How to abolish income tax

A submission by **Prosper Australia**[*] to the

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Abstract

The most efficient and equitable revenue base is economic rent. Consumption is the second-most efficient, and need not be any less equitable than income. Consumption taxes and economic-rent taxes, unlike income taxes and payroll taxes, do not feed into prices of exports. This advantage is crucial at a time when global demand is likely to fall, requiring Australia to capture greater shares of shrinking export markets in order to maintain export income.

It should not be politically difficult to replace all taxes on property, including those on insurance of property, with an economic-rent tax in the form of a broad-based holding tax on land values, provided that, in politically sensitive cases, payment can be deferred until the next sale of the property and capped to some fraction of the real capital gain.

It is even feasible to replace payroll tax in this way, thereby removing payroll tax from prices. Alternatively, payroll tax can be absorbed by a broad-based consumption tax without raising prices.

Taxes on income (other than economic rent) can be replaced by the same broad-based consumption tax *without raising prices*, provided that in the transition, existing employment contracts are interpreted so as to maintain *net* (not gross) wages and salaries. While it is not constitutionally possible for the States to legislate their own consumption taxes, it apparently *is* constitutionally possible for a State to influence the rate of a Federally legislated consumption tax within its borders, and to receive revenue accordingly. The existing GST could be rolled into the new consumption tax, or left untouched, although the latter option would serve no purpose other than to multiply compliance costs.

Thus **there is no excuse for taxing payrolls, conveyances, buildings, insurance, or income other than economic rent**. If any such tax remains on the statute books after 30 June 2012, the Gillard government will be responsible for Australia's unnecessary vulnerability to external shocks.

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Nothing in this submission is to be construed as legal advice.

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0 Income, consumption, and economic rent

All taxes suppress productive activity, except **holding** taxes on **indestructible**, **irreplaceable**, **immobile assets**, the returns to which are called **economic rent**.

A tax on *flows*—that is, on income or expenditure, as distinct from "assets"—can be avoided by forgoing the income or avoiding the expenditure. A tax on a *mobile* asset can be avoided by moving the asset out of the jurisdiction. A tax on a *replaceable* asset can be avoided by failing to produce or replace the asset. A tax on a *destructible* asset can be avoided by destroying the asset. A tax on **transactions** involving the asset—as distinct from simply "holding" the asset—can be avoided by refraining from such transactions. All these modes of avoidance amount to lost production within the jurisdiction.

Taxes that can be so avoided are costs of production and must be recovered through prices if production is to continue. Hence they are inflationary. Hence they raise the *non-accelerating-inflation rate of unemployment* (**NAIRU**), the maintenance of which is the target of monetary policy. Such taxes, being costs of production, feed into the prices of exports and import replacements and thereby damage international competitiveness.

In contrast, a holding tax on an indestructible, irreplaceable, immobile asset cannot be avoided by refraining from production and therefore has no tendency to suppress production or raise prices; on the contrary, it encourages the owner to use the asset productively in order to generate income to pay the tax. As long as the tax does not exceed the rental value of the asset, it cannot force the asset out of use, just as a landlord does not force a property out of use by offering to let it for what the market will bear.

Having stated those principles, we organize the rest of this submission around the "discussion questions" in the Treasurer's paper, *Tax Reform: Next Steps for Australia*.

0.1 At the Commonwealth level, are there opportunities to further balance the tax system towards more efficient revenue bases?

0.1.1 Yes. The most efficient revenue base is economic rent. The second-most efficient is consumption. Income as such shouldn't be taxed.

The most obvious attack on production is income tax. On the macroeconomic scale, income is identical with production: national "income" is net national "product". It is only on the *micro*economic scale that the identity breaks down. In particular, **capital gains** and **super-normal profits** overwhelmingly represent economic rent, because if an asset increases in value or yields super-normal profits, it will tend to induce the production or importation of competing assets which will reduce values and return profits to normal—unless the asset is "irreplaceable" and "immobile".

Production in turn is synonymous with **value added** on the macro scale: in national accounts, gross domestic "product" is gross "value added" (minus related taxes plus related subsidies). However, what is called a "value-added *tax*" (**VAT**) is **border-adjusted** so as to tax the value added to imports up to the point of importation while exempting the value added to exports up to the point of exportation—in other words, to tax foreign production for importation while exempting domestic production for exportation, so that in the traded sector of the economy, the damage to production is shifted offshore. Thus, for the domestic economy, a VAT is more efficient than an income tax.

This border-adjustment is not implicit in the term "value-added tax", but is done for a historical reason, namely that the VAT was invented as a means of taxing *consumption within the jurisdiction*. A consumption tax still damages production by reducing effective demand for products. But because some products consumed and taxed within the jurisdiction are produced outside it, while others

produced within the jurisdiction are consumed outside it and are therefore untaxed, the damage to production within the jurisdiction is less than that of an income tax. In particular, in a small open economy like Australia, a domestic consumption tax does not drive away capital used in production for global markets.

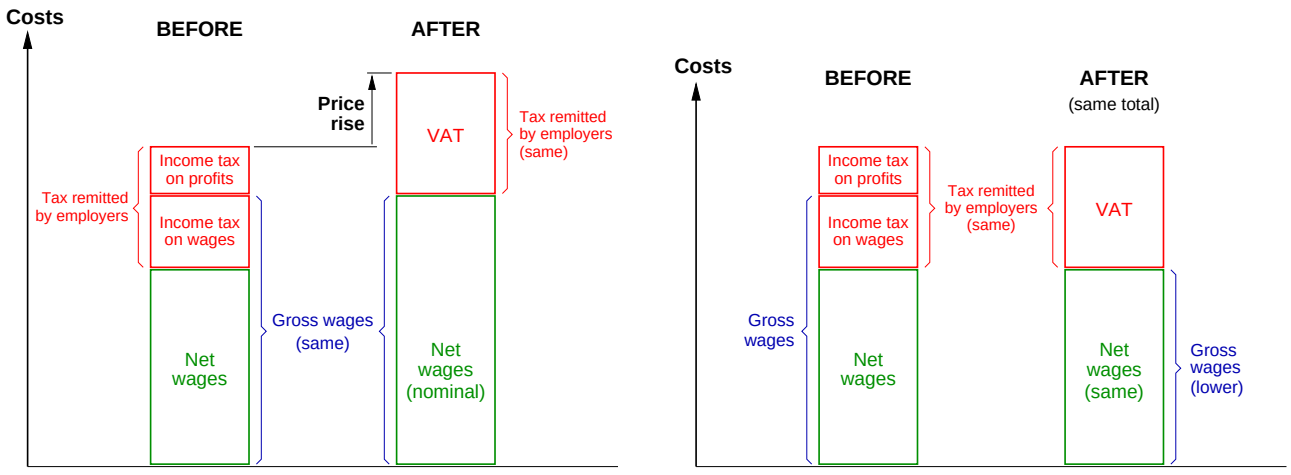
The trade-related advantage of replacing income tax with a consumption tax is a **first-mover advantage**, because other countries are free to do the same thing. But that makes action all the more urgent.

Moreover, the same policy also yields a *permanent* advantage, namely that a consumption tax, unlike an income tax, does not reduce the return on saving and investment (expressed as the ratio of future consumption to present consumption). Thus it is more conducive to capital formation and less damaging to production.

A payroll tax likewise does not reduce the return on saving and investment. But it is less efficient than a consumption tax because, whereas a consumption tax exempts exports and taxes imports, a payroll tax exempts the labour content of imports but taxes the labour content of exports. Fortunately, because consumption taxes and payroll taxes have similar tendencies to feed into prices, it is politically easy to replace a payroll tax with a consumption tax—or would be, if only politicians could agree not to tell lies about the effect on prices.

Of course, conventional wisdom holds that consumption taxes are less equitable than income taxes, because (i) if income tax is replaced by a consumption tax, prices rise, and (ii) the abolition of the progressive personal income tax overcompensates high income earners for the price rise but undercompensates low income earners.

That reasoning is valid if *gross* wages/salaries (in nominal dollars) are maintained: the personal income tax that was withheld from wages/salaries is instead paid to employees, and the consumption tax must come from another source, namely higher prices—as shown in the left-hand diagram below. But it *isn't* valid if *net* wages/salaries are maintained: in the aggregate, the funds previously paid to the government as PAYE income tax are instead paid to the government as consumption tax, so there's no need for enterprises to find extra revenue, hence no overall price rise—as shown in the right-hand diagram below.[1]



In either case, prices charged by unincorporated sole traders would behave similarly to those charged by employers, due to competition for customers, and arbitrage between working for oneself and working for an employer.

[1] The diagrams assume that the consumption tax is implemented as a VAT. Replacing the VAT with a retail tax does not affect retail prices except by reducing embedded compliance costs.

Using the industrial relations power (which is mostly in Federal hands under the corporations power), governments can ensure that in the transition to a consumption tax, net wages/salaries are maintained for existing appointments. *New* appointments can be subject to a new IR regime, preferably with a lump-sum per-shift bonus as an implicit loading for part-timers and casuals. The shift bonus would replicate the progressiveness of the existing system with respect to working hours, so that (e.g.) a worker on 18 hours/week would take home more than half the pay of an equal-ranked colleague on 36 hours/week. The shift bonus would also eliminate the need for minimum-shift rules.

As the producers of "necessities of life" are not exempt from income tax, there is no need to exempt them from a consumption tax that replaces income tax on a price-neutral basis.

0.2 At the state level, are there opportunities for the States to rebalance their tax systems towards more efficient revenue bases?

0.2.1 Yes. State property taxes should be replaced by a single charge on economic rent.

A single broad-based "land tax" (holding charge on land values) can replace the existing land taxes, conveyancing stamp duties, developer/infrastructure levies, and taxes on property-insurance premiums. If the new holding charge can be *deferred until the next sale and capped to a percentage of the real capital gain*, property owners who are asset-rich but income-poor (usually portrayed as widows or retirees) will be treated no less favourably than under the existing stamp duties on conveyances, and *more* favourably than under the existing insurance taxes (which, like the insurance premiums themselves, are non-deferrable). In terms of efficiency, a deferrable holding charge ranks somewhere between a pure holding charge and a capital gains tax. In terms of political acceptability, it should be no worse than the existing stamp duties.

In June 2009, the total value of Australian residential, commercial and rural land was $2821 billion.[2] In 2009-10, Australia's States and Territories together raised $5.767 billion from land taxes, $1.122 billion from "other" taxes on immovable property, $12.294 billion from conveyancing stamp duties, and $1.109 billion from insurance companies' contributions for fire services,[3] making a total of $20.292 billion. Dividing the revenue by the land value gives a required rate of **0.72%** per annum. This is of course only a national average, not the rate for every State.

0.2.2 Municipal rates should be on the same base.

To maximize efficiency and minimize compliance costs, Municipal rates should be required to piggyback on the State "land tax" rate, including its deferral arrangements; that is, the Municipal rate should be a surcharge on the State rate, on the same base. Values of buildings would thus be exempted from the rating base. Any charges for specific services should cover only marginal costs. Sudden increases in bills due to the change in the rating base can be blunted by caps on annual increases ("change caps", not to be confused with "rate caps").

Municipal rates (broadly defined) raised $11.645 billion nationwide in 2009-10.[4] On a total land value of $2821 billion, the required surcharge rate would have been **0.413%** per annum. This is of course only a national average, not the rate for every municipality.

[2] ABS 5204.0, Table 61.
[3] ABS 5506.0, Table 10.
[4] ABS 5506.0, Table 18.

0.2.3 There *is* a constitutional way for the States to levy their own rates on a Federally defined consumption base.

If a new consumption tax is to replace State payroll taxes, plus the existing GST (whose revenue is mostly reserved for the States), plus that component of Federal income tax which is not aimed at economic rent, then it would be desirable for the States (here construed as including the Territories) to be able to set their own rates which would piggyback on the Federal rate, making the States responsible for their own revenue.

This arrangement is greatly facilitated if the consumption tax takes the form of a retail tax, so that the applicable rate is determined by the location of the customer and there is no ambiguity as to how much revenue is raised in each State.[5]

To ensure that the States are not imposing a **duty of excise** in violation of s.90 of the Constitution, the tax can be legislated by the Commonwealth. To ensure that the Commonwealth is not discriminating between the States in violation of s.51(ii) and s.99 of the Constitution, the "piggyback" rate in each State can set annually by the Federal Parliament at the request and consent of the State Parliament, and the revenue raised by the "piggyback" rate in each State can be granted to the State on the condition that the State refrains from imposing certain other taxes. The conditional grant arrangement can even be specified in the "request and consent". Thus the Commonwealth treats every State in precisely the same way: it invites the State to pass a "request and consent" act, and complies with the "request and consent".

In the unlikely event that the "request and consent" arrangement is construed as "discrimination", there is another way to legitimize the same outcome. In *Ha v. NSW* (1997), the majority of the High Court held that a duty of excise is "an inland tax on a step in production, manufacture, sale or distribution of goods". That definition is generally understood to rule out State retail taxes.[6] The three dissenting judges preferred a narrower definition, saying that the purpose of s.90 was to "prevent impairment by the States of the common external tariff," so that "A State tax which fell selectively upon goods manufactured or produced in that State would be an excise duty…" That definition would allow State retail taxes.[7] If the States can impose their own retail taxes, they can refer the collection power to the Commonwealth under s.51(xxxvii) of the Constitution, and the Federal Parliament can authorize the collection by the ATO on the condition that the referring States accept a uniform base and refrain from imposing certain other taxes.

The enabling Federal and State legislation could cover both constitutional options, so that different High Court judges could approve the arrangement for different reasons. As long as a majority of judges agree that the arrangement is constitutional, it makes no difference if they disagree on the reasons!

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[5] It is often alleged that a retail tax is more susceptible to **evasion** than an income tax or a VAT. However, if a retail tax were to replace the vast machinery of income tax, payroll tax and GST, all the resources currently tied up in policing those three taxes would become available for enforcing compliance with the retail tax.

[6] If paying wages is such a "step", the same definition sinks payroll tax. Whether wages are relevant or not, the same definition apparently scuttles the existing State stamp duties on new cars and sales of livestock, the constitutionality of which has never been tested in court.

[7] But it gives no comfort to payroll tax, which clearly falls selectively on the labour embodied in locally produced goods, as opposed to goods produced outside the State.

1 Personal tax

1.1 Are there ways to further reduce any disincentives to workforce participation?

1.1.1 Yes. Stop taxing workforce participation.

Taxes on income are taxes on workforce participation. Taxes on economic rent or consumption, whatever their implications for what people do with fruits of workforce participation, are not taxes on workforce participation *per se*.

1.2 Are there opportunities to make policy changes to further simplify taxpayers' interactions with the personal tax system?

1.2.1 Yes. Get rid of the personal tax system.

Economic rent is imputable to assets, not persons. Consumption is assessable at the retail level without inquiring into the identities of the customers. Only income tax needs to get personal. Fortunately there is no need for income tax.

1.3 What is the best way for the personal tax system to be integrated with the business tax system in order to maintain the integrity and fairness of the overall system?

1.3.1 Abolish income tax and there'll be nothing to integrate.

Under a consumption tax, businesses remit the tax and recover the cost from consumers. Taxes on economic rent are imputed to particular assets and need not discriminate as to whether the assets are owned by individuals or corporations. Only under an income tax does one need to consider retained profits and distributed profits and whether the latter should be taxed at source or after distribution or both and, if both, whether shareholders should get credits for tax paid at source.

1.4 Does the tax system provide the right support to Australians who locate to the areas where their skills are most in demand?

1.4.1 No. It doesn't even recognize relocation expenses as work-related.

The expense of relocating to take up employment, like the expense of commuting to and from the workplace, is manifestly incurred for the purpose of earning wage/salary income but is not deductible against that income. Meanwhile negative-gearing losses *are* deductible against wage/salary income although they are manifestly *not* incurred for the purpose of earning that income.

1.5 Should consideration be given to moving towards a more neutral and consistent tax system for savings?

1.5.1 No. Saving shouldn't be taxed.

Tax exemptions for saving should apply to all forms of saving. They should not be restricted to savings that satisfy some legal definition of superannuation. In so far as superannuation is voluntary,

there is no reason why it should be favoured over any other form of voluntary saving. In so far as superannuation is compulsory, it does not require additional incentives in the form of tax concessions that are not available for savings other than "superannuation".

Taxes on economic rent or consumption automatically include the necessary exemptions for saving. In particular, a holding tax on an indestructible, irreplaceable, immobile asset does not reduce the return on that asset relative to its purchase price, because the annual income and the market price of the asset are reduced in the same proportion. Thus, if the acquisition of the asset is construed as a form of saving, the holding tax does not reduce the return on that saving. Even the *introduction* of the tax does not reduce the return if it is compensated by cuts in other taxes that affect annualized values of assets.

1.6 Are there opportunities to improve efficiency in the housing market with alternate tax settings and policies?

1.6.1 Yes. Stop taxing construction.

Construction is hit by corporate income tax on construction companies, personal income tax on construction workers, payroll tax on their employers, the same three taxes embedded in the prices of materials and components, GST on the sale of newly constructed buildings, conveyancing stamp duty (whose base includes the value added by construction), and municipal rates if they apply to combined values of buildings and land, but *not* if they apply to land values alone.

At this point it is appropriate to explain how a broad-based retail tax can avoid taxing the construction and supply of accommodation:

- All property sales (some of which are presently subject to GST) should be exempt.
- The assessment should be on the values of sites, excluding buildings and other artificial improvements.
- Commercial landlords, instead of paying income tax on received rents and collecting GST on received rents, should pay retail tax on the imputed rental values of their sites, regardless of whether the sites are developed or let to tenants; and any contractual provisions requiring tenants to pay the tax (or increments in the tax) should be void.
- Residential landlords, instead of paying income tax on rents and GST on inputs, should be treated like commercial landlords.

1.6.2 And scrap concessions and subsidies for land speculation.

Land speculation is assisted by capital-gains discounting, negative gearing, and the exclusion of capital gains from "value added" for GST purposes. Abolition of income tax would eliminate most of the problem. The rest of the solution is to define the base of any remaining consumption tax so as to include the imputed rent of land owned by registered entities.

1.7 Are there opportunities to improve the rules for superannuation during the drawdown phase?

1.7.1 See question 1.5.

There is no reason why the drawdown of superannuation should be treated any differently from the drawdown of any other form of saving.

1.8 Are there unintended or inappropriate concessions in the tax system that could be removed to help fund priorities elsewhere?

1.8.1 Most concessions are intentionally inappropriate.

Income tax is fundamentally hostile to production. On the macro scale, income *is* production. But on the micro scale, on which income tax is assessed, one entity's income can be another's production. This **unearned** component of income is economic rent. So in theory the machinery of income tax can be used to target economic rent. But in practice, when that machinery is in place, it will target earned income and spare economic rent, because economic rent buys political influence.

Thus "capital gains" get concessional treatment, although they mostly represent economic rent rather than capital formation (and although capital gains tax resembles a holding tax in that the taxable gain accumulates while the asset is held). Meanwhile income from capital, which really does contribute to capital formation (and is a transaction or series of transactions), gets no such concessions.

Thus, in Australia, current losses incurred in pursuit of capital gains ("negative gearing" losses) are deductible against wage income although they are not incurred in pursuit of wages, while commuting costs incurred in pursuit of wages are not deductible against them.

1.9 Are there better ways to structure and deliver concessions?

1.9.1 Yes, but it's simpler to choose a better revenue base.

Income-tax concessions, because of their tendency to favour economic rent over production, are somewhat less helpful than lipstick on a pig.

Unlike income tax, a consumption tax by nature is indifferent to whether consumption is financed out of production or economic rent. So it is not so easily rigged in favour of rent-takers. This is an advantage not only in efficiency, but also in equity, because the flow of economic rent is highly concentrated towards the rich. For example, in Australia in 2005-6, the top 1% of income earners received only 5.3% of wage/salary income, but received 38.6% of net capital gains,[8] which are mostly economic rent.

Land tax and site-value rates, unlike income tax or even consumption taxes, target economic rent. They can be corrupted by including values of buildings in the revenue base—that is, by turning them into "property taxes". But, as history shows, they are not so easily corrupted to the extent of taxing building values while exempting or discounting the underlying land values, which is the analog of what has been done with income tax.

2 Transfer payments

2.1 Are there ways to make the transfer system simpler for individuals and families?

2.1.1 Get the tax system right and most transfers will become unnecessary.

The main reason why people are unable to support themselves through their own efforts is that jobs are made artificially scarce by taxes that penalize production, backed by monetary policy that deliberately

[8] Treasury, *Architecture of Australia's Tax and Transfer System* (Aug. 6, 2008), s. 3.3; www.is.gd/archit_3_3.

maintains enough unemployment to cause enough wage restraint to compensate for the inflationary effects of the same taxes.

2.2 How should family payments and child care assistance support parents' choices about how to balance and share work and caring roles at different stages in their children's lives?

2.2.1 Stop taxing the middle class for working, saving and investing and you won't need middle-class welfare.

Ridiculously low income-tax thresholds create the need for transfer payments to families that pay income tax. That would not be so bad if the transfer payments were not income-tested. But they are, with the result that the disincentives due to income testing add to those due to income taxation.

There are two ways to end the destructive interaction between income testing and income taxation. One is to get rid of income testing so that the entire effective marginal tax rate (**EMTR**) is contained in the income-tax system. This does not increase the EMTR, but makes it more visible and hence more manageable. The other is to get rid of income tax, as proposed here.

The proposed raising of the income-tax threshold to accompany the "carbon tax" does not go nearly far enough; it still leaves a wide range of incomes that are subject to both income-testing and taxation.

2.3 What incentives and obligations in transfer payments could further encourage skills formation, workforce participation and promote early childhood development?

2.3.1 If you want workforce participation, stop penalizing it.

Income-testing penalizes participation; asset-testing doesn't. Taxation of income penalizes participation; taxation of economic rent or consumption doesn't.

2.4 How well do the characteristics of our income support system reflect current patterns of work life for Australians?

2.4.1 They don't, unless the object is to punish work.

Newstart is an incentive to look for work but not find it. If you actually *find* work, you lose not only that part of Newstart which recognizes the cost of looking for work, but also that part which recognizes the cost of living; and you incur work-related travel expenses which attract no income support and are not even tax-deductible.

2.5 Does the current provision of public housing impact on workforce participation? If so, what incentives could be introduced to address this issue?

2.5.1 Yes. Reduce the need for public housing by making private housing more affordable (see question 1.6).

If public housing is offered at sub-market rents, there will be a waiting list—because if there isn't, the open market must be offering a better deal. If rents of public housing are tied to household income,

they increase effective marginal tax rates and deter economic participation; and if they are *not* tied to household income, there will be a loss of vertical equity.

For these reasons, the first goal of housing policy should be to make private housing as affordable as possible and thus minimize the need for public housing.

Private housing is made more affordable by tax reforms that stimulate *supply*. Rent assistance, in contrast, is a *demand*-side measure which raises rents. That's why landlords and their lobby groups are so fond of it.

2.6 Are there unintended or inappropriate concessions in the transfer system that could be removed to help fund priorities elsewhere?

2.6.1 Yes. The treatment of owner-occupied residential land is too generous, and the treatment of earned income is too harsh.

Of course, what matters is the combined effect of the tax system and the transfer system, not the effect of the transfer system alone. But at present, *both* systems punish work and mollycoddle land ownership. Indeed, the punishment and mollycoddling are routinely meted out to the same person in different capacities, with predictably perverse influences on behaviour.

3 Business tax

3.1 What is the appropriate business tax system for Australia to maintain business tax revenue and economic growth?

3.1.1 Abolish taxes on payrolls and normal profits.

If there is a consumption tax, administrative efficiency demands that it be collected *through* businesses, which remit the tax and recover it through prices. But the only taxes that should be collected *from* businesses are those on economic rent accruing to business. Taxes on normal profits are taxes on the necessary returns to capital and therefore inhibit capital formation or drive it offshore.

It has already been explained how income tax, including tax on normal profits, can be replaced by a consumption tax without raising prices. It is even easier to replace payroll taxes by a consumption tax without raising prices. It is therefore undeniable that consumption and economic rent together constitute a sufficient revenue base for all levels of government. There is no fiscal excuse for taxing payrolls or normal profit. As the switch to consumption taxes can be made without raising prices, there is not even a social excuse or a political excuse.

3.2 Are there ways to reform the business tax system that can assist Australia to meet the challenges of mining boom mark II and make the most of the opportunities from the shift in global economic weight from West to East?

3.2.1 Mineral royalties should be on exportation, not extraction.

A mineral royalty imposed at the point of extraction imposes a floor price on all subsequent buyers, including not only offshore customers but also domestic value-adding industries. If the royalties were instead imposed at the point of exportation, local value-adders would have cheaper access to the minerals and would therefore be more competitive internationally.

To avoid any jurisdictional difficulties that might arise if the States tried to impose royalties on exports, and to close other loopholes in the royalty regime (which depends on the States' *ownership* of the minerals), the Commonwealth could impose a tax on mineral exports (presumably with lower rates for higher degrees of refinement), and could offer to grant the revenue to the State of origin on the condition that the State does not impose its own royalties.

3.3 Should the company tax rate be lowered further, and if so, what other reforms within the business tax system might be used to fund this?

3.3.1 Yes—to *zero*, except on capital gains and (for unlisted companies) super-normal profits.

The only aspects of income tax that can be defended are those that target economic rent, namely capital gains tax and super-normal profit taxes. Super-normal profits of a *listed* company are reflected in its share price and can therefore be captured by a holding tax on the *above-par component* of the total market value of its shares, payable by the company. If the holding tax is sufficiently high, it removes the need to tax capital gains on shares in the hands of individual shareholders, yielding further reductions in compliance costs.[9] Only for an *unlisted* company is there any need for transaction-based assessment of super-normal profit. To avoid compliance costs out of proportion to revenue, one could apply a threshold of (e.g.) $50 million per annum in super-normal profit, and tax the above-threshold component at a rate of (e.g.) 40%.

3.4 Are there ways to further simplify business interactions with the tax system, especially for small business?

3.4.1 Extend availability of "input-taxed" status.

At present, businesses with turnover below a certain threshold are eligible to be "input-taxed" rather than registered for GST. But this concession is largely ineffectual because GST-registered customers of such businesses want to claim input credits, for which purpose the customers need tax invoices, which input-taxed businesses can't supply. Consequently, hundreds of thousands of enterprises that are small enough to qualify for input-taxed status have been forced to become GST collectors in order to issue tax invoices. The customers' main motivation for requiring tax invoices is to keep accounting procedures the same for all suppliers. A secondary motivation is to avoid "**sticky GST**"—i.e. tax on tax, arising because the tax embedded in prices charged by the input-taxed entity is not reclaimed later in the supply chain.

One solution is to re-implement the GST using the **subtraction method**, so that inputs from all sources are deductible in the calculation of taxable "value added". Under the subtraction method, if there is an input-taxed entity in the supply chain, the value added by that entity escapes taxation; there is no tax on tax. However, because no country has a pure subtraction-method VAT, it is not clear that the untaxing of exports under the subtraction method is WTO-compliant.

A more complete solution is to replace the GST with a retail tax, which has no deductions. Under a retail tax, an input-taxed business upstream of a retail business *does* lead to tax on tax, but *doesn't* complicate the retailer's accounting, and the zero-rating of exports *is* known to be WTO-compliant.

The ability to zero-rate exports is crucial if Australia wishes to increase its market share in order to maintain export income in the face of fall in global demand.

[9] Similarly, a sufficiently high holding charge on land values removes the need to tax capital gains on property. But the point is more likely to be appreciated in the case of shares, which change hands more frequently than property.

3.5 Should there be more symmetrical treatment of tax losses?

3.5.1 Abolish income tax and there'll be perfect symmetry.

The concept of a "tax loss" is a peculiarity of income tax in its various forms. To the extent that income tax is abolished, tax losses are also abolished, along with any alleged asymmetries in their treatment.

If the concept of a "tax loss" is stretched so as to include inputs under a VAT, then the accounting for such "losses", hence any scope for asymmetry in that accounting, can be eliminated by re-implementing the consumption tax as a retail tax.

3.6 Should further consideration be given to potential longer-term directions for the business tax system, such as deductions for equity financing?

3.6.1 Abolish income tax and there'll be no deductions for *debt* financing.

When there are no deductions for debt financing, there will be no argument for matching deductions for equity financing.

3.7 Are there unintended or inappropriate concessions in the business tax system that could be removed to help fund priorities elsewhere?

3.7.1 Abolish income tax and there'll be no unintended or inappropriate income-tax concessions.

Because income tax, of all taxes, is the one most obviously hostile to production, it is the one most riddled with concessions that reward rent-seeking while pretending to incentivize production, and therefore the one whose abolition would do most to eliminate inappropriate concessions.

3.7.2 Abolish GST and there'll be no unintended or inappropriate GST concessions.

The benefit of the current GST concessions to low-income households has been greatly exaggerated. More than a third of the benefit of GST-free food goes to the top 20% of households in the income distribution.[10] Moreover, the GST-free list is not limited to necessities of life; for example, it also includes the fees of elite private schools.[11] Most of these concessions increase compliance costs which are passed on in prices borne by low-income households. Even those elite private schools would have lower compliance costs if they were input-taxed instead of GST-free.

If Australia's GST were as broad-based as New Zealand's, the rate required to yield the same revenue as at present would be 5.5%.[12] As the Government, in its wisdom, has decided that this option is too terrible to contemplate, the only remaining way to homogenize the GST is to abolish it.

If a retail tax replaces taxes on payrolls and income (other than economic rent), the obvious way to abolish the GST is to roll it into the retail tax.

[10] Henry Report, section D2-1; www.is.gd/henry_d2_1.

[11] Disclosure: The author attended an elite private school from 1976 to 1980, but would not have had that opportunity had he not won a scholarship.

[12] Estimated from Chart D2-1 in the Henry Report; www.is.gd/henry_d2_1.

4 State taxes

4.1 Does the tax system create disincentives for Australians to locate to the areas where their skills are most in demand?

4.1.1 Not if they're smart enough to avoid conveyancing stamp duty by putting tenants in the old home and renting the new one.

By *buying* the home you want to *invest* in and *renting* the one you want to *live* in, you can optimize both decisions independently, avoid stamp duty on future changes of address, and (if applicable) claim the negative gearing deduction. If you've already bought the home you live in, but need to move, you can install tenants in your present home and rent the new one, so that the State gets no stamp duty on either.

4.2 Are there opportunities for the States to replace stamp duties on property conveyances with reformed land taxes?

4.2.1 If enough people dodge stamp duty, the States will have little choice.

The revenue from a broad-based "land tax", unlike that from conveyancing stamp duties, does not depend on market turnover and therefore cannot be reduced by systematically avoiding transfers of title.

4.3 Should States abolish insurance taxes? If so, how could that revenue be raised more efficiently?

4.3.1 Yes. The revenue should come from *land* values...

Taxes on building-insurance premiums are effectively property taxes and should therefore be levied on land rather than buildings, in order not to discourage construction. If the purpose of the tax is to pay for a firefighting service, a land-value base reflects the "beneficiary pays" principle in that the availability of the service in a particular location makes land in that location more desirable for building on, hence more valuable.

Taxes on vehicle-insurance premiums are effectively taxes on road use and should therefore be rolled into the optimal system for financing roads. That optimal system, which works not only for roads but for infrastructure in general, is land-value capture.

4.3.2 ... because the benefit of location-dependent services is represented in *land* values.

The benefit of an infrastructure project—such as a road, or a public transport system, or a fire-fighting service, or any other service to particular locations—can be measured only by the price that people are willing to pay for that benefit; and whatever part of that price is not paid in **user charges** (fees, fares, tolls, etc.) is paid for access to *locations* serviced by the infrastructure. In other words, the benefit of infrastructure (net of user charges) is manifested as uplifts in *land values*—not values of buildings, which are limited by construction costs, but values of land, because land has a location (and therefore a locational value) even if no buildings stand on it.

Therefore if the benefit of an infrastructure project exceeds the cost, whatever part of the cost is not offset by user charges can be covered by taking back a sufficient fraction of the **uplift** in land values, without burdening taxpayers who do not share in the benefit. The remaining fraction of the

uplift is a net windfall to the affected property owners, who are therefore the winners. There are no losers.

In general, the **cost-benefit ratio** of a project is the **cost-uplift ratio**. So if a government claws back a certain fraction of every uplift through the tax system, any project whose cost-benefit ratio equals that fraction is self-funding, and any project with a lower cost-benefit ratio is more than self-funding, yielding net revenue that can be used for (e.g.) cutting other taxes. The remaining ("after-tax") fraction of the uplift is a net windfall to the affected property owners—a windfall which they probably would not otherwise get, because the project probably would not otherwise be funded.

This mechanism is *not* a tax increase to be spent on infrastructure. It is a change in the tax *mix*, enabling future investment in infrastructure to pay for itself by expanding the revenue *base* without further changes in tax rates or thresholds. The initial change in the mix can be revenue-neutral.

Revenue bases that expand in this manner include those of capital gains tax, land-value rates, and land tax (including any provision for deferring payment and capping to a fraction of the capital gain).

4.4 How might the reform or greater harmonisation of State payroll taxes be pursued?

4.4.1 Abolish them and the harmony will be perfect.

As already noted, payroll taxes can be replaced by a consumption tax without raising prices. It is even feasible to replace payroll tax with land tax, thereby *reducing* prices of goods and services, provided that the deferment provisions for land tax are sufficiently generous. In Tasmania, for example,

> The revenue from payroll tax, property transfer duty, insurance duty (largely passed on to property owners) and the existing land tax could be replaced by a broad-based "land tax", with no exemptions or thresholds, at a flat rate of about **1.5%** per annum, which happens to be the top marginal rate of the existing land tax.[13]

4.4.2 If you're stupid enough to tax payrolls, apply a per-employee threshold so as to exempt entry-level wages.

Payroll tax would be less damaging if it were **disaggregated**—that is, if employers were taxed on the wage/salary of *each* employee, applying the threshold to the individual wage or salary instead of the whole payroll. Entry-level jobs would tend to be under the threshold, in which case employers offering such jobs would not incur marginal payroll tax on top of the marginal wage/salary costs.

The change should be politically easy because the same class of taxpayers, namely employers, would continue to remit the same revenue as they do now, although there would be a change in employers' apportionment of the cost between employees or groups of employees.

The States could make this change voluntarily, or the Commonwealth could force them to do it on pain of losing their grants. The Commonwealth could also require harmonization of the rules in the various jurisdictions, although each jurisdiction should remain free to set (at least) its own rate.

[13] Land Values Research Group, *Replacing property taxes and payroll tax*, submitted to the *State Tax Review* (Dept. of Treasury & Finance, Tasmania), February 14, 2011 (*not* 2010 as printed on the front page); www.is.gd/LVRG_TasTax.

4.5 Do GST sharing arrangements create the right incentives for States to make their tax bases more efficient?

4.5.1 No. The GST should be abolished.

If we must have a consumption tax, it should be a retail tax legislated at the Federal level, with a uniform Federal rate plus a State/Territory rate set in each State according to the request and consent of the State/Territory Parliament; and the revenue collected in each State/Territory should be granted to that State/Territory on the condition that it abolishes a specified (and wide) range of inefficient taxes.

A consumption tax implemented in that manner would enhance the fiscal independence of the States and Territories, whereas the present GST diminishes it.

4.6 Within our Federation, what responsibility should the States take for reforming the taxes they impose?

4.6.1 The States should be fiscally independent.

The power of the Commonwealth to make conditional grants to the States (s.96 of the Constitution) has degenerated into a perennial component of State budgets, with the result that essential State services have become the subject of perennial cost-shifting, blame-shifting, buck-passing, and inaction. If politicians are to be properly accountable to their voters, the States must be made fully responsible for their own revenue—or abolished!

4.6.2 If we must have HFE, inefficient taxes shouldn't get credit for "tax effort".

Horizontal fiscal equalization (**HFE**) is not needed for the purpose of financing infrastructure, because whether the existing infrastructure is good or bad, improvements can always be financed out of uplifts in land values without subsidies from higher levels of government.

If, in addition, the States could effectively set their own consumption-tax rates on a Federally-defined base, it is not clear that HFE would be needed at all.

If we must nevertheless have HFE, its purpose is *to compensate for incapacity, not to reward inefficiency*. So, in so far as the HFE system purports to reward States' and Territories' efforts to raise their own revenue, the efforts that are rewarded should be limited to efficient ones such as land-value capture. Inefficient ones such as conveyancing stamp duties, insurance taxes and payroll taxes should be ignored or preferably penalized, *not* rewarded.

5 Environmental and social taxes

5.1 Should Australia consider ways to more closely link road charging to the impact users have on the condition and upkeep of roads?

5.1.1 Roads should be financed out of their positive effects on land values.

The benefit of a road is location-dependent and is therefore expressed in land values in the serviced locations. The efficient and equitable method of financing the road is to recycle part of the uplift in land values.

5.2 Is there a case to more closely link road charging to the impact users have on the level of congestion on particular roads?

5.2.1 Public transport should be financed out of its positive effects on land values, including those due to reduced road congestion.

The most economical method of reducing road congestion is to get people out of cars and into public transport. As usual, the necessary public transport projects should be financed out of the ensuing uplifts in land values—the more so because the uplifts will occur not only in locations directly serviced by the public transport routes, but also in locations serviced by roads on which congestion is reduced because the public transport route offers a complete or partial alternative.

But if the government prefers to reduce congestion on a road by upgrading *that* road, that too should be financed out of the uplift in land values.

5.2.2 Congestion charging should be the last resort, not the first.

If the capital cost of transport projects is financed by the efficient and equitable method—that is, recycling uplifts in land values in locations serviced by those projects or by alternative routes on which congestion is relieved by those projects—then transport will be well-provisioned, and congestion will be rare. Only in extreme and exceptional cases should it be necessary to control congestion by means of price signals. In no case should fares or tolls for *use* of a transport service be regarded as a means of defraying the *capital* cost of that service.

5.3 Are there aspects of other tax arrangements that create unintended incentives for adverse environmental outcomes, or ways in which governments could use specific taxes to ensure that people take appropriate account of environmental impacts in their decision making?

5.3.1 Urban sprawl is caused by the tax system.

Owners of property in established suburbs (who prefer to call themselves "residents") oppose any attempt by other property owners ("developers") to exploit the vertical dimension ("density"), lest it threaten their suburb's housing shortage ("character"). Consequently, new housing is relegated to greenfield developments on the urban fringe.

The NIMBY owners ("residents") regard "density" as competition. They might instead welcome it as a magnet for new transport projects—which would make their locality still more desirable, hence more valuable—if only they could believe that funding for such projects would be forthcoming. The way to guarantee funding is to redesign the tax base so as to capture a sufficiently high fraction of the unearned uplift in land values.

6 Tax system governance

6.1 How might the greater use of technology and improved coordination and management of information be used to improve taxpayers' experience with the tax and transfer system?

6.1.1 The best taxes need the least information.

The collection of a consumption tax requires information about (at least) the last sale before the consumer, but does not require any information about the consumer. Thus a consumption tax requires less information, and fewer sources of information, than an income tax.

Better still, the collection of holding taxes on the values of indestructible, irreplaceable, immobile assets requires little or no information that governments do not need to collect for other purposes. If such assets are tradeable, at least to the extent of being lettable or sublettable, they will have observable market values than can serve as the revenue base. Observation of those values is especially easy if the assets are created by governments themselves, as with licences and quotas. (Assets that can be created solely by governments are still "irreplaceable" from the viewpoint of taxpayers.) Irreplaceable assets tend to appreciate and therefore to be highly prized, causing a political demand for governments to administer Torrens-type title registers to protect buyers from fraud. The administration of a title register requires recording of title transfers. Recording the transfer *prices* requires little extra effort, and in any case is necessary to ensure that the transfers are legitimate.

6.1.2 The best "experience with the tax and transfer system" is the shortest.

> *IV. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury, in the four following ways… Fourthly, by subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, vexation, and oppression; and though vexation is not, strictly speaking, expense, it is certainly equivalent to the expense at which every man would be willing to redeem himself from it.*
>
> — Adam Smith.[14]

6.2 What are the opportunities and challenges to further advance pre-filling of tax returns?

6.2.1 Abolish income tax and there'll be no tax returns to pre-fill.

> *Capitation taxes, if it is attempted to proportion them to the fortune or revenue of each contributor, become altogether arbitrary. The state of a man's fortune varies from day to day, and without an inquisition more intolerable than any tax, and renewed at least once every year, can only be guessed at.*
>
> — Adam Smith.[15]

[14] *The Wealth of Nations*, bk. V, ch 2, par. 28.
[15] *The Wealth of Nations*, bk. V, ch 2, par. 139.

Regrettably, almost every nation on earth has opted for the inquisition more intolerable than any tax, renewed at least once every year. And even that has not eliminated the guesswork.

6.3 Should the Government pursue the development of online tax and transfer client accounts?

6.3.1 No. It should remove the need for them.

If online accounts are needed to manage the personal information required by the tax-transfer system, then the system requires too much information.

Taxes on the economic rent of assets do not require any information beyond that needed to register titles to those assets. Taxes on consumption do not require information on the final consumers.

6.4 Are there better ways that institutional arrangements for the tax system can be used to improve taxpayers experience of the tax system?

6.4.1 Start by adhering to the rule of law, the separation of powers, and the Constitution.

The existence of a court presupposes the rule of law. The institutional integrity of the court therefore precludes the court from entertaining any proposition incompatible with the rule of law. The existence of a constitution, written or unwritten, presupposes the rule of law and therefore renders unconstitutional any legislation or judicial precedent incompatible with the rule of law. The legislative power by definition is limited to the making of law. Legislation inconsistent with the rule of law is not law and is therefore beyond the legislative power.

The rule of law requires, *inter alia*, that the executive power be under the law, and that the law be applied to the facts. These requirements are not satisfied if the executive branch, for its own convenience, can deem the facts to be other than what they are. These requirements can be satisfied only if the facts are adjudicated by another branch of government, independent of the executive branch. The rule of law therefore cannot accommodate "general anti-avoidance rules" (**GAARs**) whose effect is precisely to empower the executive branch to deem the facts as it chooses.

Another consequence of the rule of law is that the law cannot require the impossible. Hence it cannot require you to know, and therefore cannot require you to obey, a law that does not yet exist. The rule of law therefore cannot accommodate "legislation by press release" whereby the government announces that some so-called loophole is to be plugged by legislation that will be backdated to the date of the announcement although the text is not included in the announcement.

If the leaks in the income-tax base cannot be satisfactorily plugged without resorting to unconstitutional GAARs and/or "legislation by press release", one must conclude that the principle of income tax is irredeemably flawed and should be scrapped. We accept that conclusion.

The above constitutional principles are universal and do not depend on any particular provisions of the Australian Constitution (although some of those provisions undoubtedly help). But that Constitution gives rise to further grounds for challenging the existing tax system.

Section 82 of the Constitution says in part:

> *82. The costs, charges, and expenses incident to the collection, management, and receipt of the Consolidated Revenue Fund shall form the first charge thereon...*

At face value, and even upon closer inquiry,[16] those words would seem to make it unconstitutional

[16] G. R. Putland, *Making the tax system comply with s.82 of the Constitution*, submitted to the Treasury review on *Australia's Future Tax System*, May 1, 2009; http://is.gd/erqeD.

to require employers, at their own expense, to *collect* personal income tax payable by employees, or to require vendors, at their own expense, to *collect* GST payable by customers. Employers and GST-registered entities would have standing to challenge existing arrangements, as would ordinary citizens whose employment prospects are damaged by employers' compliance obligations, and whose living costs are inflated by compliance costs passed on in prices. The solution is to eliminate income tax and to eliminate tax invoices under any consumption tax.

Section 90 forbids the States to impose duties of excise. It is easy to argue that payroll taxes are duties of excise in so far as they apply to labour embodied in goods.[17] And if the GST does not cease to be an excise just because it applies to services as well as goods, neither does payroll tax.[18] As payroll tax reduces employment prospects and raises the cost of living, any citizen would have standing to challenge it.

While we would never advise anyone to pick a fight with the tax authorities, we cannot help noticing that any constitutional weakness in the position of the authorities would be a trump card for any taxpayer who is already in such a fight. If the legislators don't want a situation in which every tax dispute is automatically settled in favour of the taxpayer for fear that a major tax or its collection mechanism will be struck down by the courts, then the legislators must urgently eliminate all taxes and collection mechanisms that might be unconstitutional.

7 Conclusion

What passes for public debate on tax is paralyzed by the stated or unstated assumption that all the low-hanging fruit in tax reform has been picked. In contrast, we submit that the abolition of taxes on payrolls, conveyances, buildings, insurance and income (other than economic rent) should be counted as low-hanging fruit.

[17] Cf. Footnotes 6 & 7 (p. 8).

[18] Cf. G. R. Putland, "What if GST and payroll tax are unconstitutional?" *On Line Opinion*, December 16, 2009; http://is.gd/gstptu.