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Tax deductions are not all bad

RICHARD HOLDEN THE AUSTRALIAN MAY 06, 2015 12:00AM

It seems it's open season on tax deductions. Everyone from the Grattan and Australia institutes to the Australian Council of Social Service and the Australian Labor Party have concluded that the way to repair our budget deficit is to remove any tax deduction they can find.

Concessional superannuation taxation, dividend imputation, lower taxes on capital gains: all a boondoggle for the rich.

The whole public discussion around the matter is completely off the rails. There is way too much focus on who we tax and not nearly enough on how we tax.

The reason any tax deduction is allowed — included the ones mentioned above — is to remove distortions from the economy. Setting all taxes equal on all things actually tilts the playing field in favour of certain behaviours over others, such as consumption versus saving or debt versus equity.

Take capital gains tax. Australia, like every other advanced economy, taxes capital gains at a lower rate than ordinary income. Why? Because before money can be invested you have to earn it, and pay income tax on it. So if we tax the investment earnings generated from saving at the same rate as well, people balancing the decision between consuming and investing will be much likelier to consume — the tax system is tilting the playing field in favour of consumption.

This is bad for saving, investment, growth and jobs. It is not a matter of ideology, it is a matter of primary school level arithmetic.

This is a proposition so obviously right that even the intellectual du jour of the Left, the great French economist Thomas Piketty, agrees with it.

But in the context of the Australian discussion this policy is seen as deeply unfair — after all, those “tax breaks” go to wealthy people. Ya-huh: they are the ones saving and investing.

Dividend imputation is another case in point. The Murray and Henry reviews questioned the continued case for dividend imputation — comments echoed by a series of foot soldiers on those reviews such as former Treasury secretary Martin Parkinson and business figure Carolyn Hewson.

The two finest treasurers in Australian history, Paul Keating and Peter Costello, were apoplectic, and rightly so. (OK, Keating was apoplectic and Costello just distressed, but you have to factor out the baseline.) Dividend imputation simply stops double taxation and avoids artificially subsidising debt over equity (since interest payment are tax deductible). What on earth is it being questioned for?

The sketchy argument offered by advocates of abolition is that it favours investment in domestic over foreign equities. The subtext is that it looks like a big pot of money to go after. After all, people got \$30

billion in deductions last year. Can't we abolish imputation, take that money and run back to surplus?

Actually, no. And on that point, we should be incredibly wary of statements — all too commonly made — such as “if we abolished X tax concession we would raise \$Y billion”.

Whenever I hear someone say this I am reminded of the French expression that roughly translates as “and if my grandmother had wheels she would be a bicycle”.

Yes, maybe if people didn't change their behaviours and tax arrangements it would raise that much. But if there is one universal principle that economists have established it is that people respond to incentives.

Change the tax incentives and people will change their behaviour. Governments never claw back so-called tax expenditures through policy changes — and they often create a lot of unintended (or unthought through) consequences in the process.

The central goal of any good taxation system is to raise a given amount of revenue in the least distorting way. Distortions change behaviours, shrink the economic pie, and make everyone worse off in the end.

Distributional concerns and equity are vitally important. The right way to address those concerns is through the transfer system. Transfers such as the family tax benefit, unemployment benefits and the aged pension are the right tools to use to address equity. Tax the wrong way and it reduces the growth engine that makes those transfers possible.

The bottom line is this: we should tax for efficiency and redistribute for fairness. That is unlikely to be the most popular bumper sticker at the next election. But it is a very sound guiding principle for tax policy.

There is far too much discussion about who we tax and not nearly enough about how we tax. We have wound back the clock on public debate about taxation to the pre-Keating era.

That's more than a shame, it's really dangerous.

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