Did Someone Say Tax Reform?

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The Government might not have acted on many of Henry's recommendations but Ian McAuley can see some logic to their response.

Older Australians can recall political cycles of long periods of torpor under Coalition governments which alternated with frenzied bursts of reform under Labor governments.

Those days are behind us. The Rudd Government's non-response to the Henry Review exposes a government frightened to confront the challenge of fundamental reform and unwilling to engage with the community in policy development. In this regard, however, the Opposition is even more crassly populist.

The Henry Review is a design brief for fundamental change in our tax system. It follows most of the textbook criteria for sound tax policy: keep taxes simple; minimise compliance costs; do not distort economic incentives; maintain equity; ensure there is capacity to pay taxes; use tax instruments to help stabilise the economy; use taxes to put a price on externalities such as pollution.

The review recommends a substantial simplification and consolidation of Commonwealth and State taxes, and it has many suggestions for overcoming accumulated distortions.

One serious distortion is the overly generous tax break for those who borrow to invest in real estate and shares — known as "negative gearing". With a little mathematics, any finance lecturer can demonstrate that our present system allows investors to double count expenses all the while enjoying the largesse of a capital gains tax regime that rewards speculation and penalises long term productive investment.

The Government's policy announcements have little connection to the Henry Review, however: the only aspects it picks up are the Resource Super Profits Tax and a reduction in company tax. Rudd and Swan's other initiative, a rise in superannuation contributions to 12 per cent, does not arise from the review; its recommendations are mainly concerned with improving the fairness of taxes on superannuation contributions. Most of the review lies on the table, and Rudd and Swan are presumably waiting for a more propitious time for policy reform — if ever that should occur.

Ideally the review's bolder ideas, such as reforming taxation of investor housing, reforming land tax, making pension means tests more equitable, increasing fuel excise, and introducing a bequests tax, should be subject to public deliberation. These are all hard issues, but with proper explanation the public should be able to appreciate their merits — particularly the connection between the permissive tax treatment of investor housing and our worsening housing affordability.

But in an act of political cowardice, the Government has ruled these out of any policy implementation "at any stage".

The Government's initiatives, timid as they are, do show some underlying logic. Our economy has been distorted by the mining boom: a high exchange rate is damaging competitiveness in other industries such as agriculture, tourism, manufacturing and education; serious skills shortages have emerged throughout the economy; resources needed to improve our community's infrastructure have been commandeered by the mining sector; high incomes arising from mining are fuelling inflation, particularly housing inflation, and therefore higher interest rates (which, in turn, lead to higher exchange rates).

Our economic structure is starting to resemble that of an oil-rich sheikhdom, rather than that of a developed country capable of holding its own in a world where long-term prosperity is based on wise application of human capital. Resource booms are fun while they last, but they incur a high long-term cost.

Quelling that boom, therefore, makes sense. Help for other industries, through reductions in company tax and in more generous depreciation for small business, partially compensate for economy-wide costs of the mining boom.

The rise in superannuation contributions needs to be seen in that light. It is not about adequacy: with lower fees and the reforms suggested in the Henry Review, a 9 per cent contribution rate would be quite adequate for most workers. Rather, it is an attempt to reduce wage growth and to provide funds for investment; employer groups and lazy journalists may represent it as an impost on business, but in reality it is an impost on labour (and a windfall for the financial sector). A rise in income tax would have had the same macroeconomic

effect, while giving the Government more control over how funds are spent, but it would have been harder to sell.

The Government has chosen a path which minimises immediate political pain. It's unfortunate that in doing so it has ruled out opportunities for more fundamental reform, and that it has locked in an unnecessary bonus for the financial sector.