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Senate

Finance and Public Administration References Committee

Inquiry into Business Taxation Reform

A Submission on Revenue Neutrality

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Thank you for the invitation to present some views to you today

I should say immediately that the views I present are my own and not necessarily those of HSBC. As an institution HSBC has not formulated views on the issues before the committee.

The views I offer are those of a financial market economist and a former policy adviser who has followed the proposed tax changes with a good deal of interest.

As I understand it the committee wishes to focus on the claim for revenue neutrality in the tax package. Most of our financial market work focused on the implications of the proposed package of tax changes for various asset classes. This work is not relevant to the issue of budgetary cost. Because it has not been the main focus of our work I hope to be quite brief with my comments.

Monetary policy, growth and the surplus

The first general point I wish to make is that concerns of this committee have been given special urgency and importance by the Wednesday November 3 decision of the board of

the Reserve Bank to raise the overnight interest rate. Subsequent statements by the Bank indicate a forecast of inflation at the mid point of its target band two years hence. It appears to be more concerned about rapidity of output growth than any clear and present danger of higher underlying inflation. Indeed, last night the Governor of the Bank, Ian Macfarlane, repudiated as "outmoded" his own 1997 declaration that the Bank imposed no speed limit on growth, and responded only to forecast deviation of inflation from its target band. Though circumspect, the Bank has pointedly referred to the large net tax cuts and increases in welfare payments planned to coincide with the GST introduction on July 1 next year. In the Bank's view the marked reduction in the Budget surplus to fund these payments will stimulate growth. Mr Macfarlane does not criticise the tax cuts. He argues that the element of over compensation could see less pressure for higher wage settlements. But there is no doubt that the reduction in the surplus means growth would be higher than it would otherwise be.

From a position only a few months ago where both the Bank and the Government confidently expected a growth slowdown which the tax cuts would cushion, the Bank has shifted dramatically to a forecast that growth will not slow from the current rate, and that we will see good growth over the next two years. Though we have not yet seen its numbers, Treasury has likely moved a good way in the same direction.

A very clear implication of this line of reasoning is that any further reduction of the surplus could be and perhaps should be matched with offsetting interest rate increases. Indeed, the shape of the May budget may well be the biggest single determinant of the trajectory of monetary policy over 2000.

It is quite true that the government can subsequently adjust business tax rates to recover any shortfall in revenue which results from optimistic assumptions, other misestimations, or a failure to carry through proposed revenue enhancing tax changes such as similar taxation of business entities.

But it is not true that a temporary or prolonged shortfall in revenue would be costless. Any substantial net cost is likely to impact domestic spending and saving. W widely shared perception that such a slippage was likely would in my view concern financial markets.

I have no doubt that a projected or emerging shortfall of any considerable size would in the circumstances of 2000 have an immediate and unfavourable impact on short term interest rates, on bond yields, and on the offshore perception of Australia as a transformed economy with prudent fiscal and monetary policies.

Business tax changes and the Treasurer's November 11 announcement

The second general point I wish to make is that yesterday's announcements by the Treasurer have gone some way to meeting concerns that the business tax package will have a large net cost on the budget.

To my mind the proposed business tax changes are by and large good ones, which lower the rate by broadening the base and which by removing many special tax breaks provide a more efficient basis for making investment decisions.

I have not been able to reach a conclusion on the figuring in yesterday afternoon's statement. As the committee will already have found, it is anyway quite difficult to find grounds to contradict an ATO or Treasury estimate of the cost of business tax changes because timing effects are hard to predict, economic conditions are hard to predict, and behavioural responses of business are hard to predict. Not only is it hard to for outsiders to predict, it is also hard for the ATO and Treasury. While I an economic adviser to Prime Minister Paul Keating during 1992 and 1993 we watched with a surprise which sometimes turned to horror as successive ATO and Treasury estimates of tax revenue plunged, sometimes by billions of dollars, adding inexplicably to the forecast deficit. As Treasurer Peter Costello had the same experience. The hardest revenue to predict was business tax, because very large sums were under the control of a relatively small number of tax payers, all of whom seemed to get on to the same minimisation strategies at the same time. I think the most this committee can do is satisfy itself that the business tax package can plausibly be broadly neutral. Its determination to do so has already evoked a timely announcement of the second stage of the business tax proposals.

The universe of neutrality

The second general point I wish to make relates to the relevant universe of tax changes within which neutrality is sought. The Review of Business Taxation final report, for example, claims that its proposed changes are highly revenue positive, if the relevant universe includes business tax changes proposed in the 1998 ANTS document, as well as additional changes proposed by the Ralph committee. This is a sound claim if the only issue is the amount of additional tax projected to be paid by businesses. But it is not at all relevant to the issue of the additional impact on the surplus of the measures proposed on the Ralph report.

A key point for this committee with respect the relevant universe is that capital gains tax is not a business tax. That is, it is not paid by businesses. It is certainly a tax on income derived from a business, but so is income tax on dividends - a source of revenue not considered by the Ralph committee. Capital gains taxes affect the cost of capital, but no more so than taxes on dividends.

The distributional consequences of a revenue shortfall in capital gains tax are quite different from the distributional consequences in business taxes. The final incidence of business tax is unknown. But we know that capital gains tax is paid to an overwhelming extent by the well off. Any shortfall is a transfer of income to that group. For this reason is would be unsatisfactory in my view to achieve neutrality over what is claimed to be a business tax package by applying additional business tax revenue to make up a shortfall in capital gains revenue.

Capital gains tax figuring

Our work on the capital gains tax figuring has raised many of the same issues as those presented to this committee by Australian economists and economists from the US Congressional Budget Office. These include:

- The assumption of tax elasticity of 1.7 appears to require an increase in realisations by individuals in the first year nearly double that required in the preceding year. Is this consistent with past experience? Some US studies show a rapid short-term response to changes or impending changes in capital gains tax, but the data is often tainted by the inclusion of one-offs. Just because realisations were large prior to the increase in CGT in 1987 and fell thereafter, for example, does not mean that realisations would dramatically increase for a short period in response to a permanent change in CGT, effective this year. I think we have to ask what would in the Australian context motivate a rush of realisations on this scale. I frankly doubt we would see it on anything like the scale implied by the elasticity estimate.

- Even with quite high long run elasticity the BTR numbers show the CGT change begins to cost the revenue by the end of the projection period. Presumably the longer the projection, the greater the gap.

- The allowance for tax shifting from other forms of income to capital gains is clearly too small. Again these things are hard to predict, but the Committee will have noticed the amazing number of newspaper pieces recommending strategies to minimise tax using a 50 per cent exclusion from CGT. Most of these strategies are based on negative gearing, which is essentially a way of changing salary and other income into capital gains. As has been demonstrated to this committee, a quite small proportional shift in income between wages and salaries into capital gains can dramatically change the overall revenue implication.

Capital gains tax and monetary policy

I think neutrality for the capital gains tax change has to be considered separately from neutrality for the rest of the package. I also think the cost of the change is more important as an equity issue than as a fiscal responsibility issue. If the critics are right and the BTR numbers are wrong, the cost would be let us say of the order of several hundred million dollars. This is a very significant transfer of income to those who generally already have substantial assets. As a fiscal policy issue it is dwarfed by, for example, the $5.5 billion in net tax cuts and increased social security payments planned to coincide with the introduction of the goods and services tax.

But one important economic policy impact of the proposed change has I think been overlooked. This is the wealth effect. We know that the All Ordinaries index had doubled over the decade. We know from ABS material that the value of equities owned by Australians has increased around 40% over the last four years – years during which there

was very low inflation, and therefore very little loss to the post tax value of the gains from the elimination of indexation.

What the CGT exclusions propose to do is effectively double the tax paid value of the gains, where the equities are held by individuals. The four year period during which inflation has been insignificant is also the period during which we have seen a massive increase in individual shareholding as opposed to holdings of equities through funds. We know from US experience now and we suspect from the strength of Australian consumption over the last year that stock market wealth does increase current consumption, without requiring realisation of the gains. Going into a year in which the Reserve Bank is becoming concerned about the pace of growth, this kind of tax enhancement of existing gains seems to me quite inappropriate.