Joe Hockey's Tax Paper: A Lesson in how to Avoid the Elephants in the Room

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Promoting the government's tax paper, Treasurer Hockey would like us to believe that "everything is on the table".

That's not true. The paper leaves out economically responsible options for tax reform, and glosses over significant distortions in our present tax system.

To its credit, it does say, "Australia's aggregate tax burden is relatively low compared with other developed countries" (that one must have slipped past the censors). But the clear inference from the paper is that we should re-balance our tax mix away from personal and business income taxes and towards consumption taxes, rather than increasing our public revenue to provide needed public goods and to reduce the budget deficit.

What is left out

The glaring omission is a carbon tax, described by Nobel Laureate economist Joseph Stiglitz as a "no brainer", but dismissed in the politicised foreword to the document as "a drag on growth", without any evidence or argument.

The conventional economic idea of applying taxes to cover negative externalities – that is, to bring to account costs such as pollution – gets short shrift in the paper. Rather than being described as a means of reflecting true costs, such taxes are described as "a way to change behaviour... as a way of encouraging behaviour deemed socially desirable".

That is to suggest they belong to some "soft left" agenda of social engineering, rather than as an economic instrument to influence efficient resource allocation.

It's unthinkable that the Treasury officials who wrote the paper could produce such a misrepresentation of responsible pricing. This section of the paper must have been written by one of Abbott's henchmen. It reveals the dead hand of his objection to market-based approaches to climate change – in fact his whole dismissal of the economic problem of climate change.

The other big omission is to ignore the possibility of a resource rent tax, which was a major proposal in the previous government's tax inquiry, the Henry Review. One can rightly criticise the Rudd-Gillard Government for squibbing on the Henry Review's recommendation for a strong resource rent tax – their response was too little too late (in fact the strongest criticism should be sheeted to the Howard government for letting many of the benefits of the mining boom pass out of the country).

So long as Australia has a large mining sector, we will be subject to the destabilising effects of mining booms. Coal prices are probably in terminal decline, but there will be booms in iron ore, gas and non-ferrous metals. If we are to avoid the wild ride that has so de-stabilised our economy in past booms and capture a reasonable share of mining revenues, a resource rent tax should be on the table. Otherwise we will go through the same pain of boom and bust again and again.

What is glossed over

Although the paper raises the issue of so-called "negative gearing", which has undoubtedly been one of the factors driving up house prices, it ignores one of its main distortions. That distortion is manifest when people borrow for an investment property, or any depreciable asset for that matter. There is a large degree of double-counting when taxpayers are allowed to count both depreciation and interest payments as deductions against income. In other words, such investment is highly privileged.

The Treasury officials who prepared the paper would know this: it's basic content in university economics courses. But to raise the distortion in the specific case of "negative gearing" would be to expose the fact that it is a benefit not only for mum-and-dad investors in housing, but for business investors in general, and it wouldn't do to detract from the message that business is doing it hard because of supposedly high corporate taxes.

The other aspect glossed over is the distortion introduced in capital gains tax when, in 1999, the Howard Government halved the rate of capital gains taxation but removed indexation. This stemmed from the recommendations of the Ralph Review of business taxation, the intention of which was to encourage "financial dynamism" in the Australian economy. That is, to encourage speculation and fast turnover of assets (to the obvious benefit of the finance sector).

Because indexation was abolished, taxes are effectively levied on the inflationary component of nominal capital gains. When inflation is running at around three per cent a year, after 20 years all the benefit of the halving of the rate is lost, and from then on investors are taxed on illusory capital gains.

We have a system that rewards the speculator while punishing long-term investors, but the paper makes no mention of that distortion.

Its future

Australia does need tax reform. There is even a case for increasing the rate and extent of the GST, but only if it is part of a comprehensive package aimed at collecting more revenue and making the whole system fairer.

But when tax reform is in the context of revenue neutrality, or even a reduction in overall taxes, and the message is that corporations should pay less tax while consumers pay more, the proposals are politically dead in the water.

Much is made of Australia's supposedly high rate of corporate tax. But Australian investors have the benefit of imputation offsetting corporate taxes (the paper sees no virtue, however, in giving advantages to domestic investors.)

More basically, the rate of corporate tax is only one factor in business investment decisions. The key factors in such decisions are usually about availability of a skilled workforce and physical infrastructure – which, of course, rely on public expenditure.

The regular World Economic Forum Global Competitiveness Reports tend to show that business tax concessions are the inducement of last resort, offered by countries with low education standards, poor infrastructure and unstable government.

Perhaps Hockey's push for lower corporate taxes is in realisation that Australia is becoming that type of economy.