc than based on careful market failure logic. In addition, there may be options to collect revenues by special taxes on other externality creating activities such as air and water pollution, and urban congestion.

Arguments for the relatively high taxation of the on-road use of motor vehicles through petroleum excise, annual registration fees and vehicle transfer duties include that it is a crude form of user fee for government provided road infrastructure and associated services. In fact, revenue collected this way exceeds government outlays by about two to one (Cronin, 1997). With the exception of the registration fee, the relationship of the special indirect taxes to use of road services is weak. It would seem more appropriate to set an explicit road usage fee, take this out of the tax system, much as is the case with charges for other infrastructure such as electricity, and it may be time to make greater use of modern information technology such as hubometers and e-tags to measure road use.

If the taxation of the burning of fossil fuels and their associated contribution to greenhouse gasses under the Kyoto protocol is to be taken seriously, the present petroleum excise base is far too small. It does not capture off-road use of petroleum products or the burning of coal and gas for electricity generation and for other industrial purposes. More problematic is choosing a carbon tax rate to reflect the marginal external cost of global greenhouse gas pollution.

A part rationale for the selective high indirect taxation of alcohol and gambling is to internalise the external costs of some consumption of these products. In both cases it is excessive consumption and not moderate consumption that causes problems. This means the chosen tax rate has to balance the distortionary costs forced on low and moderate users versus the desirable effect of reducing some excessive use of these "sin" products. In the case of alcohol products the current tax base for beer and spirits, namely litres of alcohol equivalent, seems more appropriate than the wine equalisation tax base, wholesale product value. But, even in the case of beer and spirits the tax rate varies. Both the tax base and tax rates vary for different forms of gambling in a rather ad hoc way, and certainly with no reference to the relative magnitudes of external costs attributable to different forms of gambling.

In the case of the very high excise rate on tobacco, the choice of tax base, now by stick rather than by weight, and tax rate seems to reflect more revenue needs and general opinion that tobacco consumption should fall rather than a careful assessment of the marginal external costs caused by the consumption of tobacco products.

In the absence of more formal frameworks and analyses for choosing tax bases and tax rates to correct for market failures we might expect further bouts of political ad hocery and short termism as the principal drivers of tax reform illustrated by changes to the taxation of beer and petrol in 2001.

5. Conclusions

A pre-condition for significant tax reform is that there be both problems with the present system and that there be options which can provide better revenue collection, efficiency, equity and simplicity outcomes. Then follows the challenging steps of gaining political and public acceptance of proposed reforms. The premise of this paper is that the pre-conditions clearly are satisfied.

The main Australian tax bases are far from comprehensive because of special exemptions and deductions. This is particularly true of the payroll and land tax bases which are less than a half of their potential. Opportunities to expand the income tax base and GST tax base are more modest, and maybe the best reform strategy is to hold the gate against inevitable interest group lobbying for new and/or additional exemptions and deductions. Broader and more comprehensive tax bases allow for lower tax rates, greater neutrality and efficiency, more horizontal equity, and usually greater simplicity.

The most serious remaining problem with the dominant income tax system is its mixed or hybrid tax treatment of different forms of saving and investment and of different business structures. Given the trend for globalisation and increased mobility of capital, reforming the taxation of capital as an expenditure or consumption base has many attractions. First, a more level playing field for different saving and investment options and for different business structures is provided. Second, the resulting increase in investment and capital per worker with a lower tax burden on the internationally mobile capital will lead to higher real wages and GDP which are likely in time to more than compensate workers for the initial higher labour income tax rate.

A high reform priority should be abolition of State stamp duties. They act as a deterrent to change and innovation, and they have become a selective, narrow based additional indirect tax on top of the more broadly based GST. Conveyance duties can be replaced by a more comprehensive land tax and duties on vehicle transfers by a higher annual registration fee.

While good market failure reasons can be provided for selective additional indirect taxation of petroleum, alcohol, tobacco and gambling products, and in other activities generating externalities, both the bases and rates for these taxes are ad hoc at present.

Table 1 - Effective Tax Rates on Major Asset Classes for 2001

(Actual gearing = g, Assumed inflation - 3%)

Personal Statutory Tax Rate (%)	**Real Effective Tax Rate (%)**					
	Interest bearing deposit	***Owner occupied housing***	***Negatively geared rental property***	***Unincor-porated enterprise***	***Local company***	***Investment abroad***
	Ungeared	**g = 10%**	**g = 50%**	**g = 18%**	**g = 35%**	**Ungeared**
15	23.2	2.3	Na	-0.6	-4.9	48.3
30	53.5	7.8	-1.9	17.4	27.8	58.4
48.5	76.3	19.4	-1.1	32.3	52.8	70.1

Completed using 2001 taxation provisions using the formulae and procedures used by Pender and Ross (1993) for their Table 4.

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