The Australian

May 13, 2008 Tuesday
1 - All-round Country Edition

Root, branch or tree

BYLINE: **Henry Ergas**

SECTION: FEATURES; Pg. 12

LENGTH: 875 words

The tax system needs an overhaul, not more ad hoc tinkering, insists **Henry Ergas**

ALL tax systems are imperfect, but some are more imperfect than others. And the more revenue a tax system has to raise, the worse its inherent imperfections become. Nowhere is this clearer than in Europe, where tax systems have been strained to breaking point by attempts to finance large-scale income redistribution through complex systems of progressive taxation. In Australia, the problems may seem less acute, but the underlying disease is no less chronic and no less in need of attention.

If the problems our tax system encounter seem less acute, it is partly because the Hawke and Keating governments' reforms and the Howard government's GST helped improve the system's structure and blunted its efficiency costs. But it is also because rapid economic growth and surging company profits have fuelled substantial ongoing increases in company tax receipts, reducing the burden that government outlays would otherwise have imposed directly on households.

At some point, however, the easy days will end, and if they do so with our present tax system in place, the efficiency costs of that system will become starkly apparent.

What this means is that now is the time to reform the tax system, as we can do so when the imperatives of revenue raising are less pressing.

Reforming is different from repairing, and it is reform that we need. History and experience show that this requires a comprehensive approach, as many of the tax system's worst distortions arise from the interaction between its component parts.

This makes it unfortunate that the Government, in announcing its ``root and branch'' tax review, excluded important aspects of the system from consideration, including the taxation of superannuation and the GST.

Roots and branches are fine, but it is the trunk that is the bulk of the tree. And even if there are compelling policy reasons for leaving some aspects of the trunk unchanged, no review can be comprehensive if it is precluded from considering the tree as a whole.

Such an integrated view is all the more important as tax systems worldwide are moving to simpler, flatter personal income tax structures that are more neutral in their impacts on resource allocation and, ultimately, impose a lower tax burden.

That is the direction in which Australia also needs to move.

But such a move is at odds with government announcements, which suggests that whatever its other merits, today's budget will make the tax system more complex in its impacts, increase some effective marginal tax rates and introduce new distortions to consumption decisions.

The mooted changes to means testing of the baby bonus and of family allowances are cases in point. While much depends on exactly how those changes are made, it seems likely that they will add to the jumps in marginal tax rates that households face in a system that Treasury secretary Ken Henry has described as already having ``a much higher than normal extent of means testing''. These changes seem even more difficult to understand when seen together with proposed changes to the Medicare levy surcharge.

It seems odd for a government intent on reducing middle-class welfare to give a substantial tax break to households that are plainly middle class. This is all the more the case as the objective of those changes appears to be that of inducing those households to rely more heavily on Medicare, rather than buying the private health insurance that they can well afford.

It may be that the Government has some architecture in mind for the health system in which private health insurance plays little or no role but, if so, it would have done well to explain that architecture and allow it to be tested before fiddling with the tax system in ways that undermine a key element of the present arrangements.

But if those changes can be viewed as tinkering, the additional tax on luxury cars seems simply foolish. There is a long history of trying to target taxes at luxuries, reflecting a curious brew of puritanism and envy. Such taxes are not only distorting but also often highly ineffective as they lead to ever more ingenious ways of scraping under the thresholds.

To make matters worse, the luxury car tax is likely to fall on many vehicles that are expensive precisely because they are fuel efficient and environmentally friendly, presumably inciting calls for compensatory subsidies to be provided, undermining whatever may have been the original policy intent.

None of this is to suggest that the Government, in making whatever changes it makes, starts from a perfect canvas; far from it.

But our tax system is as it is because we have tinkered with it for so long, while overloading it with tasks that it is poorly equipped to handle.

As the Organisation for Economic Co-operation and Development recently put it, ``true simplicity can only be achieved if the tasks that are asked of the tax system are simplified''. Until we move in that direction, the tax system will remain an impediment to making the best use of our resources and a ticking time bomb under our economic future.

Henry Ergas is chief executive of Concept Economics in Canberra and is carrying out a review of taxation for the shadow treasurer.

LOAD-DATE: May 12, 2008

LANGUAGE: ENGLISH

PUBLICATION-TYPE: Newspaper

JOURNAL-CODE: AUS