

The Grill – June 2010 – Henry tax report special

Back in December 2009, Ken Henry offered a “Report to the Treasurer on Australia’s future tax system” and the government buried it. The Report was released last month, and the government buried it again with its deft handling of the RSPT. Of Henry’s 137 recommendations, the federal government has at this stage responded to 3 and a bit, and not at all well.

This *Grill* is instead about the buried treasure in the Report. It would be nice if Australia’s future tax system looked a little more like Henry’s recommendations than the soul-destroying edifice it is now. So, in the belief that sense will ultimately prevail with tax reform as it will with a carbon price, here is a look at the future.

Looking at the Henry Report through a sustainability lens, I found it quite thought-provoking and actually a little exciting – not as much as our client projects, but more so than watching rampant self-interest fight the same tired pitch-battles in the guise of national debate.

And we should observe that Henry is far from an impractical theorist: “In principle, the home production of alcohol would be subject to tax. In practice, this is unlikely to be feasible.”

Armed with a home brew, the *Grill* takes a brief look at taxation and public policy, environment taxes, housing, resources, insurance, transport, charitable organizations and the paradoxes of smoking, gambling and drinking.

I’ve kept clear of personal and corporate tax, and transfer (welfare) payments for now. At 8 pages, this is the longest *Grill* ever. Against the 856 page original though, it’s a gift!

First principles

As with all public policies, a tax policy needs to be **effective**, **efficient** and **equitable**. To be effective, taxes need to raise enough funds to pay for public security, health, education, transport and essential infrastructure – and a heap of other things that society may support. Societies may also agree to use them to discourage private actions that impose costs on the rest of the community (eg, problem gambling), and encourage private actions that benefit others (eg, certain donations). Taxes will be efficient if their administration costs are low. “Taxes will be equitable if different groups pay taxes at levels that each sees as fair. Discuss.”

To achieve this, Henry advocates whittling the current labyrinth down to clear and simple taxes on just three things: **income**, **consumption** and **resources** (the things in Australia that aren’t going anywhere – land and the stuff under it). Payroll tax and other odds and sods would disappear. The logic is impressive. Federalism and self-interest are the hurdles. The politics are horrendous.

Housing, stamp duty and land tax

- **Proposal and rationale.** Scrap stamp duty and any other tax on the transfer of property. This should encourage land and buildings to be better matched with their most valued purpose, reduce the overall cost of housing, and increase incentives for large-scale housing investment. This has already had impact, with the Victorian and NSW Governments reducing stamp duty in their recent budgets, with the move almost universally applauded.

- **Housing affordability** is a real issue: prices have risen from 3 times to 5 times average earnings in just the past 15 years, and the proportion of 55-64yos with mortgages have increased from 13% to 30% in the same short time (make you feel better?). While the population is growing at 1.7% a year, housing completions are falling by 2.0%. So more people are sharing, which sounds good but only because the 'leave home' age has risen from 24 to 28. Mental health costs must be soaring.
- **Sustainability impact.** Terrific. Reducing transaction costs helps reduce the size of houses, and enable people to live closer to where they work. The higher the cost of transferring property, the more likely that people stay where they are even when it doesn't suit them. Empty-nesters are more likely to stay with empty rooms; families needing more rooms are more likely to renovate than move to a larger house. Renovations usually add needed room, and a bit more to make sure, and I'm pretty sure rarely shrink a house. Henry suggests that stamp duties also increase commuting, unemployment, productivity, and barriers to entering the housing market. They're a fly in the economic ointment and need to be mortined.
- **Potential actions/opportunities.** Build a portfolio of similar-style property of different sizes in the same area so that people can transfer within your portfolio at minimal cost. Design better granny-flat options. Work on governments to reform related transaction taxes. Keep an eye out on how land taxes may impact your business. Consider, again, moving from sustainability consulting to real estate.
- **Land tax** is proposed to replace stamp duties, consistent with the overall model of taxing what cannot be recreated (land, non-renewable resources, licensed markets) while maximizing its economic potential. The tax would be only on the unimproved value of the land itself, so as to not penalise improvements. However, Henry recognises that many groups, pensioners and farmers for example, may have valuable land with low incomes, so suggests using the income tax system to compensate low income earners for the land tax.

Transport

- **Make it really user pays.** Currently, two-thirds of Australian wealth is generated in the cities (sorry Twiggy), but that is hampered by congestion – a \$20.4bil impost by 2020, or about 1.5% of GDP – not counting the trauma some feel in peak hour or getting home for pre-school pickup. Unless you're careful, more roads are counterproductive: 50-100% of new capacity is filled by *new* road users within 3 years. So what do we do?
- Better charging for road use, as you'd expect from an economist. Our \$16 billion in road-related taxes basically pay for new roads, but not for their wear and tear, policing, \$15 billion worth of accidents and whatever value you want to put on 1,616 deaths. Those costs all come out of the general budget. The Henry insights are, first, that cars actually have *zero* impact on road wear-and-tear so that fuel taxes massively subsidise heavy vehicles, and second, that electronic mass-distance-location charging is now available for heavy vehicles...
- The Henry solution? User charges for heavy vehicles, an annual registration fee of about \$500 per light vehicle to give unlimited access to the public road network, a congestion charge for peak demand areas, and a greenhouse gas emission charge as part of a broader ETS or carbon

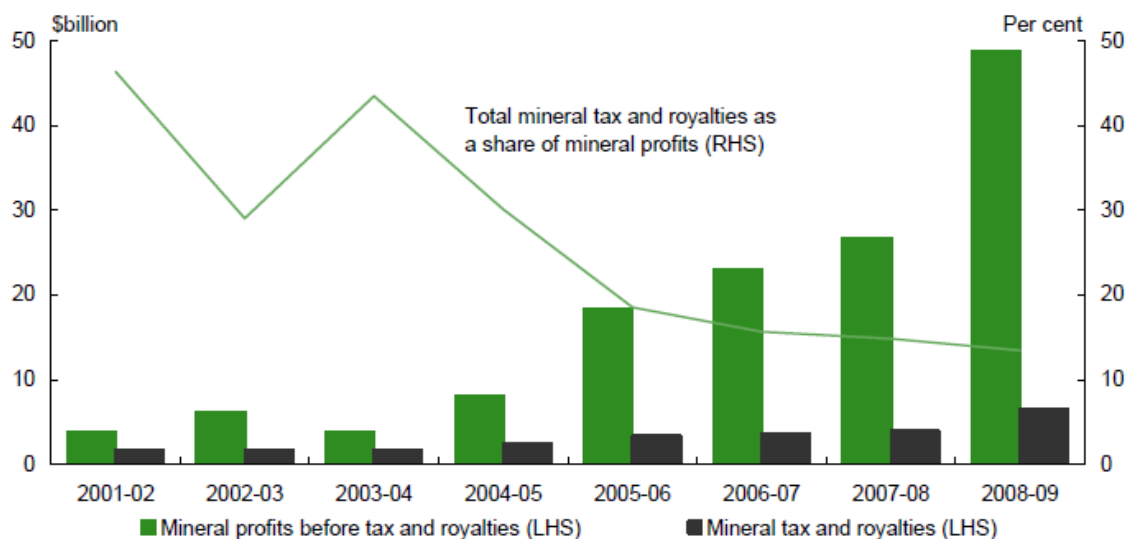
tax. These taxes would account for the social, environmental and economic costs of traffic, so all other fuel taxes should be abolished. As should stamp duties, those pesky bugs.

- It follows then that Henry also suggests abolishing taxi licence fees, other than those needed for safety and service of the taxi system. Plates worth up to [\\$477,000](#) would be a thing of the past, though the transitional compensation calculations would be fun. Anything that reduced the cost of taxi hire would be welcome, with taxis a regressive cost on the community: the poorest 20% of the community spend more than twice as much of their income on taxis as other Australians, because they are more likely not to have a car or live in areas poorly serviced by public transport.
- **Sustainability impact and opportunities.** Any shift from road to rail will help on emissions, road congestion, the essential restoration of our rail system, and so regional economies. The trade-off might be a day's delay in deliveries by rail. But frankly, I'm amazed by what gets to me overnight at little cost, and I'd be happy to wait an extra day and be able to drive on highways without risking yet another truck-horror fatality. Rail-based freight companies may stage a comeback, and corporates might encourage them with rail-freight preferences. Taxis would be more common and mobile, with more frequent and cheaper trips replacing airport carparks full of cabs. Who knows, there may even be a real challenge to the monopoly Cabcharge 10%. We live in hope.

Resources rent

- Each weekend edition of the *New York Times* consumes 250 hectares of forest – or 500 football fields in the measure I can picture best. So I shudder to think how many trees have died for the RSPT v.1, though not yet on par with the CPRS (dec'd). I'll be as brief as possible. The government's argument, flagged by the sledgehammer-named 'resources super profits tax', is that we/they want more of the cash. Though reasonable, as shown in the chart below, this is only Henry's secondary argument.

Chart C1-1: Mineral tax and royalties as a share of mineral profits^(a)



- **When an economist is a better politician.** Henry's main argument, which I'd imagine would be a lot easier to sell, is that tax (fiscal policy) may be a better way to manage the mining

boom than interest rates (monetary policy), as it would help to get the most value from finite resources, maintain a balanced economy, and not penalize the rest of us. He argues that the owner of a non-renewable resource – us – erodes its value if it is exploited either faster or slower than the optimal rate, calculated against the market's expected rate of return.

“Arguments for exploration and production faster than this rate can fail to recognise that resources kept in the ground will generate a better return for the owner if higher rents can be obtained in the future (due to future higher prices or lower exploration and production costs). Similarly, arguments to bring forward exploration and production to create jobs can fail to recognise that this may be at the expense of future jobs in the resource sector (as there is a finite stock of resources) and *may have an adverse impact on other sectors in the economy from which labour and capital are diverted.*”

- Each month, the Reserve Bank looks at raising interest rates to dampen the isolated effects of the mining boom, when the rest of the Australian and world economy is doing well to stay afloat. With mining accounting for just 1.4% of jobs directly and another 3.5% indirectly, it means that 1/20th of the economy is setting policy for the rest, while not delivering the best deal for either its developers or the resource owners. Which all suggests that the RSPT is a good idea, but like many others recently seems to be in the wrong hands to implement.
- Here is another case for better modelling and planning of the national environment, social and economic effects of major new investments or regional development. While each project may be worthwhile on its own terms, particularly to its promoters, collectively they may be counter-productive. Without wanting to undermine a thriving market-based economy, there is a point where responsible governments will take a national view. Accurate information from source broadly trusted is what is needed – if the adversarial system works in the law, a big if, it may not work in public policy. Such information sources are badly needed.

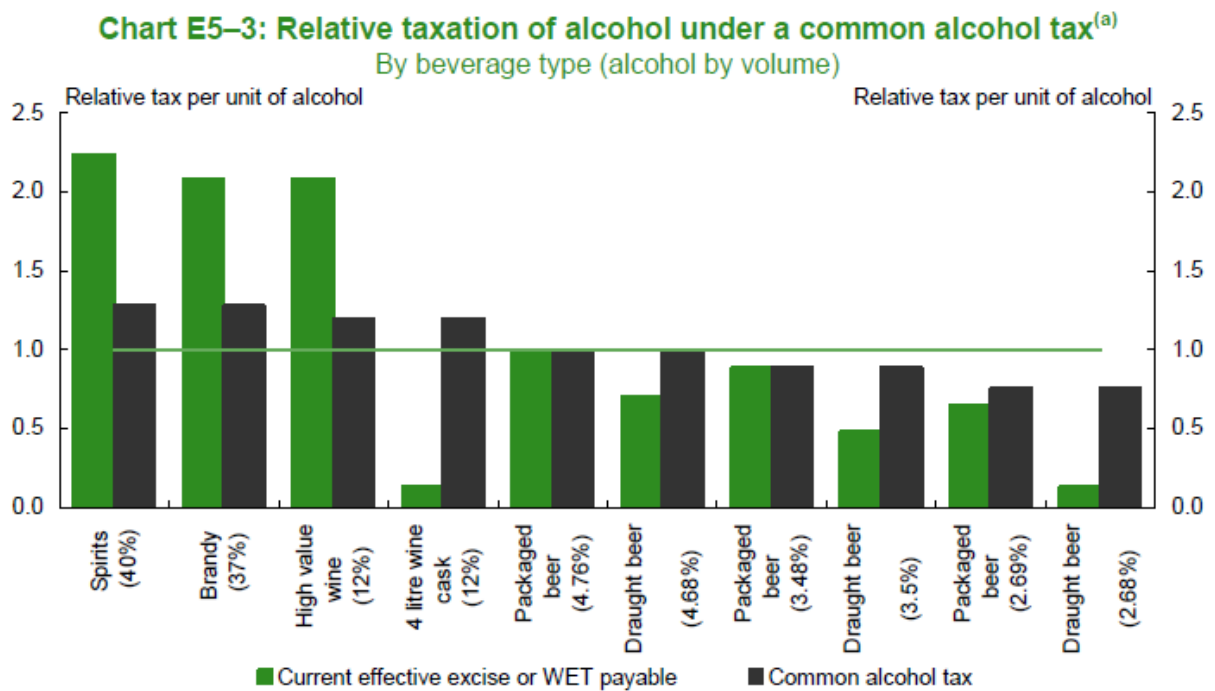
Not-for-profit organisations

- **‘Benevolent’ NGOs beware.** So you’re an NGO. Henry would like to simplify things for you. Which of the 40 pieces of legislation administered by 19 different agencies grants you your tax concessions? Your ‘public benevolence’ status is defined by the *Charitable Uses Act of ...er...1601* (the ‘Statute of Elizabeth’), so modern niceties like human rights, animal welfare, international aid and disaster relief need a separate application. But be wary. Henry assumes that “NFP organizations, like for-profit [ones], will seek to maximize their profits in support of their philanthropic activities”. So, tax exemptions on the commercial activity of NFPs should be removed, because they “don’t provide an incentive for NFPs to undercut the prices of their for-profit competitors”. But why would/should they? Orthodox economists struggle with any other model of firm performance other than profit-seeking, and use that assumption to support a range of findings. [Joke: How does an economist cross a river? First, assume a bridge.] However, NFPs will maximize their *social service* activities and expenditures rather than any profits from them, and pricing is set accordingly. Any *commercial services* are priced at market rates, because they’re intended to raise funds for the social services, and to do otherwise would cause a backlash by other market participants who might otherwise be friendly to the NGOs.

- Entertainment clubs be very aware.** Henry draws attention again to the obvious discrepancy of large mutual NFP clubs competing on a tax-exempt basis against commercial hotels and restaurants who do pay tax. Though tax-exempt, these clubs are not bound by the same rules as philanthropic NGOs, and “are free to spend their mutual receipts as they wish”. Where the only substantive activity of the club is to provide gaming, catering and entertainment to its ‘members’, “it is not clear that the wider community should entirely forgo tax on all of these profits, although some concession could be retained, particularly to support smaller [real mutual] clubs.” The discrepancies are highlighted by the clubs’ dependency on gambling (see further below). The 300 clubs without gaming averaged profits of \$18,000 in 2005 (the last year the ABS/Productivity Commission published data), while the 1716 with gaming did a little better: \$334, 000 on average.

Alcohol

- Proposals and rationale.** I love this chart. Henry advocates changing taxes from the current mess (green columns), to one based on alcohol content (black columns). Currently, expensive grog is taxed over 10 times per unit of alcohol than casks. And it’s the unit per alcohol that counts. The only rationale for alcohol taxes (beyond general consumption



taxes) is to reduce and pay for the social effects of alcohol abuse. So far as I know, no one binge drinks on Grange or Johnnie Walker Blue, and if they do I want to join them. So currently we make cheap grog super cheap to help out those “in need”. It’s a tax that if anything encourages binge drinking. Tax is a blunt instrument against alcohol abuse because it imposes a heavy cost on moderate sipping. Better policies would include advertising restrictions, doctor education, and especially upping the licence fees for the 10% of venues that are known to account for 50% of alcohol-related incidents. But if you are going to tax, tax on the alcohol content: the body processes 1L of water/hour and 12.7mL alcohol/hour, so our

drinks only stay around to do damage if they're over 1.27% alcohol. A 4.8% standard strength beer should therefore be taxed at 3 times the rate of 2.4% light beer [and a bad-tasting beer should be taxed at 6 times].

- **Sustainability impact.** Around 10% of Australians are at risk of long-term harm, at risk that is of joining the 2.5% who together consume 25% of our bar tab. We all know the health and social costs of drinking, on families as well as individuals, and the extent to which it pervades most of our social and sporting activity. Henry makes his tax proposals more to remove the inconsistencies which abound, but they would have a clear effect of making binge drinking more expensive. Perhaps, though, it does make sense to distinguish packaged and draught beer on these grounds – draught beer is meant to be served under responsible guidelines, while how people torpedo cans in their backyard is a private matter...

Gambling

- **Policy rationale.** If you include share market speculation (why not?) I may be one of the 15% of adults who gamble regularly. Of us, 10% are problem gamblers – that's 1.5% of population, or 310,000 people. Problem gambling is characterised by chasing losses, spending more money on gambling than intended, failing in attempts to stop, and losing time at work or study. As previously reported in the *Grill*, the average *annual* loss of problem gamblers is an astounding \$140,000. No surprise then that the Productivity Commission cites large debts, liquidated assets and misappropriated money as deeper indicators. Problem gamblers also suffer from "depression, stress, anxiety, lethargy, insomnia, poor nutrition, suicidal thoughts, increased caffeine and nicotine consumption, sweats, confusion, panic and ulcers". Apart from that they feel great.
- Taxing gambling is easy, so it makes up 9% of total State tax revenues. It could be more, as it's a perfect market to tax. Henry makes the point that because State governments restrict the supply of gambling services, the licence holders "make more profit than they would in a competitive market – that is, they earn economic rent". The government could tax 100 per cent of that rent and gambling companies would still offer their services, make normal profits, and offer investors an adequate rate of return on their investment.
- **Better options than tax.** However, taxing gambling more won't affect problem gambling because a gambler on a run isn't really rationalising that a 4-1 bet should be 4.3-1 and so thinking twice. They will still bet as much. Since problem gamblers make up 1/3 of gambling losses, they already account for 3% of total State tax revenue. Gambling taxes are also highly regressive, falling disproportionately on lower income groups. To reduce problem gambling, then, better options are banning advertising, limiting the size of bets, restricting opening hours, providing clocks and lighting, limiting credit and using e-card technology to track and remind gamblers of their losses.
- Welfare NGOs, the ones who see the family impacts of problem gamblers, plead with governments to enact these restrictions. But against public (State coffers) and private (listed gambling companies) self-interest, it's a tall order. Banks and retailers, who would benefit directly from reformed gamblers paying debts and buying what their families need, may find strong returns in the social investment of helping out.

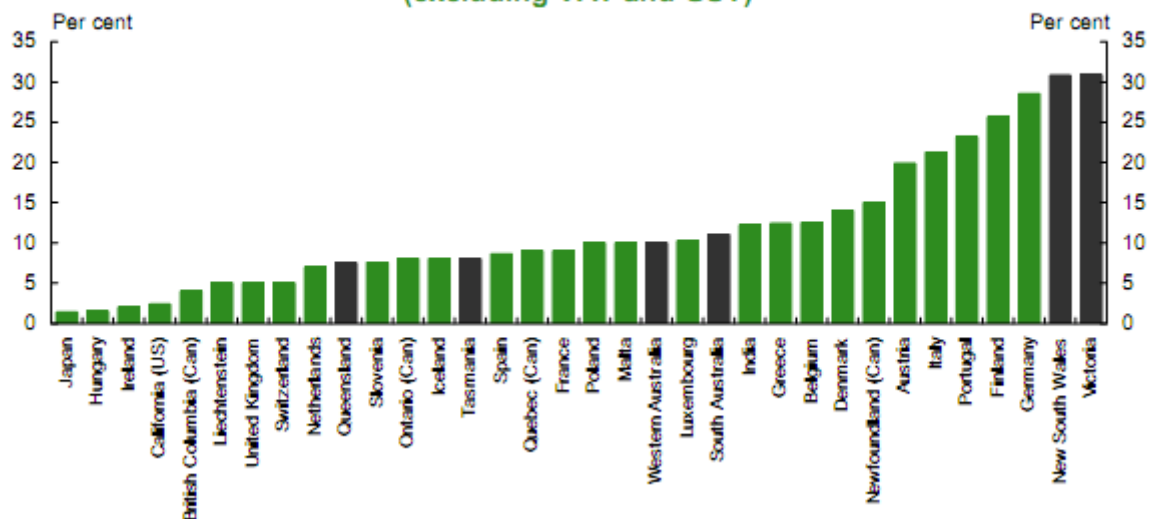
Tobacco

- Government intervention to restrict smoking is justified by its addictive qualities, its serious health impacts, its uptake by minors and the costs imposed on non-smokers. Taxes do work: a 10% increase in current taxes would reduce the number of smokers in Australia by 2.5% and consumption by 4%. There is room to act: our cigarette taxes are low compared to the OECD average, and indexed to CPI means that it is falling in real terms relative to wages.
- More importantly and uniquely in the world of taxation, a majority of smokers support an increase in the tax they pay, indicating that *most smokers want to stop and want help in doing so*. They need any help they can get: only 30% of those attempting to quit over a 5 year period are successful. Many of those trying are among the most vulnerable in our society: 17% of Australians smoke, compared to 50% of indigenous Australians, 37% of single mothers, and 64% of those with a registered mental illness (which says it all, really). The *average* starting age is 16 years, and 75% of smokers start before they turn 19.
- Any money saved on cigarettes will be spent on another, perhaps healthier, staple. There are many sectors to gain from restrictions on tobacco. Surprisingly, the jury is out on whether smoking actually costs the public health system money – the lower healthcare costs of non-smokers are balanced by the shorter lifetimes of smokers. An argument that lives only in an ethical void.

Insurance

- Whoever would have thought? Insurance taxes are bizarrely high in NSW and Victoria – over 30% of all premiums, compared to 7% in Queensland, 4% in California, 2% in Japan, 10% in India, and 8% in France, to quote a few: see chart, which excludes GST, so add another 10%.

Chart E8-1: International comparison of insurance taxes (excluding VAT and GST)



Henry is unable to identify the logic in this; quite the reverse. The higher premiums mean the insurance pool is lower, people who can least afford it are forced to self-insure, and levies such as the fire services levy are higher as they are borne by fewer people, and arguably by those who need the services least. There is no economic rationale for insurance to be any different to any other consumption: the GST is enough. Here is one area, possibly the only

one, where Henry supports the industry association in calling for tax reductions. All that needs to happen is for the fiscal fight of federalism to end ...

Environmental taxes and credits

- **Pricing externalities.** Henry stresses the idea that externalities or “spillovers” can work both ways. “An example of a negative spillover is where a river is polluted by inappropriate use of a fertiliser, causing harm to downstream users of the water. But spillovers can be positive too – a farmer who maintains native vegetation may deliver biodiversity benefits for the community, but will generally not be compensated for this service.” As these spillovers are not priced or priced poorly, “the environment is allocated inefficiently between its different uses, resulting in excessive environmental degradation.” Taxes can be used to address these spillovers.
- It’s a theme that continues in the politics around climate change. Taxes can be used to price spillovers, but Henry is the zillionth economist to confirm that a properly designed ETS is the best way of handling spillovers on greenhouse gases. “Market-based approaches allow the market to determine the lowest-cost means of abatement. Such approaches therefore provide the opportunity to deliver improved environmental outcomes at the lowest economic cost. They also provide strong ongoing incentives for investment in technology research, development and deployment, and in efforts to improve energy efficiency. [The] economic outcomes have often exceeded expectations as a result of market-oriented policy changes, as firms take up opportunities and incentives to innovate and improve productivity.” Another time, maybe.

A final word

The Henry Report, as with similar Productivity Commission reports and the like, are a rich vein of ideas and research on sustainability-related issues. While their final recommendations rarely make it through our poll-driven politics as a coherent body, there is ample material to support or counter a view or argument. It is hard to imagine an organisation that operates a business in Australia not being affected by what is covered here.

Should you wish to find out more about how such issues affect your business, please contact Dowse CSP. We can work with you to ensure that your engagement on policy, sustainability and ESG issues, particularly environmental and social issues, is pursued as an investment, with demonstrable financial returns. Call us.

The Grill is information and opinion from Dowse CSP, advisers on ESG, sustainability and related communication.

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