ADDRESS TO CEDA – THE TASMANIAN STATE TAX REVIEW

THE CONTEXT AND DRIVERS FOR STATE TAX REFORM

KEN HENRY
SECRETARY TO THE TREASURY

Thank you for inviting me to speak here today. It is always a pleasure to speak to CEDA; an organisation that provides an opportunity for people from a diverse range of backgrounds and experience to come together to discuss the challenges and opportunities that Australia will face over coming decades.

And thank you, Treasurer, for sponsoring this event. It comes at an opportune time.

Today I would like to talk to you about some of the long-term challenges facing the Australian economy and the role that tax reform can play in addressing these challenges. I am conscious that Tasmania, along with some other States, has begun its own tax review, so I will focus my observations on the role of state tax reform in addressing national challenges. This might seem a little peculiar to some of you; thinking about the national role played by state tax systems. But that's one of my points today: we could more often think about state policy matters from a national perspective.

The tax review panel I had the privilege of chairing set out to address a set of large-scale and long-term challenges facing Australia, including: (1) a population that is growing rapidly, becoming more culturally diverse, yet ageing; (2) the re-emergence of China and India as global economic powers in a world characterised by ever deepening international integration; (3) the technological transformation of government, business and personal lives, especially through advances in digital electronics and communications; (4) deepening stresses between human activities and wider ecosystems, globally and locally – of which climate change adaptation and mitigation strategies are especially challenging elements; and (5) powerful stresses on housing affordability and urban amenity.

The fact that these challenges are large, and long-term, does not mean that they are distant. Indeed, we are already feeling the effects of all of them.

I don't have time today to traverse all dimensions of these challenges, and consider the role state tax reform might play in addressing them. But I will say something about some of them.

Demographic change

Right now, we are in a demographic 'sweet spot' where there are two people of working age to support those older and younger; in somewhat crude demographic language, we might say that there are two workers per dependent. But from now on, that ratio will deteriorate each year so that 40 years from now there will only be 1½ workers per dependent.

For the last 40 years, and largely as a consequence of a collapse in the birth rate in the 1960s and 1970s, our rate of economic growth in per capita terms has benefited from the fact that the number of workers per dependent has been increasing steadily – from 1¾ in 1970 to two today. The fall in workers per dependent now underway is putting downward pressure on our per capita growth performance. The impact on growth of this turnaround of our demographic fortune is not trivial. It is roughly of the same order of magnitude as the reduction, during this decade, in our productivity growth rate.

At the same time, the ageing of our population is set to place pressure on public finances. The 2010 *Intergenerational Report* projected that over the next 40 years, based on current policies, total Commonwealth spending would grow from around 22½ per cent of GDP in 2015 to more than 27 per cent in 2050. This reflects both demographic and non-demographic trends in health spending, along with increased spending requirements in aged care and income support. The Report didn't examine spending by State governments, but State budgets are likely to suffer a similar shock. And State tax bases are not as well placed as those available at the Commonwealth level to raise those sorts of additional revenues.

From a national perspective, demographic change makes a case for reforms to our tax and transfer system to reduce disincentives to work and save for retirement. And strong population growth argues for policy change to improve the prospects for social and environmental sustainability.

Environmental pressures

Tensions between the natural environment and human commercial activities have not been well managed historically, and they are becoming more acute. Tasmanians are not newcomers to these issues. And I don't seek, today, to propose answers to the difficult questions with which many of the people in this room have been grappling for years. I will merely say that we as a country continue to consume our environmental assets – both physical and intangible – without accounting properly for that consumption; choosing to fool ourselves about the impact of our activities on the lives of our grandchildren. There is a strong case for the better pricing of our natural resources, both renewable and non-renewable.

Strong demand for mineral exports

Our tax review noted that:

> The shift of the centre of gravity in the world economy towards Asia is reducing the distance between Australia and its export markets, adding considerable value to our

natural resource wealth and opening new investment, trade and employment opportunities.

The strong rise in Australia's terms of trade over the past decade could well turn out to be the biggest external shock to our economy in history.

Rising terms of trade mean increased aggregate purchasing power and higher aggregate incomes. But not everybody's income, or purchasing power, gets a boost.

The net outcome of the economic adjustments associated with an increase in the terms of trade is what we might call a 'three speed economy':

- the mining and mining-related sectors grow strongly;
- other trade-exposed sectors (like many parts of manufacturing) grow more slowly; and
- non-traded sectors grow at a rate somewhere between those two.

In order to balance demand and supply in the non-traded sector, there will be an appreciation of the real exchange rate. That is to say, there has to be an appreciation of the nominal exchange rate and / or a period of time during which our costs of production inflate at a rate that is higher than the average inflation rate of our trading partners.

Putting this another way, the economic adjustment required to balance demand and supply in the non-traded goods sectors necessarily has the effect of making all Australian businesses less internationally competitive. And that loss of competiveness cannot be avoided unless the full income effect of the terms of trade boom is somehow sterilised.

I don't have time today to go through what would be required to secure complete sterilisation. I'll provide just one illustration. Economists will tell you that fiscal policy can help. In particular, a tightening of the fiscal stance can reduce the size of the real appreciation required to achieve macroeconomic balance. The most obvious, and most effective, form of fiscal tightening would be a higher level of taxation of the incomes of those sectors benefiting directly from the increase in commodity prices. The tax review argued this case, noting that State based royalties provide a poor foundation for any such tax increase and recommending, instead, a national profits-based resources tax.

Higher resources taxation is not the only option. Economists will point out that any other form of fiscal tightening would have some impact, even if smaller and less direct, on the size of the required real appreciation.

But consider the orders of magnitude here. Over the past decade, world prices of our non-rural commodity exports have increased, on average, by about 300 per cent. Exports of these products represent about 10 per cent of GDP. Clearly, offsetting the full income boost from higher non-rural commodity prices on aggregate demand through a fiscal contraction would require an implausibly large reduction in government spending, possibly equal to, or even greater than, the total current level of government spending in Australia. That is, to completely sterilise the terms of trade boom through fiscal policy, we may have to abolish all government spending. Note that we would, however, have to keep raising the same level of taxes as presently.

As I have said, I don't have time today to go through all of the other policy ideas that might be thought to avoid any real appreciation of the exchange rate. All you need to know for present purposes is that none of them is going to happen either.

In any event, fiscal policy is making some contribution to limiting the size of the currency appreciation, with the budget balance forecast to improve by an unprecedented 4½ percentage points of GDP over three years.

I have been talking about the need for a real appreciation of the exchange rate. Technically, we can choose how much of that comes through the nominal exchange rate, and how much we allow through domestic inflation. In the early 1970s we experienced a large terms of trade shock – somewhere between a quarter and a third the size of the one we are experiencing today. In those days, we had a fixed nominal exchange rate, so the adjustment came through domestic costs and prices. Annual consumer price inflation hit 17½ per cent by the March quarter of 1975 and, ignoring the temporary and technical impact of the introduction of Medicare in 1984, didn't come back below 5 per cent until the recession of the early 1990s.

That sort of inflation certainly reduced our international competitiveness, spectacularly 'over-achieving' what was required to rebalance the economy following the early 1970s terms of trade shock. And that loss of competitiveness did considerable damage. No one wants to pay that price again. And they won't, because these days we have a floating currency and a strong commitment – underpinned by an independent central bank – to keeping inflation to moderate levels. But what that means is that, on this occasion, most of the loss of competitiveness required to rebalance the macro-economy is coming through an appreciation of the nominal exchange rate; largely explaining why, for example, the Australian dollar is up around its post-float highs against the US dollar.

Tax reform to take best advantage of structural change

Even with the nominal exchange rate at historic highs, prospects obviously look good for mining. Just as obviously, though, this is a demanding time for those parts of the traded sector of the economy that are not benefitting directly from the strong demand for our minerals.

In this unbalanced growth there are strong incentives for capital and labour to move to mining enterprises and the other enterprises on which mining depends for various inputs.

There are, of course, costs associated with structural change; including human costs. Some will advocate attempting to avoid those costs through the provision of support for particular industries or enterprises; using targeted tax concessions or direct subsidies, for example. These sorts of measures are likely to be counterproductive. The real exchange rate would only have to move even higher – imposing an even greater loss of competitiveness elsewhere.

Policy can best respond by removing impediments to adjustment and reducing the costs of adjustment. Here, tax reform – both Commonwealth and State – has a role to play; especially in lowering the tax burden on mobile activity, including by reducing transaction taxes.

It turns out that that sort of tax reform would also respond well to other challenges we are confronting, including the task of financing the public costs of an ageing population in a world of increasing factor mobility. That challenge posits the need for a tax-mix switch to address fiscal sustainability issues in ways that are least damaging to economic performance. And as the review observed, this will mean, over time, less reliance on the tax bases of mobile capital and labour, and greater reliance on the less mobile bases of land, minerals and consumption.

Since the States presently levy the principal taxes on land and minerals, and are the recipients of most of the tax revenue generated from the consumption tax base, they can play a big part in national tax reform. But national tax reform won't be achieved if we simply cut company tax and make up the revenue by increasing the rates of tax levied by State governments. State tax reform means something other than that. Let me give you some examples.

Land tax

Demographic and environmental change provides a case for making a more efficient and sustainable use of the land tax base.

Land is recognised by tax professionals as one of the most efficient tax bases. Work by the OECD has found that recurrent taxes on immovable property have the least distorting effect on economic growth.[1]

Unlike taxes on capital, which can lead to investment going elsewhere, or taxes on labour, which can result in people reducing their work effort, a broad tax on land values does not change the supply of land. While a tax on land values may change the price of the land, it will not affect how much land there is.

[1] Johansson, A, Heady, C, Arnold, J, Brys, B and Vartia, L 2008, *Tax and Economic Growth*, Economics Department Working Paper No. 620, OECD, Paris.

While land taxes are potentially economically efficient, our current land taxes do not support good incentives for land use. Wide exemptions — especially for the owner's primary residence and for agricultural land — narrow the base and introduce strong incentives for those uses and against others.

Broad exemptions also mean that the burden of the tax can be shifted from landholders to land users – with perverse distributional consequences: exemptions for owner-occupiers and farmers make it likely that renters, rather than landlords, bear the burden of land taxes applying to rental property.

Moreover, land tax is generally imposed on a taxpayer's aggregate value of land holdings, above some threshold. This peculiar design, presumably motivated by equity considerations, creates disincentives for larger, and potentially more efficient, landholdings, and it may be undermining the prospects for private institutional provision of low-cost rental accommodation for low income households.

The tax review panel recommended that land tax be levied on as broad a base as possible and be taxed according to the per square metre value of land, regardless of the size of the holding.

Stamp duties

Stamp duties on residential property raise a considerable amount of revenue for state governments but they are such a grossly inefficient way of raising revenue that I will not spend much time on them.

They are particularly damaging in times of structural change because they fall specifically on people who, for reasons of employment, need to move house. Our report estimated that in Hobart stamp duties increase the costs of moving by three-quarters. In some capitals they double the cost of moving.

Payroll tax

The main tax on labour income levied by state governments is payroll tax. Contrary to popular opinion, payroll tax is potentially an efficient way of raising revenue. But there are a few reasons for tax policy people not to like our payroll taxes. Not only are there differences in the way the tax is levied in different States, but our payroll taxes are made more complex and less efficient by various tax-free thresholds and other exemptions.

Some of the problems with our payroll tax systems have been recognised in recent harmonisation efforts of the Victorian and NSW Governments.

Looking to the future, we might want to consider a payroll tax that more comprehensively included the value-add of all types of labour — not just the selected value-add from payrolls above a threshold — would have less impact on the decisions of business and workers.

Reducing incentives to try to avoid the tax would help to ensure that capital and labour are used where they are most productive. A broader base would also allow the same revenue to be raised with a lower tax rate and would reduce complexities associated with grouping rules and attempts to draw distinctions among different types of labour income.

The panel recommended that payroll taxes should eventually be replaced with more efficient broad based taxes that capture the value-add of labour. There are a number of ways that this could be done. One would be a broader based labour income tax, collected, for example, through the PAYG withholding system.

Road transport

Taxes also influence how well we use our physical infrastructure. State taxes on motor vehicles can be seen as a type of quasi-charge for the spill-over costs of road use, including congestion, noise, pollution and pavement damage. But the amount of tax payable by those who own and operate a vehicle is only very loosely correlated with the spill-over costs that the vehicle imposes. Over time, especially as our population grows, governments will need to think about ways of charging more directly for these spill-over effects.

Nationally, we have done something about the pavement damage due to heavy vehicles but there is room for improvement in that area and in others. In particular, we should be questioning whether we can continue *not* to put a price on access to our busiest roads at peak hour.

It is not just the taxes themselves that we need to think about, but how individual taxes fit into the overall tax system. Some state taxes target the suppliers of capital despite the fact that capital is highly mobile across state borders. The consequence is a loss of capital. Taxes on mobile capital are among the worst tax bases for states to be exploiting.

The complexity of arrangements across the federation is a further consideration. While the issue of complexity created by differences in taxes across States is well known, policy coherence is just as important in other areas. For example, in addressing environmental challenges, the effectiveness of State based schemes, such as feed-in tariffs, would need to be assessed if we had a national carbon price.

Achieving reform can be difficult

No-one thinks that the task of state tax reform is easy. It is not possible to be sure about all the reasons for this but some of the factors are clear.

First, our history suggests that it is difficult for any parliament to legislate significant tax reform unless revenue growth is strong and fiscal resources are available to ease the transition for people who would otherwise be worse off on the first day the reform is introduced. Neither the States nor the federal government are currently in the robust fiscal position that would make significant reform easy. An added dimension in state tax reform is that ‘fair’ compensation is not only a relevant consideration for individuals and families, but also for States — it is hard to expect a State government to support tax reform if the short term impact on its budget is severe.

Second, as noted earlier, capital is highly mobile between states. Any tax reform that falls on capital runs the risk of shifting some investment to other states with more generous regimes. And what may be more important is that it runs the risk of provoking politically potent claims from businesses that they will shift investment to other jurisdictions. As we all know, the tax regime is only one feature of the business environment that influences decisions about the location of investment, so it is hard to be sure how genuine these claims might be, but they are sometimes hard for governments to resist.

Third, all tax reform is made more difficult by the asymmetrical visibility of the costs and benefits of reform. In other words, many tax reforms — especially those that involve the removal of concessions — involve relatively small groups of clear losers and larger groups of winners who, individually, enjoy very small benefits. The aggregate benefit may be very large but the voices of the losers will always be louder than the voices of the winners.

Finally, people do not directly experience some of the taxes imposed by the States on a frequent basis. For example, while most people see income tax coming out of their wages every fortnight, they may only pay conveyance duty once or twice in their lifetimes. This infrequence of experience affects people’s understanding of taxes and the tax system. And it can also complicate the design of reform options. For example, a person who bought a house and paid a large amount of stamp duty yesterday may consider it unfair if stamp duty were to be abolished tomorrow.

What can individual States do?

Despite the hazards to which I have referred, I certainly wouldn’t want you to think that the task of state tax reform is insurmountable. While there are challenges to state tax reform, they can be met. Nor do I want to leave you thinking that State tax reform should be left to the Commonwealth government. In many cases, the Commonwealth will have to be involved – partly for constitutional reasons. But in other cases, including in the harmonisation of taxes across the federation, States working together can achieve what needs to be done.

And there is much that needs to be done.

The tax review panel was struck by the inefficiency of the various taxes currently relied upon by State and Territory governments.

We found that narrow-based state taxes on insurance products, motor vehicles and real estate transfers are among the most inefficient taxes in Australia. I’ve already said something about taxes on motor vehicles and real estate transfers. In the case of stamp duty on insurance products, modelling undertaken for the review estimated a marginal welfare loss of around 67 cents in the dollar.[2]

At our international tax conference, Professor Richard Bird, one of the world's leading public finance people, with an exceptional understanding of federalism issues globally, described state conveyance duties as "an absolute piece of garbage".[3]

Those who have been cataloguing the inefficiency of many of these taxes for some time would feel some impatience. But, as I have noted on other occasions, with most tax reforms, change won't come without the case for reform first being accepted by the community. And that means going beyond the concerns of those who may be disadvantaged by the reform and finding compelling ways of explaining the benefits to the wellbeing of all Australians.

The good news is that that process is getting underway.

It is encouraging to see activity by a number of governments in Australia directed at building the case for imaginative tax reforms.

The Tasmanian Review is especially noteworthy because of the broad, and far-sighted, context in which questions of reform are being framed.

The terms of reference for Tasmania's review require the panel to consider the sustainability of state taxes in light of long-term demographic, social, environmental, economic and budgetary challenges.

That is precisely what should be sought of an exercise that will help build public support for imaginative tax reforms.

Conclusion

There are good reasons for thinking that, over time, our national revenue raising efforts are going to have to place less reliance on mobile capital and labour, and greater reliance on land, minerals and consumption. And the States have their own reasons – partly driven by the fiscal implications of population ageing – for thinking about the need, over time, to raise more revenue from some of the less mobile bases. But the taxes presently applying to those bases are of generally poor quality. They are not the sorts of foundations upon which a tax system architect would want to build.

[2] KPMG Econtech, produced for the Review of Australia's Future Tax System (2000), found in Henry et al. 2009, *Australia's Future Tax System – Report to the Treasurer*, Part 1, p. 13, Commonwealth of Australia 2010.

[3] Bird, R., 2009 – *Address to the Australia's Future Tax Review Panel in June 2009*, Melbourne Institute, University of Melbourne.

In drafting our report on Australia's future tax system, the review panel articulated a vision for a 21st century tax and transfer system. We articulated a vision of a system that encourages workforce participation, an efficient pattern of saving, and stronger investment in human and physical capital. And we said that this system should 'be robust, capable of supporting large structural change, dealing with unforeseeable external shocks and encouraging patterns of economic activity that prove fiscally and environmentally sustainable'.

I've spoken today about some of the challenges likely to confront Australia over the next several decades. These are not distant challenges and, while there will, no doubt, be numerous unforeseen external shocks for us to deal with over that time, we are already having to grapple with the consequences of what could very well turn out to be the largest external shock to the Australian economy in its history. Shocks of that order imply very large structural change. Our tax and transfer system is not well placed to deal with that structural change. But it can be. For reasons that I've explained, the national tax reform effort has to involve the States. I therefore commend the State of Tasmania for the interest, energy and commitment it is investing in the reform effort. And I want to wish the tax review panel every success in its vital work.