HENRY TAX REVIEW

THE CRIB NOTES

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Introduction: Bigger than five GSTs.

The Henry Tax Review has been nearly two years in the making.

Since 2008, Treasury Secretary Ken Henry and his panel have been reconsidering every tax and every line of Australia's two income tax acts, adding up to almost 6000 pages.

All of that analysis has now been boiled down into 1000 pages, and, according to the *Financial Review*'s John Kehoe, Henry recently likened his reform proposal privately to "five GSTs".

No wonder then that Treasurer Wayne Swan has had the tome in his hands since December last year, presumably crafting the government's politically pain-free response.

The Review's ambitious terms of reference state:

> The comprehensive review of Australia's tax system will examine and make recommendations to create a tax structure that will position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century and enhance Australia's economic and social outcomes.

So how did the government respond? And what does it mean for land tax, superannuation and the mining industry? Read on to find out.

The Henry Review, in a nutshell.

Crikey Canberra Correspondent, Bernard Keane, writes:

Expectations about the Henry Review centred on a document that would be anything but the "root and branch" analysis originally sought by the Government: rather, it would offer an array of small – though significant – reforms that would improve an already strong and relatively efficient tax system.

While those expectations haven't been confounded, this is a subtle and, in the long term, potentially very significant set of proposals that sticks closely to its goal of an efficient tax system and follows them rigorously, regardless of the consequences, over a 40-year timeframe.

What Ken Henry and his team have recommended is a far simpler tax and transfer system intended to encourage productivity, participation and economic growth, secure retirement incomes, make housing more affordable and reduce the burden of tax compliance for all Australians.

In particular, the Review wants government revenue to be based on four principal sources – personal, corporate, consumption and natural resources taxes – with no other taxes except those aimed at addressing social or economic costs. In its view, all other taxes – insurance taxes, payroll taxes, fuel excise, you name it – should be abolished.

There are few of the traditional big-ticket items from tax reform processes of old, such as big new taxes. Instead, the Review has run through the entire state and Commonwealth taxation system to work out what, if we were designing it from scratch, we should change in order to improve a system that, while reasonably strong, is rife with perverse incentives, inefficiencies and inequities.

The Review team was charged with providing a long-term reform blueprint, and they've come up with one.

Key Recommendations:

The Henry Review makes nearly 140 recommendations across eight key areas. The highlights include:

Supporting productivity, participation and growth:

- Long-term reduction of company tax toward the lower end of the OECD average, initially aiming at 25%
- Build work incentives into income support payments via targeted means tests
- Better support for child care
- Streamlining the tax treatment of investment, particularly for small business
- Improving road investment through road user charges, including congestion charges, that better reflect usage
- Volumetric taxation of alcohol
- Significant rise in tobacco excise

Simpler income tax system:

- A higher tax-free threshold (~$25,000 pa)
- All transfer payments to be tax-free
- Two-step tax scale, with additional charges like Medicare integrated
- Rationalisation and reduction of income tax deductions and a fairer, work-supportive transfer system
- Three-level approach to transfer payments: pensions for aged, disabled and carers; lower-rate allowances for people of working age and assistance for young people and students
- Simplified family payments system
- Removing inefficient state taxes
- Removing state taxes like payroll taxes with a single cash flow tax, with revenue allocated to state services

Land taxation:

- Reform the taxation of immobile production factors like land, by removing or replacing resource royalties
- Replace state land taxes with a land tax system applying to all types of land

Retirement incomes:

- Overhaul superannuation taxation treatment to make it more consistent with overhaul income taxation, with continuing assistance for workers over 50
- The development of longevity income products, including a Government product

Housing:

- Boost rental assistance
- Streamline land taxation to remove disincentives to property investment
- Over the longer-term, make treatment of rental investment for personal income tax purposes more neutral
- Review infrastructure charges to remove impediments to housing supply

Simplifying the taxation system:

- Provide a one-stop shop for taxpayers on all their income and taxation information
- Most personal taxpayers should have a pre-filled tax return
- Greater involvement by and feedback from taxpayers in the taxation system

How did the government respond to the Henry Review? Um, it didn't.

Crikey Canberra Correspondent, Bernard Keane, writes:

"How did they ever make a film of *Lolita*?" was the tag line for Stanley Kubrick's adaptation of the infamous novel. As anyone who had read it knew, the answer was of course that they didn't. In the great Hollywood tradition, the book and the film didn't have much to do with each other. There was much in the novel that never made it into the film, and much in the film that had nothing to do with the novel.

And so it was about an hour into yesterday's lock-up (well, it took me an hour, brighter sparks probably worked it out much more quickly) that we realised that we'd been lured in on the basis that the government was unveiling its response to the Henry Review, but the response bore little resemblance to the Review. The physical documents told the story: the Review documents were a couple of inches thick, the response was four booklets and some press releases in a nice sleeve. And half the government's announcements weren't in the Review.

That's not to say yesterday's announcements weren't solid reforms. I suggested a super profits tax a couple of years ago, targeted at the big banks, given that mining profits had slumped in the face of the GFC. The return of high commodity prices restores the case for levying one on the mining sector.

For a while I've been suggesting retirement incomes would be boosted by forcing the superannuation industry to remove commissions, rather than the Keating option of moving the Superannuation Guarantee to 12%. The government has instead done both, but phased-in over an extended period.

That meant there was at least one Liberal happy about yesterday – John Brogden could scarcely contain his glee as he fronted up to present the Investment and Financial Services Association's response to the package.

It also means that, if the commodities boom stays on track, there'll be an extended, albeit small, counterweight to demand-driven inflation as workers are compelled to progressively move more of their income into superannuation.

The Opposition's response – not great either.

After the opposition's reaction on super yesterday and today, it's clearer than ever that they simply don't get it, and never have. Opposition Treasury Spokesman Joe Hockey, flanked by Tony Abbott and Andrew Robb, gave a good press conference yesterday afternoon – there was much to agree with in his description of the government's response, or lack thereof, to the Review.

But the Libs (former senator John Watson honourably excepted) seem only able to see compulsory super as an imposition on business, rather than employees' contribution to their own retirement income. Maybe it's because Liberals tend to the view that employees are just one more cost input among many for business, and any government interference there amounts to taxation.

Perhaps that's why the Howard government's superannuation reforms amounted to little more than trying to push some working Australians' superannuation back into the corporate sector via superannuation "choice" and lining up an array of handouts to high-income earners.

Still, if the opposition thinks it's such a massive tax grab, they can always block the package. They're blocking everything else this government does. They correctly accuse the government of being gutless in refusing to tackle reform, but then block what reform it does take and refuse to say what reform they support. The only tax policy we have from the Coalition three months out from an election is one to raise business taxes.

If the government isn't credible on economic reform, the other mob aren't either. What did we do to deserve this Parliament?

What will the resources tax mean to the economy?

Crikey Canberra Correspondent, Bernard Keane, writes:

Is the Resources Super Profits Tax -- that's RSPT for you Aretha Franklin fans -- very different from the tax slug on medium and large businesses proposed by Tony Abbott to fund his paid parental leave scheme? That's the one, you'll recall, that may have looked like a Great Big New Tax, but was actually an "investment in human capital".

Having castigated Abbott for his proposed attack on successful businesses, we should run the same ruler over the RSPT. What damage will it do? Who will really pay?

It's similar in being a tightly targeted tax. The paid parental leave slug would have only applied to a few thousand of our most profitable medium and large companies. The RSPT will target a far smaller number of big mining companies. Both in effect single out a section of the corporate sector that, while powerful, are not exactly popular with voters (that makes Abbott's comments yesterday about Rudd demonising the mining sector a bit rich). And both use the largesse reaped from it for political purposes -- in Abbott's case, to try to outbid the government on parental leave, in part by perpetuating the sort of middle class welfare that became a byword for the Howard government; in the government's case, to fund a business tax cut that strongly targets small business, a sector the government is keen to keep on side.

But the comparison ends there. Abbott's tax slug would have been passed on to consumers, and to shareholders, through higher prices and lower dividends. The RSPT will be passed on to mining companies' consumers -- most of whom are overseas -- shareholders -- many of whom, again, are overseas, particularly in the case of BHP-Billiton, Rio Tinto. Indeed, much of the RSPT will be paid, one way or another, by Chinese interests.

Hands up anyone, Clive Palmer apart, who has a problem with that?

That the RSPT will fund a permanent cut in the corporate tax rate is a mixed blessing. Our reliance on corporate tax has increased in the past decade courtesy of successive income tax cuts. This left our fiscal base more exposed to the impact of recessions, when one arrived, than it would otherwise have been. Reducing corporate tax will go some way to remedying this. The problem is that the RSPT is a potentially volatile tax base, dependent on commodity prices. Wayne Swan was asked about this yesterday and pointed out that the $9 billion a year the RSPT would generate about 3% of government revenue. Moreover, it's a fair bet commodity prices are going to stay strong for an extended period, driven by Chinese and broader Asian growth.

But if that bet doesn't come off, the design of the RSPT -- it hits super profits hard, but it also treats more marginal resources projects, and exploration, more generously -- will end up costing taxpayers a lot of money.

A more stable base, such as an expansion of the GST would have been preferable. The best option would have been to remove the moronic food exemption foisted on the Howard government by Meg Lees, which has been costing taxpayers and businesses ever since.

The last word should probably go to Mitch Hooke, of the Minerals Council of Australia. Hooke is an almost perfect indicator of good policy. If he's against it -- think a charge on carbon emissions -- then it's usually a pretty good idea. If he gives it the thumbs up -- for example, Workchoices -- then any sensible government should drop it cold.

Hooke, in his default setting of high-dudgeon bitching and whining, yesterday claimed that the RSPT "will destroy value, slow investment and increase sovereign risk in the Australian minerals industry".

On past form, that guarantees it should become an important component of out future tax system.

So mining companies get slugged… they're multinationals anyway.

Stephen Mayne writes:

While John Howard and Peter Costello did leave the federal Budget in structural deficit with all those tax cuts, you can always rely on a Labor government to crank up the spending and worsen the fiscal outlook.

However, at least most of the Rudd government's new initiatives have been one-offs such as pink batts and the building education revolution.

And as most Western countries are now discovering after the GFC, budgets are severely in the red and no-one wants to go the way of Greece.

Which brings us to the extraordinarily comprehensive range of revenue-raising options presented by Ken Henry's Review and the selection of one single monster tax to save the Budget over the medium term.

An extra $6 billion-plus a year in revenue from the Resource Super Profits Tax is no small beer but that also relies on some fairly heroic assumptions about commodity prices holding up. People forget that Australia suffered continuous terms of trade deterioration for almost 50 years until the China-driven boom really kicked in over the past decade.

With a market capitalisation of $120 billion, Rio Tinto isn't exactly about to go broke. And BHP-Billiton is trucking along quite nicely with a market value of $228 billion.

Robert Gottliebsen's *Business Spectator* column yesterday was headlined: "Are we pushing BHP and Rio offshore?"

Frankly, London-based Rio Tinto is effectively a foreign company already, given that Australians only own about 13% and there are just three Australian-based directors on the 14-person board.

If the company had followed the advice given at the 2008 AGM and moved its global headquarters to Australia whilst wrapping itself in the flag, it wouldn't be such an easy target now.

Even BHP-Billiton is now down to Australian ownership of about 40%, largely thanks to the folly of former chairman Don Argus giving away 42% of the company to Billiton shareholders in 2001 for a bunch of assets that would struggle to deliver 15% of the value these days.

The main reason a Resources Super Profits Tax works best for Australians is that more than 80% of our resource profits go to foreign owners. The North West Shelf is only about 10% Australian owned and we've got virtually nothing in Mt Isa since MIM fell to Xstrata in 2003.

While BHP and Rio together have Australian operations worth almost $200 billion, there is another $200 billion-plus of projects down under controlled by the likes of Xstrata, Mitsui, Mitsubishi, Marubeni, Shell, Exxon-Mobil, BP, BG, Chevron, Anglo-American, Peabody, Conoco-Philips, Apache Energy, Alcoa, Newmont and the Chinese government. That's another 16 players, all of which would have Australian resource investments worth more than $10 billion. Each!

It is an indictment on the directors' club and institutional shareholders that Australia has not been able to develop and retain ownership of a major global player in oil, gas or gold, but at the very least we should claw back some of the super profits going to the foreign players who are doing it for us.

Such a tax will also substantially improve the current account deficit because the $40 billion-plus a year currently being repatriated from Australian projects to foreign investors will be reduced somewhat.

We've already seen the Fortescue Metals Group team led by Andrew Forrest rail against the new super profits tax, but besides Twiggy and his 31.5% stake worth a tidy $4.5 billion, there are very few major Australian investors on the FMG top 20.

While the miners will gripe about the total tax bill at the top of the cycle, the state-based revenue regimes still apply at the bottom of the cycle when projects are making losses.

This will make the federal Budget even more susceptible to wild cyclical swings, but if the total tax take is substantially up over time, then it doesn't matter so much.

All up, this is a very good initiative by the Rudd government and Tony Abbott should show some consistency with his anti-immigration policies by supporting a move that slugs huge foreign companies but benefits little Aussie battlers.

Why is the government ignoring land tax reform?

Gavin R Putland from the Land Values Research Group writes:

In contrast to the Henry report's advice that payroll tax be eventually abolished (recommendations 55 and 57), the Rudd government has decided to increase its own payroll tax. No, really. Australia's federally mandated, employer-funded 9% superannuation contribution is equivalent in every way to a federally funded 9% contribution, paid for by a 9% federal payroll tax.

By itself, a federally funded super contribution proportional to income would be pilloried as upper-class welfare. By itself, a payroll tax would be seen as just about the stupidest way to pay for something. Put the two together, and you have such a great vote-winner that the government, without any supporting recommendation in the Henry report, wants to ramp up the tax to 12%.

Even at 9% the tax is patently worse than the much-ridiculed state payroll taxes because it has a higher rate and no thresholds. But by implementing the superannuation guarantee as a compulsory "private" transfer, the government keeps it out of the federal Budget and thereby hides the magnitude of its intervention and the crass stupidity of the equivalent tax.

Meanwhile, the government studiously ignores Henry's recommendations 51 to 54, which call for an all-in land tax with a threshold and progressive rates, levied on value per square metre rather than aggregate value. The per-unit-area basis avoids

distortions related to aggregation and ensures that most agricultural land would be below the taxable threshold.

It strikes me that such a land tax would be particularly suitable for on-budget financing of the superannuation guarantee, for the following reasons:

(1) Taxes that are politically unacceptable when used for general revenue can become acceptable when hypothecated for popular causes.

(2) Few causes are more popular than the financing of retirement incomes, because everyone hopes to retire.

(3) The main political problem with an all-in land tax is that it offends retirees who are asset-rich but income-poor, and who have based their retirement plans on the absence of such a tax. But if the tax were earmarked for superannuation, then obviously those who have taken their super would be exempt, because including them in the net would lead to churning. Problem solved.

(4) The popularity of property investment shows that rising values of land are already widely seen as a means of financing retirement. Funding the superannuation guarantee out of land tax would merely make the system official and universal. Surely a funding mechanism that is a virtue when practised by some cannot be a vice when practised by all.

If the superannuation guarantee were on-budget, there would be no support for funding it out of a 9% or 12% federal payroll tax. But I cannot resist pointing out that such a tax, imposed at the federal level, would at least be constitutional. State payroll taxes are another matter.

Under s.90 of the Constitution, only the federal parliament can impose duties of excise. If, as held by the majority of the High Court in Ha v. NSW (1997), an excise is "an inland tax on a step in production, manufacture, sale or distribution of goods", then payroll tax would seem to be an excise in so far as it applies to labour expended in "production, manufacture, sale or distribution of goods".

If, as held by the minority in the same case, "A state tax which fell selectively upon goods manufactured or produced in that state would be an excise duty", then payroll tax would seem to fit that definition in so far as it falls on goods, especially as the same judges added that "Whether a tax which falls upon locally produced goods discriminates against those goods in favour of imported goods is a question of substance, not form".

It might be argued that payroll tax does not specifically target goods as opposed to services. But neither does the GST, which is imposed at the federal rather than the state level because it is assumed to be an excise!

Payroll tax is not the only unexploded constitutional ordnance in the present tax system. Stamp duties on new vehicles (recommended for abolition by Henry) are also arguably duties of excise, while the collection mechanisms for GST and personal income tax would appear to violate s.82 of the Constitution, which says: "The costs, charges, and expenses incident to the collection, management, and receipt of the Consolidated Revenue Fund shall form the first charge thereon ..."

All of these constitutional threats can be removed with little political difficulty, no loss of revenue, and huge savings in compliance costs. But the legislators, in my experience, don't want to know. I am therefore inclined to think that the most promising venue for meaningful tax reform is the High Court.

Why the Henry Review isn't super news for low-income earners.

Eva Cox writes:

One serious omission (of many) from the government's response to the Henry review is any sign of the adoption of the principles that Henry states about the tax transfer system signalling the national views on more than just economic goals.

The many areas of increased fairness and transparency in the two systems were ignored, so government promises are not promising.

We've not seen any acknowledgment of the areas that would have benefited women, and other low income earners, for example — facilitating higher female workforce participation through more affordable care and better integration of the tax and welfare payment systems. I don't agree with work testing payments when a child turns four, but the income tax exemption of payments would make it easier to move from care to paid work.

The report was used oddly to push some non-recommended ideas. For instance, Henry recommended against the rise to 12% of super, as it was not needed by those on higher incomes and would not specifically assist low income earners. The Review's suggestion was that contributions be taxed as income, i.e. at the recipients' current tax rate. This would have created better equity and netted additional government tax income as higher income recipients would have paid their fair share rather than using super as a form of tax avoidance.

The raising the super guarantee level to 12% is a sop to the super industry, the ACTU, and a return to Paul Keating's dream. However, it ignores the serious questions of equity that make extra super not particularly desirable for those on low and intermittent incomes.

The small rebate, proposed for refunding "up to $500 p.a." for those earning under $37,000, is a small, inadequate compensation for the other tax disadvantages of the super tax concessions. While it will just cancel their 15% tax on contributions, which often unfairly exceed their average tax rate, but doesn't give them nearly the 15% to

30% beneficial tax advantage still available to contributions of those in the higher tax brackets.

In addition, many of the women who hold these lower level jobs will be likely to end up paying for their contributions in lower wage rises as they are less likely to be able to negotiate higher pay rates. Employers will want to hold pay rises to fund the admittedly slow but inevitable rises in super from 2012, so the gap between low-paid workers and the rest will increase.

One argument Henry put against raising the super contributions is that lower income earners mostly need the extra 3% in wages for expenses now rather than in retirement. However the delight of the super industry and confusion in the minds of most recipients will confound the message and inequitable super industry will continue to flourish. The public subsidies for so-called self-funded retirees will continue to be often more generous than giving them the aged pension!

The small business changes may benefit some, but the reduction in company tax will benefit big business and leave less to redistribute. The many other interesting Henry proposals for greater equity in housing and other forms of wealth accumulation await further attention. The current announcements please few as they are a gutless response to an interesting, if not always pleasing, tax review that deserves more close attention.

The philosophical statement of what makes a good tax and transfer policies has been ignored, a few unthreatening cherries being picked with the resources industry profits being cast as the big bad wolf the government pretends is threatening our national wellbeing. This allows them to claim they are doing something good! We await the Budget for more action but not with high expectations.