Tax reform = growth

Australia's tax system is better than Britain's, says **Rory Meakin**—but it's still in dire need of reform.

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Australia's tax system has its problems. Too complicated, too many special allowances and specific taxes, and too much money drained out of the pockets of working Australians. But things could be worse. Australia could have the British tax system, instead. Imagine a system that imposed tax rates on labour income which, when you add them all up, are as high as 66 per cent.

In Britain, standard income is subject to four rates of income tax while dividend and savings income each have a separate schedule of rates on top of a separate tax on company profits and capital gains tax. Labour income is also subject to an additional deceptively-named tax called national insurance which is assessed weekly rather than annually and levied separately on both employers and employees, with different rates and thresholds and classes for each. It all adds up to punishing overall rates.

The rules are covered in a set of tax accountancy guides called Tolley's. By 2010-11, the combined number of pages had ballooned to 17,795, three times higher than in 1997. The Byzantine complexity implied by those numbers imposes considerable costs on businesses and individuals in the UK. It prompted the TaxPayers' Alliance to join with the Institute of Directors in 2010 to form the 2020 Tax Commission to review the entire tax code with a view to proposing a rational system designed from first principles, but which is nonetheless politically realistic.

The final report, *The Single Income Tax*, launched in May, proposes a very radical yet necessary change to how the government raises taxes, aimed at making the system cheaper, fairer and more legitimate.

The cost of complexity goes beyond the need to employ more experts to understand more rules and conditions, although since 1996 membership of Britain's Chartered Institute of Taxation has grown every year from 10,115 to 15,400 in 2011. The perception of almost impenetrable complexity means opportunities are not exploited because it is hard for people to assess just how complex the tax system is. This leads them, rationally, to err on the side of caution and expect the worst. So they assume the rules will be at the worst end of their estimation of how complex and costly the tax code could be, just to be safe. People price in the risks associated with their ignorance on tax matters when contemplating potential projects.

In addition, complexity has led to the tax system having lost legitimacy as many people do not even really understand how much tax they should pay, let alone how much others should pay. That opacity, a direct consequence of complexity, inevitably leads many to suspect others of not paying their fair share.

In 2009, *The Guardian* reported that Barclays paid tax of 'just one per cent of its 2009 profits'. Subsequent analysis showed that the pre-tax profit figure used was that of the global Barclays Group rather than the bank's UK operations, which was compared against tax paid on UK profits. It was also inflated by including the sale of Barclays Global Investors, a type of gain expressly exempted from the company profits tax rules to avoid tax distorting restructuring decisions. Once these two mistakes alone are corrected, an effective tax rate of over 23 per cent emerges, much closer to the then headline rate of 28 per cent. Too bad. By the time corrective analysis had been released the damage to the legitimacy of the system had already been done.

TAXES SHOULD BE AS NEUTRAL AS POSSIBLE. THAT'S WHY WE PROPOSED TO ABOLISH EIGHT OF THEM

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The more evidence we heard and the more research and modelling of the system we did, the more we came to see that tax neutrality had to be the key mechanism to achieve the radical simplification needed. How an individual earns an income should not affect his liability for tax on that income. One hundred dollars should be worth the same to the payee whether it is received as salary, dividends or interest. The total income of an individual determines his ability to bear the burden of tax, not how that income is labelled.

So taxes should be as neutral as possible. That's why we proposed to abolish eight of them which do little more than complicate the system and add confusion as to who actually ends up paying the bill. Employer's National Insurance is like an especially complicated version of the state payroll taxes in Australia. It and the employee's section of national insurance are both almost indistinguishable from income tax in their impact on the labour market and their function—to raise revenue.

The insurance function implied in the name has steadily been eroded away to meaninglessness under successive reforms. Meanwhile, capital gains tax is similarly little more than an additional income tax on dividends, albeit one bafflingly levied on the difference in the expected future values between the times of purchase and sale of an asset. But the murkiest of all is corporation tax, levied on company profits, which effectively penalises some combination of labour and capital based on the economic efficiency of the company concerned. The academic literature is mixed on the question of how much of the burden of profits taxes is passed through to labour in the form of lower wages and how much is borne by capital in the form of lower returns on investments, but either way the burden falls on the employee or investor in proportion to how efficient the company is, not the individual's ability to pay.

Transaction taxes, too, bear little relation to the ability of individuals to bear the burden of a tax. It is not entirely clear why someone ought to pay tax simply because he sells his house or shares. Why should the governments discourage people from moving homes or adjusting their asset portfolio mix? The effect of stamp duties is to gum up markets for surprisingly little benefit to national treasuries: the British Government expects to collect less than $5 billion from stamp taxes on shares this year out of total revenues of around $890 billion. But those figures do not account for other tax revenues lost from discouraging share trading in the UK. Nor do they take into account the fact that the tax has been estimated to depress UK equity values alone by as much as $230 billion.

While stamp duty on land sales raises a little more and is probably less economically destructive, the rates are much higher and look especially eye-watering compared to the deposit, for many people the only bigger cost involved in buying a home. It is also arguably more unfair and comes at a particularly bad time for those who have to pay for it, when they will often have so many other bills to pay. Inheritance tax also kicks people when they are down. It taxes families again for income they have already paid tax on, just because someone has died.

Instead of that plethora of specific taxes, we have proposed that the burden individuals bear for the cost of government should be in proportion to their income, however it is received. We modelled the proposals, along with retaining some other British taxes, but cutting others on petrol, diesel and airline flights, to raise 33 per cent of national income. This requires a Single Income Tax of 30 per cent, with a personal allowance of around $16,000 before people need to pay any tax at all. Australia's tax receipts as a proportion of GDP are already below 33 per cent, so these numbers should be within reach for Australia, too.

HISTORY HAS SHOWN THAT MAJOR TAX REFORM MUST BE PART OF A CUTTING PROGRAM. **REVENUE NEUTRAL OR TAX-RAISING REFORMS RARELY SUCCEED**

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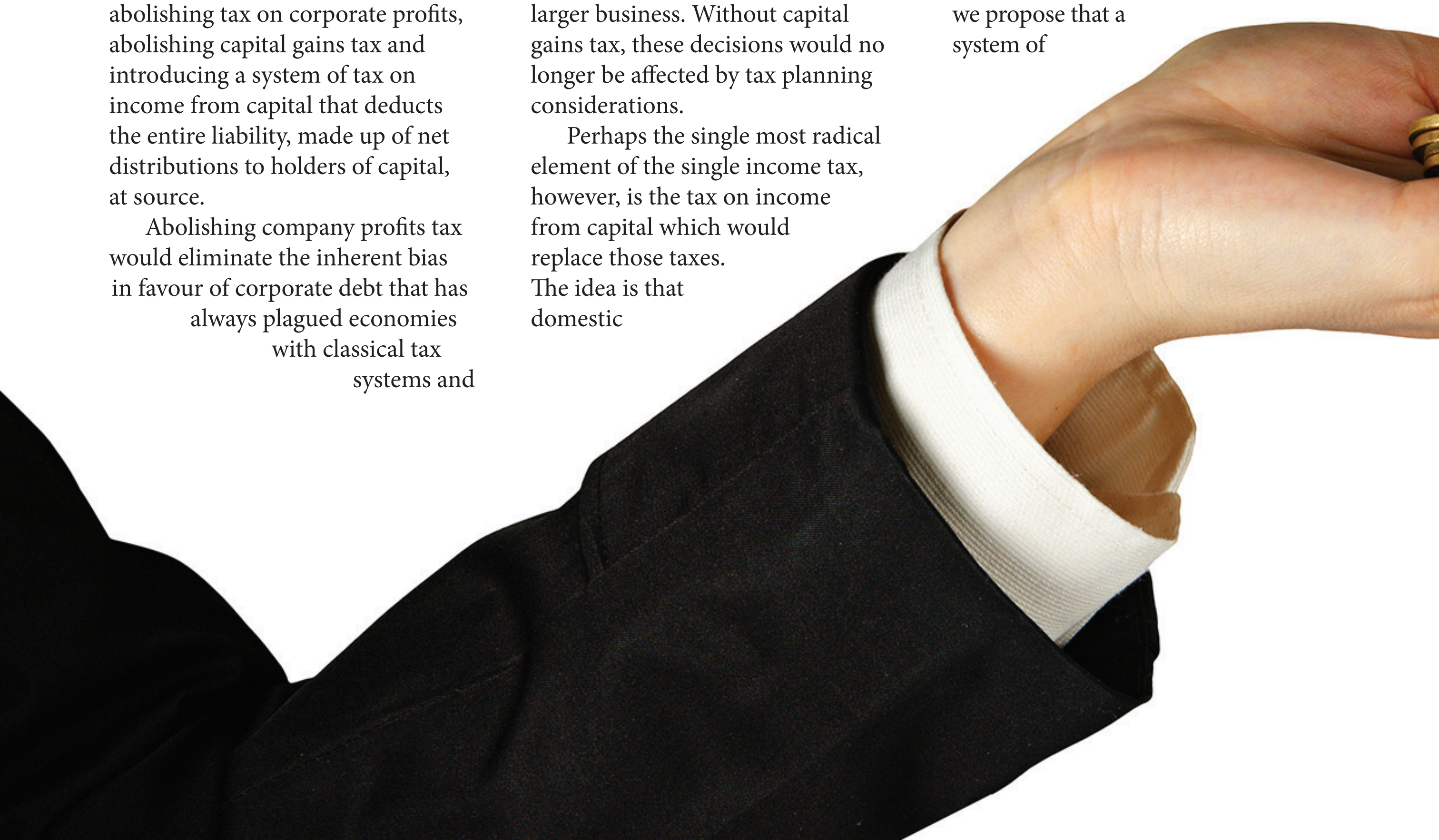
The cornerstone on which so many of the benefits of the single income tax rest is the single rate of tax. A single rate across all income types and levels allows for huge distortions in economic decision-making to be ironed out of the tax system entirely. Small businessmen could no longer achieve a tax advantage by paying themselves through a company in dividends. Similarly, there would be no reason to try to disguise their income as a family member's to benefit from a lower rate, beyond the limited effect of the personal allowance.

These neutrality advantages are further augmented by our proposals for capital tax reform, which consist of three principal elements: abolishing tax on corporate profits, abolishing capital gains tax and introducing a system of tax on income from capital that deducts the entire liability, made up of net distributions to holders of capital, at source.

Abolishing company profits tax would eliminate the inherent bias in favour of corporate debt that has always plagued economies with classical tax systems and above-the-line deductions for interest. Heavily indebted companies would not be worse off than those financed through equity, but they would no longer be advantaged by an artificially low weighted average cost of capital. Abolishing capital gains tax, meanwhile, would eliminate the distortion in favour of the status quo in ownership of assets. Capital gains tax often means that people who would otherwise sell assets to buyers who might be in a better position to make use of them instead keep them because the extra tax outweighs the economic advantages. For instance, a business that has grown too large for its founder to manage well might be retained to avoid tax rather than sold to another businessman with skills better suited to running a larger business. Without capital gains tax, these decisions would no longer be affected by tax planning considerations.

Perhaps the single most radical element of the single income tax, however, is the tax on income from capital which would replace those taxes. The idea is that domestic companies will be liable for tax on net distributions of capital to shareholders and lenders. Effectively, dividends and interest payments paid out less dividends and interest received. In addition, subscriptions to new shares, share buybacks and loan principle amounts would also be taxed or eligible for a credit against tax, depending on which way the cash flows. This would ensure that only returns to capital are taxed, not the return of the capital itself, while closing off opportunities for tax avoidance by distributing cash through share buy backs.

When these transactions are between two Australian companies (such as between a controlled company and its parent), they could be disregarded for tax purposes on both sides of the transaction. However, to account for new capital coming into Australian companies and to handle other transactions where it cannot be certain that all parties are Australian companies (such as dividend payments by public companies), we propose that a system of



transferrable credits against tax is established. Transferability is important because it would eliminate artificial incumbency advantages by ensuring that tax becomes a negligible concern for investors who prefer to extract cash from one company in order to reinvest it in another.

For instance, a company that receives $100 start-up capital from an individual would receive a credit exempting $100 of distributions from tax. That credit could then be traded and, if tax is set at 30 per cent, it should be worth up to $42.85 (because $100 equates to 70 per cent of $142.85). So a shareholder should be able to extract cash from a company and invest it in another without suffering a tax disadvantage compared to leaving the money for the first company to reinvest.

Five key principles would ensure a robust system. Credits should:

- Never result in a cash payment out by tax authorities
- Only be used to reduce a tax liability
- Not be issued until after a corresponding tax liability has been settled
- Be divisible at the request of the taxpayer with the corresponding liability
- Only be issued when the corresponding taxpayer confirms the details of the credit

For most companies the system would be incredibly simple. More complicated arrangements would only be worthwhile if they genuinely made the business more productive. And even then the tax system would not add to their complexity.

The recommendations are unashamedly radical. But they are also achievable, realistic and necessary. They would considerably shrink the size and complexity of any country's tax code, but there is a critical challenge which any government implementing the single income tax must address.

History has shown that major tax reform must be part of a tax cutting program. Revenue neutral or tax-raising reforms rarely succeed, as Britain's finance minister George Osborne has recently discovered when he tried to extend VAT to caravans and various snacks. If ordinary families get a tax cut, however, the astonishing complexity that has gradually built up in the system over decades can be substantially reduced without being derailed by those who lose out. The radical neutrality of the single income tax proposals would transform Britain's tax environment into one of the world's most competitive; unleashing enterprise and prosperity to revitalise the economy. Implementing it and leaving more money in the pockets of the taxpayers who spend it best is a huge reward for serious action to control spending.

It is a shame that the Australian government has shied away from those proposals that were commendable but nonetheless tame in the Henry Review. Australian policymakers should consider our single income tax proposal. With a little adjustment for circumstances specific to Australia, the radical simplicity we have proposed for the UK could yield huge benefits for Australia, too. Our proposals are more radical but our circumstances are more pressing. We desperately need the British government to adopt our tax reforms to transform the British economy and deliver more jobs, growth and long term prosperity.

The 2020 Tax Commission report can be downloaded from www.2020tax.org