Tax Mix Change

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Outline

- General idea of a tax mix change
- Some detailed policy options
- Importance of casting assessment in the context of a small open economy
- Economic effects of a tax mix change
- Efficiency, or productivity, gains
- Equity, or redistributional, effects
- Some caveats to change

Tax Mix Change

- Two related ideas:
  - Increase consumption tax to fund lower income tax. Reduces tax on saving.
  - Increase tax on labour income to fund lower tax on capital income. Reduces tax on income earned on saving.
- Examples:
  - GST for income tax, 1999
  - Fund retirement income via SGL rather than income tax, ongoing

A Note on Australia's Hybrid Income Tax System

- Labour income: close to comprehensive
- Capital income: hybrid treatment of different saving and investment choice options
  - Capital income exempt-owner occupied housing
  - Income taxed-financial deposits, equity returns distributed as dividends
  - Mixed-retained equity returns, capital gains
  - Law to itself-superannuation

Some Options to Change Tax Mix

- Increase indirect taxes (to fund lower income tax)
  - GST
  - Payroll tax, or SGL
- Direct tax options (to reduce tax on S or Y_k)
  - Extend capital income tax exemptions
  - Tax C = Y – S
  - The X-Tax (Modify GST to deduct labour costs, and tax labour at personal level)

International Economy Context

- Australia as a small country in a large global economy
  - Labour is relatively immobile, with a low supply elasticity
  - Capital is relatively mobile, with a high supply elasticity
- Key tax analysis implications
  - In final tax incidence, labour bears most of any tax
  - Tax efficiency says most tax on labour

Economic Effects of a Tax Mix Change (lower tax rate on capital income)

- For a given world after tax return, the required pre-tax return on Oz investment falls
- Increase investment and capital stock in Oz
- Increase income, including taxable income
- Increased capital to labour ratio increases labour productivity, and then through to higher wages

Economic Effects of a Tax Mix Change: Numbers from an Illustrative Model

- Simple small country model
  - Labour in inelastic supply
  - Capital in elastic supply
  - Cobb-Douglas production function, with labour share of 0.7
  - Competitive markets
- Long run comparative static analysis
- Experiment
  - Cut tax rate on capital from, say, 30% to 20%
  - With initial pre-tax return of 10%, a 10% pre-tax return cut

Illustrative Model Comparative Static Economic Effects of a Tax Mix Change

- The required pre-tax return on Oz investment falls
  10%
- Increase capital stock in Oz
  14%
- Increase income in Oz, including taxable income
  10%
- Increase Oz wage rate
  10%

Efficiency Effects of Tax Mix Change

- Large investment boom, increased capital stock, larger GDP, increase in market wages. (Result of application of optimal tax idea in a small economy context.)
- Reduced distortions to the choices of different saving and investment choice options.
- Reduced distortions to intertemporal consumption decisions.
- Initial increased distortions to labour decisions reversed in longer run.

Equity Effects of Tax Mix Change

- "Night after" with no base changes (zero sum game)
  - Labour lose with higher taxes
  - Domestic savers neutral
  - Oz investors gain
- Longer run when economy grows and wages increase (positive sum game)
  - Labour (and other) tax rates fall
  - Labour gain from higher market wages

Some Caveats to a Great Opportunity

- Time lags for investment and productivity growth to develop a positive sum game
- Sustainability of a single country maintaining the optimal tax idea in a global tax competition game
- Uncertainty about appropriate model and parameters in quantifying efficiency gains and redistributive effects
- So far, no country has successfully implemented a direct consumption base tax

Conclusions

- In principle, for Australia a tax mix change offers a significant win-win opportunity.
- But, implementation will require a mindset change in tax reform debates. Specifically, we have to look beyond the “night after” effects to a large positive-sum game pay-off over the medium and longer term.