



Henry Tax Review

An overview of issues for motorists

Prepared for the Australian Automobile Association

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1 Introduction

This report provides an analysis of the proposals relating to motoring contained in the document entitled *Australia's Future Tax System: Report to the Treasurer* (Henry, Harmer, Piggott, Ridout, & Smith, 2010a), more commonly known as the Henry Tax Review. It will also provide an analysis of the response of the Australian Government to the recommendations of the Henry Tax Review so far, and some economic theory to provide context for the recommendations. This report has been commissioned by the Australian Automobile Association.

2 Government Response so Far

The Government has responded to only a few of the recommendations contained in the Henry Tax Review so far. In particular, it has announced:

- a reduction in the company tax rate from the current level of 30 per cent to 29 per cent in the 2013-14 financial year and to 28 per cent in the 2014-15 financial year
- small business will receive a reduction in the company tax to 28 per cent for eligible businesses from the 2012-13 financial year
- small business will also receive an instant write-off of assets up to \$5,000 and a single depreciation pool for most other assets.
- the introduction of a new Resource Super Profits Tax (RSPT) commencing on 1 July 2012
- the establishment of a State Infrastructure Fund which will use some of the proceeds from the RSPT to assist with investing in major infrastructure projects, including roads, associated with resource projects (not a recommendation from the Henry Tax Review)
- increasing the superannuation guarantee levy rate from the current level of 9 per cent to 12 per cent by 1 July 2019 and providing a superannuation contribution of up to \$500 annually for low income earners, with effect from 1 July 2012 (not connected with any specific recommendations from the Henry Tax Review).

The Government has also announced:

In the coming months we will have more to say on a number of other areas considered by the review, especially making tax time simpler for everyday Australians, improving incentives to save and improving the governance and transparency of the tax system. This would represent a full second term agenda. (Rudd & Swan, 2010)

The Government has specifically ruled out some recommendations from the Henry Tax Review. Of particular interest to motorists are that the Government will not:

- abolish the Luxury Car Tax
- reintroduce indexation of fuel tax to the consumer price index (CPI).¹

In relation to other recommendations from the Henry Tax Review, the Government commented:

Other recommendations in the review are not government policy. We have called for a mature tax debate and expect the other recommendations to be the subject of much discussion in the coming years. (Rudd & Swan, 2010)

On the basis of the above comments, it appears the Government has put most of the recommendations of the Henry Tax Review of interest to motorists on the back burner until at least the third term of a Rudd Government.

3 Overall Philosophy

The underlying economic principles that appear to be guiding the Henry Tax Review are that raising revenue from taxes should be broadly based and avoid as much as possible distorting individuals' choices with the exception of taxes which are precisely targeted towards correcting market failures (eg congestion). A primary goal is minimising adverse affects on the allocation of resources.

According to the Henry Tax Review, revenue-raising should be concentrated on four robust and efficient tax bases:

- Personal income, assessed on a more comprehensive basis
- Business income, with more growth-orientated rates and base
- Private consumption, through broad, simple taxes
- Economic rents from natural resources and land. (Henry, Harmer, Piggott, Ridout, & Smith, 2010a, p. xvii)

It should be noted that even well designed taxes applying to these bases would not be strictly economically efficient. It would be more accurate to describe them as more efficient than other taxes in use in Australia and elsewhere.

In regard to other taxes, the Henry Tax Review outlined the following principles:

Other taxes should be maintained only if they efficiently address social or economic costs – such as taxes on tobacco, alcohol, gambling and environmental costs, and

¹ Fuel tax was considered to be a second best option for the variable pricing component of road user charging. As part of this proposal, the Henry Tax Review recommended indexation of fuel tax to the CPI.

efficient road user taxes or charges. (Henry, Harmer, Piggott, Ridout, & Smith, 2010a, p. xviii)

In keeping with these principles, the Henry Tax Review recommended abolition of the following motor vehicle related taxes:

- insurance taxes
- stamp duty on the purchase of motor vehicles
- luxury car tax
- fuel and vehicle registration taxes, if replaced by more efficient road user charges. (Henry, Harmer, Piggott, Ridout, & Smith, 2010a, p. xviii)

4 State Infrastructure Fund

While the details are vague, it appears that the proposed State Infrastructure Fund has been designed to assist resource rich states such as Queensland and Western Australia with additional infrastructure costs associated with resource development projects. According to the Government:

The Government will establish a new infrastructure fund for the States worth \$700 million in 2012-13, and that will grow over time. This fund will enable investments to be made in nation building infrastructure, including the infrastructure necessary to develop Australia's natural resource wealth.

The States will not have to wait until resource projects are complete and production comes on line for infrastructure funding to become available. The fund will enable States to deliver infrastructure as it is needed, including when new projects are being built, rather than having to wait to collect revenue until projects commence operation. (Australian Government, 2010, p. 6)

The Government has nominated infrastructure projects such as ports and roads as priority areas.

Despite its apparent political objective, there is general support in the academic literature that regions affected by resource extractive industries should be compensated for the additional costs imposed upon them.

Professor Michael L Ross from the University of California, Los Angeles, has argued that sub-national governments are clearly entitled to revenues which compensate them for the social, environmental, and infrastructure costs generated by resource extractive industries, although he contends that claims for revenues above and beyond these requirements are purely political (Ross, 2007, p. 249). According to Ross:

Local and regional governments should be compensated for the costs they bear when mineral extraction occurs in their jurisdiction. Local and indigenous peoples, who live on the land where extraction takes place, deserve special accommodations—beginning

with their full recognition as stakeholders whose concerns must be addressed before any new project begins. (Ross, 2007, p. 250)

An International Monetary Fund Working Paper by Ehtisham Ahmad and Eric Mottu argued that subnational governments should be compensated for the additional costs imposed by resource extractive industries:

If regional governments provide significant amounts of services and infrastructure for the exploitation of the natural resources, some charges may be considered a compensation for the associated costs, justifying some share of the revenues (eg a proportion of royalties) could be returned to the regional governments under the benefit-tax linkage principle.² (Ahmad & Mottu, 2002, p. 12)

5 Road Transport Taxes

The Henry Tax Review was scathing in its assessment of existing road transport taxes, commenting that they are not appropriate to meet future requirements:

Current road tax arrangements will not meet Australia's future transport challenges. (Henry, Harmer, Piggott, Ridout, & Smith, 2010a, p. 53)

The Henry Tax Review outlined a principle for road transport taxes:

Transport-specific taxes should only be imposed where they improve the way that people, businesses and governments make decisions. In general, this means that transport taxes should be designed to correct market failures in the transport sector — specifically, to ensure that users of transport make decisions based on the full costs of their activities on the community (including unpriced costs that spill over to others and the cost of consuming infrastructure). (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 375)

The Henry Tax Review found that existing road transport taxes have been designed with the specific objective of raising revenue, but will be inadequate to deal with future requirements based on increasing congestion problems:

The existing structure of fuel tax, annual registration and other road-related taxes is designed primarily to raise revenue. These taxes more than cover the direct costs of providing road infrastructure, but are not capable of providing specific prices that vary according to location or time of use. (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 376)

² The benefit-tax link principle is that if a link can be established between a tax and the willingness to pay for a public service, the tax plays a similar role to a price in a market transaction.

5.1 Congestion Pricing

The Henry Tax Review has given qualified support for the introduction of congestion pricing:

Governments should analyse the potential network-wide benefits and costs of introducing variable congestion pricing on existing tolled roads (or lanes), and consider extending existing technology across heavily congested parts of the road network. Beyond that, new technologies may further enable wider application of road pricing if proven cost-effective. In general, congestion charges should apply to all registered vehicles using congested roads. (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 377)

Externalities (also known as spillovers) occur when participants in an activity do not necessarily bear all of the costs or reap all of the benefits from the activity. Congestion is an example of a negative externality as motorists impose costs on one another through longer and more unreliable journey times and higher fuel consumption.

When there is a negative externality such as congestion, there is a gulf between the private cost to the individual and the total social cost that their actions impose on others through their decision to drive in peak times and locations.

The Henry Reviews congestion pricing recommendations are well based in long standing economic theory. Economist Arthur Pigou (1920) proposed what has become the standard economic response to the treatment of negative externalities. The method consists in taxing the agent which doesn't perceive the total social cost of his or her actions, in an amount equivalent to the marginal external cost or externality, that is, the difference between the marginal social cost and the marginal private cost perceived by the agent. This method has become known as Pigouvian taxation. Congestion pricing seeks to internalise the external cost (or negative externality) of congestion which motorists impose on one another in the form of longer and more unreliability of journey times and higher fuel consumption.

A motorist who does not highly value car travel in peak times and locations relative to other options will leave the roads at peak times and locations under a system of congestion pricing. This will free up roads for their highest value uses.

Economist William Vickrey, the 1996 Nobel Laureate for economics, considered the pricing of road usage completely out of character with pricing arrangements elsewhere in a market economy:

I will begin with the proposition that in no other major area are pricing practices so irrational, so out of date, and so conducive to waste as in urban transportation. Two aspects are particularly deficient: the absence of adequate peak-off [sic] differentials

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and the gross underpricing of some modes relative to others. In nearly all other operations characterized by peak-load problems, at least some attempt is made to differentiate between the rates charged for peak and for off-peak service. Where competition exists, this pattern is enforced by competition: resort hotels have off-season rates; theatres charge more on weekends and less for matinees. Telephone calls are cheaper at night. . . . But in transportation, such differentiation as exists is usually perverse. (Vickrey, 1963, p. 452)

Another possible solution to congestion is to increase the supply of roads. However, this will not tackle the underlying cause of congestion (that motorists have little incentive to reduce the delay they impose on others) and may simply encourage more motorists back onto the road (Hubbard, 2009, p. 8). According to economist Murray Rothbard:

Frantically increasing the supply while holding the price of use far below the market simply leads to chronic and aggravated congestion. It is like a dog chasing a mechanical rabbit. (Rothbard, 1983, p. 316)

However, the Henry Tax Review correctly pointed out:

Introducing congestion pricing does not negate the need for expanded supply of roads in many cases, or other non-price measures. However, pricing is needed to leverage the value of urban road space, to ensure that investment in road capacity is put to its highest value use. (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 381)

The Review also observed:

Congestion charges can also help finance the provision of new road capacity in congested areas. (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, pp. 384-385)

Congestion pricing makes a lot of sense from an economic perspective. The only possible drawback from the Henry Tax Review proposal of limited implementation is that the imposition of congestion pricing may divert traffic onto roads not subject to congestion pricing, resulting in the displacement rather than the suppression of congestion. However, this risk already exists in relation to existing toll roads.

The main obstacle to congestion pricing has been political and the multijurisdictional agreements that would have to be brokered. According to economists Kenneth Small, Clifford Winston and Carol Evans:

Seldom has applied economics produced an idea with such unanimous professional conviction in both its validity and its political unacceptability. (Small, Winston, & Evans, 1988, pp. 86-87)

One area of disagreement surrounding congestion pricing has been what to do with any excess revenue raised after allowing for road upkeep and maintenance. The Henry Tax Review has observed that for some motorists the time savings associated with congestion charging may not outweigh the cost of the charge, or an absence of transport alternatives in some areas may

give some groups little choice but to pay the congestion charge (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 384). In this situation, the review has argued that these groups may need compensation to ensure broad community support.

The Henry Tax Review observed that in the first instance congestion pricing would put most pressure on existing public transport services, and that its introduction would need to be co-ordinated with additional investment in public transport. The Review observed that congestion charges would help finance this extra investment. (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 384).

It is important to note that revenue from congestion charges should not be used to increase public transport subsidies. At present, public transport is very heavily subsidised. This has not been successful at alleviating congestion and is not fiscally sustainable. The increased demand for and economies from better public transport network and services should allow a reduction of subsidies and facilitate funding of a better network.

5.2 Charging for Heavy Vehicle Use

The Henry Tax Review has also highlighted the inefficiencies in the current road transport tax arrangements for heavy vehicles, which consists of a road user charge levied at a flat rate per litre of fuel (independent of the vehicle, where it is driven or the actual road-wear caused) coupled with registration charges that increase with vehicle size. The review highlighted the cross-subsidies in the current system between different categories of heavy vehicles:

These current arrangements still lead to over-recovery from some heavy vehicles (those that travel fewer annual kilometres, are more lightly laden than the average or are less fuel efficient) and under-recovery from others (those that travel further than the average, or are more heavily laden, or are more fuel-efficient than the average). (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 385)

Other problems highlighted by the review included the fact that existing charges do not fully reflect the wear that trucks do to individual roads and that current arrangements prevent road owners from receiving compensation from users for damage to their assets (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, pp. 385-386).

While the Henry Tax Review acknowledged that heavy vehicle charges covered the aggregate costs of road-wear they cause, they did not cover the total social costs they impose on providers and users of Australia's road transport system:

Heavy vehicle charges may currently cover the aggregate costs of road-wear, but these charging arrangements do not generate prices or revenues that are closely aligned with social costs. (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 386)

This situation in turn imposes hidden costs on other road users and taxpayers. As a consequence, heavy vehicle users are currently free riding on motorists.

The Henry Tax Review left it up to the Council of Australian Governments (COAG) to develop better charging arrangements for heavy vehicles and declined to make any specific recommendations. The review noted that COAG was currently investigating the feasibility of a mass-distance-location pricing system that is due for completion by December 2011.

5.3 Compulsory Third Party Insurance

The Henry Tax Review criticised existing arrangements for compulsory third party insurance on the basis that they provide little incentive for riskier drivers to drive less, or to drive more carefully (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 390). The economic implications of this are that better drivers and those who drive less are cross subsidising more accident prone drivers. This results in more accident prone drivers doing more driving than they otherwise should while less accident prone drivers do less driving.

In order to address this situation, the Henry Tax Review suggested the introduction of distance-related pricing for driver insurance:

The introduction of distance-related pricing for driver insurance would give explicit recognition to the fact that road safety diminishes, and the likelihood of road accidents increases, with distance driven. (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 390)

As a consequence, the Henry Tax Review recommended:

States should improve third party insurance to better reflect individual risks. (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 377)

It is worth noting that the same principles apply to insurance of motor vehicles. A case could be made for government intervention to induce offerings of distance (and perhaps time and location) linked insurance.

5.4 Fuel Excise and Road User Charges

The Henry Tax Review acknowledges that a number of road transport taxes have been designed to raise revenue and may have over-recovered on the cost of maintaining the road transport network:

The existing structure of fuel tax, annual registration and other road-related taxes is designed primarily to raise revenue. These taxes more than cover the direct costs of providing road infrastructure ... (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 376)

This appears to be a tacit acknowledgement that private motorists have more than paid their way, and have probably cross-subsidised other road users such as heavy vehicles.

Based on principles previously outlined in section 3 above, the Henry Tax Review suggested the current fuel excise should be phased out:

Consistent with the principle that transport-specific taxes should be imposed only where they improve social or market outcomes in transport markets, fuel tax as a source of general government revenue should be phased out. (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 398)

The Henry Tax Review has endorsed the proposal by the Australian Automobile Association for a road user charge made-up of a two-part tariff to pay for the upgrade and maintenance of the road network. A revamped car registration fee would serve as the fixed price component. The review suggested a variable pricing component based on the distance travelled, location and time.

In the absence of technology to provide a more direct measure of road usage, the Henry Tax Review has proposed that fuel excise could serve as a distant second best option for collecting the variable price component.

If fuel excise is kept for the variable pricing component of a road user charge, the Henry Tax Review wants the anomalies in the current fuel excise system addressed. According to the review, fuel tax needs to tax all energy sources on an energy-content basis. In other words, the review wants to remove the special treatment currently afforded to alternative fuels such as LPG, LNG and ethanol as well as growing sources of anomalies in the future from hybrids and plug-in electric vehicles as they become more prevalent in the car fleet.

5.5 Other Road Taxes and Charges

Also in keeping with the principles previously outlined in section 3 above, the Henry Tax Review recommended the abolition of all other State road taxes and charges unrelated to the provision of roads:

The revenue-raising component of State taxes on motor vehicle ownership and use should be made explicit, and over time only be used to recover those costs related to road provision. (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 392)

In particular, the Henry Tax Review was scathing in its assessment of stamp duty on the sale of cars. According to the review, stamp duty impedes the efficient allocation of vehicles which results in people purchasing new vehicles and scrapping old cars less often, thereby reducing the overall demand for cars. In other words, high taxes are imposing high transaction costs on vehicle purchases, which in turn is dissuading people from turning over their vehicles

as often as they would like and encouraging them to hang on to less suitable cars.

5.6 Determining Future Road Construction Priorities

The Henry Tax Review wants an economic assessment to guide future road infrastructure provision, recommending that:

Governments should continue to reform road infrastructure provision, applying economic assessment to investments comparable to that for other forms of infrastructure. (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 401)

The review also wants to reduce the incidence of politicians using road funding for pork barrelling and other non-economic purposes:

Road investment and maintenance decisions that are taken for reasons of social policy, and are shown by cost–benefit analysis to be uneconomic, should be transparently identified as community service obligations and funded from general tax revenue. (Henry, Harmer, Piggott, Ridout, & Smith, 2010b, p. 396)

5.7 Ongoing Reform Process

In order to drive the reform process for road transport, the Henry Tax Review recommended that COAG should develop a National Road Transport Agreement to establish objectives, outcomes, outputs and incentives to guide governments in the use and supply of road infrastructure. In addition, the review recommended that COAG should nominate a single institution to lead road tax reform, and be responsible for the implementation of the National Road Transport Agreement.

The Henry Tax Review is also suggesting that in the conversion to a road user charging system, the principle of horizontal fiscal equalisation should be shelved. Horizontal fiscal equalisation is essentially the principle by which the Australian Government transfers funding to the States and Territories based on the recommendations of the Commonwealth Grants Commission. It essentially seeks to compensate States and Territories for any disadvantages they face in either revenue collection or service provision such that all States and Territories have the capacity to offer a similar level of service provision.

6 Luxury Car Tax

The Henry Tax Review recommended the Luxury Car Tax should be abolished. According to the review, luxury taxes violate the principles of horizontal and vertical equity. Horizontal equity requires people of the same economic means should pay the same amount of tax. Vertical equity requires that people of greater economic means should pay more tax. Luxury taxes

violate horizontal equity because wealthy people with modest tastes pay less tax than wealthy people with a preference for luxury goods. Luxury taxes also violate vertical equity because very few luxury goods are the exclusive preserve of the wealthy.

The Henry Tax Review concludes that luxury taxes are an ineffective and arbitrary means of redistributing economic resources and that more effective mechanisms are available for income redistribution

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