IN SIGHT

VICTORIAN COUNCIL OF SOCIAL SERVICE ISSUE 4

FAIR SHARE
THE TAX EDITION

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FAIR SHARE

INSIGHT

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VCOSS raises awareness of the existence, causes and effects of poverty and inequality, and contributes to initiatives seeking to create a more just society.

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Disclaimer: The opinions expressed by our contributors do not necessarily reflect VCOSS policy.

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EDITORIAL.

Few people, perhaps, have said it better than billionaire investor Warren Buffett did recently in the *New York Times* about the current approach to economic turmoil in the United States:

"Our leaders have asked for 'shared sacrifice.' But when they did the asking, they spared me. I checked with my mega-rich friends to learn what pain they were expecting. They, too, were left untouched.

While the poor and middle class fight for us in Afghanistan, and while most Americans struggle to make ends meet, we mega-rich continue to get our extraordinary tax breaks… These and other blessings are showered upon us by legislators in Washington who feel compelled to protect us, much as if we were spotted owls or some other endangered species. It's nice to have friends in high places."

Buffett wasn't being cynical, he was calling on US lawmakers to crack down on some of the spoils that wealthier people are showered with – unfairly, unnecessarily, and unproductively.

That's what we're saying too, in this special national *Insight* edition on tax reform which is being published in the lead-up to the Federal Government's National Tax Forum on October 4-5, although our focus is not solely on the 'mega rich' but on inequity across the board, and not just on the forum itself but for the months and years ahead.

Tax is not usually a policy area inhabited by state-based bodies like VCOSS, beyond state levies like stamp duty and land tax. But we – and our members across Victoria – see the impact of the federal tax system every day, not just in the revenue it raises to fund services to address disadvantage, but – as the contributors to this edition point out - how it actually causes or exacerbates disadvantage.

We see that most obviously in the crisis in housing – with many low-income households struggling to afford a roof over their heads because tax breaks have fuelled rampant speculation, while million-dollar homes become effective tax shelters for high income earners. But it is evident across the system, from the personal income tax breaks which allow higher income earners to 'opt' for a lower tax scale to the hidden 'wealth welfare' of the superannuation system, which sees one-fifth of the annual value of super tax breaks accrue to the top 5 per cent of earners, while low part-time wage earners do not benefit at all.

These are the sorts of issues that those concerned about social justice want on the table at the National Tax Forum, which will bring together 150 representatives of the community, business, union, finance and academic sectors to consider: *Tax reform: next steps for Australia*.

No-one should hope perhaps for major packages or consensus to emerge from a two-day meeting. But we agree with the Australian Council of Social Service (ACOSS) that the forum is an important opportunity to re-open a debate that shut down too early on the review on Australia's Future Tax System led by former Treasury Secretary Ken Henry. The sector did not agree with all that Henry recommended, but his review provided high quality analysis of key problems and solutions and, as a nation, we have barely scratched the surface of many of its recommendations.

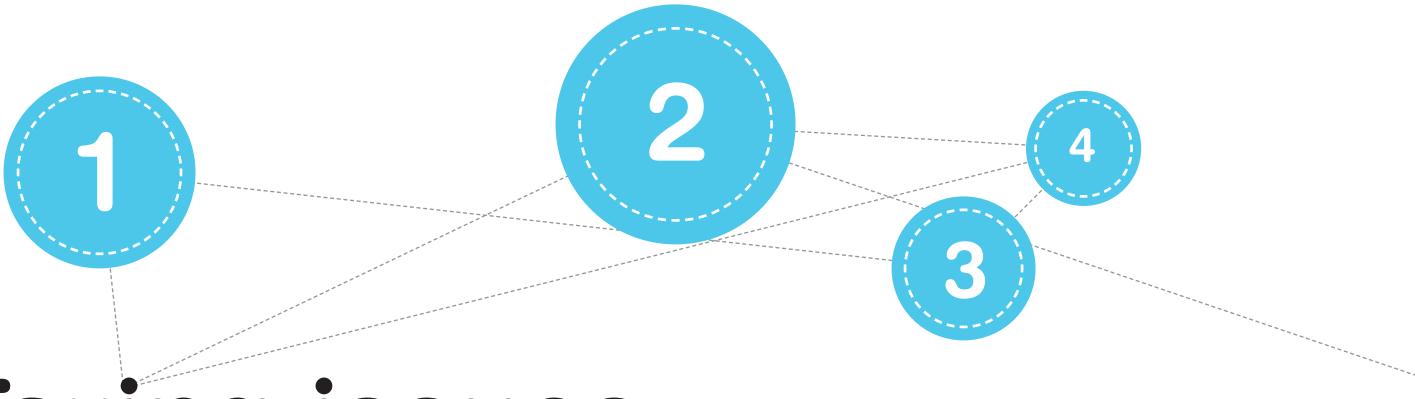
In the following pages, Cassandra Goldie, Julian Disney, and Peter Davidson lay out what ACOSS and the Community Tax Forum – an important collaboration set up in 2008 by ACOSS, the Australian Council of Trade Unions, Consumers' Federation of Australia and Australian Conservation Foundation – see as the most pressing areas for reform.

In further discussion, Saul Eslake and Sarah Toohey look at how housing taxes create and exacerbate inequity, Miles McGregor-Lowndes and Cameron Rider explore the impact of tax measures for and on the sector itself, Mark Henley discusses the pros and cons of so-called 'sin taxes', Simon O'Connor examines different models for funding social and environmental infrastructure, and our Vox Pop section asks 'what was the great social justice achievement of the tax and transfer system and what's the one that 'got away'?

We thank ACOSS and the Community Tax Forum, particularly Julian Disney and Peter Davidson, for their collaboration, support, and contributions and hope that this edition helps to build more interest in and support for tax reform that produces a fairer share for everyone.

Cath Smith
VCOSS CEO

September 2011



Taxing issues

Why does tax reform matter to the community sector, beyond that it allows sufficient revenue to be raised for programs and services? Australian Council of Social Service (ACOSS) CEO Cassandra Goldie outlines how tax can change the way disadvantage is caused and addressed, and what we can hope for from the Federal Government's National Tax Forum.

Why is ACOSS interested in tax reform – and why is it an issue that the community sector should be fully involved in?

Firstly, we need an adequate revenue base to fund community services and income support payments in future years, which will become more costly as the population ages. The largest and one of the most equitable taxes is the personal income tax, but it will not be capable of funding essential benefits and services in future unless its 'tax base' is repaired by closing off opportunities for people to avoid paying tax at the appropriate marginal rate. The most efficient and fairest way to strengthen public revenue is to tax different forms of income more consistently by closing off tax loopholes and shelters.

Secondly, the distribution of income and resources in the community is very much influenced by the tax system and, of course, the income support system. Despite all the myths around taxation, the present system in Australia actually raises a relatively low level of tax overall – our total tax revenue is in the lowest-third of the 30 OECD countries. But we raise it unfairly. Those on the highest incomes can generally avoid paying tax at 45 cents in the dollar (the highest rate) if they are well advised. At the other end of the income scale, serious anomalies in the income support system mean that single adults on the Newstart Allowance are receiving $128 less per week than someone on a pension. That's not based on relative need, it's an historical anomaly based on a perception that people on allowance payments are 'less deserving'.

The third reason we're interested in tax reform is that the tax system has an impact on behaviour. We hear all the time about tax having to provide incentives to work, but it also contains a raft of incentives to invest money in one place rather than another. That is a major cause of housing unaffordability in Australia and increases the risk of speculative bubbles in investment in assets that can cause great economic harm, as we have seen recently in the United States and Ireland, for example.

A fourth reason is how the community sector itself is taxed. Currently the tax treatment of charities and community organisations is complex and inequitable, riddled with historical anomalies and inequities. For example, an organisation that provides emergency relief directly to poor people can get the full range of tax concessions for charities, but an organisation that advocates on behalf of poor people cannot.

So ACOSS will be participating in the Federal Government's October tax forum and continuing our long-term work in tax policy with two major goals in mind:

- to seek to resolve the problems identified above, and
- to demonstrate that the community sector's interests aren't confined to the quality of community services or the level of benefit payments enabled by tax, but that we understand that the economic policy issues around tax reform have just as much impact on the lives of the people we're concerned about.

> *"The community sector's interests aren't confined to the quality of community services or the level of benefit payments enabled by tax. We understand that economic policy issues around tax reform have just as much impact on the lives of the people we're concerned about."*

WHAT DO WE WANT?

The Henry Review – or as it's more formally known, the Australia's Future Tax System report, handed down in 2010 by former Treasury Secretary Ken Henry - was the product of two years of intensive discussion amongst tax and social security experts. It provides a solid framework for reform over the next decade, and includes many proposals that we have long advocated. That now needs to be converted – by both government and community – into a series of viable reform packages.

But we have to be patient and strategic. It is one thing to develop the ideal model of income tax; getting reform through Parliament is tougher. We will focus on four key problems that concern the community, which reform of the tax and income support reform could help resolve:

1. Personal income tax (see breakout on pp8-9)
2. Adequate and equitable retirement incomes
3. Social security reform
4. Distortion of investment decisions

Adequate and equitable retirement incomes

Low and middle income earners approaching retirement are increasingly concerned about having adequate retirement incomes and whether good quality government-funded health, community and aged care services will be available when they need them. Younger generations are increasingly concerned that they will be called upon to meet those costs.

The present superannuation system is poorly designed to meet the retirement income needs of lower and middle income earners because tax breaks for super are skewed heavily towards those in the top tax brackets – fifth of their total value goes to the top 5 per cent of wage earners, and half to the top 20 per cent. Those on the lowest wages do not benefit at all from the tax breaks, and indeed pay tax at a higher rate on super guarantee contributions than on their wages. There is a strong case for restructuring superannuation tax breaks in favour of those on lower incomes – who need the most support to save for retirement and are the least likely to do so without strong incentives (see pp25-27).

While the overall cost to governments of population ageing is relatively low in Australia due to our targeted income support system, future governments will find it hard to fund health and community services, and will increasingly resort to user pays funding models, unless those mature age people with a capacity to pay income tax do so.

Currently less than a quarter of people aged over 65 pay income tax. This is partly because their incomes are often too low but also because those who are relatively well-off can avoid doing so. For example, a 55 year old in a high tax bracket can save considerable tax by churning their earnings through super accounts and taking advantage of age-based tax offsets – thus cutting their tax rates from 30-45 cents in the dollar down to 15 cents or less. People can thus take advantage of tax breaks intended to encourage retirement saving without saving anything at all! One reason such inequitable and antiquated tax breaks survive is that the system is so complex that only those who can afford professional advice understand it.

Social security reform for people of working age

The present division between 'pension' and 'allowance' payments is based on the old moral notion of the 'deserving and 'undeserving' poor. Thus, people who are deemed 'able to work' (unemployed people) 'deserve' lower payments than those who have disabilities or caring responsibilities who are therefore 'unable to work'.

These boundaries are increasingly fluid and we no longer assume that parents and people with disabilities are 'unable to work'. Yet the social security system is still lost in a previous era. Unemployed people currently receive $128 per week less than an age or disability pensioner. This gap is growing every year due to different indexation arrangements. The single age pension rose by $32 per week in 2009, but unemployed people, sole parents and students were deemed less worthy and missed out.

The differences in social security payments are arbitrary and not based on actual living costs. For example, most research on poverty and deprivation concludes that unemployed people and sole parents on income support face a high risk of financial hardship, yet they receive among the lowest payments. The basis for the increases in single rates of pension that followed the 2009 Pension Review was that the living cost of a single pensioner was typically at least two thirds that of a couple. Yet this relativity was not extended for sole parents or single unemployed people or students.

Over the last decade, the position of those people of working age on pension payments has become less secure, as governments have taken advantage of the gap between pensions and allowances to shift people to the lower allowance payments. The 2006 Welfare to Work policy diverted people deemed able to work at least 15 hours a week from the Disability Support Pension (DSP) to Newstart Allowance, and sole parents whose youngest child was over seven years of age from Parenting Payment to Newstart Allowance. The latest Federal Budget further restricted access to Parenting Payment for many sole parents with older children. Access to disability pensions is increasingly closed off to new entrants and those already on the DSP are subject to vilification in the media over so-called disability 'fraud'.

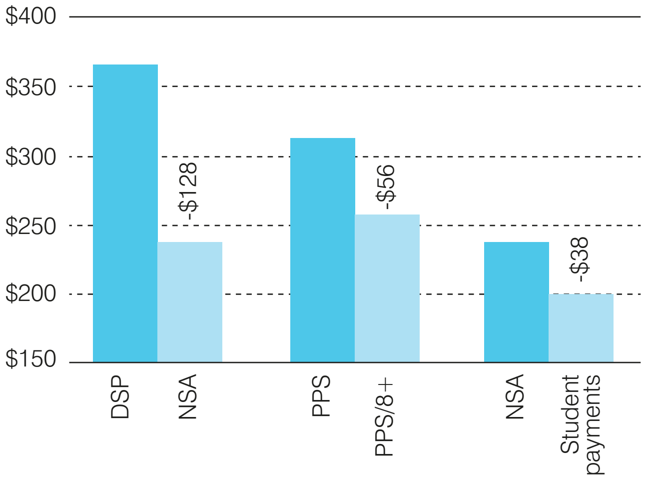
These anomalies are inequitable, entrench poverty, and are one of the main disincentives for people on pension payments to seek paid work. There is a widespread fear that if people leave the pension system they will not be able to return to it if they need income support in future, and will have to survive on the $34-a-day Newstart Allowance.

ACOSS is seeking structural reform of working age income support payments that equalises the base rates of payment and supplements this with additional payments for people with higher living costs,including the costs of a disability and caring for children alone. Similar proposals are being implemented in the UK and New Zealand.

The Henry Review stopped short of major structural reform but did recommend that single people on Allowance payments receive the same increases as pensioners (currently worth around $50 per week) and that allowances and pensions for people of working age be indexed in the same way, based on wage movements.

We also seek better Rent Assistance to improve housing affordability and the easing of some of the most severe personal income tests to improve work incentives. In particular, the 60 cents in the dollar taper rate for Newstart Allowances discourages many parents and people with disabilities who have part time work requirements from seeking such employment. The latest Federal Budget proposes to ease the Newstart income test for sole parents, but the same argument applies to people with disabilities and partnered parents who are required to seek a part time job.

Rates of payment for singles June 2011 ($pw)



DSP – Disability Support Pension; NSA – Newstart Allowance; PPS – Parenting Pension (single)

A person who moves from Disability Support to employment and later loses the job can lose $128 per week if they end up on Newstart.

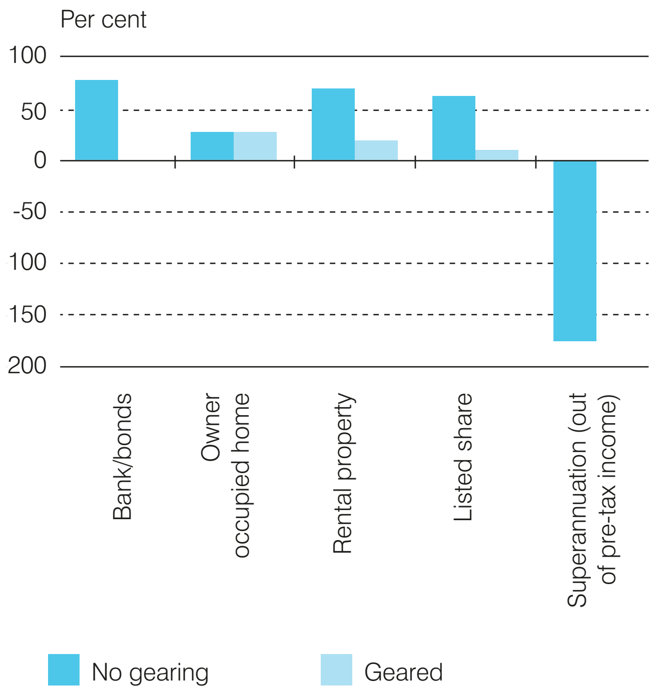
When the youngest child of a sole parent turns eight, the family loses $56 per week for the same reason, and when an unemployed early school leaver starts to study full time to improve their job prospects, they stand to lose $38 per week as they move down to a student payment.

Distortion of investment decisions

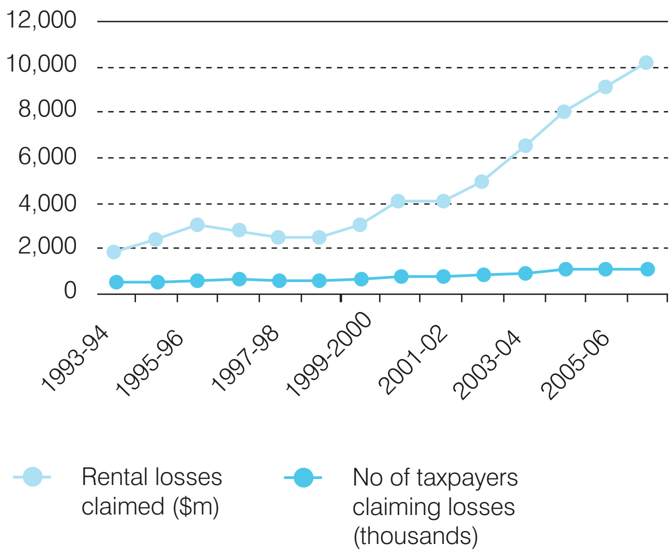
A further problem that needs attention is the way in which the tax system distorts investment decisions and, as a result, makes housing unaffordable and increases the risk of asset bubbles in the economy, posing a threat to Australia's economic development.

Over the last decade or so, there has been no shortage of investment in Australia, including from overseas. The argument that Australia is 'uncompetitive' as an investment destination because of our income tax rates for individuals and corporations doesn't hold water. Investment decisions are based on many other factors apart from tax including political stability, sound physical and social infrastructure and a well educated population. The problem is that our tax system encourages inefficient investment. A good example of this is the concessional treatment of capital gains, compared to other forms of investment income like bank interest. Capital gains are only taxed when an asset is sold, and since 2000 has only been taxed at half the normal rate (in the case of individual investors). This encourages people to invest in property and shares and other assets that appreciate in value. Combined with the effects of 'negative gearing' – where individuals invest in real estate, agricultural schemes or shares and use their investment losses to offset tax on their other income (especially wages) – this has encouraged an explosion of speculative investment in property, and to a lesser extent shares.

Real effective marginal tax rates on different investments by a high income earner



Losses claimed on rental properties



These biases in the tax system, together with weaknesses in the tax treatment of land and housing (through stamp duties and land tax) by the State and Territory Governments – have contributed to the fact that Australia has among the highest housing prices in the world. (see Saul Eslake on pxxx). A further problem with speculative assets price booms is that they make the economy harder to manage, as the Reserve Bank has pointed out.

WHAT CAN WE EXPECT?

With the mining and carbon taxes already major issues facing the Federal Government, we don't expect a major new tax reform package that addresses disadvantage and inequity to emerge from the Tax Forum. Tax reform is difficult and it takes time to build community support for major change.

A good outcome of the forum itself would be if the issues outlined above got a good airing and attracted some commitment from the Government to consider further reform in these areas and consult with the community.

A bad outcome would be an over-emphasis on issues that are very unlikely to attract consensus for future tax reform such as an increase in the Goods and Services Tax (GST). There also seems little point to further debate initiatives the Government has already announced such as the Clean Energy Future package and the mining tax. And, instead of starting from scratch, the Tax Forum should start with the positive reform proposals advanced by the Henry Report, including:

- Fairer tax treatment of super contributions similar to long-standing ACOSS proposals.
- More consistent tax treatment of investments via a standard 40 per cent discount on personal tax rates for investment income (which would lower taxes on bank interest and raise them on capital gains).
- Curbs on the deductability of investment expenses.
- An increase in the single rate of Newstart Allowance and a common system of indexation for working age payments.
- Broadening the Land Tax to properties with owner occupied housing and abolishing stamp duties.
- Reducing tax concessions for non-superannuation termination payments (golden handshakes) and for capital gains on small business assets.
- A standard work related deduction in return for curbs on excessive claims.
- Abolition of poorly targeted tax concessions such as the Senior Australians Tax Offset.

These proposals are a good place to start.

Dr Cassandra Goldie is Chief Executive Officer of ACOSS. ACOSS is a member of the Community Tax Forum, which was established in 2008 along with the Australian Council of Trade Unions, Consumers' Federation of Australia and Australian Conservation Foundation. It is convening a meeting in Melbourne on 22 September of representatives of affiliated organisations who will be attending the National Tax Forum. http://www.taxwatch.org.au/communitytaxforum

Tax reform: agenda 1

PERSONAL INCOME TAX

A progressive income tax system, where people who earn more pay a greater percentage in tax, sounds great. Peter Davidson explains how it works in practice, where wealthier Australians can 'choose' to pay their tax at a lower rate.

The personal income tax system is, in theory, one of the fairest ways to raise public revenue because it reflects people's ability to pay more effectively than taxes on consumption. In particular, it does not tax those with limited spending power and it takes account of people's income from investments which is strongly skewed towards the better off.

We also have, at face value, a progressive rate scale ranging from the $6,000 tax-free threshold and 15 per cent rate for part-time workers up to a 45 per cent rate for high income earners.

The reality is different, however. Many of those who should in theory pay tax at the top two tax rates – 37 and 45 cents – can readily avoid doing so by taking advantage of tax shelters. These include:

- the use of private trusts and companies to shelter personal income
- the 50 per cent reduction in marginal tax rates on capital gains
- excessive deductions for loss-making investments in property and shares
- salary sacrifice, for example into superannuation
- 'golden handshakes' that are taxed at much lower rates than ordinary income
- work-related deductions that are skewed towards those on the highest incomes
- poorly targeted tax breaks such as the Health Insurance Rebate.

There is a case for taxing investment income overall at lower rates than wages, in part because investment decisions are more 'footloose' and sensitive to tax than employment decisions. But the tax system is inconsistent in the way it treats different forms of investment and earnings, respectively.

If we taxed different forms of income more consistently, then not only would the system be fairer, it would also be more economically efficient because the tax system would play less of a role in people's choices about how they earn their income. It would be possible to raise the same amount of revenue (or more) using lower tax rates. Previous income tax reform packages have adopted this strategy of 'broadening the base and lowering the rates'. These have attracted pubic support because although a minority of people (those that currently benefit most from tax shelters) pay more tax, the majority pay less. The nation benefits from a more robust tax system that is capable of raising revenue for essential services.

Table 1 lists some of the main tax shelters and poorly targeted concessions. Their combined cost to public revenue is around $20 billion per year, or two thirds of the federal education budget.

Effective tax rates for a high-earner (>$180,000):

- 45% on personal earnings or bank interest
- 22.5% on capital gains
- 15% on employer super contributions
- 15-30% on golden handshakes
- 30% on income retained in a private company
- 15% on discretionary trust income split with a family member employed part-time
- Negative tax rate - on negatively geared investments

Peter Davidson is a Senior Policy Officer at the Australian Council of Social Service (ACOSS).

Table 1: Selected tax shelters and poorly targeted rebates and deductions (2009)

	How tax is avoided	Marginal tax rate for individual in 45% tax bracket	Tax revenue foregone[1] ($ millions)
Capital gains tax 50% discount	Income from increased value of assets such as shares and property is taxed at half normal rates	23%	$8,600m*
Capital gains tax small business concessions	Income from increased value of small business assets is taxed at a quarter of standard rate and not at all if the proceeds of sale are used for retirement	0-11%	$1,000m[2]*
Deductions for expenses for investments in shares, property and agricultural schemes	Taxpayers who borrow to invest in assets that yield capital gains can offset the interest and other costs against their wages (even though these are taxed at higher rates – see above)	Negative (taxes on their wages are reduced)	$4,000m[3]
Termination payments	Lump sum payments of up to $140,000 on leaving a job (such as golden handshakes) are taxed at low flat rates instead of the taxpayers' marginal rate	Usually 15% (if over 55 years old) or 30% (if under 55)	$1,500*
Private companies	A business owner or investor can use a company they control to shelter income from tax at the 30% company tax rate	30%	$1,300m[4]
Private trusts	A high income earner can divert their income to a trust they control, splitting their income with lower taxed family members and otherwise avoiding tax[5]	Depends on the structure and the beneficiaries	$1,000m[6]
Private health insurance rebate	This 'refund' typically covers 30% of private health insurance costs up to an annual ceiling	Reimburses 30% of premium	$4,900m[7]*
Total:			$22,300m

* Source: Treasury 2009, Taxation Expenditure Statement (estimate for 2008-09).

Note: excludes superannuation and retirement tax concessions

1. Note that the revenue that could be raised by closing these tax shelters would be less than these amounts, due to behavioural change, the need to take account of special circumstances, and transitional arrangements.
2. Comprising $560m for the 75% discount on the tax rate, $95m for the exemption for over-55 yr olds holding assets for over 15 years, $390m for the exemption for those using the proceeds of sale of business assets for retirement.
3. $3,000m for rental losses, plus conservatively another $1,000m for losses on other investments mainly yielding capital gains including shares and agricultural investment schemes. Source: ACOSS calculations using ATO 2009, Taxation Statistics.
4. ACOSS calculations using ATO 2009, Taxation Statistics.
5. Private trusts have also been used to avoid tax by concealing income within complex networks of trusts and companies, by converting other forms of income into capital gains, and by transferring losses from one individual or entity to another.
6. Based on estimate of $500m in revenue savings (see Review of Business Taxation 1999, A Tax System Redesigned) from the taxation of private trusts as companies (in the second year of implementation of the proposed change - 2001-02) taking account of additional revenue losses from income splitting using these trusts, and the increase in income obtained from private trusts since that time.
7. Comprising $3,875m (private health insurance rebate) + $1,050m (income tax exemption for rebate). Sources: Portfolio Budget Statements, Tax Expenditure Statement

VCOSS VOX POP

What's the greatest social justice reform of the Australian tax and transfer system – and what's the one that 'got away'?

BRIAN HOWE

Associate Professor at the Centre for Social Policy, University of Melbourne. Former Labor Minister (Defence, Social Security, Health, Housing and Community Services) and Deputy Prime Minister between 1983 and 1996

The roots of our current housing crisis – in both affordability and supply – go back 60 years to Liberal Prime Minister Robert Menzies' decision to restrict the supply of public housing in favour of large concessions to home purchasers. The Henderson poverty inquiry found 40 years later that public housing had been limited to housing the workforce for new post-war secondary industries. The Whitlam Government increased the supply of public housing without recognising the need for a shift in the direction of policy.

In Choices for a Changing Nation (1993), as federal minister for housing, I outlined the need for a shift in direction in government subsidies for housing recognising the need to utilise both public and private investment. The Rudd Government introduced more supply side subsidies for rental housing for low income people and promised to reform the Commonwealth State Housing Agreement. However the last 60 years represent a lost opportunity to develop and implement a comprehensive strategy that would decently and affordably house the vast majority of low-income people in Australia, especially private renters. It represents one of the outstanding failures of political intelligence and will in Australian politics.

ROSANNA SCUTELLA

Senior Research Fellow, Melbourne Institute of Applied Economic and Social Research

Australia's family payments system must be a frontrunner in the quest to deliver social justice. Its development can be traced back to the 1940s, beginning as a universal child endowment paid directly to the mother, then becoming a much more targeted payment to the poor in the 1980s, and since then developing into a progressive form of financial assistance provided to low and middle-income families. Amidst all the cries of the current Family Tax Benefit providing 'middle class welfare', it is not often acknowledged that it may be their appeal to the 'middle classes' that allows them to remain a critical (and popular) feature of our social support system to help safeguard families and their children against experiencing poverty.

Death duties would have to be the one that 'got away'. Broad-based death duties, or inheritance taxes, are among the most efficient and most equitable taxes around. However, in one of the examples of how 'competitive federalism' can be detrimental to good tax policy, the then Premier Joh Bjelke-Petersen started a race to the bottom amongst the states by abolishing death duties in Queensland in the late 1970s. It is now virtually impossible to even mention the words 'death duty' without being called a lefty pinko.

TONY NICHOLSON

Executive Director, Brotherhood of St Laurence

Great reforms? Medicare – we take it for granted that we get access to a large proportion of our healthcare at no cost. In other countries healthcare can be very expensive; at least in Australia an illness doesn't have to mean financial ruin in the same way as it does in places without universal access healthcare.

Also, Paid Parental Leave, which recognises how important it is to support parents in the early months of their child's life and makes it possible for low-income working parents to stay at home with their kids.

The one that got away? Our income support system is inconsistent, both in the base rates that are set and in terms of indexing. The inadequate level of Newstart is an example of this.

The very light tax treatment of housing means that the cost of housing is inflated and adds to affordability problems. Also non-homeowners and renters don't get any benefits from these tax breaks so it is inequitable.

The time is right for the universal provision of childcare, at least from the age of two or three. We know that the outcomes of high quality childcare are great for disadvantaged children and it allows parents to increase their participation in paid work. Universality ensures that there are no barriers to participation and would encourage more disadvantaged families to participate in childcare.

The time is also right for a National Disability Insurance Scheme to assist people with disabilities and their carers to participate both in paid work and in community life more broadly. We are wealthy enough as a society to ensure that those most vulnerable get a chance to live a decent life.

RICHARD KREVER
Department of Business Law and Taxation, Monash University

Twelve years ago, the Australian Democrats committed suicide with support for a broad-based goods and services tax (GST) that, largely at the urging of powerful voices in the welfare sector, excluded food.

Expenditures on food accounts for a much higher portion of the weekly spending of low-income people than is the case with the rich. Exempting food from GST, it was argued, would thus be a progressive move. The problem was that while the rich may be spending less than the poor as a percentage of their incomes, in absolute terms they spend far more on far more expensive food. In dollar terms, therefore, the exemption benefits the rich far more than the poor.

Had food not been exempted, there would have been revenue to greatly overcompensate the poor for the additional cost of GST on food, raising net welfare levels. Sceptics were doubtful, however. Some feared the additional revenue would have passed back to high-income people through further rate cuts. Others thought it might initially have been passed on as benefits to lower-income people but the compensation and overcompensation would be subject to the whim of future governments. In this view, the cost of lost revenue through the generous gift to high-income people was a small price to pay for keeping the benefit for lower-income persons out of the reach of future politicians. Many continue to wonder if this was the optimal judgement call.

JEFF LAWRENCE
Secretary, Australian Council of Trade Unions (ACTU)

The creation of the compulsory superannuation system must stand as one of the greatest social justice reforms in Australia. Super means that all workers – not just the wealthy – can have financial security in retirement. It joined Medicare and the progressive income tax as a fundamental reform that made Australia a fairer place, with more security for working people.

Of course, the system is not perfect. Unions support increasing the super guarantee to at least 12 per cent, and the tax concessions for super continue to give a greater benefit to high-income earners than to ordinary workers.

There are other elements of our tax system that undermine its fairness, and these are the potential reforms that 'got away'. People who earn their income through dividends and capital gains can end up paying far less tax than people who work for a living. Negative gearing can allow wealthy investors to unfairly reduce their tax, while making housing less affordable for working Australians.

There are also too many opportunities for high-income earners to avoid paying their fair share in tax by using trusts and company structures. Perhaps the biggest reform that 'got away' is the lack of a wealth tax or inheritance tax. We stand alone among developed nations in not taxing bequests, and this is a glaring inequity in the system.

PROFESSOR JON ALTMAN
Centre for Aboriginal Economic Policy Research, the Australian National University

Despite their clear disadvantage as a group, Indigenous Australians have never received beneficial tax or transfer treatment. Perhaps the most innovative Indigenous-specific social justice measure was the Community Development Employment Projects (CDEP) scheme, a program developed by the Fraser Government in 1977. Under CDEP, Indigenous participants received the equivalent of welfare as a part-time wage, but were then able to earn additional income and work more hours without being subject to the standard social security taper. The scheme proved so popular that, by 2004, it had over 35,000 participants. But since 2005 it has been incrementally demolished and now is limited to remote Australia where there are only 10,000 participants. It is proposed that the scheme be effectively abolished from April 2012, moving Indigenous Australians from workfare to welfare.

Very little household expenditure data is collected in many regional and remote areas where Indigenous people make up most of the local population. But it's clear that prices for most goods and services are extremely high. A special tax rebate or welfare supplement might assist to ameliorate disadvantage and be cheaper than the $100 million a year currently committed to imposed income management.

The Mining Withholding Tax (MWT) introduced by Treasurer John Howard in 1978 is levied on payments out of the Aboriginals Benefit Reserve that receives income from the Commonwealth (equivalent to royalties raised on Aboriginal land in the Northern Territory). This is a most unjust and inequitable tax because, while designed to ensure individuals pay tax, almost all recipients of mining royalty equivalents are actually statutory bodies, like land councils, or incorporated, usually charitable, Aboriginal organisations.

The MWT has cost Northern Territory Indigenous interests millions of dollars over the past 33 years and is a form of double taxation (for income tax paying salary earners) definitely without representation. There are current proposals to extend this unjust tax to recipients of native title compensation payments. The MWT should be abolished forthwith and consideration given to compensate Indigenous statutory authorities and organisations which have been financially disadvantaged by its operation for decades.

NOT TO BLAME

To whom it may concern,

As a single mother who is studying and living on Newstart (having lived below the poverty level for a long time) I ask you to advocate strongly for people like me. The government announces compensation and benefits to pensioners however this does not help those who are unemployed.

Unemployed people or students are the biggest victims of rising costs. Benefits are only given nowadays to pensioners and not those on unemployment benefits. This also occurred with the economic downturn handouts. We are forgotten and not popular.

Australia is not a country that should determine who are the deserving poor and who are not. It is discriminatory and needs to be addressed. How does the government expect a single mother with a 16 year old to live on less than $700 a fortnight, with rising costs.

I would like to hear your criticisms of these discriminatory policies every day on every media program until the issue is addressed.

It appears that we as a society are now only protecting those on pensions whereas those on Newstart, Austudy and the Youth Allowance receive by far less money and get far fewer concessions. I am very concerned and angry about this.

I know this is very direct but poor people like me need your help like never before. This issue of governments discriminating between who is deserving of assistance and who is not is not on. We start off on a lower base which is just getting lower.

We require a major media fight back. Unemployed people need support and now!!!!

Hoping you take action

Name withheld on request

(letter to VCOSS, August 2011)

IN CONVERSATION: JULIAN DISNEY

Julian Disney has advocated for tax reform and social justice since he was president of the Australian Council of Social Service (ACOSS) in the 1980s. He now convenes TaxWatch, a community network that promotes tax reform, and is National Chair of the Community Tax Forum which comprises the leading national groups from the consumer, environmental, union and welfare sectors.

1.What does and should the Australian tax system do?

Many people in the community sector focus on the tax system as the means for raising enough government revenue to support programs across a whole range of areas – welfare, income support, care, to find work, provide public housing, public transport etc – whether run by government or non-profit organisations.

But the system has at least as much impact on social justice by providing incentives or penalties that influence economic or social and environmental behaviour. For example, if properly designed it can encourage investors to put their money into long-term, productive activities rather than short-term speculation, and encourage philanthropists to make gifts to charities. On the other side of the coin it can discourage behaviour which aggravates problems such as emitting greenhouse gases or smoking cigarettes. At present, for example, the Australian system encourages rather than discourages speculative investment in housing, excessive household debt and over-use of motor vehicles.

Over the past 25 years or so a general anti-tax ideology has dominated both sides of politics. This has meant that if governments have wanted to provide assistance for some group, they have usually tried to provide it as a tax concession or tax break rather than raising enough tax revenue to provide the assistance as a direct payment (for example, through social security). This means they have reduced tax rather than increased spending.

Use of the tax system in this way can increase the risk of assistance being provided in a way which is more wasteful, inequitable and counter-productive than if it is provided openly and transparently through direct payments. This applies, for example, to the current tax breaks for housing assistance, superannuation and child care.

2. Why does tax reform matter to social policy?

The tax system actually creates or exacerbates disadvantage through misdirected tax concessions and exemptions which, in turn, reduce the amount of revenue we have got to meet the problems they have caused. If you look across almost every area of concern to the community sector, you will find there's a major contributing factor to disadvantage and inequity coming from the tax system because of the distortions that it causes.

We see it in relation to:

- **Housing** – where tax exemptions and concessions cost government revenue at least $20 billion each year while fuelling housing prices and aggravating unaffordability for low-income households. The price inflation also means governments have to pay higher costs to support public or non-profit housing and more in rent assistance.
- **Transport** – where for many lower-income people, the time and expense of travelling to work (particularly people having to live further and further from city centres to access affordable housing) have been aggravated by excessive tax incentives for cars and parking while none are provided for travel by public transport.

- **Child care** – where the child care tax rebate is excessively generous for higher-income earners, and the fringe benefits tax concession applies only to child care centres on work premises which biases it towards people who work for large employers.
- **Older people** – where money that could be spent on an adequate level of age pension and affordable health care is wasted on excessively generous superannuation tax breaks for very wealthy people.

2. What does the Community Tax Forum want on the table at the Federal Government's National Tax Forum on October 4-5 – and beyond?

We will be pushing for the National Tax Forum to focus on priorities for implementation of the Australia's Future Tax System report (the Henry Review). We don't agree with all of the report but it was a major step forward for the community sector because it said, across a wide range of areas, pretty much what the Australian Council of Social Service (ACOSS) had been advocating for more than 20 years and which we often knew Treasury agreed with behind the scenes but didn't say openly.

We don't want the Government to start backsliding from key Henry proposals of great importance to lower-income people or allowing business to shift the agenda. There's more than enough of great importance in the Henry Review to focus on implementing in the months and years ahead rather than moving even further in other directions which have weakened long-term economic development and social justice in the last two decades or so.

3. What are the top three tax reform issues for the Community Tax Forum to progress?

- **Superannuation** – we should get rid of excessive generosity for high-income people in order to reduce waste and unfairness. Contrary to public myth, superannuation tax concessions do not save the government more than they cost. They provide more government assistance for many wealthy people than if the age pension had remained available to everyone regardless of income.
- **Trusts** – we should wind back major tax loopholes that favour those who can take advantage of the rorts and deprive the rest of the community of a very large amount of revenue.
- **Housing** – this is probably the highest priority of all for the Community Tax Forum. Housing tax breaks cost many times more each year than the total government expenditure on public and non-profit housing and on rent assistance. We need to remove the land tax exemption from very high-value owner-occupied houses and wind back negative gearing on rental properties. These changes would reduce house price inflation, save a lot of government revenue and restrain household debt (see articles on housing tax reform p20 and negative gearing p22).

> ON TAX MINIMISATION

"During the last 10-15 years, there's been a major erosion of the integrity of the tax system and the face that it presents to the ordinary taxpayer. Middle Australia is now involved in tax minimisation on a scale never seen before, through a host of concessions or exemptions, such as negative gearing, fringe benefits taxes on motor vehicles, salary sacrificing and superannuation receipts over the age of 60.

Income tax scales bear very little relationship to what many wealthy Australians actually pay. A lot of theoretical analysis of income tax rates is of very little merit because it assumes that people on, say, $150,000 a year are going to be paying tax on $150,000 a year. In fact, many will have arranged their affairs to be paying on a much lower figure. (see Personal Income Tax pp8-9).

People who previously believed in paying their taxes, even if they didn't like it, are now feeling that if they don't get in on those rorts, they're really falling behind. We're seeing a serious corruption of the tax system in this way.

I am not sure whether Australians have necessarily become greedier in the last 20 years or so. But more temptation to avoid tax has been put in their way and very many people have given in to it. The temptation is now becoming close to coercion. If you're going to be substantially worse off than other people by not engaging in tax avoidance (now euphemistically called being 'tax-effective') there is clearly a very heavy pressure to get involved."

4. It seems that the importance of raising revenue is not well understood in Australia – why is tax a dirty word?

In fact, I think the public is nothing like as anti-tax as many would have us believe. Surveys have shown a clear shift away from people who want tax cuts rather than improvements in public services. But for the last couple of decades, the main product differentiation between the two political parties has been by competing to provide the largest tax cuts because it's simple and it works simply on the front page of the *Herald Sun* or *Daily Telegraph*. The fact that some other option for tax reform might have left you so much better off, even if you couldn't put a precise dollar amount on it, gets lost. We have been dominated by the anti-tax agenda of the United States. For years it's been held up as a highly successful economy with very low tax rates – but the price they've paid for not raising enough revenue has been to build up a massive public debt which, as we're seeing now, has left it in dire straits. Its recent credit downgrading was mainly because Congress refused to reduce excessive tax breaks for the wealthiest Americans.

We are riding the crest of a wave right now with our massive mineral resources and resource-hungry major neighbours but we need to look to the future by leveraging our mineral resources to help meet the costs of an ageing population. This is why it is disappointing that the mining tax has been so weakened that it will raise much less revenue than was appropriate.

5. What can we do to secure state tax reform?

The role of the states in tax reform should be one of the main issues at the National Tax Forum, because, for example, key changes in the area of housing involve land tax and stamp duty which are state levies. Some of the necessary changes are politically difficult and, at least in the short-term, could reduce state tax revenue. States are unlikely to be persuaded by sweet reason alone. One approach could be for the Commonwealth Grants Commission to take the view that states which do not impose land tax on owner-occupied property are not fully utilising their tax base and therefore their direct grants from the Federal Government should be reduced.

6. Given all the politics, what's the best way to press for reform?

The main way to achieve major tax reform is by having a package with a very attractive trade-off. If you are doing something that the general population or the business sector won't like, you need to find something to go with it that they will like. The package needs to be broad-ranging and to include improved expenditure as well as tax reform.

7. Who is the Government listening to and how do we measure the success or otherwise of the National Tax Forum?

The National Tax Forum should be measured by the extent to which it makes progress on the priority areas which I have mentioned. This does not necessarily mean major announcements at its conclusion. A government that has the carbon and mining taxes on its plate is not going to be able to take on many other big tax reforms in the short term. But the focus and impetus of the Henry Review must not be lost and the reforms of special importance for lower-income people must be entrenched as high priorities for implementation over the next few years.

The Community Tax Forum has been consulted by the Government about what we believe should be the priorities and processes for the October forum. I think the Government is listening but, of course, listening (and even agreeing in principle) is very different to acting.

ACOSS has long recognised the importance of tax policy but overall the community sector really needs to get more serious about it. Many welfare agencies now have their own research sections but they are usually very small and tend to focus on analysing their own service delivery. It is at least as important to devote resources to the deeper longer-term causes of problems. The effect of their frontline support is gravely weakened if badly designed economic and tax policies both increase the 'caseload' and reduce the resources available to help. The Brotherhood of St Laurence has taken this view for many years and, together with UnitingCare and the Benevolent Society, is now supporting TaxWatch to help build awareness in the sector about tax issues.

Julian Disney is Professor and Director of the Social Justice Project at the University of New South Wales. He is Chair of the National Affordable Housing Summit group, National Co-Chair of Anti-Poverty Week, National Chair of the Community Tax Forum, and National Convenor of TaxWatch.

He is also a former President of the NSW Council of Social Service (NCOSS) and the Australian Council of Social Service (ACOSS), and a past World President of the International Council on Social Welfare (ICSW).

TaxWatch http://taxwatch.org.au/home.asp is based at the Social Justice Project, Law Faculty, University of New South Wales, and the Department of Business Law and Taxation, Monash University.

Tax matters

HOW AUSTRALIA SCORES ON TAX

OVERALL TAX LEVELS

> Our total tax revenue is in the lowest-third of all 30 OECD countries (at least $40 billion below the OECD average as a percentage of GDP)*

> Revenues from taxes based on incomes (whether paid by individuals or companies) are below most OECD countries**

> The overall level of taxes on business is not high by OECD standards

PERSONAL INCOME TAX

> The top rate and threshold are more generous to taxpayers than in most comparable OECD countries

> The total income tax per dollar earned has fallen at least 20% for high-earners over the last 20 years but fallen little, if at all, for lower-earners

CORPORATE INCOME TAX

> The current 30% rate is in the mid-range of comparable OECD countries

> The proportion of corporate profit paid as income tax is less than it was a decade ago and two decades ago

> Only Australia and New Zealand refund all corporate income tax payments to shareholders

GOODS AND SERVICES TAX

> The rate is comparatively low by OECD standards

TAXES ON GIFTS, BEQUESTS OR TOTAL ASSETS

> Australia is one of only three OECD countries without such a tax

*even when superannuation is taken into consideration.
**under most methods of calculation set out in Aspects of the Australian Tax System.

Source: *TaxWatch report, Comparative update on aspects of the Australian tax system*, (www.taxwatch.org.au/facts.asp).

WHAT PLACE EQUITY?

"As a brash young Clerk Class 9 working on the Hawke Government's 1985 Tax White Paper, I pushed the line that the tax system was about maximising efficiency, with equity simply a constraint — rather than an outcome with intrinsic value in its own right. Fortunately, I was soon set straight… (and) I am pleased to say that today equity is central to Treasury's mission and policy advice. How we distribute prosperity is absolutely inseparable from how we create it. This is something parts of the welfare sector have been arguing strongly for some time, and it has been pleasing in recent years to see welfare representatives developing this position further."

Ken Henry, then Treasury Secretary and Chair of Australia's Future Tax System Review Panel. ACOSS National Conference, April 2009.

NEEDS OVER INTEREST

"There has been a prevailing uncritical acceptance among many in the political classes and public debate that all tax cuts are good. This is misguided.

The problem with such an approach is that it fails to address the level of social goods and services the public require, and also undermines the legitimacy of the tax system as a public good... Therefore we argue that good tax policy is about needs over interests. Before tax cuts are implemented we need a process for discussing what level of public provision we want and what the best tax structure is to deliver that. Tax reform is about good combinations of taxes, and not perennial tax cuts.

This is not to argue for increases in taxation, instead it is an argument that taxation should meet the legitimate demands for public expenditure and productivity."

Katherine Gregory, *Taxes: What are they good for?* Per Capita, October 2009

INDICATORS OF DISADVANTAGE

Having some $500 set aside for emergencies is one of the indicators of disadvantage developed by the Social Policy Research Centre (SPRC); in a 2006 survey, almost 18 per cent of the general population lacked this item, compared to almost 56 per cent of Parenting Payment recipients, 54 per cent of Newstart recipients and 42 per cent of Disability Support Pension recipients...

As Wayne said: 'When the fridge carked it, that was a sticky time... Luckily I drink black tea and coffee, don't use fresh milk, just use powdered milk....Margarine keeps reasonably in the cupboard.' But living without the refrigerator for 'the better part of a month' limited his diet markedly: 'plenty of chips, eggs and chips, beans and chips, chips and chips, chips and egg, egg and chips' (Wayne, aged 48, DSP). Cheryl, a single mother, had a similar experience. "If one thing goes wrong.... everything is out of balance: 'we lived out of an esky for three weeks because something went wrong with the fridge.... it was going to cost $140 to fix.'

Source: John Murphy, Suellen Murray, Jenny Chalmers, Sonia Martin, Greg Marston, *Half a Citizen: Life on welfare in Australia*. Allen and Unwin. 2011.

KEEPING UP WITH THE NEIGHBOURS

Australia's comparative level of tax revenue can also be assessed by calculating the extent to which it would rise or fall if it was the same proportion of GDP as in other OECD countries. For example, Table I.A below shows that our revenue would rise by about $200bn and $60bn respectively if we matched the levels in Sweden and the UK, and by about $55-65bn if we matched the averages for the OECD-9 or for all OECD countries. These increases can be compared with our 2007-8 tax revenue of about $350bn.

Table: Approximate changes in Australian tax revenue to equal levels in other countries

	(% Aust GDP)	(Aust $)
OECD-9		
Austria	+11.5	+130bn
Canada	+2.5	+30bn
Japan	-2.5	-30bn
Netherlands	+6.7	+75bn
Spain	+6.4	+70bn
Sweden	+17.5	+200bn
United Kingdom	+5.3	+60bn
United States	-2.5	-30bn
Average	+5.6	+65bn
OECD		
Average	+5.0	+55bn

Notes: OECD-9 average excludes Australia. If 50% of compulsory superannuation is treated as tax, the amounts in the second column of figures fall by about $17bn.

Source: *TaxWatch report, Comparative update on aspects of the Australian tax system*, (www.taxwatch.org.au/facts.asp).

Sector in the sights

Tax not only affects the work of the community sector, but the sector itself. After years of inactivity, it's now facing significant tax reform and the devil may be in the detail, says Myles McGregor-Lowndes from the Australian Centre of Philanthropy and Nonprofit Studies.

The taxation environment for community sector organisations may change significantly in the immediate future after a decade of incremental administrative reform and two decades of inquiries that have spawned many disregarded recommendations.

It is yet unclear whether the real driver for the mooted reforms is the revenue authorities' desire for greater regulation and compliance, leading to a constriction of concessional treatment, or to ensure the benefits which the community sector brings to Australian society and general community well-being. At present, the rhetoric oscillates between these motives and it is not inconceivable that different policy actors are pursuing different purposes for taxation reform for the community sector. This article reviews recent reforms for the sector, identifies reforms currently proposed and then looks to possible future taxation reform.

REFORMS SINCE THE GST

The introduction of the Goods and Service Tax (GST) marked an increased focus on taxation of the community services sector by the Australian Tax Office (ATO), with the need to identify charitable and deductible gift recipient status accurately, for certain GST concessions and treatments. This required registration of all such entities through an endorsement process. Together with selective audits, this has reduced the number of organisations eligible for such concessions. Very few minor categories of income tax exemption have been added; for example, closed religious orders and self-help groups. Fringe Benefits Tax (FBT) concessions were capped to either $30,000 or $17,000 per employee and left unindexed, resulting in erosion of their value over time.

During this time there was an inquiry into the suitability of the common law definition of charity (the Charities Definition Inquiry) which recommended expanding the definition of charity by amending federal legislation. While a draft bill was prepared, only a few minor issues were eventually legislated because of concern over various features of the bill, including advocacy and the treatment of unrelated business income. One of the drivers for the Inquiry's recommendations was the lack of cases considering the common law definition of charity taken to the High Court. However, subsequently, three High Court cases have in fact advanced the common law treatment of issues surrounding charities' unrelated income, advocacy, and performing overlapping government functions. All three cases were decided in favour of the charity leading to advancement or clarification of the law of charity.

The Howard Government sought to increase philanthropy through a combination of awareness campaigns and taxation incentives for gift donations. New taxation incentives included averaging of gifts over a period of income years and deductibility of conservation covenants; but the most significant was a private foundation vehicle – Private Ancillary Funds – to allow tax deductibility of gifts from private families or businesses. Tax deductible gifts have risen rapidly: from $744 million in 2000 to over $2 billion in 2009.

IMPENDING REFORMS

The 2011 Budget included plans for a number of reforms which concern the community sector:

- introduction of a statutory definition of 'charity' for federal purposes by 1 July 2013; this will take its lead from the Charities Definition Inquiry which recommended a wider definition of charity than was achieved through legislative amendment;
- consultation with states and territories to develop and adopt a uniform definition of charity;
- establishment of an Australian Charities and Not-for-Profits Commission (ACNC), which will re-assess the charitable status of organisations on the basis of the new charity definition;
- establishment by the ACNC of a general reporting framework for charities through a public information portal by 1 July 2013; and
- removing tax concessions from income generated by and retained in new unrelated commercial activities commencing after 10 May 2011 (Budget night). Initially only applying to new commercial activities, existing activities

will be phased in over time after consultation. Treasury subsequently released a Consultation Paper about reforming the use of tax concessions by businesses operated by not-for-profit (NFP) entities. It broadly proposed that NFP entities pay tax on any retained earnings (i.e. income not remitted and applied to the purposes of the tax concession entity) and that existing input tax concessions such as FBT and GST would not be available for unrelated commercial activities.

Further, the Government has indicated that it intends to amend the taxation laws to prevent community sector organisations transferring untaxed funds overseas, by requiring tax exempt organisations to operate and pursue their objectives principally (more than 50 per cent) in Australia.

From 1 January 2012 the Government also intends to reform the regulation of Public Ancillary Funds (often known as 'community foundations'). These funds seek donations from the public and then distribute the funds only to other deductible gift recipients. The reforms include a minimum annual distribution of 4 per cent of net assets; requiring funds to have a corporate trustee; and requiring them to file audited financial returns.

FUTURE REFORMS

There are many recommendations yet to be actioned by the Government; the most controversial is likely to be that involving the FBT concessions. The Australia's Future Tax System Review, led by Ken Henry, recommended that FBT concessions enjoyed by the sector should be reconfigured. This was supported by the Productivity Commission's research report on the NFP sector. The recommendation included a 10 year phase-out period, with the concession reduced gradually and replaced with direct government funding. The rationale for this reform is that the FBT concession gives community sector organisations a competitive advantage in mixed sector markets (e.g. hospitals and nursing homes) contributing to wage inflation and exacerbating labour shortages. In its place, direct government funding would be available to all tax concession community sector organisations, for funding specific projects or to assist with the cost of recruiting specialist staff. The report did note that removing FBT concessions where there was no direct for-profit competition may result in downsizing or closure of programs.

The Productivity Commission Research Report also drew attention to the FBT meal entertainment benefit – which, through a twist of the law, is presently uncapped – and noted that there was a strong case to limit or eliminate this concession.

Further, the Productivity Commission suggested that the common law of mutuality which applies to machine gaming clubs might be ripe for reform on competitive neutrality grounds and that the scope of gift deductibility should be widened progressively to include all endorsed charitable funds and institutions.

CONCLUSION

After years of inactivity in both the legislative and judicial arenas, the community services environment is facing a relatively active phase in taxation reform. Most of the proposals before Parliament are clearly aimed to increase regulation on, and enhance compliance of, the community sector. Arguably, improved accountability should boost the community's trust of the sector, through better governance and sustainability, leading to increased donations and volunteerism. Widening the scope of community organisations that will qualify for charity status, reducing the red tape costs of achieving that status, and streamlined financial filing may also be realised. The devil will be in the detail, and the outcome affected by whether the dominant motive is to restrict concessional treatments or to facilitate a robust and sustainable community organisations sector.

Key dates

- **2001:** Inquiry into the definition of charities and related organisations
- **2008:** Senate inquiry into the disclosure regimes for charities and not-for-profit organisations
- **2010:** Review of Australia's Future Tax System
- **2010:** Productivity Commission inquiry into contribution of the not-for-profit sector
- **2010:** Senate inquiry into the Tax Laws Amendment (Public Benefit Test) Bill 2010
- **2011:** Consultation paper - scoping study for a national not-for-profit regulator

Professor Myles McGregor-Lowndes OAM is the Director of The Australian Centre of Philanthropy and Nonprofit Studies (ACPNS) at the Queensland University of Technology. He has written extensively about nonprofit tax and regulation, nonprofit legal entities, government grants and standard charts of accounts as a means of reducing the compliance burden. He is a founding member of the ATO Charities Consultative Committee.

Tax reform: agenda 2

HOUSING

We have got our policy wires crossed with housing and tax in Australia, writes Sarah Toohey.

When popular commentary turns to talk of tax and housing, stamp duty is inevitably singled out as the culprit making housing unaffordable. It's the most obvious, it's the tax everyone sees when they're contemplating buying a home and working out how much they can afford. But for this very reason it's not the tax that's causing the problem.

House prices, particularly for established housing, are set by what people are willing and able to pay. Because every prospective buyer for a property faces the same rate of stamp duty (barring first home owners in many states but more on that in a minute) it affects their purchasing power in the same way. Stamp duty cuts make very little difference in one buyer's advantage over another, so they simply get eaten up in higher base prices for housing.

This is demonstrated in the first home buyer market, where despite stamp duty cuts in many states, the average first home loan has continued to rise.

Abolishing stamp duties would make the housing market more technically efficient, by removing a barrier to moving house, which is a good thing, but if it isn't replaced with something, like a broad based land tax for instance, it will leave a gaping hole in state budgets across Australia, and some nasty cuts to schools, hospitals and kindergartens as a result.

So we should turn our attention to the taxes that don't get paid – through tax breaks such as negative gearing and capital gains – because it's the absence of tax , as Saul Estlake points out in the following pages, that distort the housing market and drive up housing prices.

Negative gearing, by allowing investors to deduct all the losses associated with purchasing and renting out that property from all of their income, encourages investors to make a loss, and reduces their tax payable. Essentially negative gearing allows higher income earners to use rental housing as a tax shelter. It's the offshore account of the Australian tax system.

If that wasn't enough investors also get a 50 percent tax discount on any capital gain they make on the sale of the property. It means that any income gained through property appreciation gets taxed at half the rate of other income.

The really insidious effect of these two tax breaks is what happens when they get together. Negative gearing encourages investors to borrow more than they can afford, because they're really borrowing to make a loss on the cost of running the property, in anticipation of a capital gain pay-off. Because investors aren't constrained by what they can actually pay, they push up house prices, and get an unfair advantage over first home buyers, indeed all home buyers, who can only spend what they're able to afford based on their income.

This also causes problems in the rental market, where the majority of rental housing is provided by small scale landlords. Seventy three per cent of people claiming a loss on rental property investments have only one property. This means that a large proportion of rental housing is provided by investors who are there for the tax breaks not to provide secure affordable accommodation for tenants.

Together negative gearing and capital gains tax exemptions are conservatively estimated to cost Australian tax payers $8 billion a year. That's more than the Federal Government will spend in the life of the current five year National Affordable Housing Agreement and more than was spent on social housing in the Nation Building Stimulus Package.

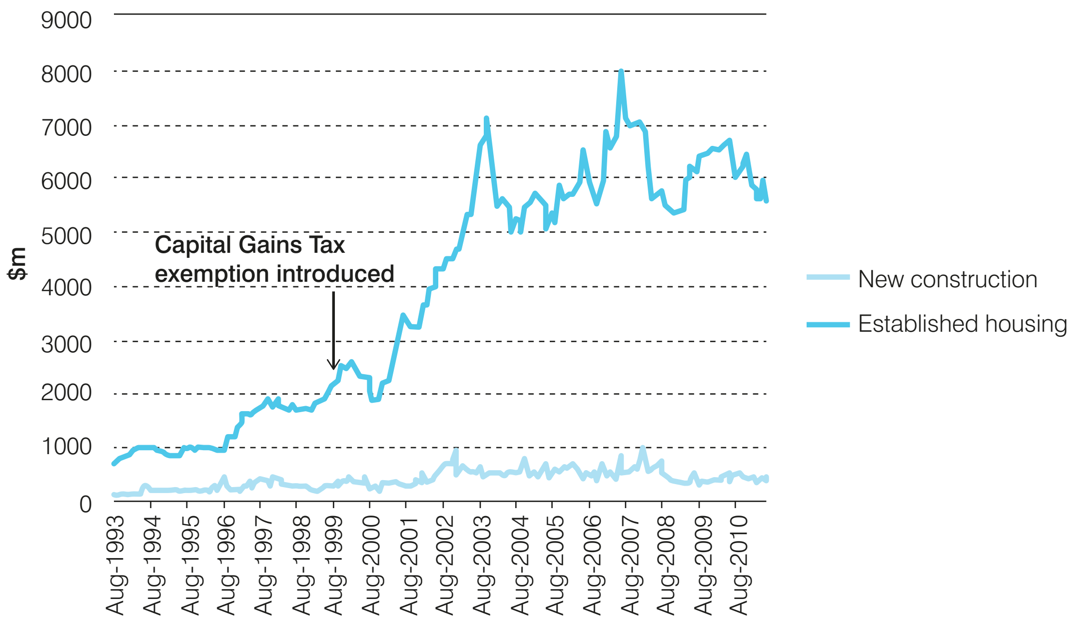
These tax breaks go to people who need it least, generally existing home owners with some wealth to spare. They encourage investment in established housing at and do little to relieve the shortage of 493,000 rental properties that are affordable and available to people on low incomes.

So what would a tax break that helped affordable housing look like? It would look something like the National Rental Affordability Scheme (NRAS) that was established in 2008. NRAS provides an annual tax discount for the construction of new housing, to be let at 80 per cent of market rents for 10 years. It's not a perfect scheme (in many markets 80 per cent of the going rent is hardly affordable), and it's not the only investment needed but it's a damn sight better than pouring tax dollars into housing investment with no defined outcome.

We have got our policy wires crossed with housing and tax in Australia. The only tax mechanism dedicated to affordable housing, NRAS, is capped at 50,000 properties, while the tax breaks provided through negative gearing and Capital Gains Tax exemptions are unlimited. It's time to make the tax system work for affordable housing.

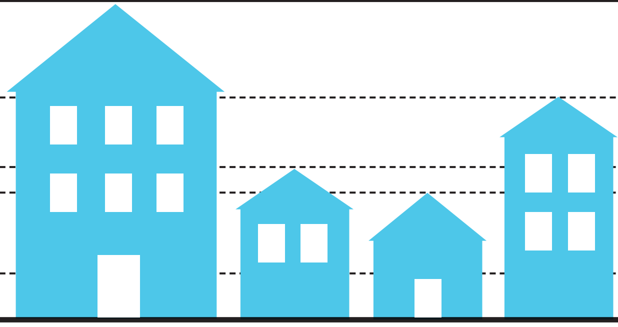
Sarah Toohey is Campaign Manager for Australians for Affordable Housing.

Housing investors rush to established housing



Source: Reserve Bank of Australia, lending commitments - all lenders

Crunch time for negative gearing



It's become the 'never ever' tax reform for both major parties in Australia, but – as Saul Eslake outlines – it's time for negative gearing to stop distorting the market and the equity of the tax system.

Apart from their education and health, there are few things that have a greater impact on people's material standard of living, or their ability to participate in employment than their ability to afford a decent place to live.

Hence governments of all political persuasions typically accord a high rhetorical priority to improving 'housing affordability', both for those seeking to own their own home and for those unable to achieve home ownership and needing (or preferring) to rent.

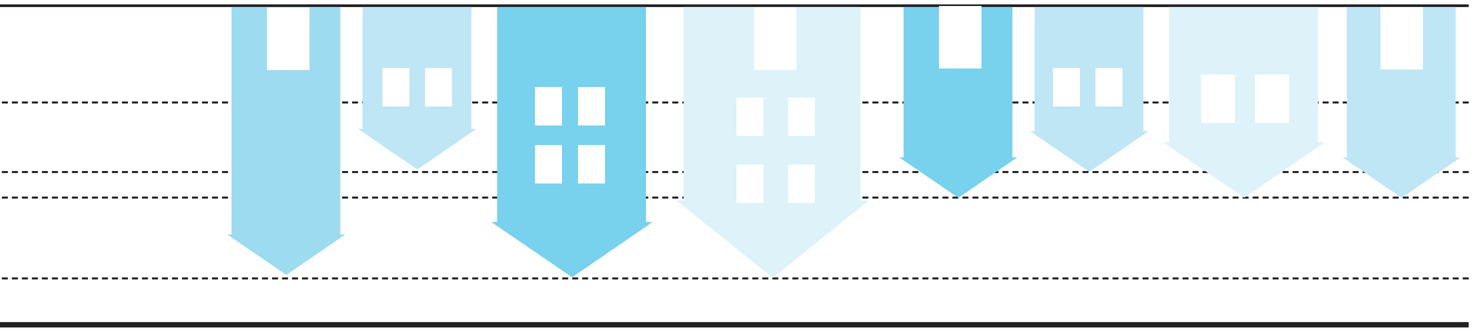
Unfortunately, the importance that governments have given to 'housing affordability' in their statements of intent has rarely been matched by policy actions that have achieved much by way of tangible progress towards that objective. Indeed, many government policies have actually had the opposite effect – they have made housing less, rather than more, affordable. And yet successive governments have been reluctant to modify or abandon those policies, or to replace them with policies that would actually contribute towards the achievement of the 'housing affordability' objectives which they supposedly hold dear.

One of the most striking examples of this is the policy of giving cash grants (and other forms of financial assistance, such as stamp duty concessions or exemptions) to first-home buyers, in the belief that this will result in higher levels of home ownership. Governments of both political persuasions have been doing this for almost 50 years. Yet the home ownership rate has never been higher than it was at the time of the 1961 Census, two years before the first of these schemes was introduced by the Menzies Government. All that the billions of dollars which the Commonwealth and State Governments have spent in this way has done has been to inflate the price of housing, making it less, rather than more, affordable to those unable to raise large deposits or service large mortgages. Indeed, it's hard to think of any government policy that has been pursued for so long, in the face of such incontrovertible evidence that it doesn't work, as this.

Another policy which – notwithstanding the stated rationale for it – has made 'housing affordability' worse rather than better, is the set of arrangements commonly known as 'negative gearing' under which investors are able to offset any excess of financing and other costs associated with acquiring and holding an investment (be it in property, shares, taxi licence plates or any other income-producing asset) over the income produced by that asset in any given year against any other taxable income which they may have. Thus, if a landlord's interest and other costs associated with owning an investment property exceed the net rental income produced by that property, he or she can offset the resulting 'loss' against his or her other income for tax purposes.

Very few other Western countries' tax systems are as generous to investors as Australia's is in this respect. In the United States, for example, investors can only deduct interest incurred on borrowings undertaken to purchase property or shares up to the amount of income (dividends or rent) earned in any given financial year; any excess of interest expense over income must be 'carried forward' as a deduction against the capital gains tax payable when the asset is eventually sold.

The benefits of 'negative gearing' to investors were substantially enhanced by the Howard Government's 1999 decision (supported by the then Labor Opposition) to tax capital gains on assets held for more than 12 months at half the rate applicable to other forms of income (such as wages and salaries), replacing the arrangement which had been in place since 1986 under which capital gains were taxed at a taxpayer's full marginal rate after allowing for the impact of inflation.



This decision converted 'negative gearing' from being an arrangement which merely allowed for the deferral of tax (to the time when the asset was sold) to one which allows for a reduction in tax payable as well as its deferral.

In effect, it allows for wage and salary income taxable at what is usually the top, or second highest, marginal rate in the year in which it is earned to be converted into capital gains, taxable at half the rate which would otherwise have been payable, at some point in the future.

> *"It's actually quite difficult to think of anything that would do more to improve affordability conditions for would-be homebuyers than the abolition of 'negative gearing'.*

Not surprisingly, the number of taxpayers taking advantage of this much more generous treatment has increased significantly over the past decade.

In 1998-99, when capital gains were last taxed at the same rate as other types of income (less an allowance for inflation), Australia had 1.3 million tax-paying landlords who in total made a taxable profit of almost $700 million. By 2008-09, the latest year for which statistics are presently available, the number of tax-paying landlords had risen to just under 1.7 million: but they collectively lost $6.5 billion, largely because the amount they paid out in interest rose almost fourfold (from just over $5 billion to almost $20 billion over this period), while the amount they collected in rent 'only' slightly more than doubled (from $11 billion to $26 billion), as did other (non-interest) expenses. If all of the 1.1 million landlords who in total reported net losses in 2008-09 were in the 38 per cent income tax bracket, their ability to offset those losses against their other taxable income would have cost over $4.3 billion in revenue foregone; if (say) one fifth of them had been in the top tax bracket then the cost to revenue would have been over $4.6 billion.

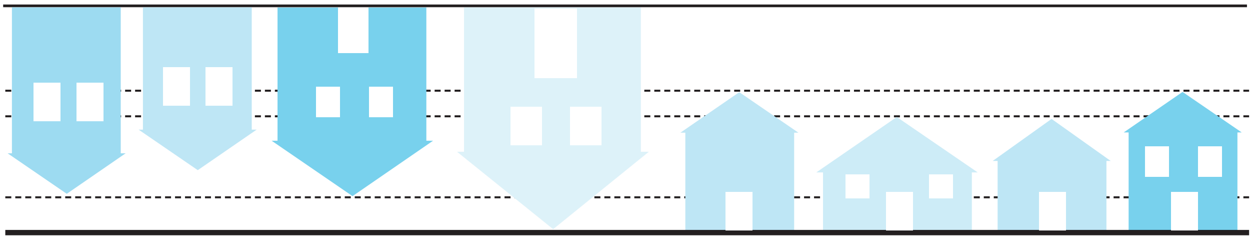
This is a pretty large subsidy from people who are working and saving to people who are borrowing and speculating (since those landlords who are making 'running losses' on their property investments expect to more than make up those losses through capital gains when they eventually sell them).

And it's hard to think of any worthwhile public policy purpose which is served by it. It certainly does nothing to increase the supply of housing, since the vast majority of landlords buy established properties: 92 per cent of all borrowing by residential property investors over the past decade has been for the purchase of established dwellings, as against 82 per cent of all borrowing by owner-occupiers.

Precisely for that reason, the availability of 'negative gearing' contributes to upward pressure on the prices of established dwellings, and thus diminishes housing affordability for would-be home buyers.

There's absolutely no evidence to support the assertion made by proponents of the continued existence of 'negative gearing' that it results in more rental housing being available than would be the case were it to be abolished (even though the Henry Review appears to have swallowed this assertion).

Most other 'advanced' economies don't have 'negative gearing': yet most other countries have higher rental vacancy rates than Australia does. In the United States, which doesn't allow 'negative gearing', the rental vacancy rate has in the last 50 years only once been below 5 per cent (and that was in the March quarter of 1979); in the ten years prior to the onset of the most recent recession, it has averaged 9.1 per



cent. Yet here in Australia, which does allow 'negative gearing', the rental vacancy rate has never (at least in the last 30 years) been above 5 per cent, and in the period since 'negative gearing' became more attractive (as a result of the halving of the capital gains tax rate) has fallen from over 3 per cent to less than 2 per cent.

Nor is there any evidence that 'negative gearing' results in lower rents than would be the case in its absence. During the period since the attractiveness of 'negative gearing' to investors was increased (by halving the tax rate on capital gains), and during which the extent of 'negatively geared' property investment rose sharply as noted above, rents rose at a rate 0.8 per cent per annum faster than the CPI (consumer price index) as a whole; whereas over the preceding decade, rents rose at exactly the same rate as the CPI.

Supporters of 'negative gearing' argue that its abolition would lead to a 'landlord's strike', driving up rents and exacerbating the existing shortage of affordable rental housing. They point to 'what happened' when the Hawke Government abolished negative gearing (only for property investment) in 1986, claiming that it led to a surge in rents, which prompted the reintroduction of negative gearing in 1988.

This assertion has attained the status of an urban myth. However it's actually not true. If the abolition of 'negative gearing' had led to a 'landlord's strike', as proponents of 'negative gearing' usually assert, then rents should have risen everywhere (since 'negative gearing' had been available everywhere). In fact, rents (as measured in theCPI) actually only rose rapidly (at double-digit rates) in Sydney and Perth. And that was because in those two cities, rental vacancy rates were unusually low (in Sydney's case, barely above 1 per cent) before negative gearing was abolished. In other State capitals (where vacancy rates were higher), growth in rentals was either unchanged or, in Melbourne, actually slowed.

But suppose, notwithstanding this history, that a large number of landlords were to respond to the abolition of 'negative gearing' by selling their properties. That would push down the prices of investment properties, making them more affordable to would-be home buyers, allowing more of them to become home-owners, and thereby reducing the demand for rental properties in almost exactly the same proportion as the reduction in the supply of them.

It's actually quite difficult to think of anything that would do more to improve affordability conditions for would-be homebuyers than the abolition of 'negative gearing'.

I'm not advocating that 'negative gearing' be abolished for property investments only, as happened between 1986 and 1988. That would be unfair to property investors, vis-à-vis other investors in shares and other assets. I'd settle for the recommendation of the Henry Review, which was that only 40 per cent of interest (and other expenses) associated with investments be allowed as a deduction, and that capital gains (and other forms of investment income, including interest on deposits) be taxed at 60 per cent (rather than 50 per cent as at present) of the rates applicable to the same amounts of wage and salary income.

Sadly, however, these recommendations were among the 19 that the Treasurer explicitly ruled out when releasing the Henry Review in May 2010, and again when announcing the details of the Tax Forum to be held in October.

That makes it hard to believe that this Government (or indeed any alternative government) is really serious about increasing the incentives to work and save – or at least, about doing so without risking the votes of those who borrow and speculate, in effect subsidized by those who don't, or can't.

Saul Eslake is a Program Director with the Grattan Institute, a non-aligned public policy 'think tank' affiliated with the University of Melbourne, and an Advisor to PricewaterhouseCoopers. However the views expressed in this article are his own, and should not be attributed to either of these organisations.

Tax reform: agenda 3

SUPER

There's been a good deal of debate lately about 'waste' in Australia's social security system. Some argue that middle class welfare is wasteful while others object to cash support for unemployed people. Yet the welfare system hidden from view in our tax law escapes scrutiny, writes Peter Davidson.

The Treasury estimates that the Government this year will 'spend' $20 billion on tax breaks for superannuation, just under the $23 billion spent on age pensions. For over two decades now, the Australian Council of Social Service (ACOSS) has argued that they should be better targeted towards low and middle income-earners to improve their equity and efficiency in raising household saving levels and reducing the future cost of the age pension.

Superannuation will shape income inequality and living standards among retired people in future years. In 20 years' time expectations about living standards in retirement will be raised by superannuation in much the same way as the growth in two income families raised expectations about living standards (and also the costs of basics such as housing) in the 1980s. In both cases the rise in overall living standards is a good thing, but we must be mindful of the gaps. Since superannuation is based on previous earnings, it reflects inequalities in the way earnings are distributed between men and women and between people in different occupations. Among people approaching retirement, 43 per cent of men and 31 per cent of women have over $100,000 in super while 32 per cent of men and 42 per cent of women have less than $50,000 . As with overseas social insurance schemes, there should be a mechanism in the system beyond the age pension to moderate the resulting inequalities in retirement incomes.

Tax breaks for saving that are directed mainly to low and middle income earners are more efficient as well as equitable. Although high income earners save more for their retirement, there is a widespread view among experts that they will do so regardless of tax breaks or compulsion. To a large extent, tax breaks only shift their savings from one area to another (e.g. from bank accounts to superannuation). It is low and middle income earners who need more encouragement to save. Also, if a key aim is to reduce reliance on the age pension then tax breaks should be targeted to those who are most likely to rely on it in future – people on low and middle incomes.

Although the superannuation guarantee forces employers to contribute to their workers' superannuation, most experts agree that it ultimately forces employees to save more for retirement because employers pass on the cost in lower wage increases. Balancing retirement saving with other calls on their limited earnings is a tricky problem for low wage earners grappling with the costs of raising children, unaffordable housing, and the risks of unemployment and marital separation. ACOSS argues that there is a strong case for allowing people to devote part of their long-term savings to these and other purposes, and for the tax system to at least partly compensate them for the loss of disposable income from compulsory saving.

Current super tax breaks

The present tax treatment of superannuation is poorly designed to meet these objectives. The Treasury estimates that one quarter of the annual value of superannuation tax breaks accrues to the top 5 per cent of wage earners. Those on low part time wages do not benefit at all.

Super now extends to the vast majority of workers but its tax treatment is still anchored in a past when it was a perk for executives, professional people and public servants. One of the main reasons for this is that few people apart from accountants advising high income earners understand how the system works!

Imagine that the Government announced tomorrow that our progressive tax scale will be replaced with a flat 15 per cent tax on everyone. People on low incomes would pay more tax, middle income earners would pay less, and high income earners would pay a lot less. Hardly a fair outcome! Yet that's exactly what the $15 billion 'spent' by the Government this year in tax breaks for employer superannuation contributions does.

When your employer deposits 9 per cent of your earnings in a super account, it escapes the normal tax on wages at your marginal rate and is instead taxed at a flat rate of 15 per cent (see table). That results in a tax saving per dollar contributed of 36.5 cents for an employee on the top tax rate and an increase in taxation of 15 cents in the dollar for a low income earner below the tax free threshold. So before the contributions have even begun to earn interest in the fund the dice are loaded against low income earners and in favour of those who are better off.

High income earners derive the greatest benefit from heavily marketed ‘salary sacrifice’ arrangements that trade off a wage increase for more super. The only limit on such generosity is that contributions above $25,000 a year ($50,000 a year for those over 50 years) is taxed at higher rates. This is half or more of the annual earnings of a typical full-time wage earner, well beyond the contributions that can be afforded by the vast majority of people.

There are a number of other tax breaks for super contributions, depending where the money came from. These include a Government co-contribution for contributions by employees on low incomes, a deduction for self employed people, and a rebate for contributions made on behalf of a partner. Some of these tax breaks are also inequitable, though their annual cost is well below that of the tax break for employer contributions. The main problem with these tax breaks is their complexity, and the fact that how much you save in tax depends on where the contributions came from, not capacity to pay.

The Government ‘spends’ another $14 billion on tax breaks on the investment income of the funds. Again a flat 15 per cent tax replaces the marginal tax rate you would normally pay if you earn interest in a bank account.

In the 1980s, the Hawke Government tried to redress these inequities to some extent: benefits above a high level called a ‘reasonable benefit limit’ were taxed at either 15 or 30 per cent depending on a person’s age. In 2006 the Howard Government abolished taxes on superannuation benefit payments. This wouldn’t have been such a problem if super was taxed fairly at the contributions and fund earnings end of the process.

The inequity and waste in the present system is compounded by the ability of people over 55 years old to churn their earnings and investments through their superannuation accounts which opens up opportunities for people of mature age to reduce their tax to a maximum of 15 per cent. Also self employed people can shift their business assets (for example, a property) into superannuation without paying the capital gains tax that has accrued over the years on those assets.

While this is a boon for those baby boomers that came into the superannuation system late in their working lives, it mainly benefits those on the highest incomes. It also raises serious intergenerational equity issues given that the next generation will to a large extent have to pay for the boomers’ health care costs when they grow older. At present less than one quarter of people over 65 years pay income tax. Unless that rises over the next 20 years, there is a real danger that a two tier system of health and aged care will emerge – one for those with enough superannuation (or home ownership) to pay their way and a second class system for those with less wealth and lower incomes.

What should be done?

ACOSS has long argued that our ‘upside down’ tax breaks for saving should be turned right-side up. Tax breaks for superannuation contributions should provide a higher subsidy per dollar contributed to low and middle income earners than to those on the top tax rate.

To achieve this, we have argued that all tax breaks for contributions be replaced with an annual rebate. This would have two rates: a dollar-for-dollar government contribution up to a low annual contribution threshold such as the first $300, and a lower rebate for every additional dollar contributed up to a ceiling (for example, 20 to 30 per cent up to annual contributions of around $7,500). The table compares the existing system with our proposed reforms.

Imagine that the Government announced tomorrow that our progressive tax scale will be replaced with a flat 15 per cent tax on everyone. That’s exactly what the $15 billion ‘spent’ this year in super tax breaks does.

All contributions would be treated in the same way regardless of their source. This means that employers would deduct tax at the employee’s marginal rate from the employer’s contributions before they are passed onto the fund, so that employer contributions are treated the same way as money deposited in super from a person’s after-tax earnings.

All would benefit equally from the rebate, per dollar contributed, up to the contributions ceiling. The ceiling could be based on the amount required in annual contributions over a typical working life to fund an adequate retirement living standard well above the pension level. Other taxpayers should not be called upon to subsidise a luxurious retirement! There would be no need to income test the rebate as the ceiling would limit its benefits for those on high incomes. Tax incentives to save would then be targeted to where they would do the most good – at low and middle income

Table: Existing tax treatment of superannuation contributions and ACOSS proposal

Source of contribution	Current tax treatment	ACOSS proposal
Employer	No tax on that part of earnings contributed to super (super guarantee or salary sacrifice) Flat tax of 15% on transfer to super fund of the first $25,000 p.a. ($50,000 if 50 years or over) New Government proposal: 15% government contribution for employer contributions (capped at $500p.a.) for an employee on up to $37,000 p.a.	All contributions paid from after-tax earnings (employers deduct tax from their contributions to the super fund). A two tier co-contribution or tax offset for all contributions up to a specified annual limit, paid into the fund at end of each year. For example, 100% for the first 0.5% of AWE (approx $300), plus 20-30% for additional contributions up to 12% of AWE (approx $7,500)
Employee	Earnings taxed at marginal rates Capped co-contribution for personal contributions by low and middle income earners	
Self employed	Earnings taxed at marginal rates Tax deduction for personal contributions	
Spouse	Earnings taxed at marginal rates Capped annual tax offset for contributions on behalf of a spouse	

earners (because in their case the superannuation guarantee contributions would be well below the annual contributions ceiling for the rebate).

The proposed change would make superannuation fairer and simpler and improve incentives for low and middle income earners to save. It would have no adverse impact on savings already accumulated in super funds. It would only increase or reduce the after-tax value of future contributions.

A very similar proposal was put by the Henry Report. It differed in proposing that tax on employer superannuation contributions be deducted from wages instead of from the employer's deposits into the super fund. This was intended to be a form of 'forced saving' to offset the rejection of any increase in the superannuation guarantee (the Henry Panel also recommended abolishing the tax on the interest earned by superannuation funds for the same reason). Now that the Government has announced that compulsory contributions will be raised to 12 per cent, this form of forced saving, which would have directly reduced the disposable incomes of people on low incomes, is unlikely to attract support.

The Government did not respond directly to this proposal from the Henry Review. Instead it announced that it would introduce a rebate on employer contributions for people in the lowest tax bracket (under $30,000) to offset the 15 per cent tax paid on their employer contributions to super. This would boost retirement incomes for these low income earners but not as much as our proposed higher rebate. It would not increase support for retirement saving by middle income earners nor reduce it for high income earners. Further, the Government proposes to increase the contributions ceiling for those over 50 with less than $500,000 in super, which would mainly benefit high income-earners.

There is growing support for the rebate approach from unions and industry super funds as well as the community sector. It's time to clear the fog of ignorance that surrounds our antiquated tax system for retirement saving and expose it to the same rigorous tests of fairness and efficiency that we apply to other forms of government 'welfare'.

Peter Davidson is a Senior Policy Officer at the Australian Council of Social Service (ACOSS).

FUTURE FUNDING

Critical social and environmental action can cost many billions of dollars. If governments can't or won't act through the tax system, what options are there? Simon O'Connor from the Australian Conservation Foundation explores new ways to boost investment to tackle major social and environmental challenges.

Innovative financing is probably a term that makes most of us cringe – and well it should in the post-global financial crisis world. Yet the amount of public funding invested in critical social and environmental programs remains all too scarce and continues to hinder the potential to deliver critical improvements to the health and well-being of our society.

Both globally and within Australia, new ways of raising funds for such programs are being trialled that aim to bolster limited government funding with additional private investment. These innovative financing measures offer the potential to support priority social and environmental programs at levels they require.

THE CHALLENGE

Take climate change as an example of an area that requires a substantial uplift in investment if we are to achieve a stable and safe climate in a clean economy.

In a recent Australian Conservation Foundation (ACF) report, it was estimated that an investment of up to $100 billion would be required across the economy for new and retrofitted infrastructure to merely achieve emissions reductions targets by 2020.

An extensive overhaul of our economy is required to avoid climate change with significant investment in low-carbon infrastructure, including electricity network upgrades, new low emissions generation capacity, distributed generation to take pressure off networks and a huge push to use energy more efficiently. Further investment in transport and water assets will also be needed to more effectively move humans around increasingly populated cities and to climate-proof populations from weather fluctuations.

Globally, the International Energy Agency has estimated that a $10 trillion investment in the energy sector would be needed by 2030 to maintain global greenhouse emissions at the modest goal of 450 parts per million (ppm).

The cost of much-needed social infrastructure is slightly less daunting, but nonetheless capital intensive: in order to build housing for the 100,000 people who are homeless on any given night we would need to invest $25 billion nationally, or $44 billion if we were to provide housing for the nearly 180,000 Australians on public housing waiting lists.

When considered in the context of the planned $42 billion in upgrades and maintenance to our electricity poles and wires over the next five years, or the $40-plus billion estimated cost of the National Broadband Network (NBN) or even the proposed $100 billion investment recommended within the 2009 Defence White Paper, these funding requirements are significant, but not outside the scale of the challenges confronting our governments.

However, with the current lack of political will to scale up public investment to this level, we are left with the big question of how to fund this investment.

If we look at the pools of capital in our economy, including over $1 trillion in savings sitting in Australian superannuation funds, it is evident that the problem is not one of a lack of capital, but rather an inability to connect capital to the right social and environmental priorities. For example, in simple terms, on an annualised basis, the $100 billion required to transform our economy to one producing much less carbon pollution represents less than 1 per cent of the total assets managed by Australia's superannuation funds.

Emerging on the edges of finance are new ways of connecting private capital to these programs on the scale required to target our most critical social and environmental challenges.

"It is evident that the problem is not one of a lack of capital, but rather an inability to connect capital to the right social and environmental priorities."

One of these innovative mechanisms is government bonds. A bond is a conventional debt product used commonly by government to raise public finances above and beyond tax revenues to support their program expenditure. Currently bonds in various guises are being tested as an important tool to bring private finances to traditional government program areas.

PACE Bonds

Property Assessed Clean Energy (PACE) Bonds are a United States (US) local government finance initiative to fund residential energy efficiency retrofits. PACE bonds are issued by local governments specifically to raise low-interest funds for energy efficiency and renewable energy improvements in domestic housing.

PACE bonds, enabled through legislation in over 20 US states, are used to offer low-interest long-term loans to property owners for these energy efficiency improvements, which are then repaid through additions to property rates.

What is most interesting about this mechanism is that the repayments are set lower than the energy cost savings resulting from the retrofit investment, thereby mitigating the cash flow impact upon households. As the cost of these retrofits are spread across the life of the assets (up to 20 years), this effective guaranteed saving on costs minimises the upfront cost, commonly the single largest impediment to retrofitting residential and commercial properties. The loan repayment obligations are automatically transferred to the next property owner if the property is sold.

The PACE bond presents an innovative lever for overcoming the so-called split incentive for upgrading rental housing – that is, the cost of the investment being carried by the landlord for the benefit of the tenant, resulting in most landlords avoiding the investment. The PACE bond structure ties both the costs and the benefits to the tenant, if the increase in rates is passed on to rental costs and offset by lower cost energy efficient house operation.

The model is also being tested in the United Kingdom (UK) under the name of 'Pay As You Save' (PAYS), and early moves have now been made to transfer this mechanism to Australia.

Melbourne City Council is currently introducing a PACE bond-style low-cost financing mechanism to support green commercial building retrofits for its 1200 Buildings Project (the project aims to retrofit 1200 commercial city buildings over 10 years). With relatively minor amendments to legislation, low-cost loans for green building retrofits have been enabled under an 'environmental upgrade agreement'. The Council then recoups the cost of the investment and repays the loan through an additional levy on the building rates.

The same enabling amendment to legislation has recently been passed in New South Wales that similarly enables low-cost loans with repayments to be repaid by an extra council rate, but again targeting commercial buildings rather than residential housing.

Some further testing of this model in Australia could lead to its eventual application for driving low-cost financing of residential energy efficiency retrofits, particularly targeting those most in need in low income households.

CLIMATE BONDS

Beyond just PACE-style energy efficiency retrofits, government bonds are the recent innovative mechanism of choice for tapping additional commercial private financing for both climate and social related projects.

'Climate bonds' are being increasingly utilised by governments and multilateral development banks to fund climate mitigation projects, such as clean energy investments, whilst tapping the demand for sustainable investment options by large institutional investors.

Climate bonds offer institutional investors the opportunity to take a stake in green projects aimed at climate change mitigation and adaptation without having to take a direct holding in sustainable investments such as renewable energy projects.

Far from new, governments have a long history of tapping the bond market to raise funds for projects of national significance – whether that be public infrastructure such as sewerage systems, exploration voyages in search of 'new lands' or to finance war efforts. Being government-backed and generally lower risk, bonds have historically been attractive to both institutional and retail investors.

To date, billions of dollars have been raised globally through climate-themed bond issues, mainly from multilateral development banks such as the World Bank and Asian Development Bank.

Themed bonds are not a new idea in Australia, with both sides of Australian politics proposing at the last federal election a form of Aussie Infrastructure Bond to finance either the NBN or large infrastructure projects.

The proposal underlying the recent announcement of the $10 billion Clean Energy Finance Corporation, announced as part of the Clean Energy Future carbon pricing package, initially suggested using climate bonds to raise funds for investment in clean energy projects, as is the case with the similarly modeled UK Green Investment Bank.

SOCIAL IMPACT BONDS

On the social front, bonds are also being tested to raise additional private finance. Immunisation Bonds have been issued to raise finance for vaccinations in developing countries and the International Finance Facility for Immunisation (IFFIm) has raised over $3 billion in bonds issued by governments to generate a reliable stream of funding to support developing country programs of vaccination, tapping private sector capital to pay up-front long-term government pledges.

Further innovation includes Social Impact Bonds being tested in both the UK and Australia. In New South Wales, the State Government recently announced a dedicated trial. The Social Impact Bonds proposed in both the UK and NSW would bring additional private funds for outcomes-based programs such as delivering reduced hospital admissions through preventative health programs or targeting reduced offending rates for at risk young people. The bonds are a way of financing upfront the costs of these preventative programs, targeted at specific population segments that can deliver reduced future costs for long term public service provision.

In March, the NSW government committed $25 million to the trial. Time will tell of its effectiveness.

CONCLUSION

Predictably, there is a risk that these initiatives could be used to get governments off the hook from having to fund what are core duties of state. Applied correctly, however, these forms of innovative financing bring a critical boost to funding shortfalls in social and environmental programs.

In light of the current shortfalls and the limited political appetite for step change in the spending priorities for government tax revenues, the additional boost possible from these innovative financing options could go some way to lifting the level of investment critical to tackling the major social and environmental challenges of today.

Simon O'Connor is the economic advisor at the Australian Conservation Foundation. Simon has worked in the areas of finance, economics and environment in Europe and Australia; as a responsible investment analyst for the UK and Australian pension fund industry, an environmental economist for the private and not-for-profit sectors, and as a sustainability consultant to major industrial clients in Australia.

CARBON COSTS

Climate change has come to be seen as an environmental problem requiring a solution designed by economists. Australia is following the trend with the Federal Government's proposed carbon pricing mechanism – or 'carbon tax' – due to commence 1 July 2012.

The proposal is constructed on the faith that market mechanisms deliver superior social outcomes. Its proponents are untroubled that climate change is itself the product of market failure in environmental matters – namely, the failure of the market to impose a cost on economic activity which damages the environment for future generations.

The carbon tax is intended to correct this market failure. It does this by imposing a new form of consumption tax. The tax is a levy on the carbon content of goods and services produced in Australia. It aims to increase the price of goods and services according to the volume of carbon dioxide emissions generated in the course of their production.

The theory is simple. By increasing the price of carbon-intensive goods and services, consumers will follow the price signals and direct consumption to less carbon-intensive products. In turn, businesses will follow the demand signals, and begin investing in more carbon-efficient forms of production. Thus will the market lead us to a clean energy future.

While the theory is simple, actually imposing a tax on the carbon content of goods and services is more complex. The government has decided to do this by imposing a carbon tax, initially set at $23 a tonne, on the emissions of the country's largest polluters in areas such as electricity generation, coal mining, oil and gas production, manufacturing, landfill waste storage and transport.[1]

It is assumed that the businesses subject to the new tax will initially pass on the increased tax cost by way of increased prices to their customers, who will in turn pass on those increased prices to their customers. In this way, the new cost of carbon – initially $23 a tonne – will trickle down through the market economy to individual Australian consumers.

1. The carbon 'tax' is actually in legal form a combination of instruments. The primary carbon tax is a permit scheme. From 2012 to 2015, companies controlling facilities producing more than 25,000 tonnes of emissions per annum will have to purchase a $23 permit for each tonne they emit. After 2015 the government will start imposing a cap on the number of available permits and allow for permits to be bought and sold in the carbon market; they will also allow permits to be bought from overseas carbon markets. This means companies with carbon emissions will need to purchase permits at market prices which may depart significantly from $23 a tonne. The carbon permit scheme will not apply to transport fuels – but in lieu they will be subject to a shadow carbon tax via changes to fuel excise duties and credits.

As with all consumption taxes, the carbon tax suffers from the serious defect that its burden falls disproportionately on low-income households. This is because they spend disproportionately more of their income on the things that become more expensive under a carbon tax, namely electricity, gas, petrol and transport. In particular, Treasury modelling predicts that electricity and gas prices will rise by 10 and 9 per cent respectively.

In recognition of this, the Federal Government has borrowed from the strategy used by the Howard Government when it introduced the GST in 2000. 'Not a new tax, a new tax system' was the mantra then, and the 10 per cent GST was offset by significant personal income tax cuts, and increases to pensions and other social security allowances. The same approach is being taken with the carbon tax. In its initial public relations assault, the Government has emphasised that the carbon tax will be accompanied by changes to the income tax and social security system which increase after-tax family incomes for most Australian households.

This fiscal magic is achieved by using carbon tax revenues to fund income tax cuts, and increases in pensions and social security allowances, directed primarily at low and middle-income households. The changes, it should be emphasised, are relatively modest, and rest heavily on Treasury modelling that the carbon tax should only increase the cost of living, as measured by the CPI, by 0.7 per cent, in the period 2012-13. This is much smaller than the 2.5 per cent increase caused by the GST.

Treasury estimates that average weekly household expenditure will increase by $9.90, including a $3.30 increase in electricity bills, and a $1.50 increase in gas bills. The compensation package of income tax cuts and increased government allowances will provide the average household with $10.10 a week. Hence the average household, on the modelling, should be 20 cents a week better off.

"The economic package assumes that businesses will be able to offset their increased electricity, gas and other costs by passing them on to consumers through increased prices. The not-for-profit sector generally cannot do this."

Marginally more of the total compensation package will be directed to low-income householders. The income tax cuts are delivered by raising the effective tax-free annual income threshold from $16,000 to $20,542.[2] This ensures that that the largest tax reduction – $600 per annum – goes to those earning less than $20,000, while those on $25,000 obtain a reduction of $500, those under $65,000 receive a $303 tax cut, and those above $80,000 a $3 cut.

Government benefits such as the age pension, disability support pension, Newstart allowance, parenting payment, carer payment and family tax benefit will all be increased. There will be a one-off Clean Energy Advance lump sum payment in May or June 2012, followed by a new CPI-indexed Clean Energy Supplement, designed to deliver a 1.7 per cent increase in maximum payment rates. This is intended to more than offset the projected CPI increase of 0.7 per cent on introduction of the carbon tax[3]. There will also be other benefits for low-income households such as an essential medical equipment payment of $140 and changes to pension tax offsets.

There are, however, some gaps in the protection for low-income households. One gap is the treatment of the not-for-profit-sector, which provides vital support to low-income households. The economic package assumes that businesses will be able to offset their increased electricity, gas and other costs by passing them on to consumers through increased prices. The not-for-profit sector generally cannot do this. Unless it receives additional government funding, its only option in response to increased costs will be reductions in services, or a rather rapid transition to a carbon-free mode of operation.

The Federal Government package does not address these concerns directly. It does propose increased funding for its Low Carbon Communities program. This provides up to $330 million in competitive grants for local councils and communities to improve energy efficiency in council and community use buildings, and low-income households.

Another gap in the Government's compensation package concerns those individuals who currently live outside the tax and social security system, and hence will not be able to access tax and allowance benefits intended to offset the projected cost of living increases. They may be eligible to apply for a Low Income Supplement of $300, to be administered by Centrelink. But no doubt many in this category will need help from the not-for-profit sector to penetrate Centrelink's systems to access their entitlements.

Crucial to the impact of the carbon tax on low-income households, and their not-for-profit support services, will be the accuracy of the Treasury modelling. If the CPI increase exceeds that modelled, the compensation packages for low-income households will be inadequate, and the not-for-profit sector will face significant cost increases.

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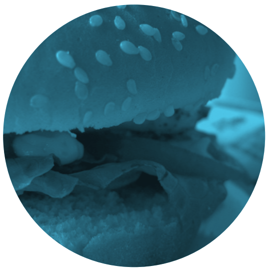
2. The effective tax-free threshold is a function of the income threshold at which income tax is payable, and the low income tax offset (LITO) which then rebates income tax for low incomes. Income tax is taken out of worker pay packets each week by the employer. The LITO is paid back by the Government when workers lodge a tax return at year end. The Government is increasing the income threshold and reducing the LITO. This means that workers will keep more of their income as it is paid, and some low-income workers will no longer need to lodge a tax return.

3. When the carbon tax transitions to a permit trading scheme in 2015 (see note 1), Treasury modelling predicts a further CPI increase of 0.2 per cent. This will be covered by further small income tax cuts in 2015-16 achieved by lifting the tax-free threshold from $20,542 to $20,979. There will be no specific changes to pensions and allowances, but the Clean Energy Supplement is CPI indexed so it should respond to the CPI increase.

Give 'em a nudge

Alcohol taxes are widespread, but the 'alcopops' tax is arguably one of the few implemented with a policy objective of consumer protection rather than revenue raising.



'Sin taxes' – innovative ways to help people live healthier lives or an unfair impost on the poor? Mark Henley looks at this complicated new area of tax reform.

A part of tax reform discussion that tends not to get the same level of attention as other elements is taxes that are designed to influence consumer behaviour, with the intended benefits being for both individuals and the broader community. Cigarette taxes have been a long-running example, as have some alcohol taxes, while, more recently, saturated fat, sugar and 'soda' taxes have been proposed. Hence a sometimes-used collective noun to describe such taxes is 'sin taxes': taxing life's pleasures!

The economic argument is quite compelling: increasing the price of a product which is considered to have harmful impacts, particularly where the harm increases with levels of consumption, will reduce the demand and shift behaviour away from harmful consumption. There are longer-term benefits for the public purse as future health system costs are reduced, whether it's from tobacco-induced cancers, alcohol-fuelled road trauma or fat and sugar contributions to obesity and associated health problems.

But not all agree with the proposition. The three main arguments against 'sin taxes' are:

1. They don't work.
2. They are highly regressive.
3. They represent 'Nanny state' intervention.

The 'they don't work' arguments suggest that either consumption of the harmful product will be substituted by even more harmful consumption – for example, young people will replace 'alcopops' (ready to drink (RTD) pre-packaged mixes of spirits with carbonated drink and sugar) with high concentrations of spirits – or that the targeted products will just be moved to the black market where controls are harder to implement.

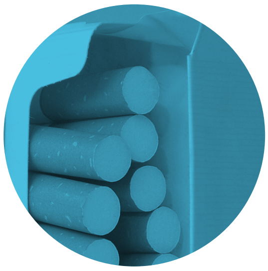
For people with equity concerns the 'sin tax' proposal poses ethical concerns. Generally people on lower incomes consume more of the targeted products than those on higher incomes, so the incidence of such taxes is borne disproportionately by poorer people, who can least afford them. The addictiveness of some target products also means that people with higher consumption levels are unable to change their levels of consumption. Even a steep increase in the price of cigarettes is unlikely to change the levels of consumption of a regular smoker, so – the argument goes – they just pay more to maintain their habit, quite possibly reducing consumption of healthier products, delivering a double negative impact.

Who's applying them?

Tobacco specific taxes are widely applied throughout the world and have been applied in Australia for many years, with the policy focus shifting over the last couple of decades from revenue raising to actually reducing use.

Australia's most recent incursion into taxing to reduce demand for a risky product was the introduction of a tax (70 per cent increase on the excise) on alcopops. Public health practitioners argued that these drinks were designed to appeal to teenage women and were likely to help induce unsafe levels of drinking. Alcohol taxes are widespread, but the alcopops tax is arguably one of the few implemented with a policy objective of consumer protection rather than revenue raising. Similar taxes exist in France, Germany, Switzerland, Ireland and some states of the United States.

In the 'fat tax' area, five European Union (EU) countries have a 'soda tax', with Denmark going it alone with a broader sugar tax that includes confectionary and chocolate and which raises about DKK 1.5 billion ($282 million) each year.



The Danish government is further developing taxation options to promote healthier food by introducing a tax on saturated fats at a rate of DKK 16 (about $3) per kilogram of fat for domestic and imported food, from October. There is considerable opposition to the tax on the grounds of: no evidence of links between fatty food and cardio-vascular disease, contravention of EU free trade rules, fear of damage to the Danish food industry and loss of competitiveness. However, Scandinavian colleagues Finland, Norway and Sweden are all reported to be considering similar 'fat tax' measures.

Do they work?

There is little argument that nations with high tobacco taxes like Australia have witnessed significant reductions in tobacco use over the last couple of decades. However, it should be highlighted that taxation has been accompanied by ongoing public health strategies including 'Quit' campaigns and support for smokers through ready access to nicotine patches, gum and related substitutes for tobacco.

Recent research by the National Drug Research Council concludes that the Australian alcopop tax has also been successful, with a 27 per cent reduction in teen drinking levels over the three years since the tax was introduced, without substantial substitution of drinking from alcopops to other forms of alcohol. However, the New Zealand Government concluded in 2009 that an alcopops tax would have no beneficial impact, citing studies from Europe that concluded that taxing 'ready to drinks' was more likely to increase aggregate alcohol consumption. There is less evidence available about the effectiveness of 'sugar/soda' and 'fat' taxes, just considerable debate.

Plans for Australia

The Henry Review made 138 recommendations, including proposals to use tax to help change behaviour on road use (congestion taxes) and through carbon pricing. These taxes, however, are not generally regarded as 'sin taxes' because their focus is to include 'externality costs (e.g. pollution)' into the prices for goods and services. The review proposed introducing a volumetric tax for alcohol, where alcohol would be taxed at a standard rate, irrespective of the beverage in which it was located. No change was proposed for tobacco taxes and sugar/soda and 'fat' taxes were not considered.

The 'nudge' effect

How much governments should interest themselves in individual and personal consumption is always hotly debated. An approach to public policy that seeks to provide a workable compromise between individual choice and public health is the concept of 'nudge' policies, articulated by Richard H Thaler and Cass R Sunstein. They develop the idea of 'choice architecture' where consumers are 'nudged' to make healthy choices by the architecture that supports a person's choices about purchases; for example by putting healthier food at eye level in supermarkets and by using default settings, such as unhealthy food in smaller serves than healthier food. A recent example of a 'nudge' policy has been the rebates offered by the Hobart and Adelaide city councils for smoke-free outdoor dining venues.

What role equity?

While the initial impact of taxes intended to improve public health is most likely to increase costs for consumers with low ability to reduce consumption, consumption is likely to fall over time, with associated health benefits. It is imperative, however, that any tax increases for unhealthy products are accompanied by other direct public health measures – such as education campaigns and incentives to use healthier alternatives – to make it as easy as possible for consumers to change habits and behaviour: a 'tax and nudge' approach.

With that approach, there is merit in proposing that 'sugar' and 'fat' taxes are put on the table at the National Tax Forum in October.

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