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Covid-19 has exposed the weaknesses in the Australian tax system: Tax reform will be required for recovery

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Abstract

The economic shock and government response to COVID-19 highlight weaknesses in Australia's tax system. COVID-19 puts pressure on a system under strain from long-term structural forces and the tax-free and tax-reduced status of certain sources of income. Returning to a sound structural budget position cannot be accomplished through passive action that relies on 'natural' revenue growth from current tax sources. Discussions should focus on comprehensive reform. Reducing reliance on income (particularly labour) taxes and applying a more equal tax treatment to different individuals and income sources over time are priorities which will support improved well-being and labour market activity.

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Keywords: Covid-19; Tax reform

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Introduction

A tax system can be considered sound when it is able to fulfil its basic financing role over time. How sound is the Australian tax system? And how necessary is tax reform to securing a sound foundation in the aftermath of Covid-19? These are the questions that we turn to in this article.

We first detail a framework for evaluating the tax system. We then explain how longer-term trends were ensuring that Australia's main sources of tax were all under pressure before Covid-19, and that the Australian tax mix renders any conversation about meaningful tax reform in Australia largely one about income taxation. We follow this by highlighting how 'tax free' designations on a range of income sources have led to the perverse outcome where it is now feasible for someone with household assets worth $10 million, generating a comfortable lifestyle, to pay less income tax than someone earning income close to the poverty line. In addition to flying in the face of common sense, such outcomes violate the core, broadly agreed upon, tax design principles of equity, efficiency and simplicity.

We also put forward a case for comprehensive, structural tax reform to be a central plank in efforts to manage the post-Covid-19 Australian economy. The debt repair challenge that Covid-19 (and associated government action) presents can be anticipated to prove too large to be addressed through passive action, such as allowing 'natural' revenue growth via bracket creep and from increased collections from companies when economic activity recovers to something resembling more 'normal' settings. The inevitable tax policy discourse can either be focused on constructive reform through a comprehensive and cohesive plan or be progressed as a series of ad hoc incremental changes at the Commonwealth and state government levels, each of which will be subject to attempted hijacking by special interests. And when considering reform options, important context is that Covid-19 represents a significant transfer from the current working age population to current older population. This has created potential space for a political narrative focused on tax reforms that benefit the working age population but that may adversely impact existing asset holders.

We conclude with a suggestion that a comprehensive tax reform agenda should focus on a fairer, simpler tax system that better supports economic growth and that has fewer fiscal vulnerabilities. This agenda should be delivered through action that reduces the share of income (particularly labour) taxes in the Commonwealth tax mix, and moving towards a more equal tax treatment applying to different individuals and income sources over time. Australia's heavy reliance on direct taxation--income and corporate tax—falls particularly heavy on workers. Stamp duty reduces worker mobility and the current system of savings taxation punishes active workers relative to (mostly retired) non-workers. More sensible taxation of savings, reducing the heavy reliance on direct taxation and switching from stamp duty to land tax will all contribute to increased labour market dynamism and job and wage growth.

Framework for assessing tax reform

A constructive conversation about taxation reform relies on a framework (or benchmark) for assessing taxation.

In general, there is some common foundational ground for assessing the Australian taxation system (see, for example, Tax and Transfer Policy Institute (TTPI) (2018). It is generally accepted that the tax system should pay for what we need in a stable and sustainable way. With economic growth as key to raising living standards, the tax system should minimize its distortions around decisions to work, invest and save (efficiency). At the same time, the tax system should treat people with equal ability

to pay equally and expect those with a higher capacity to pay to contribute a greater amount (fairness). The tax system should also be easy to understand and not have lots of technical rules that savvy people can exploit to avoid paying taxes (simplicity)

The general acceptance around the basic pillars of efficiency, fairness, and simplicity are a result of decades of Australian public tax debate, underpinned by a number of major taxation reviews. Most notable among these are the 1975 *Report of the Taxation Review Committee* chaired by Justice Ken Asprey (the Asprey Report) and the 2009 *Review of Australia's Future Tax System* chaired by Ken Henry (the Henry Review).

The public policy reviews are supported and underpinned by an extensive public policy literature on optimal taxation theory that has its roots in Smith (1776), Ramsey (1927) and Mirrlees (1971). Among the number of highly valuable insights from the literature is the rule of thumb that a broad based and low rate form of taxation will prove to be less distortionary than a high rate, narrow base form of taxation (Mankiw et al. 2009); that taxation that is more neutral across tax forms will be less distortionary; and that the supply of savings is more elastic than income and therefore taxes on capital should be lower than taxes on income or consumption (Summers 1981).

The challenge for tax reformers comes about when considering the inherent trade-offs within and between the pillars. Any given proposal to change the tax (and transfer) system will not advance the basic pillars in an even way. Instead, changes require confronting trade-offs among and between the different pillars. The weighting put on subjective concepts such as fairness, in particular, will be based on individual philosophies, subjective valuations and analytical judgements. Invariably, the weightings we place on these concepts will diverge from the weighting others put on them.

Empirically, there is also uncertainty about the size and nature of distortions. For example, empirical studies have found large effects of tax settings on the composition of savings, but struggle to find large effects on the overall level of savings (see Varela, Breunig and Sobeck (2020).) Likewise, it may be hard to estimate the size of deadweight losses arising from different taxes. The evidence is not always unambiguous in helping to decide which taxes should be raised and which lowered.

There are also limitations on how prescriptive modern (post-Mirrlees 1971) optimal tax theory can be in informing these tradeoffs, given its dependence on a number of specific assumptions. These include the shape of the social welfare function, the degree to which returns are based on (unobserved) ability, and how taxpayers respond to higher rates. Differences in value judgements on these concepts and competing interpretations of the evidence can lead to a range of estimates for 'optimal' top marginal tax rates that vary from 0 (Tuomala 1990) to more than 80 per cent (Piketty, Saez and Stancheva 2014). In addition, the narrow pursuit of (vertical) equity and efficiency objectives has generally led to the neglected (or absence of) consideration of crucial public finance principles such as the benefit principle, simplicity and horizontal equity.

A consequence is that economists are typically divided when asked questions about, for example, the desired shape of income taxes (Chicago Booth 2019). With economists sharply divided on the theory, it has proven nearly impossible to reach a public consensus around a raft of basic tax system design questions, such as how much revenue the tax system should raise, or how progressive specific taxes should be in order to facilitate the movement from those designated rich to those designated poor.

Tax sustainability: Covid-19 will place pressure on the Australian tax system

In the tax realm, Covid-19 can perhaps be best considered as source of pressure. The primary purpose of the tax system is to fund public services. And, as noted above, it is generally considered desirable that this be done in a fair, efficient and simple manner. Covid-19 will test the Australian taxation system on both these fronts.

Covid-19 has caused a profound shift in economic activity. People are behaving in ways that they don't ordinarily behave. Government actions to protect lives have further restricted opportunities and freedoms. Three months since the virus gained prominence within Western economies, it remains unclear how long emergency measures will need to be in place, and what form they will need to take.

The Covid-19 economic shock has both demand and supply shock characteristics, both of which will directly impact on Australia's tax system. The demand shock arises from whole populations going into quarantine across every major economy in the world, reducing demand for Australian-supplied goods and services. The supply shock has a genesis both in restricted domestic activity, largely as a result of what forms of economic behavior governments have determined to be legal, and from newfound global impediments to the flow of people and goods.

The government response to address the economic consequences of Covid-19 has been comprehensive. At the Commonwealth level, it is headlined by major short-term programs to fix deficiencies in the social safety net, through: increasing the rate of payment of unemployment assistance and relaxing asset tests around accessing it; providing a wage subsidy; allowing working-age Australians early access to up to $20,000 from their superannuation balances; changing social security deeming rates for public pensions; and relaxing superannuation draw down requirements for retirees (Commonwealth of Australia 2020a).

Alongside direct income support for individuals, the Commonwealth Government, Reserve Bank of Australia and Australian Prudential Regulation authority have taken a number of coordinated steps to support the flow of credit, improve investment incentives, and provide loan guarantees for the banking sector (Ibid). Further, sectors and regions particularly affected by Covid-19 such as aviation, tourism, not-for-profits, construction, childcare and the university sectors have received targeted support at varying degrees of generosity. The Commonwealth's actions have been bolstered by a range of state government actions, including payroll tax relief for businesses, assistance for utility bills, cash payments to vulnerable households, support for health spending, and construction and infrastructure packages (IMF 2020).

While it is still too early to determine the distributional impacts of the shock or the impact of the myriad government measures to respond to it, it is apparent that a wide range of people have been affected detrimentally. In the face of declining incomes and reduced consumption, Australia's tax and transfer system is combining to dampen the negative impact on people and businesses. One consequence of the automatic stabilizer function and the new, temporary assistance programs has been a significant addition to Australia's public debt levels, shared across multiple levels of government. Early attempts at estimating medium-term fiscal consequences the shock at the Commonwealth level alone from PwC (2020) and the PBO (2020) suggest a revenue hole in the (broad) range of $10-$50 billion annually by 2029-30, with potentially deficits for a generation.

Australian Treasury Secretary Steven Kennedy has observed that heightened debt levels can be effectively managed through a sound structural budget and long-term focus on full employment (Karp 2020). A prospective and sizeable long run 'revenue hole' places tax sustainability as a central

concern in ensuring that Australia has a sound structural budget. And tax sustainability takes on heightened interest considering the Australian tax mix was already under strain before Covid-19.

The Australian tax mix was under strain before Covid-19

At the Commonwealth government level, Australia's tax system is remarkably reliant on the direct taxation of people and businesses. While there are over 120 different taxes in Australia, in 2019-20, nine out of every ten dollars of tax raised by the Commonwealth government will be brought in from a narrow band of personal income taxes[2], corporate income taxes[3] and the GST (Frydenberg and Cormann 2020). Three quarters of Commonwealth taxes come from just the personal and corporate income taxes – representing approximately a sixth of Australia's GDP.

A point made in major Australian tax reviews, as well as in a range of publications from international institutions such the IMF and OECD, is that Australia's strong reliance on income taxes for revenue-raising makes us something of an outlier among the international community. Many OECD countries have broader and more diversified tax bases and make greater use of consumption and other income tax bases.

In addition, the three main sources of tax (personal, corporate and consumption) have become increasingly concentrated in recent decades.

Davis et al. (2019) estimate that since the mid-1990s, Australia's personal income tax base has become more concentrated on a narrow band of high-earning personal taxpayers. In any given year, close to 50 per cent of Australia's personal income tax will be raised from the top 10 per cent of income earners who are taxed at high marginal income tax rates. Around half of the adult population will not pay any income tax. The revenue-raising burden from corporate income taxes is even more concentrated than for personal taxpayers.

The ATO corporate tax transparency report for the 2017-18 year revealed that half of the $52 billion in corporate income tax payable in 2017-18 was paid by just 18 companies, predominately located in the banking and resources sectors (ATO2019a). The report also reveals that approximately half of the $83.5 billion in total company tax collected in 2017-18 was paid by approximately 170 companies. Regardless of the choice of base for calculating, it is clear that corporate income tax in Australia relies on a highly concentrated tax base.

Further, a succession of analyses from the likes of the Australian Treasury and Parliamentary Budget Office have shown that households spending more of their budgets on rent, health, education and international internet purchases over time has reduced the share of consumption that is subject to the GST, while the slow growth in the consumption of excisable goods has meant that associated excise and customs duties (an additional 8 per cent of tax receipts) have undergone a gradual decline in revenue raising prominence.

A growing literature is raising concern around the longer-term sustainability of these sources of taxation. Notably, the Parliamentary Budget Office (2018) warned that based on recent trends and government policy settings, the coming decade could be anticipated to see pressure on all three of the personal income, corporate income and consumption tax bases. In sum, all of these problems will get worse with inaction.

[2] Personal income taxes here refers to individuals and other withholding taxes, fringe benefits tax and superannuation tax.
[3] Corporate income taxes here refers to company tax, the Petroleum Resource Rent Tax and the Bank levy.

Three trends were specifically highlighted: the ageing of the Australian population, combined with continued attractiveness of investing through superannuation, leading to an increasing proportion of labour income being taxed concessionally; ongoing pressure to lower company tax rates amid significant uncertainty in global corporate tax settings due to accelerating technological, global economic and commercial change; and structural trends in consumer behavior and technological change driving a continued downward trend in consumption taxes.

As a broad generalization, the baseline or 'status quo' pre-Covid-19 scenario suggested that if Australia were to merely retain revenue collections at current levels, then personal income taxpayers – and particularly a narrow group of higher-earning wage and salary earners already paying high tax rates – would be expected to shoulder more of the taxpaying burden.

Further, there are two reasons, one policy-based and one conceptual, to question how robust revenue from personal taxpayers will prove to be post-Covid-19. The policy-based consideration is that one of the features of eliminating the third tax threshold as part of the 7-year tax plan is to dampen the revenue raising potency of bracket creep for some time to come.

The conceptual consideration, raised in Sainsbury and Breunig (2020), comes from three observations: there are a wide range of legal tax planning opportunities available to some taxpayers; there are strong incentives for taxpayers at all income levels to find legal ways to reduce their tax bills; and there has been growth in the adoption of tax-effective vehicles over time. While the strategies are legal options for taxpayers within a comprehensive income tax system, which severely limits the data that can isolate their effect or extent, warning signs are evident.

For some, having the tax burden fall narrowly on high income earners is an attractive proposition. However, the reality is that this combination of opportunities for tax avoidance and a strong incentive created by high tax rates means that the tax burden falls quite heavily on some high income earners (those with limited flexibility around how they earn their income), while other high income individuals shoulder little or even none of the burden.

The approach to income taxation is leading to outcomes that are at odds to the principles of good tax design

Based on the broadly-accepted Schanz-Haig-Simons[4] definition of income, Australia's hybrid[5] tax approach sees most forms of personal income (wages, salaries, interest, dividends and rent) taxed under a global regime at full progressive rates. Corporate income and some capital gains are taxed under the same global regime, but at flat rates. Some capital income receives discounted tax treatment under the global regime, while other capital income (linked to retirement savings) is taxed under its own schedule.

The result is a complex web of marginal income tax rates, with marginal personal tax rates generally higher than the tax rates that apply to companies, capital gains and superannuation. The main rates relating to personal, corporate and capital income are depicted in Chart 1.

The differentials in tax rates for different forms of income reflect a variety of economic and social policy goals that successive governments have introduced into the tax system, including progressive taxation, the desire to provide a discount for capital gains and supporting saving for retirement through superannuation. Like any complex system, some design features have a stronger rationale

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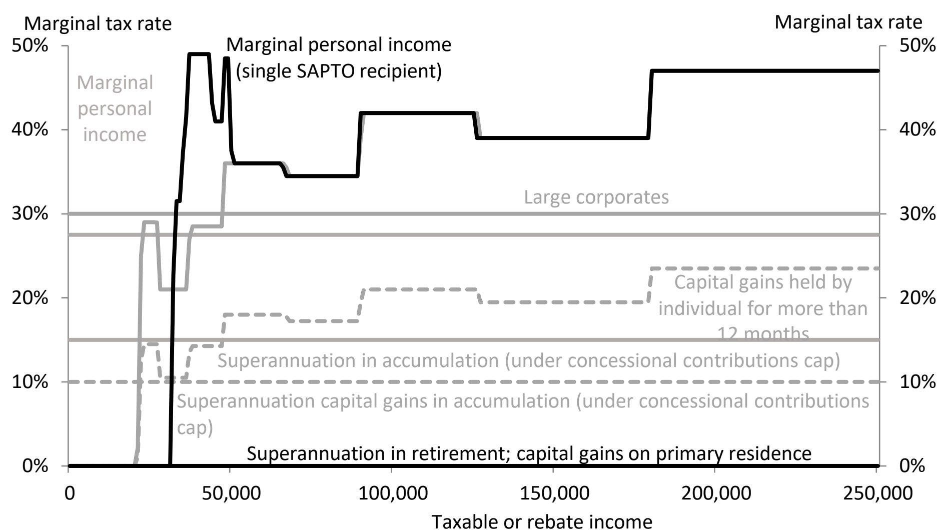
[4] The comprehensive measure of income advocated for by Schanz (1896) and developed by Haig (1921) and Simons (1938) is generally considered by economists to be the best measure of wellbeing.

[5] Hybrid refers to a mixture of comprehensive and schedular income tax structures.

than others. But overall, the shape of Australia's tax system reflects the kind of uneasy compromises that policymakers have to constantly grapple with when attempting to deliver a system that Australians accept.

One prominent set of differentials are the three[6] major areas of tax-free income, emphasised by solid black lines in Chart 1. The first is capital gains on the primary residence, with no limits on how much can be realised tax-free. The second is the personal income tax-free threshold. For most Australians the tax-free threshold is $18,200. For Australians aged over 67 that are eligible for the seniors and pensioners tax offset (SAPTO), the threshold increases to $32,279 for an individual or $57,948 for a couple (ATO 2020b). And the third is tax-free superannuation in the retirement phase.

Chart 1. Main marginal tax rates in Australia, 2019-20



Source: Author's calculations. A variant of this chart is included in Sainsbury and Breunig (2020).

Taxpayers combining these tax-free thresholds to their maximum extent can lead to stark differences in tax burdens across the Australian population. However, such differences can be difficult to identify and measure through taxation data, given those within tax free thresholds are generally able to avoid lodging tax returns. That said, a more anecdotal approach can still be instructive.

To illustrate the differences, take two individuals in the 2019-20 income year. Individual 1 and their partner each earn approximately $25,000 from casual employment. Individual 1 is carrying a small amount of debt and aspires towards home ownership in the future but has no assets. Individual 2 is a member of a couple that jointly (and fully) owns the following: a $5 million family home purchased 25 years ago and which for tax purposes is their primary residence; $3.2 million in assets held in a super fund – that they are drawing down for a return of $128,000 per annum (and is carrying a reasonable stock of unused franking credits); and $1.8 million in a share portfolio held outside super which yields annual dividends of $54,000, split equally between the two. Individual 2's household's $182,000 income stream, from share portfolio and super investments, finances a comfortable lifestyle such that neither member of the household feels the need to work. The situations of the two individuals are summarized in Table 1.

[6] In addition to these, interactions with a range of exemptions and deductions on the incomes that are available to businesses can also lead to zero (or low) tax rates.

Table 1. Income sources and associated tax liabilities for two stylized individuals, 2019-20 year

Individual 1		Individual 2	
Labour earnings	$25k	Labour earnings	$0
Income streams from assets No assets as: • Rents home • Just opened a super balance • No dividend portfolio	$0	*Income streams from assets:* • Primary residence - unrealised • Superannuation (4 per cent draw down, half of $3.2 million portfolio) • Dividends outside super (3 per cent return, half $1.8 million portfolio)	$0 $64k $27k
Total income	**$25k**	**Total income**	**$91k**
Total personal income tax	**$1k**	**Total personal income tax**	**$0**

Source: Author's calculations.

Which individual pays more tax under the current Australian tax regime: the one with earnings that would be classified at or around the OECD's relative measure of poverty, or the member of a couple with $10 million in assets generating a $182,000 income stream? It may be surprising to discover that Individual 2 can pay not just less tax than Individual 1 (who pays approximately $1000 in tax after factoring in personal income tax liability and relevant tax offsets and levies), but **no** tax. In fact, Individual 2 might be eligible to receive more in dividend refunds than Individual 1 earns.

Some additional details are required to understand how this is possible. Think about Individual 1 as someone aged in her early 20s and Individual 2 as a member of a retired couple aged in her late 60s or early 70s. These ages are important as the 'no tax' situation for Individual 2 only comes about after exploiting four separate settings in the tax system.

First, the value accruing in the primary residence is not taxed until the property is realized (sold) - and capital gains made on the primary residence are tax free in any case. Second, because the couple is over 60, the earnings they generate through superannuation are tax free, subject to various asset thresholds. Third, because she is over 67, she can take advantage of a significant offset built into the personal income tax system: the Seniors and Pensioners Tax Offset (SAPTO). SAPTO eligibility for the couple means that her tax-free threshold is in effect, $28,974; her "rebate income" falls below that at just $27,000 per member of the couple. Fourth, due to the presence of refundable dividend imputation and Individual 2 remaining within tax free thresholds for all income streams, Individual 2 could generate up to $25,025 (based on a 27.5 per cent corporate tax rate) or $27,300 (based on a 30 per cent tax rate) in dividend refunds.

The key implicit principle driving the difference in tax burdens is that Individual 2's asset mix is what public policy settings have designated as warranting 'tax free' status. Specifically, deviations from the 'Individual 2 formula' are a cause for higher taxes. And it's not clear that there is a link between those receiving zero tax rates and people's capacity to pay tax. Which raises serious questions about fairness.

Individuals benefiting from a tax-free (or tax-reduced) lifestyle are likely to view it as a great development that should be retained. However, as outlined extensively by Breunig and Sainsbury (2020), tax rate differentials are a problematic feature of the Australian tax system. We will draw out some of these specific arguments as they apply to zero tax rates (which can be thought of as an extreme tax outcome – the lowest bound of statutory tax rates and therefore having the potential to produce the highest differential with other rates in the system)

Less fair

First, a strong argument can be made that zero tax outcomes reduce the fairness of the tax system.

Fairness is a challenging concept to objectively analyse. This is partly because notions of fairness are subjective. There is no single view on what is fair. People form value judgements based on morals and ethics, and arguments are drawn from a range of theories and philosophies of distributive justice (e.g. Konow 2003 and Davis et al. 2019)

That noted, Davis et al. (2019) observe that there are two fairness principles that are often invoked in evaluating the tax system which have attracted widespread political and community support within Australia over an extended period of time. These are the benefit principle, which can be generalised as taxation being the price of living in civilised society, and the capacity to pay principle, which can be generalised as an individual's capacity to pay tax increasing as his or her income (or wealth) increases. The capacity to pay principle can be further defined by two key concepts: horizontal equity (the notion that it is fair that persons in the same situation should be equally treated) and vertical equity (the notion that those in different situations should be differently treated, with those more favorably placed required to pay more).

The tax outcomes of Individual 1 and 2 can be objectively judged as unfair on both a horizontal and vertical basis. Start with horizontal equity. As noted above, Australia's tax system is highly complex with different income tax rates applying to companies, individuals, and superannuation funds. This means that two individuals in the same economic position can achieve markedly different tax outcomes at any given point in their life course (and across generations).

The unfairness extends to comparisons of lifetime incomes, not just at one point in time. Individual 1 could follow the same lifetime income course as Individual 2. In which case, Individual 1 would have the ability to achieve the same asset mix that Individual 2 has currently. After extending the (strong) assumption that there is no change in tax policy settings in the intervening (say 45) years, they could then feasibly realize the same tax-free lifestyle. On this superficial basis, it suggests that the tax system achieves some level of horizontal equity. However, Individual 1 might happen to generate more of their income in ways that attract a higher rate of tax, such as wage and salary income, holding money in savings accounts, or investing outside superannuation. In which case it becomes clear that those with the same income path can shoulder different tax burdens. Horizontal equity is thus undermined.

Vertical equity principles are similarly undermined. Most obviously it is because people with lower current capacity to pay tax are paying more tax. But it also extends to considerations over a lifetime. This is because the future is, by definition, uncertain, and it's not clear that Individual 1 will enjoy the same income path as Individual 2. There are a range of reasons why people's income paths diverge, for example due to differences in (unobserved) abilities, different choices about investment (whether in financial or human capital), because of support received (whether by governments or through inheritances or other forms of private, usually family-driven assistance), motivations to invest in their capacity or take on high paying jobs, and sheer luck with opportunities. In general a well-designed tax system will reward hard work and thrift but also provide some insurance against bad luck. The reality is that there is no real link between lifetime capacities, incomes and tax outcomes in Australia.

In a system so reliant on income taxation, the benefit principle can be undermined at the (somewhat extreme) point when people with high incomes are completely exempt from income tax. There are various points in life – such as early in life, when income levels are low and individuals might be

investing in education, during periods of unemployment, due to sickness disability or later in life once one reaches in retirement – where people's capacity to earn income might be impaired and thus their contributions to society might be anticipated to be low or zero (or a net recipient from other taxpayers). For some, these periods might extend across large portions of their lives.

However, it is hard to argue that those generating comfortable incomes through passive investment should not be making a contribution to the functioning of Australian society. The consideration becomes more acute when considering that, through the Australian dividend imputation system, these individuals are in the process of claiming full refunds on the taxes that the companies they invest in have previously paid.[7] And outcomes can become corrosive to society if there is a section of the population who have strong incentives to preserve and increase the benefits they receive from government, no stake in minimising the tax burden of financing such benefits, and who possess the capacity to focus intensively on resisting constructive policy change.

Less efficient

A system designed with a number of large tax free thresholds on widely-held assets and income sources also imposes deadweight costs and detracts from the efficient allocation of economic resources.

Tax exemptions lead to a tax system that is high rate and narrow base, in direct opposition to the key learnings from the optimal tax literature. It should be noted that a chief argument for tax-free thresholds is that they reduce the degree of 'churn' in the tax and transfer system, wherein welfare recipients both pay taxes (whether personal, on housing or through retirement incomes) and receive income support payments such as unemployment assistance or the old-age pension. Carling (2016) observes that a highly targeted welfare system with means testing has the potential to reduce instances of the sorts of extremely high effective tax rates that come as a result of tax-transfer system interactions (typically displacing high rates to a different income level).

However, this comes at a high fiscal and economic cost. Tax-free thresholds that aren't targeted (and in the extreme case of owner-occupied housing, uncapped and not linked with pensions assets tests) result in significant revenue leakage, as a large population of adults – combining those with high and low capacity to pay tax – all benefit. It imposes economic costs from the higher statutory tax rates (and associated deadweight loss) that must be imposed on the taxpaying population in order for tax authorities to be able to 'make up' for the foregone revenue.

Tax is also a material consideration into decision making. A relatively extensive literature (which is also growing as administrative taxation data becomes more accessible) points to taxpayers' propensity to respond to tax incentives. International studies such as Feldstein (1999), Saez (2010) and Kleven (2016) and Australian-focussed studies such as Breunig and Johnson (2016) observe that the bigger the difference in marginal rates, the greater the tendency for taxpayers to structure their affairs, and that those with more flexible forms of income have a higher propensity to respond to incentives.

The mix of investment choices within Australia suggests that Australians have in aggregate responded to the tax free status of key investment choices. In 2017-18, more than 70 per cent of Australians' net worth was invested into housing and superannuation (ABS 2019). Noteworthy is that

[7] The core idea behind dividend imputation, that individuals should pay tax at their marginal rate, may be sound but when combined with the tax free status of so much other income and wealth it is corrosive to fairness.

housing has remained relatively steady since 2000, while the share of assets housed within superannuation has grown significantly.

Such an asset mix is suggestive that Australia's tax settings are a prominent part of a broader public policy landscape that is biasing people's – and firm's – lifetime decisions towards investing in particular domestic asset classes. In the process, the tax system is detracting from the efficient allocation of economic resources. In the media and around the world, there have been many calls for reduced globalization in response to Covid-19. Some have suggested that production which has been offshored should be moved back on shore and that less trade and movement of people might be desirable. While we disagree with these sentiments, they are gaining traction. If a post-Covid 19 world triggers a prolonged decline in international capital mobility, such a shortcoming of the system will take on greater importance. Exploring the links between tax incentives and the macroeconomic and distributional consequences of such an asset allocation would be a valuable avenue of future research.

Imposing a broad-based and neutral tax regime that takes place from the first dollar of income (with appropriate compensation for low-income earners and retirees with low-asset levels) would carry the prospect of generating much more revenue, with fewer distortions and could facilitate low economy-wide tax rates. Varela, Breunig and Sobeck (2020), for example, find that a flat capital tax rate of 6-7 per cent would raise a similar amount of revenue to what is currently being collected through capital, if it were to be applied uniformly on all sources of capital including housing, superannuation, equities and bonds. Furthermore, they show that such a change would actually produce a more progressive tax system compared to the current regime (which is regressive in practice).

More complex

The Individual 1 and Individual 2 scenario is an exhibit of Australia's highly complex tax system. It shows how tax outcomes depend on specific individual and family circumstances, such as age, type of employment relationship, marital status, or the presence of adult children in the household. This is part of the reason approximately three quarters of Australian taxpayers engage tax agents to manage their tax affairs (ATO 2019b). An increasing number of artificial arrangements and legal fictions are also being established to deal with increasingly complex tax laws.

The different tax rates, vehicles, and variety of opportunities also add up to a tax code that is a nightmare to administer, particularly for a tax administrator trying to direct finite resources to ensure effective compliance. The system itself requires constant adjustment and continual legislative change.

Yet as the 2020 decision measure to allow the early release of up to $20,000 in superannuation has revealed, incremental changes to specific parts of the tax system are now fraught with risk.

The early withdrawal measure was designed to allow eligible individuals affected by Covid-19 access to up to $10,000 of their superannuation in the last three months of the 2019-20 income year, and if eligible, apply for another $10,000 in the first three months of the 2020-21 income year (Commonwealth of Australia 2020b). Notably, eligibility was defined by the level of financial impact from the coronavirus: being unemployed; being eligible to receive one of a small number of unemployment assistance payments; or, on or after 1 January 2020 a) being made redundant, b) having hours reduced by 20 per cent or more, or c) being a sole trader whose business was suspended or there was a reduction in turnover of 20 per cent or more (Ibid).

With eligibility defined by financial impact, no constraints were placed upon an individual's capacity to absorb the financial impact and no constraints were placed on their ability to contribute back to superannuation through salary sacrifice arrangements in the same financial year that they withdrew from superannuation. As a result a tax arbitrage opportunity was created (Breunig and Sainsbury 2020). Further, the application process involved limited checks or up-front material to substantiate claims, and the ATO waited until June 2020 to issue comprehensive guidance around the conditions for access for the new program (ATO 2020c). Given these preconditions, it was unsurprising that a survey of withdrawal behavior suggested that up to 40 per cent of those withdrawing super had either no decrease in income or had received government benefits to cover any loss experienced (Ryan 2020). A succession of media reports since the scheme was announced, documenting that a substantial number of ineligible applicants were withdrawing from super and a significant number of younger people were withdrawing the entire balance of their superannuation funds, have been similarly unsurprising (e.g. Jolly 2020).

What at face value is a relatively modest change to enable working-age individuals to access a limited sum of their retirement savings over a six-month period has, as at 21 June, seen in excess of 2 million applications withdrawing more than $17 billion (APRA 2020). It is having broader knock-on implications for the financial system, undermining personal income tax collections, and altering the dynamic between the private and public retirement income streams for a significant share of the Australian population. It is quickly becoming a cautionary tale that incremental, piecemeal change in the Australian tax system can have significant unintended consequences. The only enduring way forward for the Australian tax system will be comprehensive reform based on commonly agreed principles.

DISCUSSION

Is now different?

Slemrod and Bajika (2008) illustrate the challenging general task that tax reformers face well when they invoked the plight of Hercules:

> *"who as penance for having killed his wife and children in a fit of madness, was given twelve tasks of immense difficulty. The fifth of these tasks was one of the most daunting of all – to clean, in one day, thirty years of accumulated manure left by thousands of cattle in the stables of Augeas. (The analogy to the tax system is, we fear, obvious). Hercules did not attempt to clean out the stables one shovelful at a time. Instead, Hercules diverted the rivers Alpheus and Peneus through the stables, ridding them of their filth at once."*

There is much to clean up in the Australian tax system, and the scale of change implied here does resemble a truly Herculean task.

That prospective task appears even more challenging considering that identifying and raising concerns around the efficiency, simplicity and fairness of the Australian tax system is not a particularly new practice. Such issues were neatly encapsulated by former Treasury Secretary Ken Henry, who, as part of 2018 remarks to the Australian Institute of Company Directors, noted that "tax reform is a decade overdue" (Henry 2018). Persuasive cases on the benefits of reform have fallen upon deaf political ears, notwithstanding the presence of a strong and detailed conceptual blueprint for tax reform in the form of the Henry Review.

Australia's increasing trend away from comprehensive change and towards incremental, piecemeal change in the past four decades does not inspire much confidence either.

The Australian tax system has undergone a seemingly perpetual process of reform since the mid-1970s – perhaps the most comparable recent juncture in which pervasive systematic biases encouraged taxpayers to convert taxable income into exempt income. Specifically, in the 1970s, partnerships were a common tax-effective vehicle for engaging with the economy, and schemes such as the 'bottom of the harbour', 'dividend stripping' and 'disguised income schemes' were popular.

The key changes to the tax system since the 1970s have been designed to meet a range of policy objectives and priorities. That noted, they can also be viewed as a cycle through which successive Australian governments have responded to taxpayer behaviour and taxpayers have responded to government actions.

As a broad generalisation, the focus in the 1980s was one of flattening different tax rates and removing the systemic biases that were pervasive in the 1970s. In particular, the late 1980s saw the introduction of some notable tax system features in the form of the 1985 capital gains tax and the fringe benefits tax, and the 1987 introduction of full dividend imputation (at a time when the top marginal income tax rate align briefly with the corporate tax rate).

The 1990s then saw the focus move towards fostering an Australian economy that could remain internationally competitive for foreign capital. Notably, the ensuing reductions in corporate tax rate opened up a significant gap between top personal income tax rates and company tax rate.

By the 2000s, the focus had shifted again, towards reducing personal tax burdens. The decade began with the most recent enduring major structural addition to the Australian tax system: the introduction of the GST in 2000 part of a tax-mix switch. The year 2000 also saw the introduction of the fundability of franking credits, fulfilling one of the recommendations of the Ralph Review of Business Taxation. The public revenue windfall from a mid-decade mining boom then facilitated large scale personal tax cuts, a wide expansion of small business tax concessions and the introduction of tax-free superannuation.

The 2010s, meanwhile, were heavily influenced by budgetary pressures following the onset of the global financial crisis in 2008 and a fractious political discourse that followed. Notwithstanding the blueprint provided by the Henry Review, enduring tax system reform has been elusive. A carbon tax and mining resource rent tax introduced by one administration in the early part of the decade were repealed by the subsequent administration, while a 3-year temporary budget repair levy was explicitly temporary as a design feature.

The enduring changes in the 2010s have come from personal income taxes introduced the end of the decade, which are legislated to take effect incrementally by 2024-25, along with a dramatic increase in the tax-free threshold that was designed as compensation for the carbon tax. Overall, the result is to contribute to the increasing concentration of personal income tax base onto high earning income taxpayers. In general, the Australian political system has been gridlocked on meaningful tax reform, and instead focussed on budget repair through passive action – principally allowing bracket creep and corporate income taxes to grow faster than the economy during the economic recovery – supported by narrow, technical 'integrity fixes' to prevent obvious cases of tax base erosion.

When casting forward to tax reform prospects as at 2020, two observations from this brief, sweeping history are worth remembering. The first is that the period from the mid-1980s to the introduction of the GST in 2000 witnessed significant tax policy reform, while in the past two decades, tax policy in Australia has been defined more by the accumulation of incremental policy change, and temporary reform. However, it remains too soon to determine if the years immediately

following the global financial crisis are an aberration, or symptomatic of a deeper reluctance within the Australian political process to embrace tax reform in the aftermath of economic shocks. The second is the successive incremental policy decisions over recent decades, each designed to achieve a range of at-times conflicting objectives (including progressivity, providing incentives for investment and supporting retirement incomes) have collectively contributed to the Australian tax system losing its way.

Given this context, though, it is easy to become disillusioned at the prospect that future tax reform efforts, particularly ambitious and comprehensive reform, will ultimately prove dismal exercises.

Covid-19 presents a burning platform for reform

Despite a less-than-inspiring context around a Herculean task, there are two reasons to suspect that now might be present a genuinely different context for tax reform.

The first is that Covid-19 debt levels, combined with current structure of the Australian tax system, presents a genuine burning platform.

PwC (2020) and the PBO (2020) have outlined a scenario where, under reasonable assumptions, Commonwealth government public debt levels are expected to balloon, and where managing them presents as a generational challenge. What's particularly interesting is that these scenarios have been constructed partly based on an assumption that governments persist with the '2010s blueprint' of passive gradual fiscal repair through increased tax burdens on personal income taxpayers (through bracket creep) and companies.

Given the challenge chiefly occurs in the medium-to-longer terms, it's possible that the current Commonwealth government chooses to ignore the debt levels, proceed with a gradual fiscal repair strategy and consign tax reform as a matter for future administrations. However, what Covid-19 has revealed is that this approach cannot be maintained indefinitely. The longer reform is delayed, the easier it will become to envisage a time where a future Australian government's decisions at a critical juncture becomes constrained from a vicious combination of a leaky revenue base and high debt financing requirements. In the interim, there will be an ongoing vulnerability that the Australian tax (and broader fiscal) agenda becomes hijacked for political tax grabs by opportunists espousing ad hoc changes – changes which will invariably be supported by particular sectors of the community. And the longer the reform is delayed, the more Australian asset investment decisions will be directed towards low or zero tax options.

There are several further reasons to suspect that a passive fiscal repair approach is very likely to prove to be fiscally unfulfilling. The range of medium-term estimates – in the order of $10-$20 billion (PBO) to $50 billion+ (PwC) in 2029-30 - reveals the significant degree of uncertainty the surrounds medium term forecasts, made much more challenging by a major economic shock. That noted, all such forecasting exercises will prove overly optimistic if the economic fallout proves more severe than expected, if Covid-19 returns in a significant and economically disruptive way, or if the economic recovery is longer and more arduous than anticipated. In the near term, Governments might also feel compelled to deliver sizeable short-term fiscal action focussed on stimulating the Australian economy, using the public balance sheet. If any (or all) of these situations eventuate, there will be consequences for the structural budget settings that will need to be in place once the crisis management phase has ended.

Paul Krugman's (2001) remark that fiscal policy is like morphine is also worth bearing in mind[8]. If temporary spending or tax settings prove to be addictive to governments and the broader community (that is to say, hard to reverse and policy programs take on a more permanent or 'structural' character) then the long-term revenue financing challenge will grow. A further consideration is that while this picture paints a story at the Commonwealth level, state governments face their own financial challenges in the aftermath of Covid-19.

In all, sooner or later, action to address the fiscal consequences of Covid-19 will be necessary at the Commonwealth government level. Instead of asking if reform will occur, the real choice governments face are when the conversation will begin, and whether the discourse can be focused on constructive reform through a cohesive plan, or whether it is instead defined by a series of ad hoc changes, negotiated through special interests, at both the Commonwealth and state government levels.

The second stems from the uneven distribution of the consequences of Covid-19. The health and economic responses to Covid-19 were put in place to protect the entire populations but they provide a disproportionate benefit to older populations that are more susceptible to the virus. At the same time, shutting down the economy has disproportionately affected working age Australians, and particularly the young in (or formerly in) casual employment. While much still needs to be analysed before a definitive statement can be made around the distributional consequences from a complex web of actions, it is likely that Covid-19 has already seen a significant intergenerational transfer from the current young and working age population towards current older Australians. The transfer becomes more stark when considering that the younger generation will bear the heaviest burden of income taxation going forward.

These two reasons point to a potentially narrow window of political debate around the prospect of comprehensive change to tax burdens. Comprehensive in the sense of the kinds of actions more akin to the diversion of rivers than to those that require a shovel. A well-articulated plan that places an increased tax burden on the holders of existing wealth and a decreased tax burden on the working age taxpaying population may prove more socially acceptable now than it has been in recent decades. Crucially, this consideration also extends to the all-important debate about transitional arrangements that get from current to desired future systems, which can make or break tax reform efforts.

There are reasons to be cautious when expressing optimism, however. While there is a window of opportunity, there also needs to be the political willpower at multiple levels of government to proceed with what will invariably be politically challenging and sensitive reforms. Compromise will be essential. It remains to be seen how wide or enduring this window of opportunity will prove to be. It also remains to be seen whether the Australian political system will be able to consign the early 2010s as a temporary aberration of stalled tax reform, or whether the post-Covid-19 years will prove as grid-locked as those in recent history.

Conclusion

In this article, we explained that Australia's tax system is heavily reliant on income taxation, and that Commonwealth revenue raising has become more concentrated on a narrowing band of

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[8] Fiscal policy as morphine was likened to monetary policy, which was like aspirin. "Both are painkillers, but when you feel a headache coming on you reach for the aspirin first. It's quicker and easier to use, good enough for most purposes, and not addictive. You use morphine only when over-the-counter painkillers fail and only when you have a very good reason to run the risk of using something dangerous."

high-income taxpayers paying high tax rates. At the same time, there is a path towards zero tax outcomes for a significant range of income and assets which are being used by some Australians.

We have also pointed out the types of structural trends that are suggestive of an increasing reliance on high-earning personal income taxpayers into the future. When all major Commonwealth revenue sources are being eroded by a powerful cocktail of longer-term forces – including globalization, technological advance, changing consumption trends and taxpayer arbitrage – it is right to ask questions about how sound and sustainable the tax system is.

The Covid-19 shock and associated public response has revealed that the Australian tax system needs reform to ensure it will continue to have the capacity to meet future calls on government. The key questions of interest are whether tax reform will occur sooner rather than later, and whether it will be in the form of comprehensive, coordinated reform rather than ad hoc, incremental change that is beholden to lobbying by special interests.

In our view, a public policy and structural reform priority should be placed on coordinated actions to amend the tax system in ways that reduce fiscal vulnerabilities and improve societal wellbeing. And an important aspect of such reform should be eliminating or dramatically curtailing the amount of economic activity that attracts tax free status.

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