Prosper's submission to the federal Tax White Paper

by David Collyer

Late last year, the Abbott government called for submissions on its tax reform white paper. Since the call, the popularity of the government has plummeted and the tax white paper deferred.

Prosper has serious concerns about the equity and economic efficiency of the reform proposals - notably broadening the GST,, which is a regressive tax. Our submission spells out why.

Is broadening the GST really tax reform?

Members of the Abbott government has argued strongly for extending the GST base onto food and other exclusions negotiated to allow the passage of *A New Tax System (Goods and Services Tax) Act 1999.*

The GST has some virtues. It has low deadweight costs – provided it is universally applied – and is a distinct improvement on the scattered and inefficient sales tax regime it replaced.

However, it is regressive, falling most heavily on low and middle-income earners who spend a larger proportion of their incomes on food staples and cannot change their behavior without compromising nutrition. The rise in consumer prices reduces the purchasing power of after-tax wages with impacts on labour supply and nominal labour income.

The GST's reduction of after-tax labour incomes has a corollary - a significant lift in after-tax private capital incomes, as explained in KPMG Econtech's *CGE Analysis of the Current Australian Tax System.*

The benefits conferred on after tax private capital incomes are substantial, particularly as the main gains are enjoyed by a small proportion of citizens.

This burden-shifting between economic classes has not been openly discussed by economists and commentators, yet it is clear from citizen discussion they intuit the significance and do not like it.

We note and agree with Treasurer Joe Hockey's recent statements that middle income earners face effective taxation rates of 50 per cent due to bracket creep and the genuine risk of widespread work disincentives.

If Australia is to endure the upsets and costs of tax reform, we have an obligation to migrate to bases that economists can demonstrate have the following features:

- Nil deadweight losses
- Cannot be avoided or passed on
- Are equitable
- Reflect capacity to pay
- Can be universally applied

Australian economic activity

The Australian economy faces serious challenges. The downturn in commodity prices means the very large investment in mining construction investment will generate modest returns in the short to medium term. Manufacturing activity has shrunk dramatically due to our strong currency and is set for further falls as car manufacturing ends. Prosper is, however, very optimistic about an eventual manufacturing and agricultural revival on a much lower Australian dollar.

Larger than all these negatives and a more difficult challenge for policy is land costs.

Australia is very richly endowed with land. This is a key national economic advantage over almost all competitor countries. Government has an unceasing obligation to nurture advantage in this by siding with the future (buyers) over the past (vendors).

Over the last 30 years, land prices have boomed – propelled by speculation, easy credit, restrictive planning and rising real incomes. On one hand, many have made their fortunes, on the other, first home buyers now find it nearly impossible to buy a house to start a family and enter the independence, privacy and security of property ownership except on extremely onerous terms.

Universal access to inexpensive land is a core economic and cultural Australian value.

An inefficient taxation system, comprised of high wage taxes and low land taxes, allows landowners to expropriate 'geo-rent' (economic rent derived from land) by capturing the uplift in land values generated by taxpayer-funded infrastructure and rising economic productivity derived from labour and entrepreneurial activity. As property valuer Bryan Kavanagh notes: "...land price is actually the private capitalisation of imputed site rent remaining on a site, developed or undeveloped, after the deduction of government charges."

Because government has preferred to tax wages and enterprises ahead of land, the capital sum people are willing to pay for this asset is elevated by its privileged status. Counter-intuitively, reducing wage and business taxation and increasing land tax would not necessarily lower land prices, given the offset of increased final wages, profits, and real and imputed rents. This macro reform – urged on government by every independent tax review in living memory – would solidly correct the price/income and price/rent ratios.

If Australia wishes to escape or ameliorate the profound financial destruction of a bubble burst, the solution lies in this equation. Further, there are major economic benefits available in reducing deadweight costs and our very large tax expenditures by shrinking tax bases we know distort behavior and shedding the tax relief extended to preferred groups.

The generous scope of tax expenditures relating to the housing market has increased land costs. Tax expenditures are defined as a deviation from the commonly accepted tax structure, whether it is a tax exemption, concession, deduction, preferential rate, allowance, rebate, offset, credit or deferral. Australia has the highest rate of tax expenditures among our OECD peers, at more than 8 per cent of GDP.

Tax expenditures are vulnerable to lobbying, and compromise the fairness and efficiency of the tax system. Lavish tax expenditures for both owner-occupied and residential investment property has significantly worsened housing affordability. They allow landowners to capture greater amounts of land rent and prioritise unearned wealth and income over what is earned. Existing home owners capture the greatest benefit, ahead of first home buyers, investors and tenants.

The profound influence on human behavior of where and how governments choose to tax is amply demonstrated by the emergence of a very large cohort of negatively geared property investors – the overwhelming majority middle income earners seeking to escape the PAYE tax system, although the biggest income losses are made by high income negative gearers.

These tax expenditures, reinforced by already low property taxes, provide strong incentives to speculate on housing prices. Investors perceive rental income as secondary to expected rises in capital prices, while first home buyers over-leverage themselves to enter a bubble-inflated market.

In Australia, a perverse culture of homeowner entitlement is compounded by a degenerate taxation system that penalises hard work and innovation, while rewarding speculation.

A New Federalism

The ideal tool to moderate land bubbles and properly fund infrastructure already exists in the hands of state and territory governments: State Land Tax. Unfortunately, this tax has been so riddled with exemptions and concessional treatments it must be considered dormant. The states show no interest in, for example, removing conveyancing Stamp Duty or Payroll Tax – both very damaging tax bases - and funding this by also removing exemptions from SLT. They fear the political consequences.

We recommend the Abbott government introduce a nation-wide one per cent Federal Land Tax - fully rebatable on State Land Tax paid - to oblige the states and territories to migrate their revenue bases away from genuine economic injury. State governments could adjust their tax rules and keep every dollar the Federal Land Tax raises, to the great benefit of all Australians. The Commonwealth would be entitled to argue this intervention is for sound economic reasons and dissipate the political fallout.

Transitional arrangements would need to be considered. A logical solution is to credit all landowners with the amount of stamp duty paid and then deduct the hypothetical land tax they would have paid since the date of purchase. This would address much of the fairness question.

Placing state and territory finances on sound bases would vastly improve the federal system mandated by Australia's Constitution. It would also introduce a new dynamism into all levels of government and overall economic activity.

Conclusion

The Abbott government is confronted by hard choices that will determine Australia's future economic character and direction. Investor activity is currently deflected to speculation in residential property, notably in Sydney and Melbourne, by the sum of the economic incentives available here and in investment alternatives. If government chooses to advance sectional advantage over the universal prosperity that would emerge from the tax reforms we suggest, both rich and poor would be diminished.