

Narrow Road Capital – Submission on the Tax Discussion Paper

Introduction – The Need for Change

The tax system in Australia is clearly performing sub-optimally. As the table below shows there are many issues that need rectification. Many of the issues feed off each other and create a negative spiral for the Australian economy. For instance, higher unemployment increases expenditure on welfare and social services, which requires higher levels of taxation, which discourages work and incentivises tax minimisation and tax evasion.

Issue Needing Rectification	Outcomes from Not Resolving Issues
Disincentives that discourage businesses from hiring	<ul style="list-style-type: none"> • Lower income tax collections • Higher welfare payments • Generational cycles of welfare dependence
Disincentives that discourage people from working	<ul style="list-style-type: none"> • Lower income tax collections • Higher welfare payments • Generational cycles of welfare dependence
Incentives and disincentives that encourage risky and unproductive investment, particularly in residential property	<ul style="list-style-type: none"> • A dependence on international funding for the banking system • Encourages speculation rather than investing, resulting in more borderline and unproductive investments being funded • Lower economic growth
Incentives and disincentives that discourage low risk investments including bank deposits and bonds	<ul style="list-style-type: none"> • Increased cyclical in the economy (boom and bust cycles) • Greater risk in planning and managing retirement outcomes
Insufficient enforcement and penalties for tax evasion	<ul style="list-style-type: none"> • A thriving black economy, which reduces overall tax collection and increases tax rates for law abiding citizens and companies • Encourages and perpetuates criminal activity
Vertical fiscal imbalance	<ul style="list-style-type: none"> • No delineation of responsibilities in balancing government spending with tax collection • Overlap in the tiers of government in spending and administration resulting in reduced efficiency of government activities
Relatively high company and individual tax rates	<ul style="list-style-type: none"> • Reduced incentive to maximise income/profit, reducing growth and productivity in the economy • Increased likelihood of businesses and citizens relocating to lower tax jurisdictions, resulting in reduced tax collection • Excessive focus on tax minimisation strategies at the detriment of productive investment
Disincentives for an aging population to work beyond the retirement age	<ul style="list-style-type: none"> • Lower income tax collection • Higher welfare payments

Forces Working Against Change

A horde of vested interests are calling for taxation changes that would benefit their special interest group and will argue loudly against changes that will negatively impact their special interest group. Politicians almost inevitably lose their nerve in such situations pointing to previous negative experiences such as the mining tax. This reluctance to change has meant that piecemeal approaches of picking off weak areas for tax increases (e.g. bracket creep or alcopops) is pursued rather than a wholesale restructuring of the tax system.

Where Change Works

Those fearful of change have lost sight of (a) the good outcomes it will bring and (b) that governments in New South Wales (electricity privatisation), the ACT (land tax) and New Zealand (many major reforms) have successfully pursued major reforms and have done so whilst remaining popular. Putting forward the positive case for change for a sustained period has proven to be vital in undertaking major reform.

For tax system reform the issue of fairness will be repeatedly cited by those groups that are set to lose most by change. The best way to fight against this is to adopt the simplest possible system with all changes implemented at the same time. If change is done this way almost everyone will pay less tax in some areas and more tax in others. The overall aim is to make the system more efficient, so that economic growth can improve and thus provide greater income and wealth opportunities to all Australians.

What Does a Better Tax System Look Like?

This submission focusses most on the major changes needed in the big three taxes; income, GST and land tax. Along with stopping the black economy these must be the primary focus of reform. Some brief comments are also made on the minor forms of taxes. In preparing this submission Narrow Road Capital did not have substantial tax and economic data modelling tools at its disposal. Therefore, the major reforms proposed are framed as ranges which the various Treasury departments are able to refine in the lead up to COAG negotiations about a new tax system.

The Major Reforms

Company, Trust and Personal Income Tax: 20-25% Top Rate

Ideally a tax free threshold that runs to at least \$25,000 accompanied by one tax rate thereafter would be implemented. Closing the many loopholes and eliminating special interest deductions will greatly eliminate complexity for calculating the amount of tax to be paid. Closing loopholes is an extremely progressive move as the wealthiest companies and individuals take most advantage of loopholes and tax structuring techniques. Negative gearing, franking credits and the current disincentives for low risk investing versus incentives for high risk investing are all made less relevant if the top tax rate is lowered.

The inclusion of trusts for tax is a simple correction that ensures all structures that receive income are taxed evenly. Whilst it is commonly argued that company tax should be lower than personal income tax as companies are easily able to relocate, the reality of the modern workforce is that the most talented and highest earning individuals are also easily able to relocate. Australia should not only encourage the best companies to operate here, but also the most productive and talented individuals to work here as well. A large pool of skilled workers is one of the biggest attractions for multinational companies in determining where their offices will be located.

This change would see the Federal Government lose substantial revenue, but by closing loopholes and eliminating special interest deductions the revenue losses would not be nearly as bad as a straight line calculation would indicate.

GST: 15-20%

The GST needs to be lifted and exceptions are to be removed. Some additional welfare assistance may be necessary for the poorest 10-20% of the population, but the remainder of the population will benefit from lower rates of income tax and will not need additional assistance. This change would greatly increase State Governments revenues.



Land Tax: 0.8%-1.25% Per Annum

As highlighted in the Re:think discussion paper, by far the most efficient major method to raise taxes is land tax. It is also the area of taxation reform that Australia most desperately needs. The property industry and political class in Australia have long forgotten that property is firstly a place for people to live and work, and secondly an investment opportunity. Introducing a land tax will substantially correct the excessive debt and speculative investment attracted to property and will shift that capital to far more productive sectors of the economy.

In terms of social impacts, lowering the cost of housing (primarily rent but also the cost of purchasing) is arguably the most pressing issue for low income households. Affordable housing near public transport hubs doesn't exist for most of Sydney and Melbourne. Reducing the cost of housing will greatly decrease the welfare expenditure for both State (public housing) and Federal (unemployment benefits and pensions) governments.

In order to discourage properties sitting vacant that could be rented out, residential properties that are occupied for less than six months of the year should be subject to triple the rate of land tax. This measure will increase the amount of housing stock available for rent as well as increasing the local economies where previously unoccupied properties have been a blight on community and economic activity.

Changing property revenues from stamp duties to land tax will increase the revenue that State Governments receive and provide far greater stability to that income.

The Minor Reforms

Capital Gains Tax

By lowering the top income tax level special treatment for some types of capital gains can be removed. Serious consideration should be given to removing the exemption for the primary home.

Payroll Tax

It is hard to think of a tax than comes with worse disincentives than payroll tax. It discourages employers from hiring additional workers, which means less income tax and higher levels of welfare payments. It should be eliminated completely with either land tax or the GST covering any gap.

Minerals Taxes

Minerals taxes should be solely collected by state governments, with a mix of both flat per unit royalties and upside sharing when the market prices are cyclically high.

Fringe Benefits & Work Related Deductions

With a lower income tax rate the arguments for special treatment for fringe benefits are less relevant. Where fringe benefits are given, it should be at the discretion of the employer whether they would pay the tax due or whether the liability would be passed onto the employee.

Work related deductions should be eliminated. If the items involved are important, the employer can pay for the item directly and deduct the cost from their income or alternatively pay the employee an additional allowance.

Alcohol & Tobacco Taxes

Alcohol taxes should be equalised. The introduction of a higher rate of taxation for alcopops simply encouraged many excessive drinkers to shift to straight spirits or cask wine. The revenue from alcohol and tobacco taxes should be redirected to State governments to match their primary responsibility for health expenses, which are often caused or exacerbated by alcohol and tobacco usage.

Agricultural Exemptions

Agricultural enterprises, whether incorporated or unincorporated are no different to many other small businesses in that their income can be highly variable. Agricultural businesses should learn to save in the fat years and be prepared for the lean years, just as all other types of small businesses are expected to. Requests for special treatment such as farm management accounts and drought assistance should be refused. The primary method of assisting agricultural businesses should be negotiating more open access to international markets.

Superannuation

The primary purpose of superannuation is to increase the income of retirees thus reducing the demand on the Federal Government for age based pensions. It therefore makes sense to encourage all working age Australians to target a specific retirement balance that will be sufficient to fund a decent lifestyle for at least 20 years. The Federal Government should annually calculate a “target retirement balance” taking into account prospective inflation, investment returns and life expectation for a person at the retirement age. Different target levels may be appropriate for people living alone and couples sharing housing.

The taxation of superannuation should align with the target retirement balance, with a two tier system proposed. For people with less than the target balance a lower rate (for instance 0-15%) should apply to all contributions and income earned within the fund. Once the target balance is exceeded, the top marginal tax rate should apply to contributions and income. By applying a higher taxation rate once the target balance is reached, the need for caps on annual contributions can be removed. The perceived tax subsidy for superannuation largely disappears when the higher taxation rate is applied to larger balances. The rate of contributions should also be increased to at least 15% of income so that a much greater proportion of middle and high income earning Australians retire with sufficient superannuation to be fully self-funding.

Once the retirement age is reached then superannuation should be locked into a drawdown process where it is either converted to an annuity or where 5-15% of the balance is withdrawn each year. The amount leaving superannuation would be treated as income and subject to the tax free threshold and income tax levels.

Charitable Deductions

The argument over tax deductibility of gifts to not for profit organisations is somewhat lessened by lowering the income tax rates. However, deductions should generally be retained in order to encourage activities that lessen or eliminate costs that would otherwise have negatively impacted government budgets.

For instance, if donations for medical research are substantial, then governments are likely to reduce their allocations to medical research. Many religious and non-religious organisations provide social services such as counselling at little or no cost, which reduces both direct and indirect government expenditures. Sports clubs (the actual sport not the poker machine dens) contribute to society by encouraging physical health and community involvement.

Bringing Sunlight to the Black Economy

Arguably the easiest way to collect more tax is to bring sunlight to the black economy and stop the estimated 10-30% of GDP where taxation is not being fully applied. Despite the enormous revenue leakage there appears to be little political will for change and little thought put into what change will be cost effective. Tax evasion is stealing from fellow Australians, who are forced to pay higher taxes as a result. It is an act of greed and self-enrichment and should therefore be punished punitively.

The follow on impacts from leaving the black economy untouched goes beyond the direct impact of the burden of taxes being shifted. Widespread non-compliance punishes honest behaviour and creates a culture where bribery and corruption is rife. Greece is the most obvious Western example of what happens when cheating on taxes becomes a national practice, with basic services such as medical care now routinely requiring bribes to be accessed.

Small Business and Personal Tax Evasion

Two relatively simple measures will dramatically decrease the level of taxes evaded at the smaller end of the economy. Firstly, electronic record keeping and the availability of electronic methods of payment need to be mandatory. Each time a sale is made it should be a legal requirement that it is recorded electronically on the spot, with a receipt able to be issued.

The reform of credit card surcharging being considered as part of the Financial System Inquiry is another vital part of assisting electronic record keeping. By mandating a maximum surcharge of 0.50%, which may require legislated reductions to the various fees that banks charge to small businesses for accepting electronic payments, the cost to business of accepting electronic payments will be greatly reduced.

If electronic payments are cheaper to process, it is then reasonable to mandate their availability. Most service businesses already issue invoices and accept payments directly to their bank accounts and therefore no change is needed. For retailers and trades people, a desktop or handheld EFTPOS terminal could be the most efficient method of receiving electronic payments. The arguments that cash is a cheaper and more convenient way to transact are rebuffed by giving businesses the ability to pass on credit card surcharges, subject to the maximum of 0.50%. Proponents of cash transactions frequently ignore the handling costs and security costs that cash transactions incur.

Once electronic methods of payment are mandatory, the job of monitoring and enforcing tax compliance becomes far easier. ATO employees and the general public can keep copies of their receipts and these can be used to cross check against the records of the business. If a sample of transactions shows that some are not declared as part of GST or income reporting then it is likely the business is evading its tax requirements and should be subject to a full audit.

The second way to greatly reduce tax evasion at the smaller end of the economy is via the creation of a national tax lottery. The ATO should have a well-advertised online and phone service where citizens can report suspicious activities, such as offers to reduce the price for cash payment or where receipts or electronic methods of payment were not available. Each month, a lottery with a substantial prize pool (for instance \$20 million per month) would be nationally televised. Each report of a potential tax evasion incident would entitle a person to one entry in the lottery. Prizes could be both large and small, with perhaps 10 winners of \$1 million each and 1,000 winners of \$10,000. As a result of creating a tax lottery the rate of reporting of non-compliant activity will skyrocket and a perception will be created that any dodgy transaction could result in a business or individual being subject to investigation.

Large Business Tax Evasion

Tax evasion methods utilised by large businesses are often complex and may involve multiple jurisdictions. Gathering evidence to substantiate complex tax evasion frequently requires whistle blowers with insider information, such as employees, bankers, accountants and lawyers. While the protection offered by well thought out whistle blower legislation is nice in theory, it frequently fails to prevent employees being fired, demoted or having their responsibilities curtailed as retribution for reporting dubious practices. Employees who report white collar crime are frequently placing their careers at risk, with the likelihood of being unemployable in their current industry once their efforts to correct wrong doing have been exposed.

The solution to both the complexity and career risk issues is best resolved by a revenue sharing arrangement. In the US, the tax service (IRS) and the securities regulator (SEC) pay up to 30% of the additional revenue collected to whistle blowers. This is an enormous incentive to report tax evasion and financial crime. It creates major headlines when large fines and penalties are issued as well as when large payments are made to those who provided evidence. This incentivises both reporting of tax evasion and financial crimes and serves as a major discouragement for those considering committing such crimes. Employees whose careers are impacted can receive substantial compensation whilst governments benefit by collecting a greater share of the taxes owed.

Penalties for Tax Evasion

Given the widespread nature of tax avoidance in Australia, existing penalties are not severe enough and are not enforced sufficiently often to deter tax evasion. Tax evasion is undertaken to enrich the individual or the owners of the business and penalties should be focused on directly attacking that motivation rather than the threat of imprisonment. Tax evaders should not only be required to pay what they owe plus interest and legal/enforcement costs, that number should be multiplied depending on the behaviour involved in the tax evasion activity.

Accidental Evasion: In situations where there is a simple error in calculation and no malintent a penalty that includes interest and legal/enforcement costs is sufficient.

Negligent Evasion: When an error has been made that a reasonable person would not have made or would have taken steps to avoid, the penalty should be double that of accidental evasion.

Wilful Evasion: Where taxes are being deliberately evaded, such as consistently failing to declare all income or incorrectly using offshore jurisdictions to lower taxes then the penalty should be four times that of accidental evasion.

Implementing the Proposed Changes

There are two key components to implementing the changes needed to the Australian tax system, public engagement and political leadership. The Re:think discussion paper follows a long list of tax reviews that have clearly shown the need for and benefits of tax reform. Public engagement has begun and should continue, but it is now time for federal and state politicians of all sides to acknowledge the issue and to begin negotiating at COAG forums. If the work begins now, wholesale changes in tax collection and government spending can be implemented from 30 June 2016. Now is the time for leadership not excuses.

Conclusion – The Benefits of Implementing the Proposed Changes

As the table below shows, the many issues identified at the beginning of this submission are dealt with by the proposed changes. By implementing changes that increase employment and encourage more productive investing a positive spiral is created that will further enrich Australia and its population. By encouraging more employment, welfare payments and social issues will decrease, which decreases government expenditure, which allows for lower taxes and higher quality services, which results in greater employment and further investment in the economy. The time for talk has ended, it is now the time to take action and implement change.

Issue Needing Rectification	The Impact of Proposed Changes
Disincentives that discourage businesses from hiring	<ul style="list-style-type: none"> The elimination of payroll tax and lowering of company tax encourages domestic and multinational companies to increase employment
Disincentives that discourage people from working	<ul style="list-style-type: none"> The substantial shift of the tax base away from work income and towards investment income, consumption taxes and land taxes encourages people to work
Incentives and disincentives that encourage risky and unproductive investment, particularly in residential property	<ul style="list-style-type: none"> The reduction in income tax and equalised taxation of capital gains will substantially reduce the amount of negative gearing and leveraged investing in the economy
Incentives and disincentives that discourage low risk investments including bank deposits and bonds	<ul style="list-style-type: none"> The introduction of land tax and equalised taxation of capital gains levels the playing field for low risk investing The disincentives to save and to invest in opportunities that offer a sensible reward for risk are largely eliminated
Insufficient enforcement and penalties for tax avoidance	<ul style="list-style-type: none"> The population is financially incentivised to report tax evasion by the tax lottery and whistle blower payments Potential tax evaders know that the risk of being reported and the penalties for being caught are much higher
State governments unable to raise sufficient taxes to fund their activities	<ul style="list-style-type: none"> The increase in consumption taxes and land taxes will eliminate the vertical fiscal imbalance The shift of alcohol and tobacco tax revenue to the states better aligns the revenue collected from these taxes with the health care costs associated with their use
Relatively high company and individual tax rates	<ul style="list-style-type: none"> The reduction in the individual tax rates and increase in the tax free threshold, when accompanied by welfare reform, encourages everyone who is capable of working to undertake paid employment The reduction of company tax and removal of loopholes and deductions greatly reduces the possibility of and incentives for corporate tax minimisation and avoidance strategies
Disincentives for an aging population to work beyond the retirement age	<ul style="list-style-type: none"> The reduction in the individual tax rates and increasing the tax free threshold, when accompanied by welfare reform, encourages everyone who is capable of working to undertake paid employment

End of Submission



Written by Jonathan Rochford for Narrow Road Capital. Narrow Road Capital appreciates the opportunity to make comment on the tax system and welcomes feedback on this submission at info@narrowroadcapital.com

Disclosure

This paper contains information derived and sourced from a broad list of third parties, and has been prepared on the basis that this third party information is accurate. This paper expresses the views of the author at a point in time, and such views may change in the future with no obligation on Narrow Road Capital or the author to publicly update these views. Narrow Road Capital advises on and invests in a wide range of securities, including securities linked to the performance of various banks and financial institutions.