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A STOCKTAKE OF THE TAX SYSTEM AND DIRECTIONS FOR REFORM

FIVE YEARS AFTER THE HENRY REVIEW

Miranda Stewart, André Moore, Peter Whiteford and R. Quentin Grafton

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ABBREVIATIONS

ACT	Australian Capital Territory
AWE	Average Weekly Earnings
ATO	Australian Taxation Office
BEPS	Base Erosion and Profit Shifting
CGT	Capital Gains Tax
CPI	Consumer Price Index
COAG	Council of Australian Governments
CPRS	Carbon Pollution Reduction Scheme
EMTR	Effective Marginal Tax Rate
EU	European Union
FBT	Fringe Benefits Tax
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GST	Goods and Services Tax
HILDA	The Household, Income and Labour Dynamics in Australia Survey
IGR	Intergenerational Report
LITO	Low Income Tax Offset
MRRT	Minerals Resource Rent Tax
MYEFO	Mid-Year Economic and Fiscal Outlook
NFP	Not-For-Profit
NSW	New South Wales
OECD	Organisation for Economic Co-operation and Development
PAYG	Pay-As-You-Go
PRRT	Petroleum Resource Rent Tax
SME	Small and Medium Enterprises
TES	Tax Expenditures Statement
TTPI	The Tax and Transfer Policy Institute
VAT	Value Added Tax

ABOUT THE AUTHORS

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THE TAX AND TRANSFER POLICY INSTITUTE

The Tax and Transfer Policy Institute (TTPI) was established at Crawford School of Public Policy, The Australian National University, with the mission to undertake independent research and policy analysis relevant to the Australian tax and transfer system. The TTPI aims to carry out and support independent research and policy development in taxes and transfers at a national, State and local level, in regional and global context. The establishment of the TTPI implemented Recommendation 134 of the Henry Review (Henry 2010a).

TTPI pursues the following strategies to support excellent research for tax and transfer policy for public benefit:

- > Building postgraduate, doctoral and postdoctoral research positions in all disciplines relevant to tax and transfer policy;
- > Forming partnerships with other universities in Australia and throughout the world to harness the best expertise on taxes and transfers;
- > Publishing research and policy analysis widely in both academic and public forums to inform, enhance and influence public knowledge and debate about taxes and transfers.
- > Engaging with government agencies to learn about policy concerns and to build researcher access to data on taxes and transfers for evidence-based policy, including through secondments and exchanges between academic, government and private sector.
- > Holding public and invitational events on tax and transfer policy to inform, engage and influence policymakers, stakeholders and the public and to further academic research.
- > Establishing a network of fellows across relevant academic disciplines including public finance, economics, law, accounting, political science, psychology, governance and philosophy.

TTPI does not exist to offer a single perspective on tax and transfer policy. Rather, it aims to foster a richness and diversity in tax and transfer policy research in Australia and internationally for the short and long term, exploring issues and solutions to the critical tax and transfer policy challenges facing governments over the next few decades.

EXECUTIVE SUMMARY

Tax reform is in the news daily. Calls for fundamental reform have become louder, but there are diverse views on the direction and scope of the reform that is needed. The Liberal/National Coalition Government has committed to a White Paper process on Tax Reform, which the Government has indicated will commence with the release of a discussion paper designed to prompt a national conversation about tax reform. The Government has also commenced a White Paper process for reform of the federation (DPMC 2014; 2015), which is examining the distribution of responsibilities between State and Commonwealth governments, with implications for federal financial relations, including taxation.

But what is tax reform? What needs fixing in Australia's tax system, why, and what can and should be done? Hotly debated issues range from whether to broaden the base or increase the rate of the Goods and Services Tax (GST), to how we can properly tax multinational corporations. There is debate about whether superannuation tax concessions are fair; the impact of tax on housing; and many other issues ranging from the complexity of tax rules for small business to the volatility of stamp duty revenues.

Five years ago, the Henry Review (*Report on Australia's Future Tax System*, Henry 2010a) made a detailed examination of Australia's tax and transfer system. To place the myriad of tax issues, proposals and debates in context, this TTPI report provides a stocktake of the tax system five years after the Henry Review. Tax reform is fundamentally political. Rather than recommending specific reforms, we aim to identify key principles and directions for tax reform and to show what we know, and where the gaps are in our knowledge of tax policy.

This TTPI report:

- > reviews the economic and social challenges which the Henry Review identified and identifies new ones which have come to the fore in the last five years;
- > provides an overview of the tax and transfer system and changes since the Henry Review, including comparisons with selected countries;
- > identifies principles for analysis and discusses some of the broad choices and trade-offs that will need to be considered in any reform;
- > assesses the extent to which the Henry Review continues to provide a basis for considering the direction of tax and transfer system reform; and
- > identifies areas that warrant further consideration and research.

Principles of tax reform

Taxation is our primary mechanism for funding government. The transfer (or social security) system is our primary tool for redistribution to those who are in need. The tax system must deliver sufficient revenue for governments to achieve service delivery and policy development, including adequate levels of transfers or social security, in line with expectations of the Australian people. Since federation, the Australian community has made broad choices about the desired level of government expenditures, redistribution and taxes based on the history of our government and economy, community values and the political contest of ideas.

Tax reform should aim to support sustainable and inclusive economic prosperity through improving efficiency, promoting fairness in an overall progressive tax-transfer system and building resilience in the tax system in the face of economic, social and technological challenges. As recommended by the Henry Review, Australia needs a broad based tax system that raises adequate revenues from personal and business income, economic rents from resources and land, and private consumption. Tax reform should aim to strengthen the tax system across all of these bases.

Taxes and transfers affect the behaviour of individuals and businesses. Economic theory and modelling of tax efficiency and the incidence of the tax burden is difficult and relies on many assumptions. However, it is an important input to tax policy decisions that aim to support economic prosperity by reducing distortions in individual and business decision making, especially where capital or labour is mobile or tax planning margins exist.

Fairness is critical to the system to ensure appropriate contributions from those with capacity to pay, to enable redistribution to those in need through the transfer system, and to support essential government goods and services for the wellbeing of all Australians. Fairness should be considered across the tax and transfer system, and government as a whole. The principle of ability to pay remains important in delivering progressivity in the tax system.

The concept of resilience of the tax and transfer system aims to capture a range of important goals relating to the effectiveness and adaptability of the system as it operates in the real world. Goals for a more resilient tax and transfer system include simplicity, sustainability, certainty, cohesiveness, legitimacy, ease and low costs of administration and compliance, flexibility and resistance to tax avoidance and evasion.

Much of the recent commentary and analysis about reform of the Australian tax system has focused selectively on 'priority' areas for reform. The Henry Review addressed the overall Australian tax system including Commonwealth, State and local taxes and sought to take into account interactions between different taxes and in the tax and transfer system. It then identified a broad set of taxation arrangements to position Australia for dealing with the social, economic and environmental challenges for the next forty years.

There is much we do not know about the effects of the tax-transfer system. In particular, new empirical research into responses to the tax system and the effects of administrative and compliance mechanisms can give us new insights into how to design a resilient system. Significant research and policy analysis is needed on future options for tax reform.

Challenges for the tax system

The Henry Review identified six challenges and opportunities for designing a future tax and transfer system for Australia. These were: demographic change; the social context and expectations; the environment; increased factor mobility; addressing system weaknesses; and growth in Asia.

The following challenges have come to the fore in the last five years to form the context for tax reform today. These build on those identified by the Henry Review:

1. the effect of the mining investment boom as it declines, including the decline in the rate of economic growth, effects on revenue and structural changes in the Australian economy;
2. demographic changes especially population ageing and changing patterns of work, family and care;
3. Australia's lagging productivity performance;
4. concerns about fairness and inequality;
5. the digital global economy including new multinational business models; and
6. environmental challenges and climate change impacts.

The current state of the tax-transfer system

The Commonwealth Government levies income tax and GST exclusively, as well as petroleum and gas resource rent taxation, customs and excise. State and Territory governments levy land tax, payroll tax, stamp duties, gambling taxes and some other levies exclusively and also receive royalties from mineral resources extracted from within their jurisdiction. Local governments levy property rates. Australia's total tax burden across all levels of government in 2012 was 27.3 per cent of GDP. This was below the OECD average of 33.7 per cent and below Canada (44 per cent) and New Zealand (33 per cent). Australia's tax level has declined in recent years.

The Commonwealth Government raises around 80 per cent of all tax revenues. There is a significant disparity between the broad governing responsibilities of States, and their limited tax revenues, termed *vertical fiscal imbalance*. This is a key issue for the government's White Paper on reform of the federation, which must be taken into account in tax reform.

Australia relies less on consumption taxes than many other countries, especially in Europe. Australia collects proportionately less revenue than other countries including New Zealand and Canada, from a broad-based consumption tax such as the GST.

The Intergovernmental Agreement that allocates GST to the States and Territories requires any reform to the GST rate or base to be unanimously agreed between the Commonwealth and all State and Territory Governments. It has proved to be quite stable in its 15 years of operation. It is unlikely that the Commonwealth would proceed with any significant change without the agreement of all States and Territories.

The personal tax-transfer system is Australia's main tool for redistribution of incomes. Tight targeting of transfers means Australia is the fifth lowest spender relative to other OECD countries and spends less than both Canada and New Zealand on the transfer system.

Government spending may be undertaken through targeted concessions or subsidies in the tax law, called *tax expenditures*. We cannot get a full picture of government taxing and spending without taking account of tax expenditures. The largest tax expenditures in the personal income tax relate to superannuation and other forms of savings and investment. In the GST, tax expenditures include the exemptions for food, education and health. Broadening the tax base often requires removing or reducing some tax expenditures.

Personal income tax, transfers and saving

Personal income tax comprises about 40 per cent of all tax revenues and close to half of Commonwealth taxation. It is Australia's largest single source of tax revenue. Our reliance on personal income tax is similar to New Zealand and Canada. Australian personal income tax revenues have declined as a share of GDP because of cuts in average tax rates over the last 2 decades. Fiscal drag, or *bracket creep*, will cause average tax rates to rise again in the future, unless changes are made to rates or thresholds.

The highly targeted nature of Australia's transfer system including income and asset testing produces high effective marginal tax rates for many who receive support. This reduces the incentive and economic return to paid work, lowering workforce participation especially for women caring for young children. The combined effect of personal income tax and transfers on work incentives and on fairness must be taken into account in any reform of either system. The economic return from increased women's workforce participation supports a tax reform direction that would increase support for childcare and reduce effective marginal tax rates on low and moderate wage earners.

There are gaps and complexity in the personal income tax base. There is scope to broaden this base, especially in relation to savings and investment, and deductions related to work and saving. Broadening of the personal tax base would strengthen revenue collection and could enable a reduction in tax rates on work and business income if desired. Lower marginal tax rates on low and middle income earners could improve incentives to work and do productive investment. The Henry Review recommendations to tax saving more consistently under a 40 per cent savings discount and to restructure superannuation tax concessions can provide a significant direction for reform.

The personal income tax could also be made more resilient by simplifying the legal design. This could reduce planning boundaries in respect of expenses, legal entities and forms of investment as well as reducing administrative and compliance costs.

Company tax

Australia's company tax is an important element in Australia's tax mix. Australia raises substantially more revenue than many other countries in company tax (around 5 per cent of GDP, or 17 per cent of all tax revenues).

The Australian statutory company tax rate is 30 per cent and the effective tax rate for Australian companies is close to that rate, although it may vary across industries and sectors. The company tax has a fairly broad base with few exemptions and concessions. Australian nominal and effective company tax rates are higher than the OECD average and than Canada and New Zealand.

Economic modelling of the company tax in a global economy suggests that it deters foreign investment and is borne in the long run substantially by Australian workers or consumers. A reform implication of this modelling is that a lower company tax rate would lead to increased national wellbeing. However, the ideal level of taxation on companies, or capital more generally, is debatable.

The specific benefits of lowering the company tax rate are extremely difficult to test. Australia's company tax collects revenues from economic rents, including from the resource industry, and is an important backstop to the personal income tax. The corporate-shareholder imputation system provides an incentive for Australian companies to pay company tax but also may deliver an excessive return to shareholders. A lower company tax rate would increase tax and planning margins for the personal income tax.

Company tax rules are complex for all sizes of business. Multinational enterprises carry out sophisticated global tax planning that may reduce their Australian and global tax rates to zero or close to it. The OECD Base Erosion and Profit Shifting (BEPS) project, and Australia domestically, are taking some steps to increase country cooperation to prevent base erosion. It is not clear how successful country efforts at coordination will be in protecting the company tax base. As indicated by the Henry Review, further research is needed into the best approach to company tax for Australia for large and small business in future.

GST and payroll tax

State and Territory governments have broad power to tax but raise only about 18 per cent of total tax revenue. Together, the GST and payroll tax are the most important taxes for the States. The GST raises about 13 per cent of total tax revenue.

GST is provided to the States and Territories under a horizontal fiscal equalisation formula. This means that GST is shared across States and Territories on a basis aiming to equalize their revenue and spending capabilities. There is dispute about whether the current formula achieves the correct balance.

The GST is Australia's only broad-based tax on consumption. It applies at a flat 10 per cent rate on a wide range of goods and services but taxes less than half of consumption, as exemptions or input-taxed elements make up more than half of the GST base. The GST rate is lower in Australia than in many comparable countries. The Henry Review was not able to examine GST reform specifically. However, trends in other countries have been to raise the rate and to reduce exemptions in the base, to the extent possible.

The payroll tax is a tax on the wages paid by businesses. If comprehensive, a payroll tax is equivalent to a tax on wages. Australia's State and Territory payroll taxes have various thresholds and exemptions that introduce distortions for business decisions and make it less efficient than otherwise. The Henry Review recommended broadening the payroll tax on wages, or that it be replaced by a cashflow business tax, perhaps also replacing the GST.

Property and insurance taxes

Australia raises about 3 per cent of GDP in taxes on property, a lower proportion than many comparable countries. Land taxes and council rates are the most efficient taxes, according to economic models. Land taxes are primarily levied by the States and Territories, but are designed less efficiently than they could be.

Most States and Territories rely significantly on stamp duties on property conveyancing and insurance. These are easy to collect but revenues are volatile. They are considered among the least efficient taxes as they deter individuals from moving as their personal circumstances change and encourage under-insurance. Reform is challenging politically and in terms of the potential impact on housing markets; a long term transition may be required.

CHAPTER 1 INTRODUCTION

MAIN POINTS

- > The Henry Review, published in 2010, was the first major review of Australia's tax and transfer system since 1975. Its framework, analysis and findings can contribute significantly to good tax reform.
- > Tax reform should aim to support sustainable and inclusive economic prosperity through efficiency; promote fairness in an overall progressive tax-transfer system and build resilience in the tax system in the face of economic, social and technological challenges.
- > As recommended by the Henry Review, Australia needs a broad-based tax system that raises adequate revenues from personal and business income, economic rents from resources and land, and private consumption. Tax reform should aim to strengthen the tax system across all of these bases in the long term.
- > Economic modelling of tax efficiency and the incidence of the tax burden is difficult and relies on many assumptions. However, it is a useful input to tax policy decisions that aim to support economic prosperity by reducing distortions in individual and business decision making, especially where capital or labour is mobile or tax planning margins exist.
- > Fairness is critical to the system to ensure appropriate contributions from those with capacity to pay, to enable redistribution to those in need through the transfer system and to support essential government goods and services for the wellbeing of all Australians. Fairness should be considered across the system as a whole. The principle of ability to pay remains important in delivering progressivity in the tax system.
- > The concept of resilience of the tax and transfer system captures a range of important goals relating to the effectiveness and adaptability of the system as it operates in the real world. Goals for a more resilient tax-transfer system include simplicity, sustainability, certainty, cohesiveness, legitimacy, ease and low costs of administration and compliance, flexibility and resistance to tax avoidance and evasion.

1.1 Tax principles

This chapter discusses the history and context of the Henry Review and then explains key concepts and principles of tax policy that are essential to understanding and engaging in the tax reform debate.

The Henry Review discussed various principles of taxation in detail in its Architecture Report (Henry et al 2008a) and Consultation Report (Henry et al 2008b). In the final analysis, the Henry Review identified five tax and transfer design principles (Henry et al 2010a, Box 2.1):

- > Equity
- > Efficiency
- > Simplicity
- > Sustainability
- > Policy consistency.

The first three principles are traditional tax policy and design principles. The latter two principles reflect a focus in the Henry Review on revenue and environmental sustainability and coherence of the tax-transfer system with overall government policy.

In this report, we follow the Henry Review in using the principles of *efficiency* (to contribute to economic prosperity) and *fairness* (equity). In place of simplicity, sustainability and policy consistency we use the single concept of *resilience* to indicate a tax system able to operate effectively in the face of social, technological and economic challenges. Each of these principles is discussed below.

It is important to view tax and transfer laws and reforms in the context of the system as a whole. Sometimes tax principles are mutually reinforcing. Often, the principles seem to be in conflict. In any real-world tax system, all tax policy and reform decisions will have trade-offs and consequences for the distribution of benefits and burdens. However, taking a broader view of the goals of economic prosperity, fairness or resilience for the system as a whole can assist in resolving conflicts in these tax principles.

1.2 The Henry Review

The Henry Review was the first ‘root and branch’ review of Australia’s tax and transfer system in more than 30 years. The Review was system-wide in scope and long-term in vision, presenting an ambitious blueprint that identifies a range of reform directions. It was intentionally framed in terms of a 40-year vision aimed at identifying reform pathways for emerging medium and long-term challenges facing Australia.

The last comprehensive reviews of Australia’s tax and transfer system were completed in 1975. The Asprey Review (Asprey et al 1975) examined the tax system and the Henderson Review (Henderson et al 1975) examined the social security system. The Asprey Review set a reform framework with the central objective of broadening the tax base and lowering tax rates; this was progressively achieved in successive reform packages over ensuing decades. These goals continue to be relevant in current debates about tax reform.

Changes to the tax system following the Asprey Review took place through a number of policy analysis and political reform processes. The Draft White Paper (Commonwealth of Australia 1985) led to the introduction of Fringe Benefits Tax (FBT), Capital Gains Tax (CGT) and the corporate-shareholder dividend imputation system while reducing personal and company tax rates. Numerous tax and retirement system reforms established our superannuation system and associated tax concessions during the 1980s and 1990s. A New Tax System (Commonwealth of Australia 1998) introduced the GST, eliminated many inefficient indirect taxes including the wholesale sales tax, and reduced income tax rates. The Review of Business Taxation (Commonwealth of Australia 1999) led to a reduction in the company tax rate, broadening of the company tax base and lower tax on savings, including the introduction of the CGT 50 percent discount.

The Henry Review had a breadth of expertise on its Panel drawn from the public sector, academia and business. It engaged both the community and tax experts through an extensive process of consultation which attracted more than a thousand public submissions and carried out significant research and economic modelling, releasing several preliminary papers and convening an international academic and policy conference.¹ Some other countries conducted substantial tax reviews at the same time, including the Mirrlees Review (Institute for Fiscal Studies 2011) in the United Kingdom and the Tax Working Group (2010) in New Zealand.

The guiding principles and motivations for the Henry Review were set out in its Preface (2010a, v-vi). Its underlying premise was that economic, social, technological and environmental changes would profoundly affect Australia’s tax and transfer system but that these changes would evolve slowly. The Review did not conclude that the tax and transfer system was broken or in crisis, but it recommended that early consideration of challenges and reforms is needed in order to position Australia’s tax and transfer system for the future.

In spite of its broad remit, there were limitations in the Henry Review’s terms of reference that hampered its ability to comprehensively examine tax policy settings. The two most significant limitations were exclusion from consideration of the GST rate and base and the treatment of tax-exempt superannuation benefits (although the Review addressed taxation of superannuation contributions and earnings). The Review did examine the role of a consumption tax base in Australia’s tax system, suggesting a business cash flow tax as a direction for reform. However, there is no doubt that exclusions from its terms of reference influenced the final form of the Henry Review’s recommendations.

The Review examined Commonwealth, State and local taxes in the federation and it identified the need for intergovernmental agreement in a federal context as necessary for reform of Australia’s tax system. However, the Review did not consider a reform of the federation including State and Commonwealth roles and responsibilities, tax allocation, grants and expenditures. If it is to contribute to sustainable tax and transfer reform, the analysis of taxes must be embedded in a fuller understanding of how we fund governments in our federation, while any federation reform necessarily requires analysis of taxes.

¹ The Henry Review presented an Architecture Report Consultation Papers on the Tax System and Retirement Income, a Report on Strategic Issues in the Retirement Income System and a Final Report Part 1 (Overview) and two volume Detailed Analysis, released on 2 May 2010. All reports and research papers are available at www.taxreview.treasury.gov.au.

The Review produced a list of 138 Recommendations (see the Appendix), some of which are specific and others general. Most of the reforms proposed by the Henry Review were intended to be considered in a holistic way with other recommendations rather than separately, and as guidance for future tax policy and law development rather than as a discrete package of tax reforms. Around a third of the Recommendations have been implemented by governments in the last 5 years. However, no coherent package of reform has been based on the Review and previous attempts to enact some of the more important recommendations have led to significant missteps in tax policy and law design and implementation, especially in relation to the Minerals Rent Resource Tax (MRRT). Proposed reforms to State taxes have scarcely been addressed, except in the ACT.

1.3 Tax bases and tax incidence

The Henry Review offered a detailed explanation of tax principles, concepts and bases in its various reports. We briefly discuss the most important concepts that provide a framework for thinking about alternative tax systems and tax reform.

Tax bases

The Henry Review adopted a framework of the economic factors of production, labour, capital and land as the foundations of three tax bases of income, consumption and wealth. In general, production taxes levied on income or taxes on wealth are *direct taxes* levied directly on the taxpayer who derives the income from one of these factors of production. Consumption taxes are today levied mostly as *indirect taxes* on the suppliers of goods or services (such as the GST or excises) rather than on the ultimate consumer.

The Henry Review made the following fundamental recommendation about tax bases, which remains centrally important today:

Recommendation 1 (Henry et al 2010a)

Revenue raising should be concentrated on four robust and efficient broad-based taxes:

- > personal income, assessed on a more comprehensive base;
- > business income, designed to support economic growth;
- > economic rents from natural resources and land; and
- > private consumption.

This recommendation acknowledges that to be effective, a tax system must likely use all substantial bases, rather than relying on any one 'ideal' base. Reform proposals to change the *tax mix* usually aim to shift the balance between these tax bases, especially between income, consumption and land. However, it is useful to consider tax policy in light of two well-established 'ideal' approaches to defining tax bases as this can provide a benchmark for analysing the current system.

An 'ideal' income tax base is the comprehensive income tax. The comprehensive income tax applies to net economic gain, adjusted for inflation, derived by an individual taxpayer in a period of time. Income defined comprehensively includes all real, accrued gains from work or investment, net of losses or expenses. Comprehensive income is equivalent to consumption plus the change in net wealth of an individual in the period.² In the real world, income taxes do not succeed in taxing all net economic gain of an individual for various reasons. In particular, they usually only apply to realized gain, gain derived when an asset is sold or income is earned, and rarely adjust fully for inflation or capture all forms of return.

An 'ideal' consumption tax, sometimes known as an 'expenditure tax', would tax all expenditures of an individual in a period of time and would exempt savings and investment. Savings are assumed to be deferred consumption and so would not be taxed until actually consumed. Thus, the expenditure tax base excludes the change in net wealth and under certain restrictive conditions it is equivalent to a tax on labour income. The longstanding practice of exempting the home from the income tax, zero or lower taxation of capital gains and low taxed superannuation means that Australia's personal income tax is a hybrid that has characteristics of a expenditure tax (see discussion in Chapter 4).

² It is sometimes called the Schanz-Haig-Simons income tax base in honour of the economists who invented it, most famously Simons (1938).

Tax incidence

Public perceptions of tax incidence may differ from economic or legal incidence, while alternative academic views about the relative merits of taxation reform proposals often reflect a different understanding of where the burden of taxation actually falls (Henry et al 2010a, 19). All taxes ultimately fall on the returns to individuals as owners of the three factors of production of labour, capital and land (Henry et al 2008a, Appendix B). That is, all taxes are borne by people, whether as workers, investors or consumers.

For instance, company tax is not borne by the company but is ultimately borne by individuals who may be investors through a reduction in the return to capital, or consumers or workers through a shifting of the burden in prices or wages. The extent of tax shifting through prices or wages may vary.

The question of who bears the incidence, or real financial burden, of taxation is a difficult and debated area of tax policy analysis that requires complex whole-of-economy modeling. Tax shifting is a consequence of the impact of taxes on prices and factor returns and of individuals' decisions. The responsiveness of prices and factor returns, such as the economic return earned by working, is known as the *price elasticity* of the good, service or factor. This depends on a range of factors including:

- > the extent of market competition and the existence of economic rents (returns above a 'normal' rate of return taking into account inflation and a risk premium);
- > mobility of factors of production, principally capital but also labour;
- > substitutability of products, and of labour for capital (and vice versa); and
- > size of the domestic economy and its degree of openness (Rimmer et al 2014, 35).

To take another example, the GST levied on the producers and retailers of goods is borne by the ultimate consumer through being passed on in prices. However, in some circumstances, the GST may not be fully passed on to the consumer. For example, the burden of GST may fall instead on an individual business owner if the market for a product is not fully competitive.

In spite of the complexity and difficulty of tax incidence analysis, it is useful to try to model tax incidence to help understand the economic and distributional impact of a tax change. The estimated tax incidence may also help in assessing arguments for compensating particular groups who might be affected by tax reform.

1.4 Efficiency to support economic prosperity

Tax reform should aim to support sustainable and inclusive economic growth through improving efficiency, to ensure economic prosperity for all. While taxation clearly delivers benefits to society through government goods and services and redistribution, it also imposes economic costs.

To support economic growth, the tax system should be as efficient as possible. Economists define an *efficient* tax system as one that meets revenue needs while minimising the distorting effects of taxes on private decisions to work, save, consume and invest.

In some circumstances the distorting effects of taxes can be utilised by governments to improve societal outcomes using *selective taxes* or *tax expenditures*. Taxes may be used to correct market distortions or to regulate behaviour.

For example, the substantial tax concessions for voluntary superannuation saving are intended to encourage individuals who have sufficient income to save as much as possible in superannuation. The research and development tax offset available for companies is intended to address a market failure that leads to underinvestment in research and development, by improving the returns to companies which engage in research and development activities. Selective taxes or tax expenditures may also generate economic costs and may have unintended consequences and reduce revenue-raising overall.

Optimal tax design

One important theoretical approach to modeling economic efficiency of taxes is called 'optimal tax design' (see Abelson 2008, 416). It aims to inform policy-makers about how taxes and transfers can best be designed to minimise negative effects on economic growth, accepting that almost all taxes distort economic behaviour in one way or another.

In the case of businesses, taxation can alter decisions about how businesses are structured; how much they invest and where; how many people they employ and what they produce. For individuals, the tax system can alter the choice of investment, work and saving in ways that are less productive for the economy as a whole (see, e.g. Heferen (2012)). The greater the size of these taxation-induced behavioural changes or distortions, the more the tax system detracts from overall economic efficiency. This distortion can be at a point in time when a tax is paid, or it may affect future behaviour and actions over time.

The simplest economic model compares decisions made in the tax system to decisions made in a 'no-tax world'. In this model, all taxes are inefficient apart from a head tax which is a lump sum on every individual. However, as all decisions by individuals are made in the real world with pre-existing taxes, regulations and public goods, this simple theoretical basis is of limited relevance in practice.

The extent to which an individual actually responds to a tax—the *elasticity* of his or her response to taxation—is an empirical question and will depend on the characteristics, choices and context for the individual. Studies in optimal taxation recognise that 'real world' choices must be taken into account in assessing efficiency of a tax system (Slemrod and Gillitzer 2014, Apps and Rees 2010).

Efficiency should be considered in the context of the tax and transfer system as a whole. It is often difficult to identify how taxpayers will respond to changes in taxes or transfers. Consequently, it may be difficult to target tax bases and set tax rates in ways that are least likely to distort behaviour (see, e.g. Mankiw et al 2009). However, in some contexts, the empirical evidence is clear. One important lesson from optimal tax theory combined with empirical measurement concerns the different responses of men and women to changes in the tax system (for example, see Apps and Rees 2010). Women are more responsive to tax rates, in respect of their work behaviour, than men. High effective marginal tax rates as incomes rise and transfers are withdrawn can reduce work, particularly among low and middle-income women. We return to this issue in Chapter 4.

Individuals and businesses may respond to tax systems in a variety of ways, not only through choosing to change their decisions about work, investing and saving. For instance, a taxpayer may plan their affairs by claiming a large expense deduction so as to reduce taxable income, or choose to leverage investment in an asset such as real estate, generating a tax deduction to shelter their wage income from tax. Some large businesses, including some multinational enterprises, have almost unlimited ability to minimise taxes while maintaining investment in productive sectors around the globe. Small or privately owned businesses have less access to global strategies but can take advantage of family relationships that may facilitate minimizing tax.

On the other hand, many economic decisions of taxpayers are driven by factors other than taxes, and most taxpayers are compliant with the tax system. It is critical to build and maintain a tax system that is easy to comply with and is perceived as legitimate to support Australia's high level of voluntary compliance, so that it will raise adequate revenues.

A feature of tax policy design has been reliance upon a broad-based personal income tax for much of the revenue raising task, featuring a progressive rate scale with the average tax rate rising as incomes rise. This can achieve a reasonable degree of progressivity and distributional equity without excessively harming efficiency (Auerbach 2010, 63).

Excess burden of taxes

Economists attempt to estimate the efficiency effects of tax reform proposals for taxation by estimating the excess burden of a tax. Mathematically, economists seek to estimate the dollar value of the size of the tax-induced change in economic behaviour (substituting an activity that is taxed for another activity) over and above the cost of the tax.

The *marginal excess burden* reflects the economic cost over and above the revenue impact from a small increase in a tax expressed in cents per dollar of additional revenue. The *average excess burden* represents the economic cost from introducing a new tax, expressed in cents per dollar of additional revenue raised by the new tax. The marginal excess burden may be useful for considering the impact of small changes in the tax, such as an incremental change in the tax rate or tax base, while the average excess burden may be useful for considering the impact of introducing, or abolishing, a tax (KPMG Econtech 2010, 4). Both measures provide some rough and ready guidance about what taxes are preferred from an economic efficiency perspective.

The lower the calculated marginal excess burden, the more efficient is the tax. The Henry Review presented indicative³ modelling undertaken by KPMG Econtech of the excess burden from a 5 per cent increase in selected major Australian taxes.⁴ This modelling indicated a wide variation in the relative efficiency of different taxes (Henry et al 2010a, 13).⁵

3 The Henry Review noted that its modelling results could only be indicative due to the difficulty of modelling the full range of potential efficiency costs and interaction effects when there are simultaneous changes to different taxes (Henry et al 2010a, 13).

4 Royalties and crude oil excise, insurance taxes, payroll tax, corporate income tax, labour income tax, motor vehicle taxes, stamp duties, GST, land taxes, municipal rates and petroleum resource rent tax.

5 Updated modeling published by KPMG Econtech in 2011: <https://www.cpaaustralia.com.au/~media/Corporate/AllFiles/Document/professional-resources/taxation/kpmg-econtech-final.pdf>

The most efficient taxes (with lowest marginal excess burden) are found to be land and resource taxes, as they are considered to apply in general to an immobile source of return.⁶ The next most efficient taxes according to this model are broad-based taxes on consumption because they do not distort the decision to save or consume, and taxes on labour such as the personal income tax or a comprehensive payroll tax. The GST is an efficient tax; however the GST base has many exemptions which make it less efficient, as explained in chapter 6.

The least efficient taxes are modelled to be company income tax and taxes on capital, assuming that capital investment is mobile and taxes that fall on market transactions, such as stamp duties and insurance levies, that impede people from productive market activity.

The Henry Review recommended reducing company income tax in the long term, while increasing taxation of non-renewable resources and land. This does not mean that Australia would stop levying taxes on capital. Rather, a shift in the tax mix towards consumption tax and taxes on land is argued to increase economic prosperity because these taxes are more efficient. OECD modelling (Johansson et al 2008) suggests that a revenue-neutral shift of one per cent of tax revenue from income tax to consumption tax could increase long-run GDP by up to three quarters of a per cent. However, Hines and Summers (2009) point out that greater use of consumption taxes in place of income taxes has potential implications for tax progressivity and distributional consequences that would require careful consideration from the perspective of fairness.

1.5 Fairness

Two principles are useful for determining fairness of the tax and transfer system. These are the *benefit principle* and the *ability to pay principle*.

Fairness may be considered at a point in time (a static distribution) or over the lifecycle of individuals. There are times when considering inequality between individuals at a particular time is appropriate. While it may be more difficult to assess, it is also important to examine the effect of the tax and transfer system for individuals as they move in and out of dependence and independence and are situated in different family and work structures through the lifecycle, or even across generations (intergenerational equity). The Henry Review placed a strong emphasis on lifecycle and intergenerational equity. We discuss this further in Chapter 4.

⁶ However, the extent to which even resources such as minerals are 'immobile' depends on how much technology or intellectual property is used in their extraction. See further chapter 5.

Benefit principle

The benefit principle states that it is fair that we pay taxes in exchange for the benefit derived from government as a whole including government services such as education and health and public goods such as roads, rail, public transport, sewage and water infrastructure, and our redistributive transfer or social security system. This can be expressed broadly as 'taxes are what we pay for civilized society'.⁷

The benefit principle is most useful as a broad justification for adequate taxation across the community as a whole, rather than the distribution of relative burdens of taxation. It carries considerable weight in the community, for example in terms of the relationship between taxes paid and transfer payments and tax concessions received over a person's life, with an expectation that some tax paid over the course of a working life should be returned in retirement.

In applying the benefit principle, we should take a broad view of outcomes from government as a whole, including taxes and transfers, as well as expenditures on public goods. Examining the tax system in isolation, and at a single point in time, does not present the full picture of the distributional impact of taxes and transfers.

The benefit principle also underpins specific taxes or user charges on identifiable groups, such as agricultural levies or local government rates applied to a particular community. In an international context, the benefit principle is the main justification for taxing multinational enterprises that are not based in Australia on their profits derived from Australian operations or activities. This is because these multinationals gain a positive benefit from goods and services such as infrastructure that are funded from Australian tax revenues.

Ability to pay

The ability to pay principle helps to identify what is a fair amount or proportion of tax to be paid by individuals relative to each other. Ability, or capacity, to pay taxes is generally considered across two dimensions:

- > individuals with the same economic capacity should pay the same amount of tax (*horizontal equity*); and
- > individuals with greater economic capacity should pay more tax than those with lower economic capacity (*vertical equity*).

These principles of horizontal and vertical equity are widely accepted, yet equally open to wide interpretation. They depend on the particular characteristics of a taxpayer and their circumstances, and on a measure or metric of ability to pay.

⁷ *Compania General De Tabacos De Filipinas v. Collector of Internal Revenue*, 275 US 87 (1922) (United States Supreme Court) per Oliver Wendell Holmes J, 100.

In an income tax, the measure of ability is provided by the concept of taxable income, which is the legal definition of income, less deductions, that is subject to tax. To ensure fairness, it is important to ensure that the legal definition of taxable income provides a proper reflection of ability to pay. In a consumption tax such as the GST, ability to pay can be assessed by examining taxed consumption against a benchmark of either total consumption or total income of the taxpayer.

We often consider ability to pay in respect of a single tax, such as the personal income tax. However, it is the overall outcome across the tax and transfer system, including interactions between policy at different levels of government and effects over the lifecycle, which ultimately determines the fairness of the system.

Progressive, proportional and regressive taxes

In general, we measure the progressivity of a tax with respect to the income of the taxpayer. A head or lump sum tax would be fair in the sense that each individual would pay exactly the same amount. However, it is clear that such a tax would have a larger impact on a low income individual, relative to its impact on a higher income individual. That is, because incomes are unequal, individuals must pay different amounts of tax if the system is to be fair.

A *proportional* tax levied at a flat percentage rate would provide for an equal and proportionate sacrifice across all individual taxpayers. An example would be a 30 per cent tax on all income.

In Australia, as in most comparable countries, it is recognised that an individual's ability to pay tax increases as his or her income or assets increase. This supports a *progressive* tax in which higher income earners are subject to higher marginal tax rates and average tax rates than lower income earners. This has been a long-standing design feature of the Australian tax system. Progressivity in our tax system is principally delivered through the personal income tax, by increasing the marginal tax rate as incomes rise. Some other taxes, such as local government rates, are also progressive to a limited extent.

Chart 1.1 indicates the marginal tax rates and average tax rates in Australia's personal income tax (for more detail, see section 4.2 below). The *average* tax rate is calculated as the total tax an individual pays as a percentage of his or her taxable income. The average tax rate is always lower than the marginal tax rate except at very high income levels when it converges to the marginal tax rate.

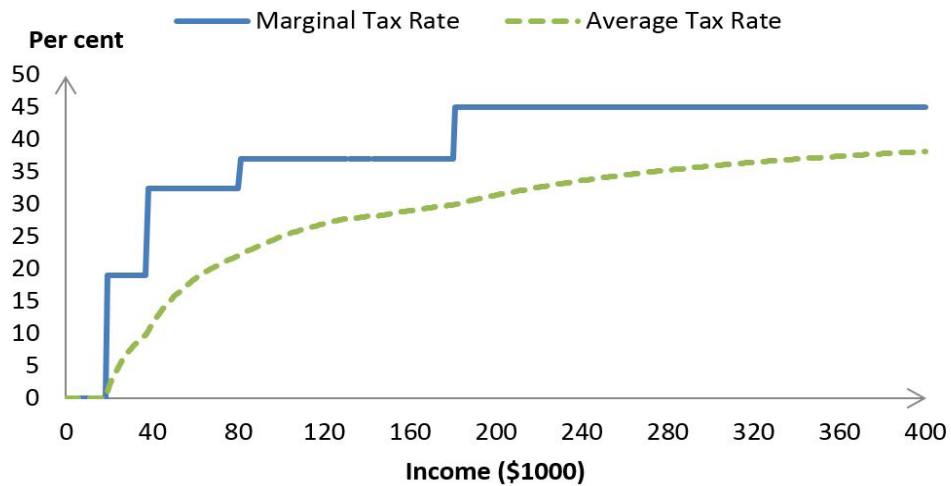
Chart 1.1 shows that even for income earners in the top one per cent earning more than \$250,000 per year, the average tax rate (the tax take as a percentage of taxable income) is less than 35 per cent although they face a marginal tax rate of 45 per cent (excluding the Medicare levy and deficit reduction levy).

The GST is a proportional tax as it is levied at a flat 10 per cent rate on all consumption in the base. However, relative to the income of taxpayers, the GST falls more heavily on low income taxpayers who spend more of their disposable income and have less capacity to save. This is because the GST does not tax income that is saved but only income that is 'consumed'. High income individuals can afford to, and do, save some of their income. Consequently, the GST is considered to be regressive with respect to income. Australia's GST exempts many basic consumption items including fresh food and vegetables, education, health, childcare and water, which are widely thought to reduce its regressivity. However, the extent to which these exemptions achieve this outcome is less clear.

Chart 1.2 represents how the average tax rate increases as income increases under a progressive tax, compared to a proportional tax (average tax rate stays the same) or a regressive tax (average tax rate declines).

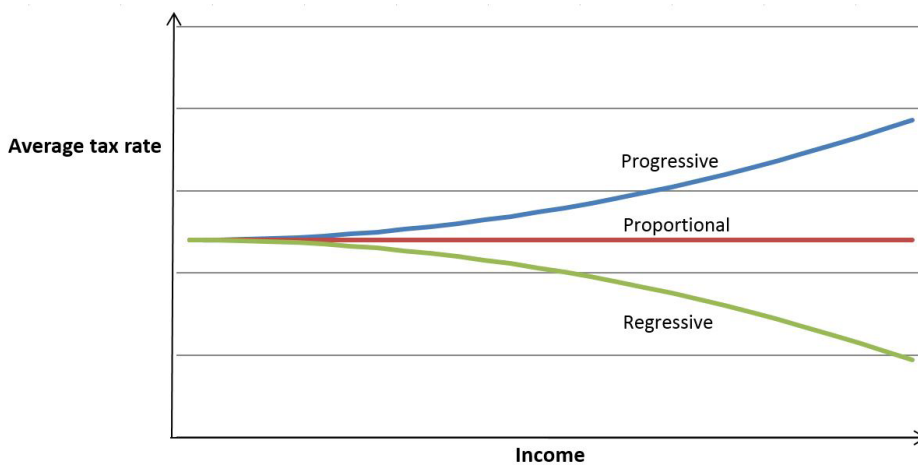
The tax and transfer system takes account of a broader range of factors that affect an individual's ability to pay, including household size, the number and age of children and the nature of any caring responsibilities. In Australia, as in most comparable countries, the basic unit of taxation is the individual. The tax system contains some allowances for variations in living costs due to family structure and other factors through targeted tax relief. However, most provisions recognising family circumstances are in the transfer system. We discuss this in Chapter 4.

Chart 1.1: Marginal and average tax rates



Source: ATO (2014a). Tax rates are the individual resident income tax rates in 2013-14, excluding Medicare Levy and temporary levies.

Chart 1.2: Progressive, proportional and regressive taxes



1.6 A resilient tax and transfer system

The concept of resilience of the tax and transfer system aims to capture a range of important goals relating to the effectiveness and adaptability of the system as it operates in the real world. The dictionary definition of ‘resilience’ is the ability to rebound or recover quickly and to be adaptable or flexible in changing circumstances.

In this report, we use the concept of resilience to embrace a range of important principles for design and operation of taxes and transfers, including:

- > simplicity
- > sustainability
- > certainty
- > cohesiveness
- > legitimacy
- > ease and low costs of administration
- > ease and low costs of compliance for taxpayers
- > flexibility
- > resistance to tax avoidance and evasion.

The tax system needs to be adaptable to changing economic circumstances locally and globally including changes in the way we do things, technologies and employment, investment and savings patterns. Resilience is a dynamic concept that aims to capture how the tax and transfer system responds and adapts to address changes in the behaviour of individuals in relation to their family, work, and other economic and social opportunities or misfortunes.

Examples

- > Individuals and employers are changing how work is done from standard employment relationships to casual, self-employed and flexible working hours. The tax and transfer system must be designed to ensure that a fair share of tax is borne by all who earn income and that social security payments are available for this flexible workforce when needed most.
- > In a digital economy, the value in multinational businesses is increasingly located in intangibles such as brands and trademarks. The tax law must be able to define and locate profits based on the value of intangibles, so tax administrators can identify the taxing rights of Australia and apply this law so that the right level of company tax can be collected.

Sustainability

Resilience includes the ability for tax revenues to be sustainable and to recover in the face of external shocks. Australia’s tax revenues as a proportion of GDP have not fully recovered since the Henry Review reported, in part because of the GFC and in part because of slowing economic growth. A decline and lag in recovery of tax revenues is not surprising and shows flexibility of the system, as business and investment losses are absorbed over time. Tax revenues should grow with the economy, but Commonwealth tax receipts are lower now as a proportion of GDP than they were in the last decade. State tax receipts have also declined as a percentage of GDP.

Simplicity, certainty and consistency

Resilience requires certain and reasonably simple tax laws. It also requires a stable and predictable tax system. Dramatic swings of policy direction generate significant uncertainty for individuals and businesses and this may undermine economic prosperity. Nonetheless, the system should also be sufficiently responsive and flexible to changes in the technological, social and economic environment.

Tax laws should be internally coherent and consistent with transfer policy and laws, to the extent possible. There are numerous tradeoffs in this context. For example, the individual unit is used in the tax system as it best reflects ability to pay and supports work incentives. However, the transfer system generally tests eligibility for income support payments based on couple or household income. Tax and transfer laws should also be consistent with other government policy, especially regulatory policies aimed at changing behaviour.

A relatively uniform treatment of different kinds of income, consumption, or assets, and of different individuals and legal entities will contribute to resilience of the tax system. The more uniform the system, the fewer planning margins exist to create opportunities and incentives for individual taxpayers to modify their behaviour or to avoid or evade tax. However, a balance must be struck. Tax law cannot be completely uniform because of inevitable differences in the characteristics and circumstances of taxpayers and goals of fairness.

Excessive complexity can make the tax and transfer system less fair. Some taxpayers will be better able to deal with complexity and adapt to change in the tax system (including by adopting structures for minimising or avoiding tax) than others. It is for these reasons that many tax systems offer simplified taxation arrangements to small businesses, for example in relation to depreciation of assets, while targeting complex integrity measures at larger businesses and multinational corporations.

Poorly managed interactions between different parts of the tax system offer avenues for taxpayers to exploit boundaries, for example, by shifting income to a lower taxed individual or entity or converting it into a more lightly taxed form, such as capital gains. The tax system should be designed to cope with these challenges without increasing the wasteful burden of complexity for the system and economy as a whole.

Minimise administration and compliance costs

All taxes involve administration and compliance costs that detract from overall efficiency.

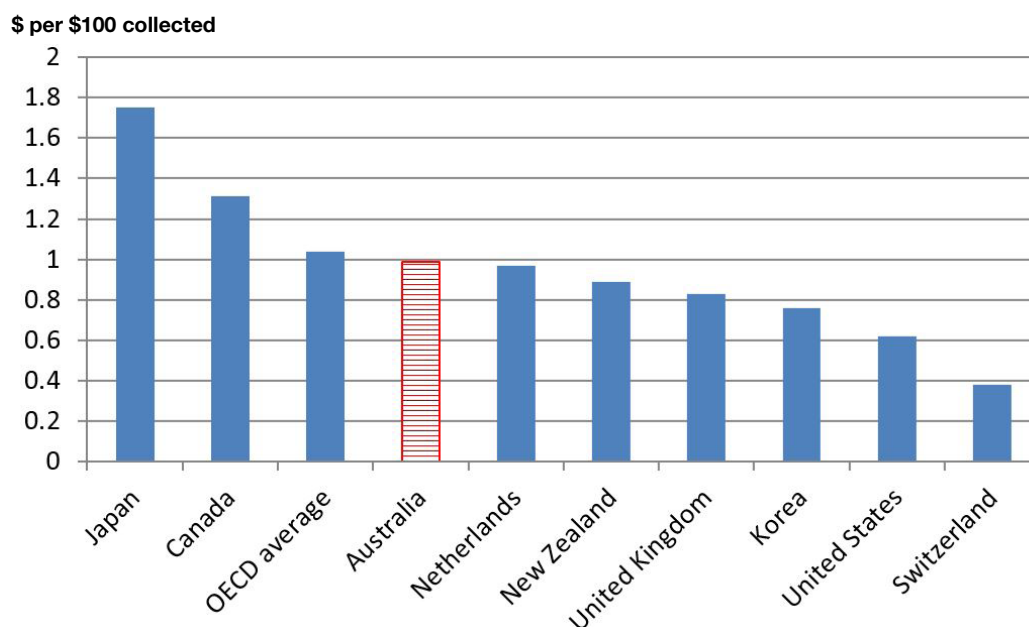
Administration costs include the costs to government of designing, operating and changing the tax system. The Australian Tax Office (ATO) is widely regarded as an effective tax administrator. It has an overall cost of collection of less than \$1 for every \$100 of net tax collected (ATO 2014b). The ATO's cost of collection ratio, which measures the

administrative cost per \$100 of net revenue is comparable to the ratio for similar countries. This is indicated in Chart 1.3 below. However, overall, New Zealand and the United Kingdom have lower ratios than Australia.⁸

Tax administration costs vary depending on the tax and as a result of specific contextual factors. In Australia, the GST has a relatively high administration cost of approximately \$1.29 per \$100 of GST revenue, close to \$700 million in 2014-15 (Treasury 2014a, Paper 3, Table 3.9). We discuss some reasons for this in chapter 6. The ATO's cost of collection for the personal income tax is lower than the cost of collection ratio indicated in Chart 1.3.

A range of other indicators may also indicate challenges for tax administration. For example, the ATO has a significant amount of 'collectable debt' from Business Activity Statements, income tax and superannuation guarantee obligations, totalling \$19.5 billion in 2013-14 (ATO 2014b, Table 2.13).

Chart 1.3: Tax administration costs as a percentage of revenue collected



Source: OECD (2013b) Table 5-3.

⁸ Caution is needed in comparing the cost of collection ratio as this ratio is an average across taxes and also does not cover all taxes in each country; nor does it usually cover sub-national tax agencies.

A more resilient tax system would enable the ATO to reduce administration costs further, to provide clearer up-front legal guidance, settle outcomes to disputes for timely collection and build cooperative approaches to audit backed by strong enforcement where needed, while enabling it to adapt to new tax planning structures and approaches.

Compliance costs are borne by taxpayers and include the financial cost and time individuals and entities spend complying with their tax obligations. This encompasses the costs of engaging tax agents and accountants to assist with managing and planning tax affairs. Compliance costs in Australia are substantial and the empirical evidence suggests that compliance costs tend to be regressive.

Recent analysis by Tran-Nam et al (2014) reports survey data suggesting that personal tax compliance costs totalled around \$9.6 billion in 2011-12, or around 7 per cent of Commonwealth tax revenue. They also provide evidence suggesting that personal tax compliance costs fall disproportionately on lower-income earners who are least able to deal with them. For businesses, compliance costs fall more heavily on small firms relative to larger firms.

More than 75 per cent of all individual taxpayers lodging a tax return utilised a tax agent in 2011-12 (ATO 2014c), among the highest rates of tax agent use in comparable countries. For individual taxpayers, a resilient tax system would be one which compliance costs are reasonable, engagement with the system simple and minimal, and tax payments could be easily made on time so that tax debt is manageable.

Digital advances in data, payment and financial systems have potential to streamline and improve tax administration and compliance in future. Technological upgrades are costly but may generate benefits. For example, individual taxpayers may be able to view their tax obligations and transfer entitlements in a single uniform online account in future. Governments may be able to collect multiple taxes, perhaps even for different levels of government, from businesses in a simpler way using online business accounting systems, such as the Pay-As-You-Go (PAYG) wage withholding system.

1.7 Institutions and the pathway to tax reform

It is crucial for a resilient tax system that taxpayers accept that the tax law is legitimate and that processes of tax reform, law making and administration are fair, transparent and accountable. The Henry Review focused significant attention on tax institutions, governance and administration. Recommendations 111 to 138 address processes of tax policy and law making, tax and transfer administration and monitoring of the tax system.

This report does not address the institutions and processes of the tax system in detail. However, one Recommendation that we wish to highlight concerns the need for good empirical research to build a resilient tax system. As far as possible, we should aim to design and administer the tax and transfer system based on empirical evidence of how the system really works and how people really behave. The Henry Review recommended that the Commonwealth, State and Territory governments should systematically collect data on taxes and transfers and make this information available for empirical research (Recommendation 133) while also updating the privacy framework for taxpayers (Recommendation 129). The TTPI aims to support governments in making tax and transfer data available for good research to support a resilient tax system.

The Henry Review also put forward a number of necessary elements in the pathway towards tax reform. Its main points concerning the pathway to tax reform, which we support, are briefly summarized here (Henry et al 2010a, xxiv-xxv):

- > Tax and transfers are instruments of government policy and must be reviewed and reformed in light of overall tax, regulatory and expenditure policy of government.
- > The field of taxes and transfers is very broad and tax reforms will need to be made over time.
- > Businesses, individuals and markets need time to adjust to new settings in the tax and transfer system; it must also be recognised that adjustment has costs.
- > Implementation of effective tax reform will require agreement of the Commonwealth and all State and Territory governments and the implications for revenue sustainability must be assessed in detail.
- > Tax reform should not be pursued independently of the overall fiscal and macro-economic circumstances facing Australia.
- > All tax reforms affect the distribution of benefits and burdens across taxpayers. Transition is critical and compensation or other assistance may be required for affected taxpayers.

CHAPTER 2 CHALLENGES FOR TAX REFORM

MAIN POINTS

- > The Henry Review was undertaken over an 18 month period in 2008 and 2009, at a time of uncertainty regarding the economic outlook in Australia and globally. This uncertainty arose principally because of the impact of the global financial crisis (GFC) and the expected future trajectory of the mining boom.
- > The Henry Review identified six challenges and opportunities for designing a future tax and transfer system for Australia. These were: demographic change; the social context and expectations; the environment; increased factor mobility; addressing system weaknesses; and growth in Asia. These challenges remain for tax reform today however some aspects have become more pointed in the last five years.
- > The mining boom has transitioned to a third phase of production and lower investment accompanied by lower prices. Combined with the decline in the rate of economic growth and accelerating changes in the Australian economy towards services, this presents a number of tax challenges. These include lower corporate revenues than predicted and the need to build a tax system to support investment in Australia.
- > The digital global economy including new multinational business models poses a major challenge to the tax system. It is likely that coordinated global solutions will be needed to fully address these challenges. New technologies also present opportunities for improvements in tax systems that will make compliance and administration easier and more effective in future.
- > Australia's lagging productivity performance means that tax policy should focus on reducing distorting effects of taxation on decisions of individuals and businesses with the aim of improving skills and efficient allocation of labour and capital.
- > Since the Henry Review, Australia's population profile has reached a turning point, with the proportion of the population at working age in long term decline. There is a need to broaden workforce participation especially by young people, women currently working part-time or not at all, and older workers transitioning to retirement, in order to maintain the tax base while also addressing needs for family and care through the tax-transfer system. New work practices also pose challenges for resilience of the tax system.
- > The tax-transfer system is a key element of Australia's policy response to ensure a fair distribution of economic rewards. Fairness, actual and perceived, is critical to legitimacy and sustainability of the tax system. In the face of increasing public and policy concern about inequality, investigation of policies to address uneven benefits at the top end of the income and wealth distribution, and ensuring an adequate basic minimum for all, should be prioritised.
- > Environmental challenges and climate change impacts continue to grow, Tax policy should aim to support environmental sustainability coherently with other government policy, while not generating perverse incentives that run counter to environmental policy goals.

2.1 The mining boom and structural economic change

The greatest single influence on Australia's economic fortunes over the last decade has been the 'millennium' mining boom supported by East Asian industrialisation and burgeoning Chinese demand for coal, iron ore and natural gas (Garnaut 2013; Grafton 2014). The mining boom and the associated terms of trade effect has been the major factor driving the expansion in Australians' material living standards. This is reflected in increases in wages and profit levels and in the level of government goods and services funded through taxation, including family transfers and age pensions.

The mining boom has proceeded in three distinct, yet overlapping phases:

- > **Phase 1:** from 2003 and peaking in 2011, a rapid and sustained rise in global prices for Australian minerals exports which, in turn, drove the Australian dollar and terms of trade—the ratio of export prices received to import prices paid—to record levels;
- > **Phase 2:** from 2006 and peaking in 2013, a large and rapid increase in new mining investment; and
- > **Phase 3:** a production-driven phase, still continuing and characterised by rising export volumes, but accompanied by lower global minerals prices, with a lower level of new mining investment and a reduction in employment in the (mining) construction sector.

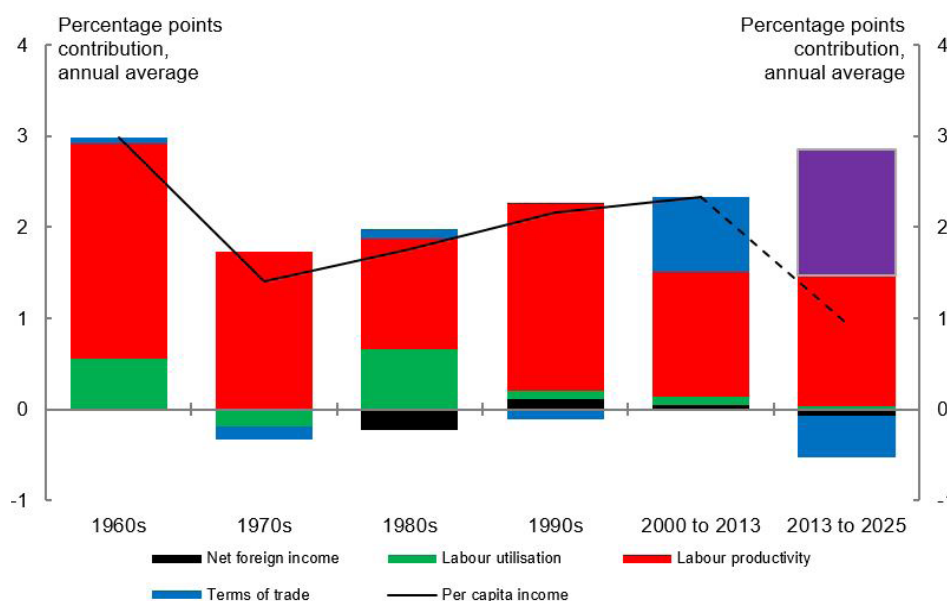
The resulting rise in living standards continues a record of strong Australian national income growth that started in the 1990s with a productivity boom. Per capita income grew steadily in the period from the 1970s to the mid-2000s. Per capita income is projected to level off in future years.

The effect of the mining boom on the broader economy is contested (see, e.g. Edwards 2014; Pincus 2014). It has been suggested that the mining boom and the high Australian dollar have contributed to accelerating structural change in the Australian economy. This involves a more rapid shift away from the trade-exposed agriculture and manufacturing sectors that previously lost international competitiveness under a high Australian dollar, towards mining and services (Connolly and Lewis 2010).

The recent pace of change has fuelled community concerns about the implications of a 'two-speed' economy and how returns from investment in previously expanding sectors such as mining and financial services should be captured and distributed as part of the structural adjustment process.

These changing drivers of income growth, as estimated in the 2014-15 Federal Budget, are shown Chart 2.1.

Chart 2.1: Changing drivers of per capita income growth



Source: Treasury (2014a), Paper One, Statement 4.

Note: The purple area in the 2013-2025 column represents the additional labour productivity growth required to achieve long-run average growth in real gross national income per capita. The dotted line is a forecast of the growth in national income per capita if labour productivity grows according to the 2014-15 Budget forecast.

The Henry Review coincided with the early part of the investment stage of the mining boom and linked it to the long run rise of Asian economies (Henry et al 2010a, 7). The latest projections in the Commonwealth Government's Mid-Year Financial and Economic Outlook Statement (MYEFO) (Treasury 2014b) indicate that annual growth in real per capita incomes will be 2.5 per cent in 2014-15, increasing to 3 per cent in 2015-16.

However, as the mining boom enters its third phase and Australia's terms of trade decline, *nominal* GDP growth will be only 1.5 per cent, 'the weakest nominal GDP growth in a financial year in over 50 years' (Treasury 2014b, 3). At the recent G20 summit, an overall challenge of increasing economic growth was highlighted by all participating governments including Australia.

The decline in the rate of economic growth is one cause of the recent and projected fall in tax revenues. As observed by the Parliamentary Budget Office (PBO), nominal economic growth is the main driver of government revenue (PBO 2014, vii). The mining boom underpinned strong growth in company tax collections during the early phases of the boom (2003-2008) but weaker growth since 2008. This is also partly a result of an increase in deductions generated by new mining investment.

A fall of more than 30 per cent in iron ore prices since the 2014-15 May Budget has led to downward revision of company tax receipts of \$2.3 billion in 2014-15 and \$14.4 billion over the next four years. Lower wage and employment growth will also reduce personal income tax receipts by an estimated \$2.3 billion in 2014-15 and \$8.6 billion over the next four years (Treasury 2014b, 3).⁹

The mining boom's transition raises other issues for tax policy, including how the taxation system supports capital investment and the efficient taxation of resource profits. The MRRT implemented by the previous government in 2012 was intended to harness gains from the mining boom. It failed to do so and in 2014 the MRRT was repealed by the current Government.

2.2 Demography

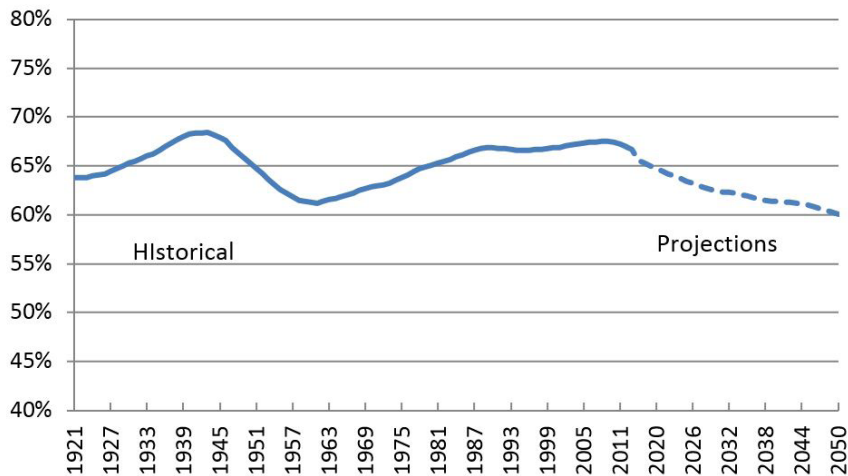
The changing structure of Australia's population has been a key driver of the rise in Australian living standards and tax revenues. The impact of population on economic wellbeing is driven by the size of the potential labour force and by the proportion of that potential labour force that is in work or is searching for a job. The forthcoming 2015 Intergenerational Report, not yet released, is expected to confirm these trends.

The working age population is often defined as that proportion of the total population that is between the ages of 16 and 65. The proportion of the labour force in work (or looking for work) is also called the *participation* rate. Between 1970 and 2010, the working age population as a proportion of the total population increased from 62.8 per cent to 67.4 per cent, largely a result of the baby boomers and net migration (Treasury 2010, 10). The participation rate rose from 60.7 per cent in 1978-79 to peak at around 66 per cent in 2010 (Connolly et al 2011, 1).

The Henry Review identified the ageing of the Australian population as a key feature of the next 40 years which would reduce some tax bases and raising the costs of health, aged care and dependency (Henry 2010a, xv). Since the Review, Australia's population profile has reached a turning point, as the proportion of the population that is working age is now in long-term decline. This trend is indicated in Chart 2.2.

⁹ The sensitivity of budget parameters to changes in the economy are also discussed by the PBO (2014b).

Chart 2.2: Working age share of the population (aged 16-65)

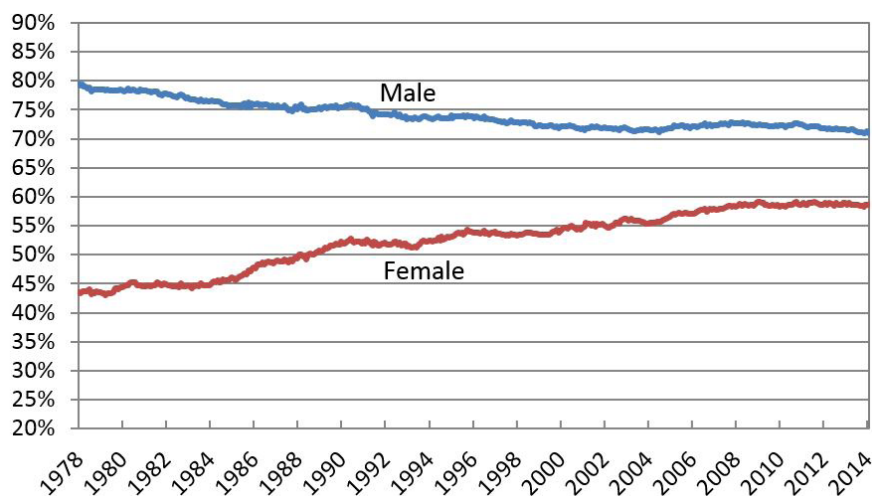


Source: ABS (2008), ABS (2014a) and Productivity Commission (2013b).

The increase in workforce participation from 1957 up to 2010 was primarily because of increasing participation by female workers, older workers (aged over 55) staying longer in the workforce, and a greater focus on attracting skilled migrants of working age. This participation was of various kinds including full and part-time work.

In particular, women’s workforce participation increased from below 45 per cent in the 1970s to almost 60 per cent by 2014. The *Harvester* family¹⁰ comprising a man who works full time in paid work and a woman who cares for children at home without pay is now a small minority (Garnaut 2013, 162). Trends in male and female workforce participation since the 1970s are shown in Chart 2.3.

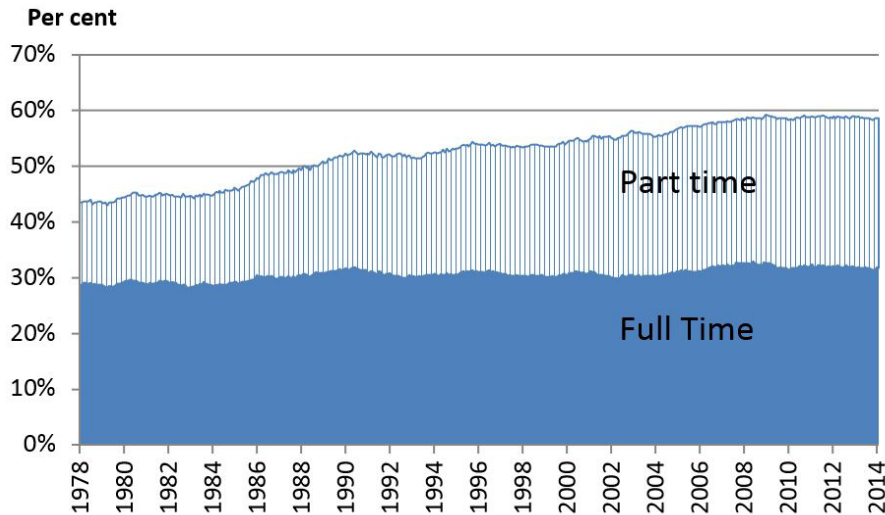
Chart 2.3: Trends in male and female workforce participation



Source: ABS (2014b).

¹⁰ The famous *Harvester* ‘family wage’ judgment (1907) 2 Conciliation and Arbitration Reports 1.

Chart 2.4: Trends in full-time and part-time female workforce participation



Source: ABS (2014b).

Chart 2.4 shows that almost half of female workers are in part-time employment. It is growth in part-time work that has driven the dramatic increase in female workforce participation. Australia's female workforce participation rate is higher than the OECD average but lower than that of Canada and Scandinavian countries, while more Australian women work part-time than do Canadian women (OECD 2012).

The expansion of employment opportunities in service industries, flexible working arrangements, changing social norms, improved technology and access to paid parental leave and formal child care have provided families with more options for blending work and family. Among employed mothers with children aged between three and five years, utilisation of formal childcare increased from 48.8 per cent in 1984 to 71.2 percent in 2011 (Baxter 2011, 9). Provisions in the tax and transfer system support increased use of child care services, and hence female participation. These include the ability to salary sacrifice employer-provided child care and both universal and family means-tested child care benefits. However, around 65 per cent of households with children aged under 5 years experienced difficulties with the availability of childcare and around 55 per cent with affordability in 2011 (Wilkins 2014, 14).

Today, families face a complex array of choices about who works, how much and when; how to value and prioritise work, education and business decisions of individuals;

care arrangements; and how household saving should be managed including decisions about buying a home and saving for retirement. Many of these choices are directly affected by the tax and transfer system, as all individuals and families, to a greater or lesser extent, move in and out of engagement with paying taxes, and receiving transfers across the lifecycle.

Effect of workforce participation on taxes and transfers

The 2010 *Intergenerational Report* (IGR) estimated that by 2049-50, there will be only 2.7 people of working age to support each Australian aged 65 years and older, compared with 5 people of working age per aged person in 2010 (Treasury 2010, viii). The workforce participation rate is projected to fall to less than 61 per cent by 2049-50 (Treasury 2010, ix).

The greater tendency for women and older workers to work part time, and for younger people to delay entering full time work to pursue further education, mean that even as the participation rate has increased, a greater proportion of the labour force are part-time workers (Connolly et al 2011, 1). This trend is expected to continue as baby boomers transition from full-time work into part-time work and retirement.

As noted by the Henry Review, an ageing population has implications for sustainability of government budgets. Until recently, increasing workforce participation by women and older workers more than offset the ageing of the population, contributing to higher national incomes and taxation revenues. However, population ageing will increasingly detract from economic growth and tax revenues in future decades. Demographic ageing also puts upward pressure on spending on age-related health, pensions and aged care (Treasury 2010, 45).

The IGR does not examine ageing-related fiscal impacts for the States and Territories. To address this gap, the Business Council of Australia commissioned ‘An Intergenerational Report for the States’, mirroring the approach taken in the 2010 IGR with a primary focus on long-term projections of health and ageing expenditure (Deloitte Access Economics, 2011). Based on the report’s projections, expenditure by the States and Territories on health and ageing sectors is projected to rise from 26 per cent of total State and Territory government expenditure in 2009-10 to 41 per cent in 2049-50.

Tax and transfer reform can help address these challenges through encouraging more workforce participation by women, older workers and the unemployed. Tax reform can also aim to improve productivity of the workforce, supporting higher wages and consumption which will also bolster tax revenues. To achieve growth and better tax revenue, governments at the G20 committed to a significant increase in women’s workforce participation (G20 2014).

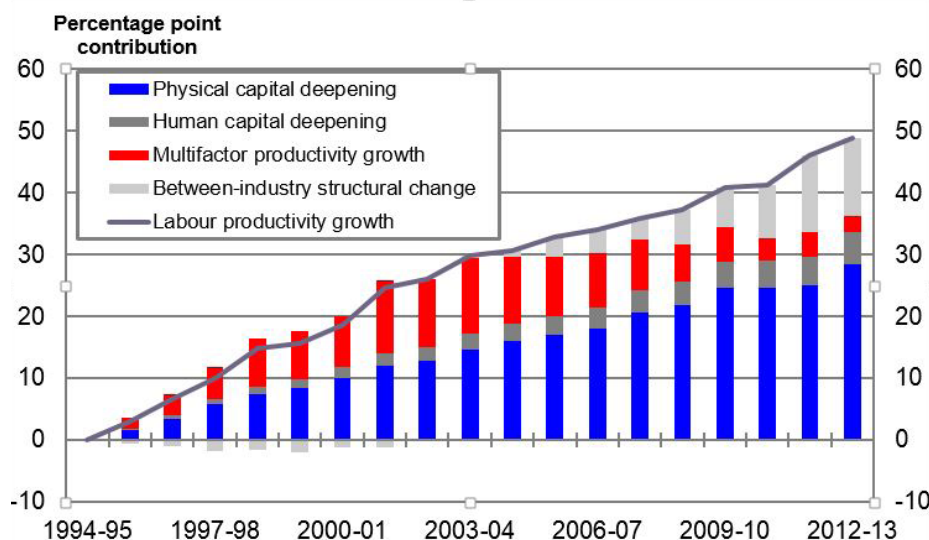
2.3 Productivity

As we face the end of the mining boom and population ageing, there is a need for other drivers of growth. Improved productivity can fill the gap so Australians can continue to enjoy improvements in living standards (e.g. Minifie et al 2013).

Productivity is defined as the amount of goods and services produced by an individual, a business or the whole economy, relative to the amount of resources or inputs used in production. Measures of productivity attempt to measure how efficiently and effectively those production inputs, such as labour and capital, are used to produce goods and services (Department of Industry 2013, 2).

In the last four decades of the 20th century, productivity accounted for around 90 per cent of national income growth (Gruen 2012, 3). Workforce productivity growth averaged around 1.5 per cent annually over this period and contributed strongly to overall productivity. However, workforce productivity growth has dropped significantly, with only a slight improvement in recent years (Treasury 2014a, 4-6). Multifactor productivity, a residual indicator that captures the efficiency with which labour and capital inputs are combined in production, has also declined in the last decade (Banks 2010; Treasury 2014a, 4-8, 4-13, 4-14).

Chart 2.5: Contribution of various factors to labour productivity growth



Source: Unpublished ABS data and Treasury.

There are multiple pathways to improving national productivity including adopting new production processes that allow existing resources to be used more efficiently, greater utilisation of technology and capital infrastructure, improving individual capabilities and skills. Another pathway is to reform regulatory and tax policy to support a more efficient allocation of factors of production (land, labour and capital).

Reforms that reduce the distorting effects of taxation on decisions taken by individuals and businesses can contribute to improving individual skills and participation in more productive work.

2.4 Inequality

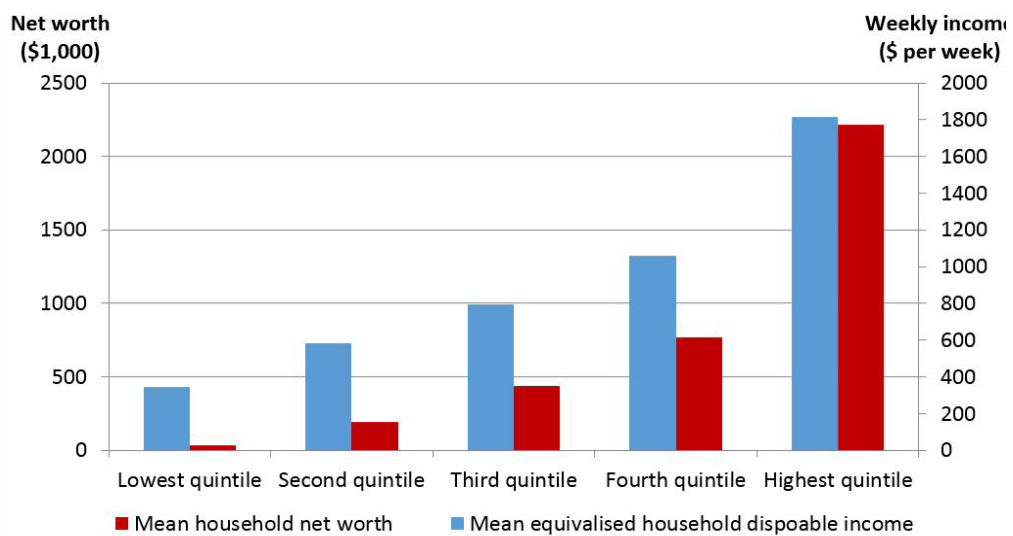
A fair distribution of economic rewards is important in maintaining national wellbeing, social cohesion and acceptance of our political and social institutions. There is widespread public concern about rising inequality and wealth in Australia and comparable countries. In Australia, concern has been expressed in community and policy studies (e.g., Oxfam 2014, Douglas et al 2014). The evidence of rising inequality in income and wealth and the effect of government policy has been discussed in government reports and scholarly research (e.g. ABS 2013a, 2013b; Wilkins 2013; Leigh 2013; Whiteford 2013).

Internationally, attention has focused on the long-term trends, causes and consequences of rising income inequality across wealthy and poor countries (OECD 2011; Piketty 2014; IMF 2014; Stiglitz 2014; Atkinson and Morelli 2014).

Australia’s tax and transfer system plays a central role in sharing the benefits of economic growth across society in an inclusive and fair manner. We can measure income inequality after taxes and transfers have applied, by measuring *equivalised household income* standardized for household size and composition. This is basically the *disposable income* of households after all sources of income (including income from work and business, capital gains, dividends, interest and so on), taxes and cash transfers from government are taken into account.

Using this measure, inequality in income and wealth may be measured by household income surveys (e.g. ABS 2013a, 2013b; Wilkins 2013) or expenditure surveys (Greenville et al 2013).¹¹ Chart 2.6, based on the ABS household income survey shows that the top 20 per cent (highest quintile) had nearly five times the disposable income of the bottom 20 per cent. The distribution of net assets is much more unequal.

Chart 2.6: Distribution of Australian household disposable income and net worth



Source: ABS (2013a).

11 Measures of income distribution and of inequality are sensitive to data sources and changes in data collection methodologies. There is some divergence of opinion about levels of inequality and the magnitude of change in Australia over time, depending on the timeframe and data source. However, the trends summarized here are consistently identified across studies.

CHALLENGES FOR TAX REFORM continued

The mining boom generated economic benefits for most Australian households, and Australia has had stronger growth in real household disposable income than the OECD average leading to improvements in per capita living standards across the income distribution. The Productivity Commission estimates that equivalised household income grew by 4.5 per cent for the top 10 per cent and 3 per cent for the bottom 10 per cent per year since the 1990s in Australia (Greenville et al 2013, 99). This compares to 1.9 per cent growth for the top 10 per cent and 1.3 per cent for the bottom 10 per cent per year since the 1980s across the OECD (Greenville et al 2013, 103).

Nonetheless, the benefits of growth have not been spread equally. The groups enjoying the largest real increases were at or above the middle of the income distribution and those in the top 10 per cent.

Measures of income inequality

The most commonly used index for tracking changes in inequality over time is the *Gini coefficient*. This index measures the degree to which the income distribution of a country is different from a perfectly equal distribution of income across a population. A lower Gini coefficient indicates a more equal distribution of income (a value of 0 represents perfect equality in which every person has

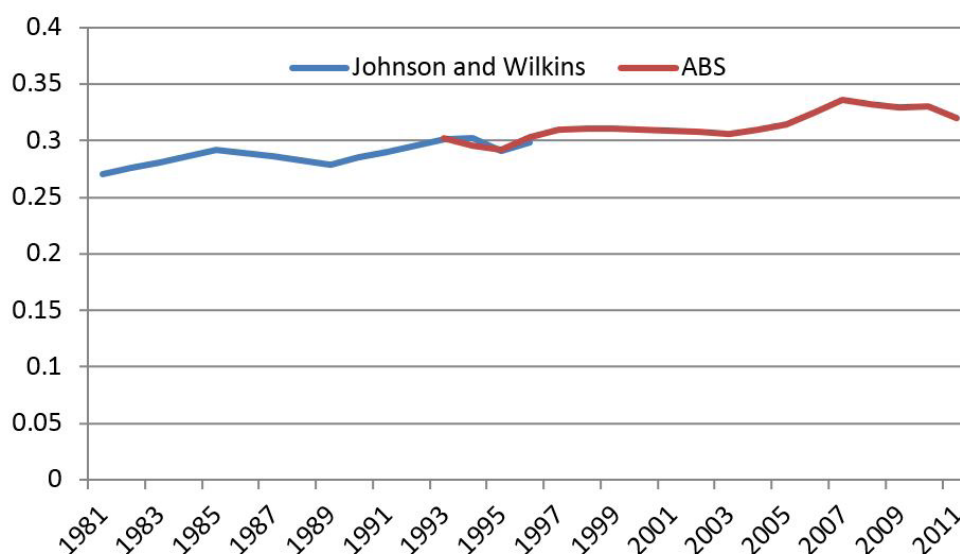
exactly the same income). A higher Gini coefficient indicates a more unequal distribution (a value of 1 represents perfect inequality, in which one person has 100 per cent of the income and all others have zero income).¹²

In Australia, inequality in disposable household income measured by the Gini coefficient has increased over the last few decades, as indicated in Chart 2.7. OECD estimates suggest that in Australia, inequality in income has grown faster than in most other OECD countries, although this is in part due to changes in ABS survey methods (Greenville et al 2013, 100-101).

The trend in growing inequality is not uniform. Whiteford (2013) shows that income inequality:

- > declined between 1994-95 and 1996-97 during a period of expanding employment following the recession in the early 1990s;
- > increased gradually between 1996-97 and 2003-04 during a period when the microeconomic reforms of the 1980s and early 1990s took hold;
- > declined in 2002-03 and 2003-04, coinciding with the expansion of government payments to families; and
- > rose rapidly from 2003-04 to 2007-08 during the early phases of the mining boom before falling back in 2009-10 following the GFC.

Chart 2.7: Trends in income inequality in Australia, Gini coefficient, 1981 to 2011



Source: Johnson and Wilkins (2006), ABS (2013a).

¹² See Jenkins and Van Kerm (2008) and Greenville et al (2013, Appendix A) for methods of measuring inequality, including the Gini Coefficient.

Increases in inequality are not just a function of increasing incomes at the top of the income distribution, but are spread across the income distribution. Household incomes at the top of the distribution have increased relative to the middle of the distribution, and incomes in the middle have increased relative to the bottom of the distribution over the last decade (Wilkins 2013).

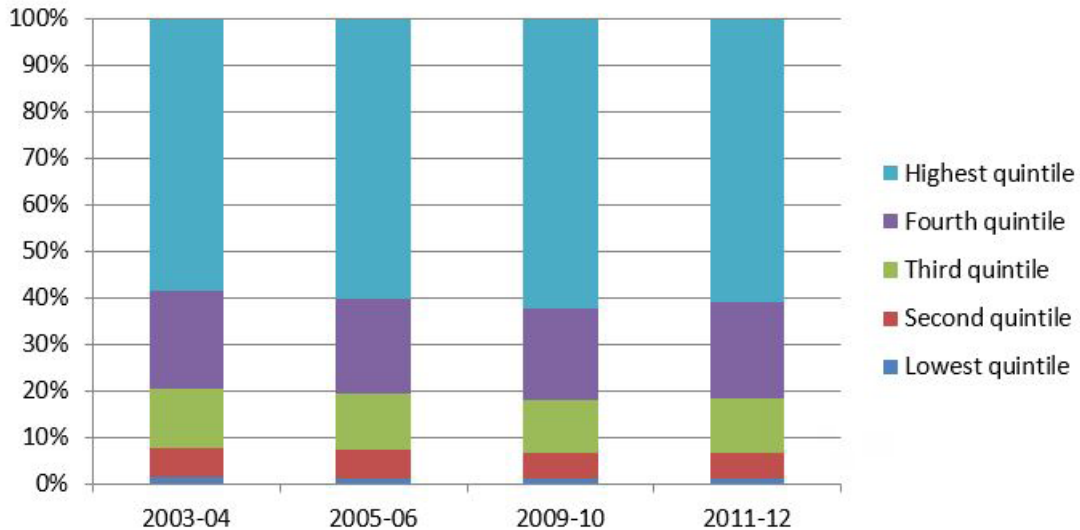
Inequality in labour and capital income

A key factor driving change in household incomes especially in the upper half of the income distribution is growth in labour income. Between 1988-89 and 2009-10, individual labour earnings increased by 38 per cent across the Australian economy (Greenville et al 2013, 5). Low income households benefited from increased employment, while high income households benefited from higher wages (Greenville et al 2013, 106). Increases in some transfers, such as the age pension, have also supported rising incomes for households in the bottom 20 per cent, although the unemployment benefit has not kept pace with income.

We know less about the distribution, composition and trends in wealth and assets among Australian households than we do about income; this is an important issue that warrants significant further research. However, capital gains and income from assets have contributed to increased incomes for the top 20 per cent (Greenville et al 2013, 106). Recent analysis also indicates substantial and growing gender inequality in the distribution of assets (Austen et al, 2014).

Chart 2.8 shows that the top 20 per cent of households (highest quintile) own 61 per cent of total assets while the bottom 20 per cent of households (lowest quintile) own just 1 per cent of total assets. This distribution is fairly stable over the last decade.

Chart 2.8: The distribution of household assets over time



Source: ABS (2013b).

2.5 The digital global economy

The digital economy revolution, increasing capital mobility and the rising economic value of intangible assets may be the most significant factors influencing economic prospects in the next few decades. Digital developments also may offer opportunities for streamlined and more efficient tax administration in the future.

Rapid innovation in communications and digital technology and the emergence of new multinational business models have recently gained greater attention. Governments are increasingly concerned about so-called base erosion and profit shifting (BEPS) by multinationals. The OECD is currently carrying out a major project on BEPS, building consensus on an Action Plan focused on multilateral coordination on information exchange and design of tax integrity arrangements that has been endorsed by the G20 (OECD 2013a; G20 2014). We return to these challenges in Chapter 6.

In dealings with consumers, digital companies are increasingly selling goods and services including books, films and games online (famously represented by Google, Apple and Amazon). This poses challenges for sales taxes like the GST. The sale of goods and services via digital download has made the origin of supply increasingly uncertain, with suppliers often having no single location and consumers not being subject to taxes when they purchase online. The recent growth in the use of cloud technology and new ways of transmitting value, such as cryptocurrencies, also present challenges. These new systems potentially eliminate the intermediary from the transaction, allowing anonymity, while also allowing the location of supply to be determined arbitrarily by the supplier.

In the global economy, multinational enterprises can use legal and commercial structures to invest and operate across national borders and can shift mobile intangible assets within these structures. They can also take advantage of innovative financial structures that operate across many countries. All of these strategies can be used to reduce tax on multinational enterprises. For example, the use of a Luxembourg based company for financial arrangements can take advantage of differences in the taxation treatment of debt and equity in different countries.¹³

Intangible assets

Increasingly, the economic value of businesses is held in *intangible* assets such as patents, trademarks, brand names, copyright, corporate and insurance services and marketing information about products, customers and systems. These intangible assets are central to the commercial success of many service and technology-based multinational companies.

Intangible assets have several features that make them difficult to tax. They are often intrinsic or unique to a particular firm and rarely traded, making it difficult to identify, value and measure income from the asset. They are also *mobile*, which means that they can be owned by legal entities anywhere in the world.

Not only digital companies, but ‘real’ or traditional businesses, are becoming digital in this way. Businesses that deal in assets, such as coffee (e.g. Starbucks) or furniture (e.g. IKEA) and even mining companies that must extract minerals where they find them, hold an increasing share of value in mobile intangibles including technology, services, brands and patents.

See further OECD (2013a).

A multinational enterprise can use offshore companies as a repository for marketing, corporate services, intellectual property and insurance functions, typically located in low tax or no tax jurisdictions. Multinational enterprises organise their supply chains on a global, rather than a national basis. Geographic dispersion of the different elements of a multinational’s operations offers considerable flexibility around how intra-firm revenues and expenses—and hence, corporate profits—are located.

The Henry Review identified these trends but they have become increasingly pointed. For example, in 2011, the Treasury’s review of transfer pricing rules pointed to significant growth in intra-firm trade in the areas of interest and insurance and services (Treasury 2011, 2).

¹³ Some such structures were revealed in the ‘Luxembourg Leaks’ published by the International Consortium of Investigative Journalists: <http://www.icij.org/project/luxembourg-leaks>.

Australia's historical advantages that typically encourage inbound investment, such as high levels of political stability and institutional transparency, effective market regulation, quality infrastructure and an educated and skilled workforce may offer a less distinct advantage in the future as other nations in our region develop. This makes the burden of taxation on mobile factors of production a more important consideration. It is not clear whether these challenges are significant enough to warrant change to Australia's company tax system, for example by lowering the rate, or whether the current system can support economic prosperity and adequate revenues for the foreseeable future.

2.6 The environment

The Australian environment faces multiple challenges which are likely to have serious economic consequences. These include the economic costs of climate change and climate variability, the expanding footprint of our cities and suburbs as the Australian population grows and the impact of economic growth and structural change on resource utilisation, investment and consumption patterns of individuals and businesses. The goal of economic growth must be sustainable in the long-term.

Our growing population is leading to new and increasing demands on housing, transport, water, energy and communications and waste management infrastructure and supply. Over the coming decades, Australian governments will need to find ways to fund new investment in public infrastructure to meet these demands.

For example, land clearing associated with expanding agricultural production, resource extraction and expansion of Australia's urban centres averaged around 1 million hectares each year in the decade to 2010 (State of the Environment Committee 2011, 25). This leads to soil erosion and loss of habitat and biodiversity. Expanding development along Australia's coastline has impacts on the coastal environment. Other challenges include transport congestion and high levels of household energy use in our cities and towns.

The Intergovernmental Panel on Climate Change (IPCC) indicates that Australia is continuing to experience long-term trends towards higher surface temperatures, more heat extremes and fewer cold extremes and lower rainfall levels, particularly in south-eastern Australia (IPCC 2014).

Australia has many policy tools to address these challenges, although the appropriate policy response to some challenges is the subject of intense political and social debate.

The Henry Review emphasised sustainability of the tax and transfer system, referring to both revenue and environmental sustainability. In relation to climate change, the Henry Review did not directly address the issue of a carbon tax or emissions trading scheme, as this was the subject of a separate policy process. The contentious political debate about the use of a carbon tax or carbon pricing scheme is evidenced by the recent enactment and then repeal of the Carbon Pollution Reduction Scheme (CPRS), an emissions trading scheme that operated like a carbon tax in its initial period.

There are different tax and regulatory approaches that can be taken to climate change. We note that a carbon emissions pricing approach is being increasingly adopted in various other countries and regions in the world, including the European Union and China. The G20 has highlighted climate change as a key issue that requires policy reform (G20 2014).

It is also important to ensure that our tax and transfer settings do not work against environmental goals or generate perverse incentives that would undermine other environmental policy or regulation. For example, current Australian land tax arrangements tend to support land degradation at the expense of regeneration of native forests and other ecosystems (Wentworth Group 2014). The Henry Review recommended monitoring of tax concessions that affect environmental outcomes, to ensure their effectiveness (Henry et al 2010a, Recommendation 60).

CHAPTER 3 CURRENT STATE OF THE TAX AND TRANSFER SYSTEM

MAIN POINTS

- > A comparison of Australia's tax and transfer system with the systems of other countries can provide a useful benchmark for understanding its coverage and scope, its distinctive features, where it performs well and where there is scope for improvement, although caution is required as context, history and data may differ across countries. Comparisons are made with a selection of OECD member states and in some cases with other countries in the Asia-Pacific region. We make specific reference to New Zealand and Canada for comparison in tax systems.
- > Australia's total tax burden in 2012 was 27.3 per cent, below the OECD average of 33.7 per cent and below that of Canada (44 per cent) and New Zealand (33 per cent). Australia's tax burden has declined since the Henry Review.
- > The Commonwealth Government levies income tax and GST exclusively, as well as petroleum and gas resource rent taxation, customs and excise. State and Territory governments levy land tax, payroll tax, stamp duties, gambling taxes and some other levies exclusively and also royalties from mineral resources. There is a disparity between the broad governing responsibilities of States and their limited tax revenues, termed *vertical fiscal imbalance*.
- > Australia relies less on consumption taxes than other countries, especially in Europe. In particular, Australia collects proportionately less revenue than other countries including New Zealand and Canada, from a broad-based consumption tax such as the GST. The GST comprises 13 per cent of all tax revenues.
- > Taxes on income including personal and company tax comprise more than 60 per cent of all tax revenues. Australia's reliance on personal income tax, the single largest source of tax revenue, is similar to New Zealand and Canada. Australia has a heavy reliance on company tax compared to other countries.
- > Australia's transfer, or social security system, provides flat-rate, means-tested income support payments to those not expected to work (retired people, lone parents and carers), unable to work (people with disabilities and the sick) or unable to find work (the unemployed). Payments for families with children provide direct cash assistance for more than half of all families. Other payments include paid parental leave, assistance with childcare costs and private rental assistance and war pensions.
- > Australia has a mixed system of public and private support for retirement. The income- and asset-tested age pension is available for all eligible Australians. To support retirement saving Australia has a system of both compulsory and voluntary superannuation, funded by employers and employees as well as through contributions by the self-employed. The superannuation system is supported by substantial income tax concessions at a very significant cost to revenue. The most benefit of these concessions is derived by high income earners.
- > There has been a significant increase in spending on social security in recent years. Despite this, Australia remains the fifth lowest spender relative to other OECD countries and spends less than both Canada and New Zealand on the transfer system.
- > The highly targeted nature of Australia's transfer system including income and asset testing produces high effective marginal tax rates for many who receive support. This reduces the incentive and economic return to paid work, lowering workforce participation especially for women caring for children.
- > We cannot get a full picture of government taxing and spending without taking account of tax expenditures, which are concessions or exemptions in the tax system. The largest tax expenditures in the personal income tax relate to superannuation and other forms of savings and investment. In the GST, large tax expenditures include exemptions for food, education and health. Broadening the tax base usually requires removing or reducing some tax expenditures.

3.1 Analysing and comparing Australia's tax and transfer system

In this chapter, we discuss the overall tax burden in Australia in the context of the historical and current fiscal position of the country and we explain the framework of Australia's federation, which forms the legal and democratic context for our tax and transfer system.

The Commonwealth Government derives most of its tax revenue from direct production taxes levied on sources of income, for example on income from labour or capital; and consumption taxes levied on the uses (or consumption) of income. Wealth is taxed primarily through property taxes, including land taxes levied by State governments and rates levied by local governments. Overall, Australia has substantial reliance on direct taxes on production and this has been remarkably stable for the last 60 years.

Why compare Australia with other countries?

The comparison of Australia's tax and transfer system with the systems of other countries can provide a useful benchmark for understanding its coverage and scope, its distinctive features, where it performs well and where there is scope for improvement. It is common to compare Australia with other OECD members (generally advanced industrial countries), and the OECD collects and publishes comprehensive standardised taxation data for comparison of its members.

Informed comparisons between countries must take into account the impact of different economic structures and endowments of inputs into production (labour, capital and land) on the composition of national tax systems. When making cross-country comparisons, caution is necessary as there are differences in approaches to data collection and statistical analysis as well as to the design of tax and transfer systems. For example, although the OECD relies on a standardised definition of a 'tax', there remain some difficulties in comparison of the tax and other regulatory policy settings in different countries.

What is a tax?

A tax is generally characterised as 'a compulsory and unrequited transfer to the general government sector' (Henry et al 2008a, 11; ABS 2005, 140, 162). A tax may be distinguished from a fee or user charge, as a taxpayer's liability does not bear a direct relationship to the cost of a particular government service or benefit that the payer of a fee or charge personally receives. A tax is also distinguishable from a penalty for wrongdoing or breach of the law.

One area of controversy is retirement contributions. Australia has a system of superannuation contributions required by law by employers into each individual employee's superannuation account, or voluntarily by self-employed individuals. These contributions are pooled with others and invested on behalf of the individual. Contributions and earnings can be accessed by the individual for private use on reaching the retirement age. Australia does not treat superannuation contributions as a tax although they may comprise a significant proportion of an employee's total remuneration (ranging from 9 per cent to 17 per cent or more).

In contrast, in many other countries retirement incomes are funded (at least in part) by a social security tax or 'social insurance' contributions that are required to be paid by employers to the government, usually to be invested in a government fund. Social security taxes are generally counted as a tax on wages for OECD comparisons.

CURRENT STATE OF THE TAX AND TRANSFER SYSTEM *continued*

In this report, we make specific reference to New Zealand and Canada. Both New Zealand and Canada have similarities in colonial history, legal system and a substantial Indigenous population. New Zealand has close economic ties to Australia. However, there are significant differences as well. New Zealand is much smaller in population and geographical size, does not have a federal system or bicameral parliament and has very different resource endowments from Australia. Linguistic and cultural factors (especially, the French language and culture of Quebec) and Canada's close interdependence with the United States are two ways in which Canada differs from Australia.

Given Australia's location and major trading partners, it may also be relevant to compare our tax and transfer system with countries in Asia. Australia is an open trading and investment economy in the Asia-Pacific region and globally. The design and outcomes of Australia's tax system are directly affected by the mobility of factors of production such as capital and skilled labour. Other countries in the region are also competitors for capital investment and for skilled labour.

These issues relate generally to the 'international competitiveness' of Australia's tax system, which is frequently raised in public debate, especially concerning personal and company tax rates. When such comparisons are made, it is important to bear in mind that many other factors including the level of services, security and infrastructure provided by country governments influence decisions by workers and investors about where to locate their activities.

Finally, as Australia's trade and cross-border investment in the region increases, the inconsistencies between tax systems, poor understanding and lack of engagement between country tax agencies can create frictions and inefficiencies to the detriment of all. This is a good reason for comparisons and harmonisation.

3.2 The constitutional framework

Australia's tax and transfer system is fundamentally structured by our federal legal and institutional system comprising democratic governments at Commonwealth, State and local level. The Constitutional framework has had a significant influence on federal financial relations, including processes for reforming the tax system.

Under Australia's Constitution, the Commonwealth Government has a broad power to levy taxes of any kind, although it is not able to discriminate between States or parts of States in taxation.¹⁴ The Commonwealth Government has exclusive power to levy excise taxes and customs tariffs.¹⁵ This broad taxing power contrasts with the rather limited powers of the Commonwealth Government to legislate on other matters specifically listed in the Constitution (for example, corporations, labour arbitration, defence, immigration, foreign affairs, statistics, currency, banking, marriage and divorce).

Where it does not have a specific power, the Commonwealth Government can legislate in agreed areas if State governments refer power to it. The Commonwealth Government can also provide financial grants to State and Territory governments that are conditional on those governments carrying out defined activities or policy goals.¹⁶

The Constitution grants the Commonwealth Government specific powers to establish and maintain Australia's social security system including invalid and old age pensions;¹⁷ and maternity allowances, widows' pensions, child endowment, unemployment, pharmaceutical, sickness and hospital benefits, medical and dental services, benefits to students and family allowances.¹⁸

14 Section 51(ii) of the Commonwealth of Australia Constitution Act (Cth) 1901, available from www.comlaw.gov.au (*the Constitution*).

15 Section 90 of the Constitution.

16 Section 96 of the Constitution.

17 Section 51(xxiii) of the Constitution. Most transfers are provided under the Social Security Act 1991 (Cth).

18 Section 51(xxiiiA), inserted into the Constitution in 1946 after a successful popular referendum.

State governments have broad powers to levy taxes of any kind, apart from excise and tariffs. State and Territory governments levy land tax, payroll tax, stamp duties, gambling taxes and some other levies exclusively and also receive royalties from mineral resources extracted from within their jurisdiction, which are owned by the State governments.

State governments also have broad responsibilities for government in general, except for specific listed matters such as defence that are exclusively the domain of the Commonwealth Government. This means that they have primary responsibility for health, education, law and order, infrastructure and planning, except where an agreement exists with the Commonwealth Government. State Governments can provide social security benefits but there are only a few relatively small State-based transfer payments.

There is a disparity between the broad governing responsibilities of States, and their limited tax revenues, termed *vertical fiscal imbalance*. Essentially, the States only raise half in taxation of their expenditure responsibilities (DPMC 2015).

Disparities in revenue-raising capacity and expenditure responsibilities exist across States and Territories. This is taken into account in the *horizontal fiscal equalization* formula for allocating the GST, and in some targeted grants. These are key issues in the government's White Paper on reform of the federation and are also relevant to tax reform.

Prior to World War II, all States levied income tax (as well as the Commonwealth Government). However, income tax was taken over by the Commonwealth during wartime and grants were made to State governments. Afterwards, income tax was retained at Commonwealth level and greatly increased in rate, scope and base. States could again levy income taxes from the 1970s but none have done so. In contrast, all Canadian provinces levy income taxes that apply on top of the Canadian federal income tax.

The GST and the Intergovernmental Agreement

The GST was enacted by the Commonwealth Government in 1999 and it replaced the previous Commonwealth wholesale sales tax. The reform was carried out under an Intergovernmental Agreement between the Commonwealth, State and Territory governments which commits the Commonwealth Government to provide all the GST to the States and Territories.¹⁹

The distribution of all of the GST revenues to the States (net of administrative costs) is made on a *horizontal fiscal equalisation* basis. The Commonwealth Grants Commission makes recommendations on the distribution of the GST to the States and Territories on the basis of a formula that aims to equalise the revenue raising and spending capacity across all of the States and Territories. The formula is controversial, with some States (especially Western Australia) arguing that the formula is unfair.

In a contrasting federal arrangement, Canada also has a GST but the Canadian provinces directly levy sales taxes largely on a harmonized base, with different rates, in addition to the central government GST.

As a matter of law, the Commonwealth Government could unilaterally change the GST because it is a Commonwealth tax (it could override the Agreement). However, the Intergovernmental Agreement requires any reform to the GST rate or base to be unanimously agreed between the Commonwealth Government and all State and Territory Governments. The Agreement has proved to be quite politically stable in its 15 years of operation and it is unlikely that any reform would proceed without agreement of all the States and Territories.

19 A New Tax System (Goods and Services Tax) Act 1999, s 1-3; Intergovernmental Agreement (2009) cl. 19, available from www.Commonwealthfinancialrelations.gov.au.

3.3 The tax burden

A common measure of the tax burden, or tax level, of a country is the total taxes collected by all levels of government as a percentage of Gross Domestic Product (GDP). Australia's tax level in 2012 was 27.3 per cent of GDP (OECD 2014d). Of this, the Commonwealth raises the majority of revenues: Commonwealth taxation was 21.4 per cent of GDP in 2012-13.

Australia's tax level is low relative to most other OECD countries. It is below the OECD average (33.7 per cent of GDP in 2012) and is also significantly lower than Canada (44 per cent of GDP) and New Zealand (33 per cent of GDP). The historical trend and these country comparisons are shown in Chart 3.1.

Long term trends in Australian tax revenues since federation show the growth in government role and size of Australia (in a similar pattern as other comparable countries) during the 20th century. This is revealed in Chart 3.2, which also shows the proportion of tax revenues collected by the Commonwealth Government, compared to State, Territory and local governments.

The Commonwealth fiscal balance

A fiscal surplus or deficit arises if government expenditures exceed revenues in a fiscal year.

It has been Commonwealth Government policy to achieve budget surpluses on average over the economic cycle (Treasury 2014a, Statement 3). The Commonwealth Government (both the current Government and the former Rudd/Gillard Governments) has indicated a desired cap on tax revenue. This is not binding but is a budgetary mechanism to signal the intent to limit Commonwealth taxation levels. In 2013, the Gillard Government committed to keeping Commonwealth taxation as a share of GDP lower on average than the 2007-08 level of 23.7 per cent (Treasury 2013a, 6). In 2014, the Abbott Government imposed a cap on Commonwealth tax revenue of 23.9 per cent (Treasury 2014a, 3-9).

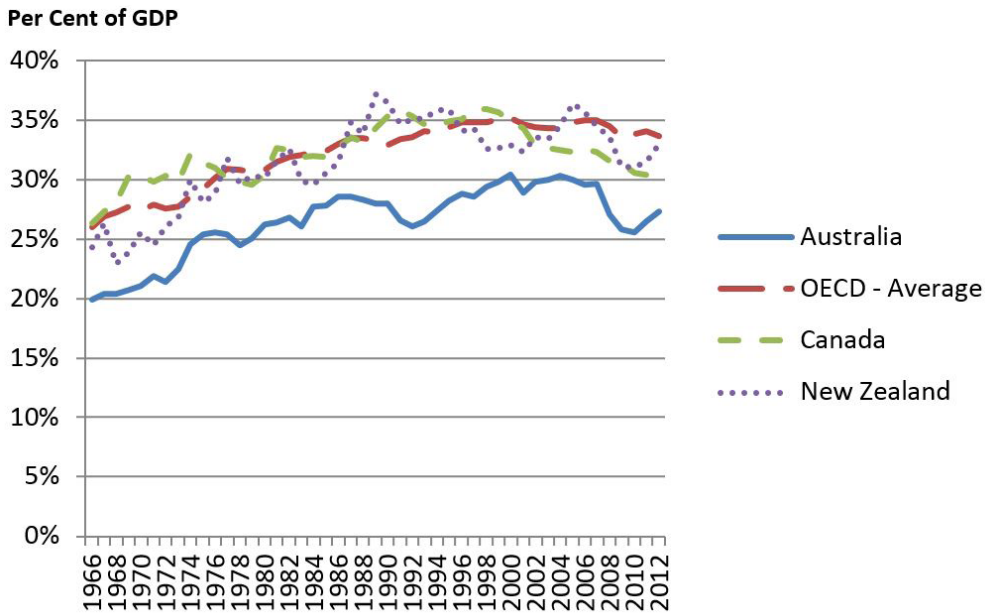
Unlike some other OECD countries with relatively low levels of taxation, Australia has sustained a lower tax level without running large budget deficits for some years. However, the Commonwealth budget has been in deficit since 2008 and the fiscal deficit is currently 1.6 per cent of GDP. This is projected to return to balance after 2017-18 (Treasury 2014b).

The Commonwealth deficit has been identified by the PBO as structural rather than merely cyclical, as a result of both tax and expenditure factors (PBO, 2013). Commonwealth tax revenues peaked in 2007-08 after a decade of growth and have since declined. Lower tax revenues are partly a result of the economic challenges discussed in Chapter 2. They are also due to the cumulative effect of the successive personal income tax cuts granted between 2003-04 and 2008-09 (PBO 2013, 3). Another contributor was a decline in revenues from fuel excise (for which indexation was halted in 2002-03 and has recently been reintroduced) and from excise on cigarettes and tobacco because of a decline in consumption.

One factor that tends to increase tax receipts is *fiscal drag* or *bracket creep*. The tax system is based on nominal wages and incomes. As nominal wages increase with inflation, individual taxpayers face higher average taxes because the personal income tax rates and thresholds are not adjusted to take account of inflation. Over time, this drives up tax receipts.

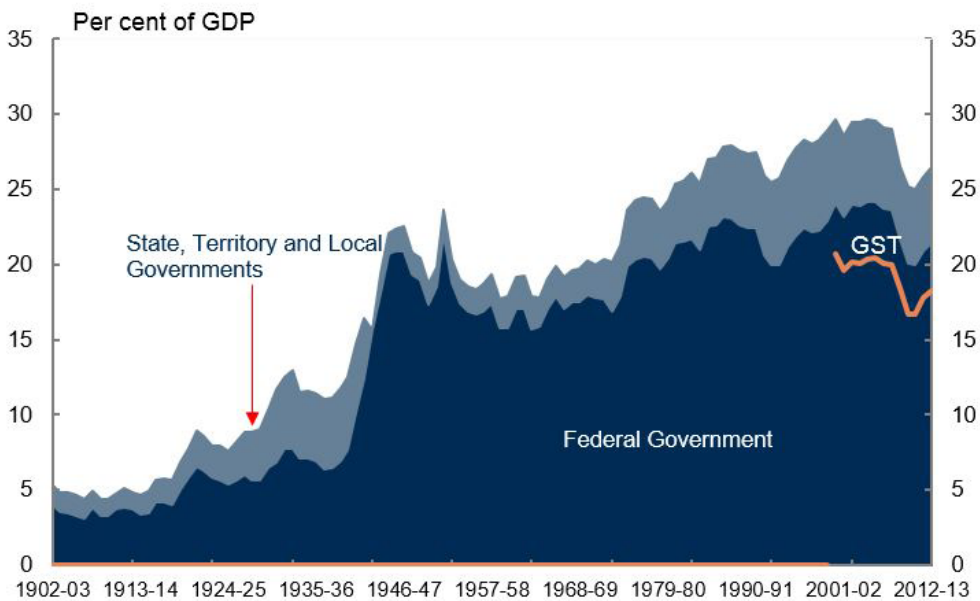
Fiscal drag makes a big difference to Commonwealth tax revenues because personal income tax comprises nearly 50 per cent of those revenues. Fiscal drag is projected to increase tax revenues above the Commonwealth Government tax cap by 2021-2022 (MYEFO 2014). We return to this issue in Chapter 4.

Chart 3.1: Trends in tax burden as a percentage of GDP, selected countries



Source: OECD (2014f).

Chart 3.2: Commonwealth, State, Territory and local tax burden since federation



Source: Treasury.

Note: The GST line indicates GST revenues collected by the Commonwealth Government but which are allocated in full (net of administrative costs) to State and Territory governments.

CURRENT STATE OF THE TAX AND TRANSFER SYSTEM *continued*

Table 3.1: Commonwealth Government Taxes

Tax	Revenue (Commonwealth receipts 2013-14) (\$million)	Percentage of Commonwealth tax revenue (% rounded)	Approximate percentage of total tax revenue from all levels of government (% rounded)
Income Tax (includes capital gains tax, Medicare Levy)			
Individuals (and other withholding)	156,300	47.9	40
Fringe Benefits Tax	3,922	1.2	1
Company Tax	66,911	20.5	17
Superannuation Fund taxes	7,661	2.3	2
Minerals resource rent tax	310	0.1	0.1
Petroleum resource rent tax (net impact) (a)	1,507	0.5	0.4
Total income tax	236,610	72.5	60.7
Sales Tax			
GST	48,596	14.9	12.5
Wine equalisation tax	725	0.2	0.2
Luxury car tax	434	0.1	0.1
Total sales taxes	49,755	15.2	12.8
Excise			
Petrol	5,990	1.8	1.5
Diesel	8,594	2.6	2.2
Other fuel products	3,466	1.1	0.9
Tobacco	7,660	2.3	2.0
Beer	2,257	0.7	0.6
Spirits	1,931	0.6	0.5
Other alcoholic beverages	944	0.3	0.2
Total excise	30,842	9.4	7.9
Customs duty	2,713	0.8	0.7
Other indirect taxes			
Carbon pricing Mechanism	3,631	1.1	0.9
Agricultural levies	463	0.1	0.1
Other taxes	2,412	0.7	0.6
Total other indirect taxes	6,506	2.0	1.7
Total taxation revenue	326,426	100.0	83.7

Note: (a) Petroleum resource rent tax is deductible against company tax.

Source: Treasury (2014a) Paper 1, Statement 5, Table 8. State revenue from ABS (2014c).

3.4 The tax mix

The Henry Review did an exhaustive survey of Australia’s tax system at Commonwealth, State and local levels. The majority of revenues come from personal and company income tax and the GST. Australia’s overall tax mix has remained remarkably stable over time.

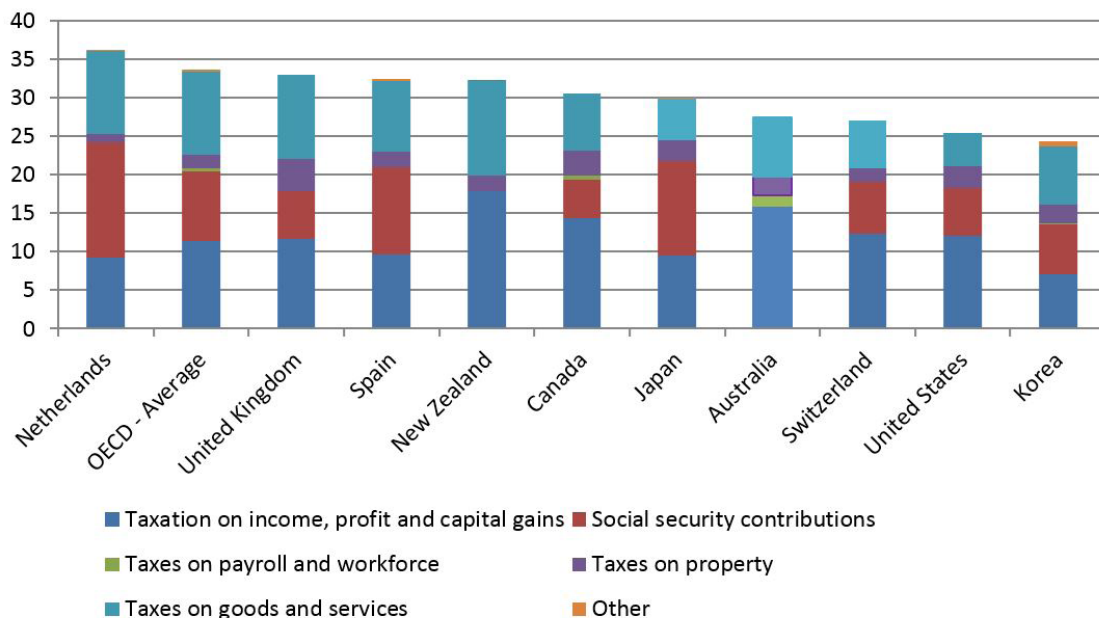
Chart 3.3 shows Australia’s tax mix, or composition of taxes, in comparison to selected OECD countries. Taxes on income comprise 64.3 per cent of total Australian tax receipts. Taxes on income include personal income tax, fringe benefits tax, superannuation fund tax and company tax at the Commonwealth level, and payroll taxes levied by States.

Australia’s reliance on income tax is broadly similar to New Zealand. If we include social security taxes levied on employers, then Australia’s reliance on wage taxation is similar to that of comparable countries. Our heavier reliance on company tax is discussed in Chapter 5.

Chart 3.3 indicates that Australia relies less on consumption taxes than other countries, especially in Europe. In particular, Australia collects proportionately less revenue than other countries from a broad-based consumption tax such as the GST. This is discussed further in Chapter 6.

The Commonwealth Government tax mix has not changed significantly in the last 60 years. The numerous tax reforms since the 1980s made significant changes within tax bases but left the overall composition of the tax system broadly unchanged. This is shown in Chart 3.4, which presents four snapshots of the composition of Commonwealth taxes: from 1950-51, a few years after the Commonwealth began levying personal income tax; 1975-76, at the time of the Asprey Report; 2001-02, after the introduction of the GST; and in 2011-12, at the peak of the mining boom.

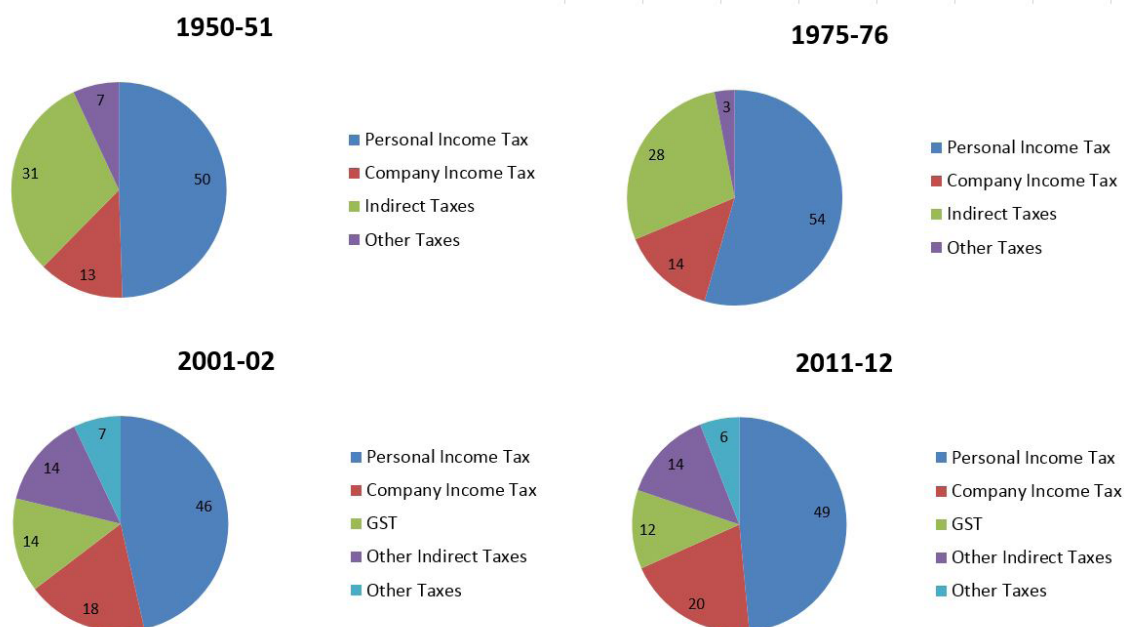
Chart 3.3: Composition of tax bases, selected countries, 2011-2012



Source: OECD (2014d).

CURRENT STATE OF THE TAX AND TRANSFER SYSTEM *continued*

Chart 3.4: Composition of the Commonwealth tax system since 1950



Source: RBA statistics and Treasury estimates.

3.5 The transfer system

Australia's transfer, or social security, system of income support payments has a long history; the age pension was established in 1908 (for a detailed analysis, see Whiteford 2013). As explained above, all income support payments are made by the Commonwealth Government and funded from Commonwealth general revenues, primarily taxes. The Commonwealth Department of Social Services has policy responsibility for income support transfers worth around \$100 billion in 2012–13.²⁰

The social security system provides flat-rate, means-tested income support payments to those not expected to work (retired people, lone parents and carers), unable to work (people with disabilities and the sick) or unable to find work (the unemployed). Payments for families with children

provide direct cash assistance for more than half of all families and higher levels of assistance for those receiving income support benefits or in low paid jobs. Other payments include paid parental leave, assistance with childcare costs and private rental assistance. The Commonwealth also pays pensions for war veterans and dependents.

Australia has a mixed system of public and private support for retirement. In addition to the income- and asset-tested age pension, Australia has a system of both compulsory and voluntary superannuation, funded by employers and employees as well as through contributions by the self-employed. The superannuation system is supported by substantial income tax concessions at a very significant cost to revenue. These superannuation tax expenditures are briefly discussed below and in detail in Chapter 4.

There appear to be two long-standing values that provide the basis of the Australian social security system. One is the recognition of government and community responsibility to assist those in need of poverty relief. The other is that private provision is to be encouraged as far as possible, with the social security system seen primarily as a safety net. Mutual obligations and activity conditions for income support payments are a fairly recent feature, requiring certain benefit recipients to participate in activities of value to the community.

²⁰ This discussion focuses on cash transfers. A broader definition of social security would also include compensation arrangements for work and road accident injuries and deaths (financed by insurance-type schemes and levies of State and Territory governments); paid sick leave provided and financed by employers; and a wide range of other welfare benefits and services, such as subsidised childcare, public housing and transport, care services for aged and disabled people, rebates on local government property taxes for pensioners and reductions in charges for utilities such as water, electricity and gas.

Australian income support payments are not related to earnings and this distinguishes Australia from most other OECD countries (apart from New Zealand). They are subject to income and assets tests and are in general available on an ongoing basis subject to the means tests. Coverage of the system is universal, subject to residence requirements. In contrast, in many other countries, the primary principle is one of contributory earnings insurance and income replacement across an individual's lifecycle.

While protection from poverty is a primary objective of Australia's system, it is by no means the only goal. For

example, family and childcare benefits are paid to many low and middle-income families to assist them with the extra costs associated with having children. Age pensions are payable to roughly 80 per cent of the aged population, many of whom live in their own home and have substantial other assets. For many, the age pension operates similarly to an income replacement insurance scheme in retirement.

Table 3.2 shows the main income support payments and supplementary assistance available at March 2014 (McClure et al 2014).

Table 3.2: Transfer (social security) payments

Income support payments	
Age Pension	Parenting Payment Partnered
Widow Class B Pension (closed 1997)	Carer Payment
Wife Pension (closed 1995)	Austudy Payment
Partner Allowance (closed 2003)	ABSTUDY Living Allowance
Widow Allowance	Youth Allowance (Student and Apprentice)
Bereavement Allowance	Student Assistance (DVA)
Service Pension (DVA)	Newstart Allowance
Income Support Supplement (DVA)	Youth Allowance (Other)
Disability Support Pension	Sickness Allowance
Parenting Payment Single	Special Benefit
Supplementary assistance	
Pension Supplement	Rent Assistance, without child
Pension Supplement (minimum)	Family Tax Benefit (FTB) Part A
Pension Supplement (basic)	End of year supplement-FTB Part A
Seniors Supplement	Rent Assistance, with child (FTB Part A max rate only)
Youth Disability Supplement	Family Tax Benefit Part B
Income Support Bonus (to be abolished)	End of year supplement-FTB Part B
Pensioner Education Supplement	Remote Area Allowance
Education Entry Payment	Utilities Allowance
Fares Allowance	Pharmaceutical Allowance
Mobility Allowance, higher rate	Telephone Allowance
Mobility Allowance, standard rate	Clean Energy Supplement
Carer Allowance (child) and (adult)	Clean Energy Low Income Supplement
Carer Supplement	Large Family Supplement
Child Disability Assistance Payment	Multiple Birth Allowance
Double Orphan Pension	Assistance for Isolated Children Scheme (various)
ABSTUDY Scheme Supplementary Payments (various)	Baby Bonus (until 28 February 2014)
Student Start-up Scholarship/Loans	Stillborn Baby Supplement (from 1 March 2014)
Relocation Scholarship	Newborn Supplement and Newborn Upfront Payment (from 1 March 2014)
Schoolkids Bonus (to be abolished)	Single Income Family Supplement
Essential Medical Equipment Payment	Approved Program of Work Supplement
Incentive Allowance (closed 1991)	Language, Literacy and Numeracy Supplement
Pension Bonus Scheme (no new registrations from 1 July 2014)	Community Development Employment Program Participant Supplement (closed 2009)

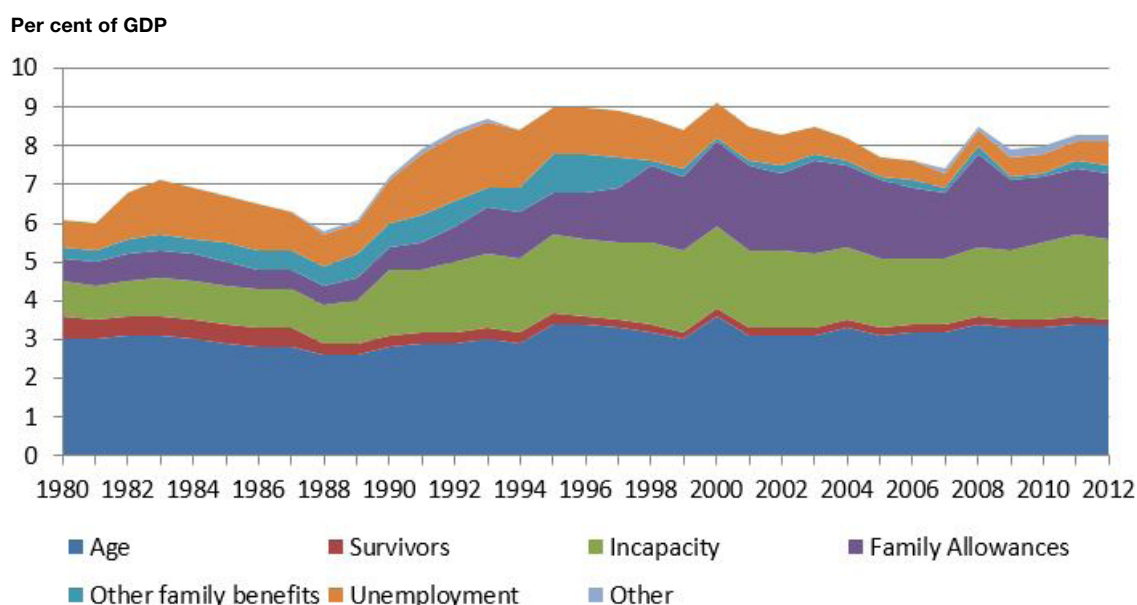
Source: McClure (2014).

CURRENT STATE OF THE TAX AND TRANSFER SYSTEM *continued*

Over the past 40 years, there has been a significant increase in the level of social security transfers and in the number of individuals and families receiving payments. Chart 3.5 shows that spending was close to 7 per cent of GDP in 1983. It fell in the recovery of the mid to late 1980s, before rising considerably in the 1990s. After 2000, social

security spending fell back to about 7.3 per cent of GDP in the strong period of economic growth leading up to the GFC, but rose substantially as a result of the stimulus packages in 2008 and 2009, a significant part of which was in the form of cash payments.

Chart 3.5: Level and composition of spending on transfer payments



Source: Calculated from OECD (2014c).

Note: The spike between 1999 and 2000 is largely a result of the compensation package for the introduction of the GST.

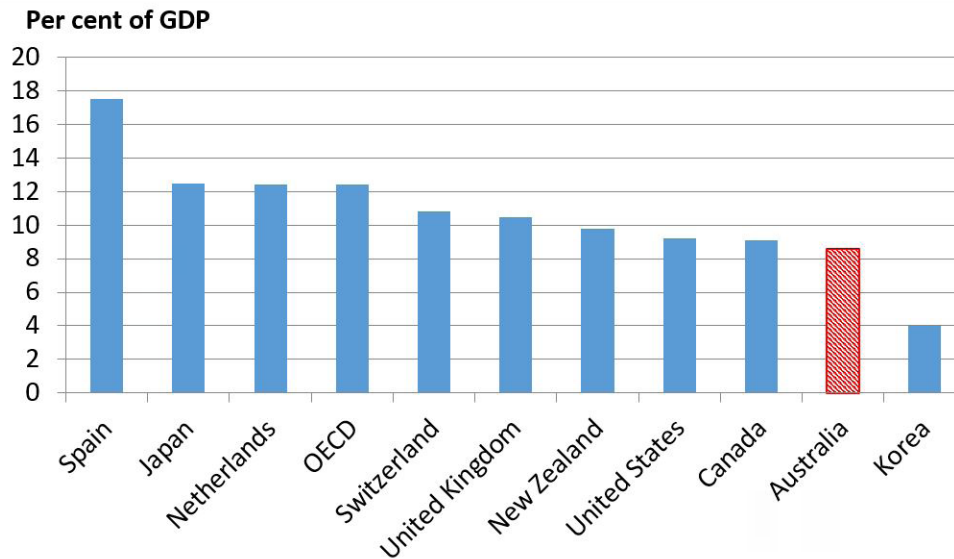
In general terms, changes in the economic and social environment have been the most significant contributors to increased transfer spending over the past 30 years. Spending on age pensions has remained the largest single program and has been broadly stable at about 3.5 per cent of GDP since the 1990s. Over different periods, in response to the business cycle, unemployment spending has been the largest contributor to the total increase in spending.

Policy changes have had varying influences on the level of transfer spending. From the late 1980s onwards, first as part of the Hawke Government's pledge to end child poverty by 1990, and subsequently by increases in assistance for families in the period of the Howard

Government, the real level of family payments increased significantly. In 2009, the real level of age and disability pensions was increased significantly.

Despite the increase in spending on social security, Australia remains the fifth lowest spender relative to other OECD countries, as shown in Chart 3.6. Australia spends less than both Canada and New Zealand on the transfer system; the main explanation for this is our low relative spending on age pensions, which are well below the OECD average. Most other transfer components are very close to the OECD average, with the exception of family payments, where Australia spends around twice the OECD average.

Chart 3.6: Spending on transfer payments, selected countries, 2012

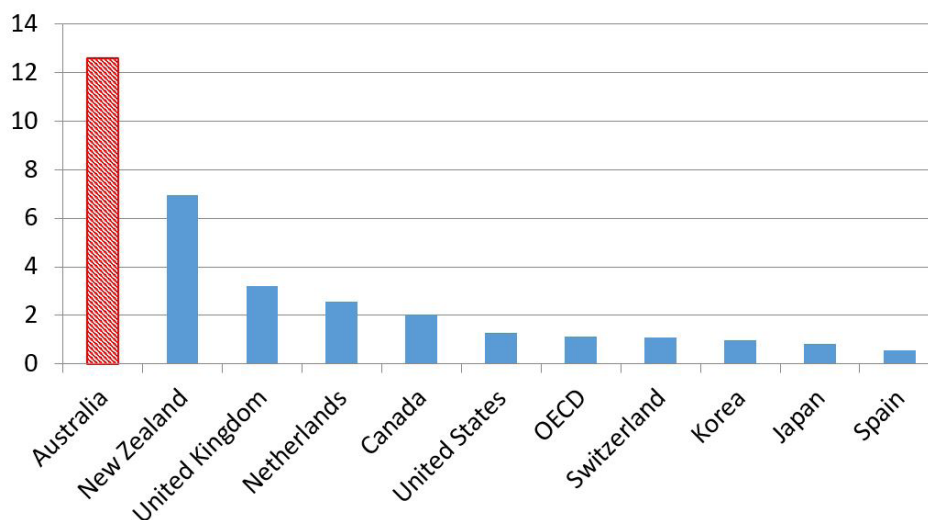


Source: OECD (2014c).

OECD analysis indicates that the combined redistributive impact of personal income taxes and cash transfers is higher in Australia than the OECD average. This is because Australia has relatively greater reliance on progressive income taxes than regressive consumption taxes, combined with a long history of tight targeting of transfers at families raising children and low income earners (Joumard et al 2012; Whiteford 2010).

The most recent figures (Causa et al 2014) show that the poorest 20 per cent of Australian households receive 12.6 times as much in transfers as the richest 20 per cent. This ratio is shown in Chart 3.7 covering selected OECD countries.

Chart 3.7 Ratio of transfers received by poorest 20% to those received by richest 20%, selected countries



Source: OECD (2014c).

CURRENT STATE OF THE TAX AND TRANSFER SYSTEM continued

The high degree of targeting in Australia is a product of concentrating a higher share of resources on lower income groups, together with the virtual exclusion of the richest 20 per cent of households from the social security system. The richest quintile in Australia receive around 1 per cent of their disposable income from transfers compared to 9.9 per cent for the OECD on average, and close to 30 per cent in Italy and France.

3.6 Tax expenditures

Government spending may also be undertaken through concessions in the tax law, called *tax expenditures*.

Tax expenditures include tax exemptions or holidays; special tax deductions or tax offsets; preferential tax rates; concessional valuation of benefits or assets; timing rules that enable a taxpayer to defer paying tax or to bring forward a deduction; and administrative concessions or safe harbours that permit a more generous treatment of some taxpayers or particular types of transaction. They are 'rules and practices which reduce the amount of tax revenue collected, compared with a benchmark tax system' (Burton and Stewart 2011, 3; Burton and Sadiq 2013).

Typically, tax expenditures are less scrutinized than direct expenditures. The Australian Treasury produces an annual *Tax Expenditures Statement* (TES) each year as required by the *Charter of Budget Honesty Act 1998* (Treasury 2015). A summary of tax expenditures is also included in the budget and MYEFO.

A tax expenditure may have similar effects to the direct payment of a grant or cash transfer. However, a tax expenditure is not a real payment but is estimated revenue foregone by the government. Estimating tax expenditures is difficult for a number of reasons. It requires an estimation of the revenue that would be collected without the tax concession, and an assumption of repeal only of the specific concession, with no other changes.

The usual approach of estimating revenue foregone from tax expenditures does not take account of behavioural responses to the tax law (as explained in Chapter 1), or interactions of different tax expenditures. For example, if the CGT 50 per cent discount was removed, individuals may choose to hold onto their capital assets for a longer period of time instead of selling them to realise the gain. Such a major reform would also likely change other elements of the tax system, producing other effects on behaviour, which are not taken into account in estimating the tax expenditure.

An alternative approach adopted by the Treasury is called the revenue gain method, which aims to estimate the tax revenue that would be gained if the tax expenditure was repealed. This aims to take into account behavioural responses but it still cannot account for interaction between different tax concessions and it cannot always be estimated. The estimate of the tax expenditure by the revenue gain method is typically lower than that estimated as revenue forgone.

Defining and estimating a tax expenditure also requires definition of the benchmark tax system. There are important debates about the correct benchmark for estimating tax expenditures. The TES uses a comprehensive income tax benchmark for estimating tax expenditures in the personal income tax. The Treasury defines the benchmark as all nominal income and gains derived by an individual taxpayer, less expenses for earning income, at marginal income tax rates. For the GST, the benchmark is all consumption in Australia (real expenditure) at a flat 10 per cent rate.

The choice of benchmark can substantially affect calculations of revenue foregone. The treatment of savings is particularly contested and we return to this issue in chapter 4. When considering taxation of savings, should an income tax or consumption tax benchmark be used? Under a comprehensive income tax benchmark, income from capital is taxed at marginal rates but under an expenditure or consumption tax benchmark, income from capital is exempt from tax. It may be argued that a consumption tax benchmark is more appropriate when considering lifecycle saving (which economists define as deferred consumption).

Table 3.3 presents selected large tax expenditures in the personal income tax and GST, estimated for 2014-15 by the revenue foregone method. Even acknowledging the weaknesses of estimation methods and debate about benchmarks, it can be seen from Table 3.3 that the government provides substantial benefits to individuals and households by means of tax expenditures.

The TES does not capture tax planning or minimization strategies in the tax system, many of which rely on benchmark rules or the interaction of different rules for different types of entity or source of income.

We cannot get a full picture of government taxing and spending without taking account of tax expenditures. From a tax policy perspective, broadening the tax base would involve removing some tax expenditures. More generally, the policy question is, should the particular benefit or subsidy be provided by means of a tax preference? Is this the best means of establishing an efficient, fair and resilient tax system and of delivering other aspects of government policy?

Table 3.3: Largest tax expenditures in personal income tax and GST, 2014-15

Tax Expenditure	Revenue Foregone (estimate \$m)
Income Tax—Main residence CGT exemption (Item E6 discount component)	25500
Income Tax—Main residence CGT exemption (Item E5 exemption component)	20500
Income Tax—Superannuation concessional taxation of employer contributions (Item C3)	16300
Income Tax—Superannuation concessional taxation of earnings (Item C6)	13400
GST – Exemption of fresh food (Item H28)	6400
Income Tax – CGT 50 per cent discount for individuals and trusts (Item E11)	5800
GST – Exemption of education services (Item H16)	3950
GST – Financial supplies input-taxed (Item H2)	3550
GST – Exemption of medical and health services (Item H19)	3550
Income Tax—Concessional taxation of termination payments (e.g. redundancy payments) (Item C5)	2700
Income Tax – Exemption of Family Tax Benefit A and B (Item A38)	2220
Income Tax – Medicare Levy exemption for residents with taxable income below the low income thresholds (Item A19)	1710
Income tax – Exemption of private health insurance rebate (Item A17)	1570
Income tax – Exemption from fringe benefits tax for public benevolent institutions (excluding public and not-for-profit hospitals) (Item D14)	1400
Income tax – Exemption from fringe benefits tax for public and not-for-profit hospitals and public ambulance services (D10)	1360
Income tax – Philanthropy – Deduction for gifts to deductible gift recipients (Item A54)	1100
GST – Exemption of childcare services (Item H5)	1090
GST – Exemption of water, sewerage and drainage (Item H6)	1010

Source: Treasury (2015).

Note: The Treasury observes that the reliability of these estimates is low in many instances.

CHAPTER 4 PERSONAL INCOME TAX, TRANSFERS AND SAVING

MAIN POINTS

- > Personal income tax is Australia's largest single source of tax revenue. Australia collects more personal income tax revenue as a proportion of GDP than many other OECD countries but relies less on personal income tax than Canada and New Zealand.
- > Personal income tax revenues have declined as a share of GDP because of cuts in tax rates over the last 2 decades. However, fiscal drag will cause average tax rates and revenues to rise again in coming years unless changes are made to rates or thresholds.
- > The personal tax-transfer system is Australia's main tool for redistribution of incomes and delivery of progressivity to the tax-transfer system as a whole.
- > The combined effect of personal income tax and transfers in particular on work incentives must be taken into account in any reform of either system.
- > There are gaps and complexity in the personal income tax base and scope to broaden this base, especially in relation to aspects of work and fringe benefits tax income and deductions. There is also scope for improvement in taxation of savings and investment including superannuation tax concessions. The Henry Review recommendations to tax saving more consistently under a 40 per cent savings discount and to restructure superannuation tax concessions provide a significant direction for reform.
- > Substantial broadening of the personal tax base could raise sufficient revenue to enable a reduction in tax rates on work and business income, especially on low and middle income earners. This could improve incentives to work and do productive investment.
- > The personal income tax could be made more resilient by simplifying the legal design to reduce planning boundaries in respect of expenses, legal entities and types of income. This could also reduce administrative and compliance costs.

4.1 Trends in the personal income tax

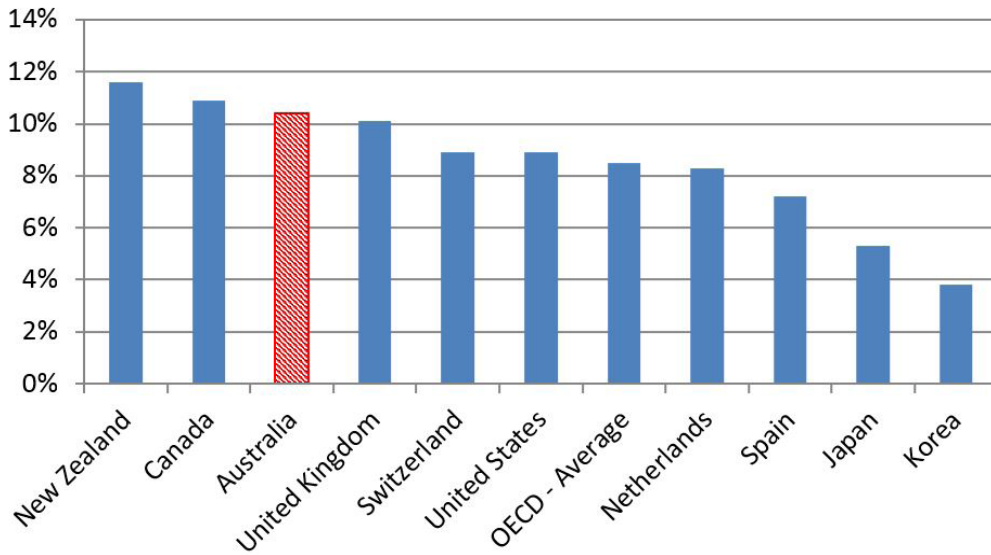
Personal income tax is the largest single source of government revenue in Australia. It comprises (including fringe benefits tax and tax on superannuation contributions) more than 10 per cent of GDP and nearly half of Commonwealth Government taxes. Chart 4.1 illustrates Australia's reliance on personal income tax compared to other countries and the OECD average.

Australia has a similar reliance on personal income tax to Canada, New Zealand and the United Kingdom, but significantly more reliance than Japan, Korea and many European countries. Chart 4.1 excludes social security taxes which operate as a substantial tax on wages in many countries. If those taxes are included as similar to the income tax, Australia is more comparable with other countries. For a comparison including social security taxes, see Chart 3.3.

Chart 4.2 shows a decline in the average tax rate over the last 30 years. This, combined with a lower share of national income derived by workers, is the primary driver of the fall in personal income tax revenues, most notably during the 2000s (PBO 2014a). Governments reduced the personal income tax burden during this period by more than required to return fiscal drag, as discussed in section 4.2 below.

The Henry Review argued that core reform objectives for the personal tax system should be reducing disincentives to work and improving incentives to save through simpler, more transparent policy settings. Tax reform should aim to provide clearer signals to people about the impact of their alternative choices and ease the administrative burden of the tax and transfer system (Henry et al 2010a, 29). The Henry Review also emphasized the importance of fairness to ensuring the personal tax system is legitimate and sustainable.

Chart 4.1: Personal income tax as a percentage of GDP, selected countries



Source: OECD (2014f).

Chart 4.2: Trends in personal income tax revenues and average tax rate



Source: PBO (2014a).

Note: The average tax rate is calculated by dividing personal income tax receipts by taxable income (excluding net capital gains) for individuals.

PERSONAL INCOME TAX, TRANSFERS AND SAVING continued

The Henry Review argued that fairness could be enhanced by treating activities with the same economic value consistently, facilitating easier choices and ensuring progressivity in final tax outcomes.

These objectives were encapsulated in the following reform directions for the personal income tax:

- > Flatter and lower—but still progressive—statutory personal income tax rates and thresholds on individuals, involving a higher tax free threshold of \$25,000, absorption of the Medicare levy into the statutory rates, the removal of structural offsets such as the low income tax offset, introduction of a standard deduction for work-related expenses and exempting pensions, allowances and transfer payments from tax (Recommendations 2 to 7);
- > taxing most forms of remuneration consistently including taxing fringe benefits at personal marginal rates in the hands of employees, simplifying and limiting deductions and strengthening rules for personal services income (Recommendations 8 to 13);
- > taxing capital gains and investment income, net of deductions including interest on debt, more consistently through a standardised 40 per cent discount against personal marginal rates (Recommendations 14 to 17);
- > maintaining the home exemption in the income tax and capital gains tax. This is because of its special role in facilitating redistribution of income over a person's lifecycle and sustainable responses to the ageing of the population; and

- > fairer taxation of superannuation, and examination of longevity insurance and direct tax policy to increase workforce participation in retirement (Recommendations 18 to 24).

Some reforms were introduced by Governments in the last five years, following these recommendations, in particular concerning the tax rate structure and tax offsets. However, there has not been a major reform of the personal income tax base.

4.2 Personal income tax rates

Australia's statutory personal income tax rates and thresholds are shown in Table 4.1. The Commonwealth Government has enacted a temporary budget repair levy of 2 per cent for incomes exceeding the top threshold of \$180,000, applicable for three years from the 2014-15 year.

A low income tax offset (LITO) provides additional tax relief for taxpayers earning up to \$67,000 in 2013-14. Individuals eligible for the full LITO pay no tax on incomes below an effective tax-free threshold of \$20,542. The withdrawal of LITO increases the effective marginal tax rate for taxpayers earning between \$37,000 and \$66,667, by one and a half per cent above the statutory personal income tax rates.

Table 4.1: 2014-15 Resident personal marginal income tax rates

Taxable income (\$) (tax bracket)	Tax payable (\$) and marginal rate
0-18,200	Nil (tax free threshold)
18,201-37,000	19% of excess over 18,200
37,001-80,000	3,572 + 32.5% of excess over 37,000
80,001-180,000	17,547 + 37% of excess over 80,000
180,000 +	54,547 + 45% of excess over 180,000 + 2% of excess over 180,000 (temporary 'budget deficit levy')

Source: ATO (2014a).

Note: Non-residents are not eligible for the tax-free threshold or 19 per cent marginal tax rate and must pay 32.5 per cent to \$80,000 and higher marginal rates above that.

Most taxpayers pay a Medicare levy of 2 per cent of taxable income, increased from 1.5 per cent from 1 July 2014, to assist in funding the National Disability Insurance Scheme. The Medicare levy nominally contributes to funding the costs of public health care, but in practice it provides only a fraction of total Commonwealth Government health costs and is not hypothecated to health expenditure, instead forming part of consolidated revenue. A Medicare levy surcharge of up to 1.5 per cent applies to higher income earners who do not maintain adequate private health insurance coverage. Very low income earners are exempt from the Medicare levy as are Defence Force members and some veterans, non-residents and some other individuals not entitled to Medicare coverage.

Chart 1.1 in Chapter 1 illustrates marginal tax rates and the equivalent average tax rate for individuals. It shows how the average tax rate is always lower than the marginal rate except at very high incomes. This is also illustrated in the following example.

Example

Joe earned full-time average weekly earnings of about \$75,000 this year. After expenses are deducted, Joe has a taxable income of \$70,000. Joe faces a marginal tax rate of 34.5 per cent including the Medicare Levy. Joe's average tax rate is 22.4 per cent including the Medicare Levy.

Jane is a partner in a major law firm. This year, Jane earned \$250,000 in salary and partnership profits, net of expenses (this places Jane in the top one percent of income earners in Australia). Jane faces a marginal tax rate of 49 per cent including the budget deficit levy and Medicare Levy. Jane's average tax rate is 37 per cent.

The Rudd/Gillard Governments increased the tax-free threshold and broadened the personal tax base by more tightly targeting or removing tax offsets. Effective 1 July 2012, the tax-free threshold was increased from \$6,000 to \$18,200, equivalent to earnings of approximately \$350 per week (about 20 hours at the minimum wage).

There were some simplification benefits from these rate structure changes because low earners at or below the new tax-free threshold did not have to file a tax return. The Rudd/Gillard Government estimated up to one million workers potentially benefited in this way, although in practice the number of beneficiaries may be lower. Many low-income workers opt to continue filing tax returns for other reasons, including accessing family payments through the transfer system.

There is also debate about whether such flattening of the rate structure is the most fair or efficient strategy. For example, Apps and Rees (2010) show that it increases marginal and average tax rates on secondary earners with children (mostly women) and this undermines goals to increase workforce participation and may negatively affect tax revenues and economic growth.

The former Government legislated for a second round of tax cuts linked to the CPRS implementation, including a further increase in the tax-free threshold to \$19,400. However, the current Government has opted not to proceed with these second-round tax changes as it has now abolished the CPRS.

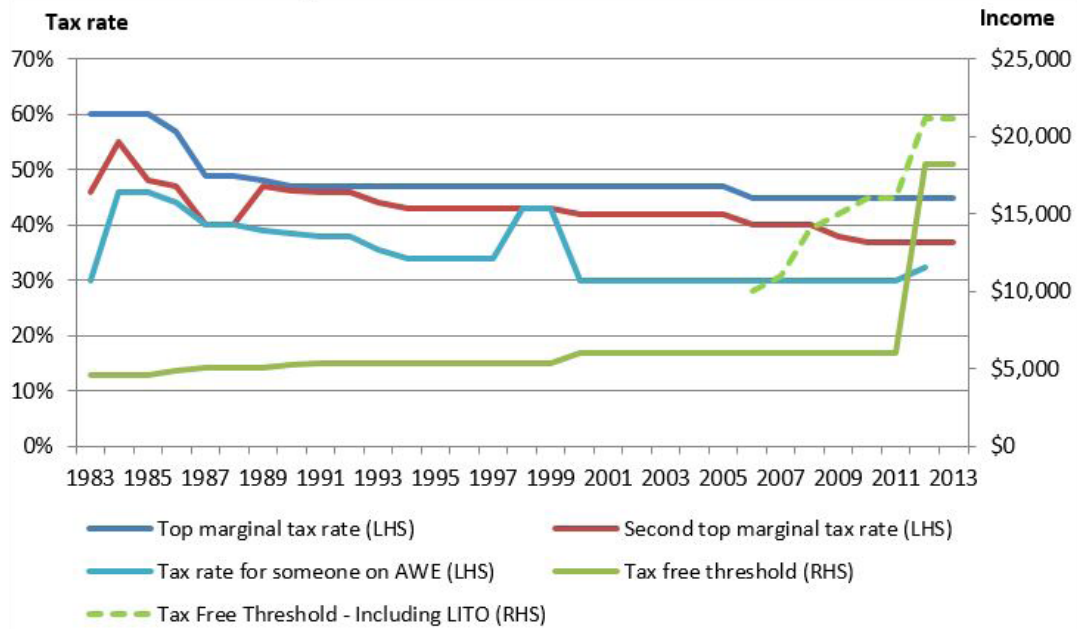
The longer term trend has been to reduce the number of thresholds and rates in the personal tax system, from more than 20 in the early 1970s to only four rate thresholds above the tax-free threshold in the current system. There has also been a significant reduction in the top two marginal tax rates. These trends are illustrated in Chart 4.3.

Australia's top marginal tax rate of 45 per cent excluding the Medicare levy, rising to 47 per cent for 3 years as a result of the deficit reduction levy, is a little higher than the OECD average and relatively high by international standards. This is shown in Chart 4.4. Top marginal tax rates commence at very different thresholds across countries. Chart 4.4 shows, based on the right axis, the AUD equivalent level at which the top marginal tax rate commences in each country (with appropriate estimates for sub-national income taxes).²¹

²¹ Average wages also vary significantly between countries; the average tax rate for the average worker is shown in Chart 4.6.

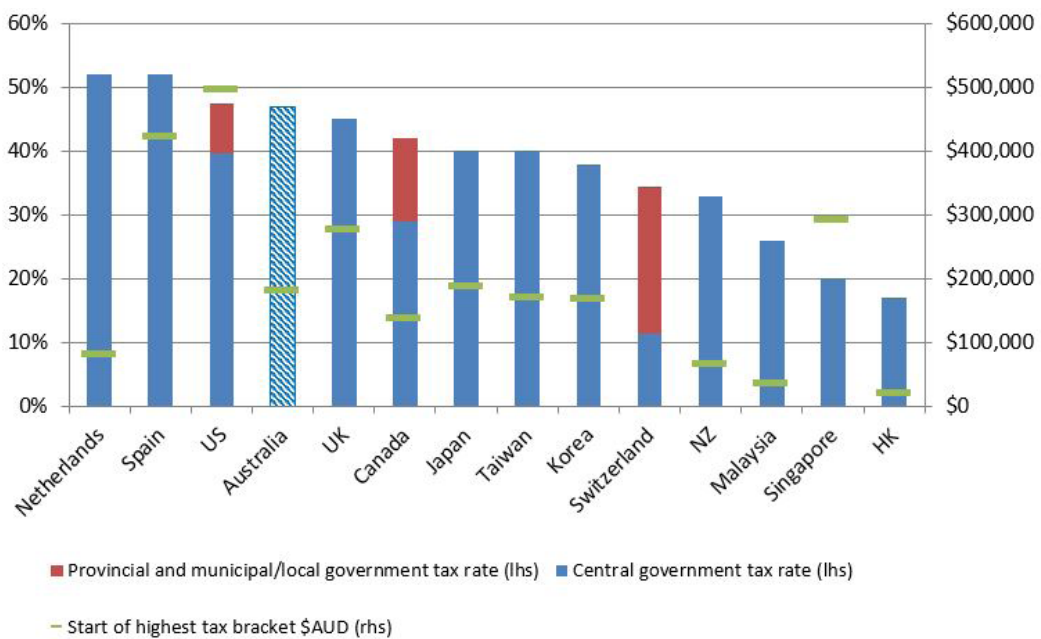
PERSONAL INCOME TAX, TRANSFERS AND SAVING continued

Chart 4.3: Trends in marginal tax rates



Source: Treasury.
 Note: The dotted line shows the increase in the LITO and its effect on the tax-free threshold.

Chart 4.4: Top marginal tax rate in selected countries



Source: International Bureau of Fiscal Documentation Tax Research Platform (2014); Canada Revenue Agency (2014); KPMG (2014).
 Note: Includes central government tax rates and selected sub-national government tax rates where significant. (a) Canada – example of Ontario; (b) Switzerland – example of Zurich; (c) United States – example of Minnesota.

Dependent and other tax offsets

Some family circumstances are taken into account in the tax law but most family support is in the transfer system. The most significant reform following the Henry Review has been the staged removal and consolidation of complex and out-dated tax offsets. These changes include:

- > phase out of the dependent spouse tax offset in the 2012 Budget by limiting access to dependant spouses born before 1952, abolished from 1 July 2014;
- > consolidate a range of dependency offsets into a single tax offset targeted at taxpayers maintaining a spouse who is invalid or a carer. The single Dependant and Carer Tax Offset now provides tax relief to taxpayers maintaining an invalid or carer spouse;
- > merge the pensioner and senior Australians tax offset in to a single tax offset;
- > phase out Mature Age Worker Tax Offset, subsequently abolished from 1 July 2014;
- > restrict access to the medical expenses tax offset for high out-of-pocket medical expenses through a means test and higher eligibility threshold;
- > abolish the entrepreneurs' tax offset.

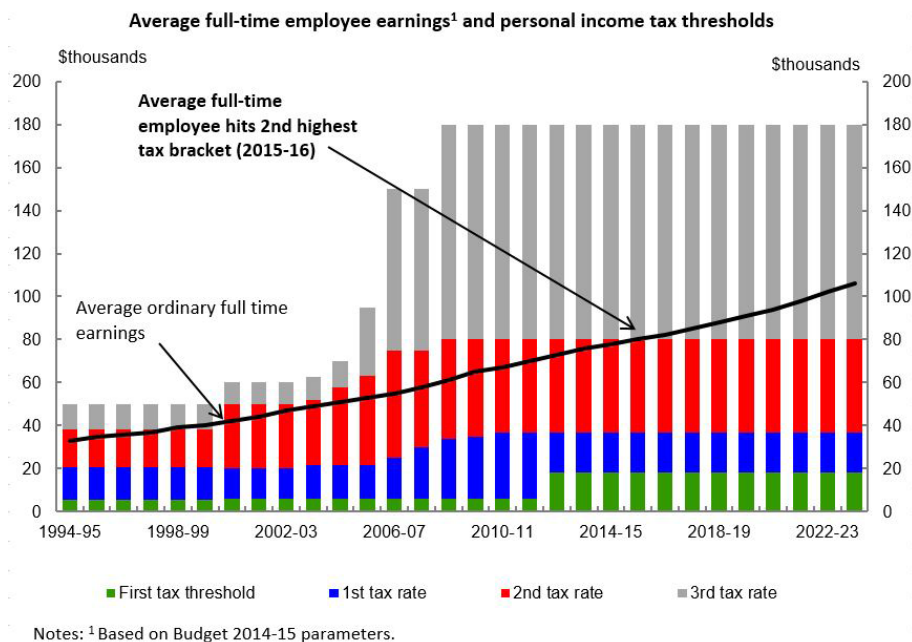
Fiscal drag

Australian personal tax thresholds are not indexed to inflation. Individuals face higher tax rates over time as their nominal wages (and other incomes) rise. This effect is known as *fiscal drag* or *bracket creep*. Historically, Australia has taken the approach of periodic ad hoc adjustments to tax thresholds and rates to address this issue. Most countries in the OECD follow the same approach as Australia by not indexing income tax thresholds. Some countries, including Canada and the United States, index certain tax thresholds for either wage or price inflation.²²

Analysis in the 2014-15 Budget indicates that, without policy change, the effects of fiscal drag will be a major factor underpinning growth in Commonwealth revenues over the next decade (Treasury 2014a). The budget projected that personal tax revenue would exceed 12 per cent of GDP by 2017-18. This would fully claw back all tax cuts provided since the introduction of the GST in 2000.

Treasury estimates that a person on average full-time earnings²³ will be pushed into the second-top 37 per cent tax bracket by 2015-16 and will face an average tax rate of 28 per cent by 2023-24, compared with 23 per cent today (Parkinson 2014). This is shown in Chart 4.5.

Chart 4.5: The effect of fiscal drag



Source: Parkinson (2014, Chart 6).

Note: Based on Budget 2014-15 parameters.

²² See Canada Revenue Agency (2014); Inland Revenue Service (IRS) (US), Revenue Procedure 2013-25.

²³ The correct benchmark of earnings for this index is complex. Because many people work part-time, the tax rate that applies to an average worker is lower than the rate that applies to full-time workers. Moreover, the increased prevalence of part-time work will act to decrease the tax rate paid by the 'average' worker.

PERSONAL INCOME TAX, TRANSFERS AND SAVING continued

Fiscal drag has the potential to affect adversely work participation incentives at the same time as the impacts of an ageing population are being more strongly felt. It may increase incentives for individuals to enter into tax planning arrangements so as to avoid higher marginal rates and it also has the effect of reducing progressivity of the tax structure as low income earners move into higher tax brackets over time.

4.3 The tax-transfer system: interactions and effects

The personal tax and transfer system aims to achieve redistributive outcomes that broadly reflect a ‘commitment to Australian values of fairness and support for those who are disadvantaged’ (Henry et al 2010a, 59), as well as recognition that some level of equalisation of incomes is an important aspect of social cohesion and a marker of national progress. The combined impact of the personal tax and transfer systems is to reduce the final disposable income of higher income households and increase the final disposable income of lower income.

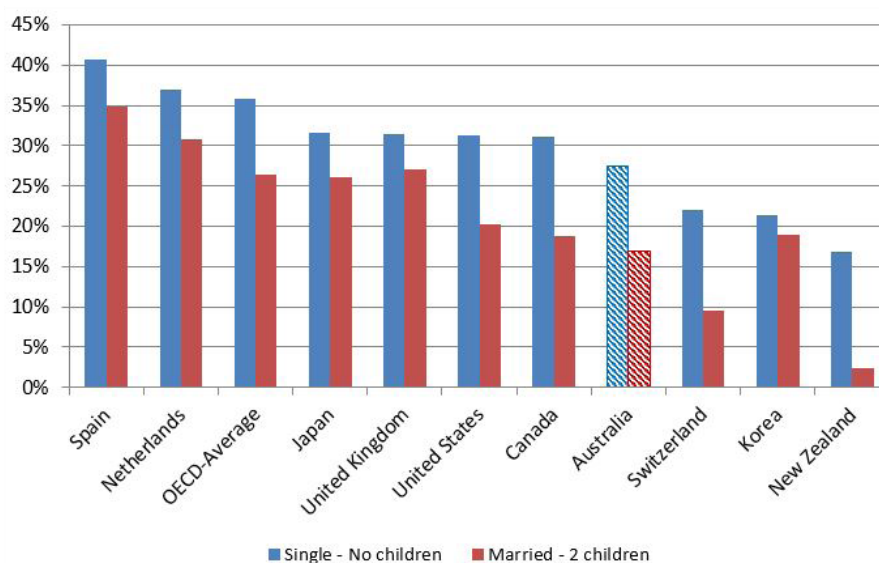
The general features of Australia’s transfer system and its redistributive effects are summarized in section 3.5, while the challenge of inequality is considered in section 2.4. The tax and transfer system historically and today has a

significant effect in reducing inequality. It achieves these objectives at relatively low budgetary cost compared to other nations because Australia has the most targeting of transfer payments in the OECD, as shown in Chart 3.7 above (Whiteford 2014).

However, the tax-transfer system is less redistributive than it was 20 years ago (Herault and Azpitarte 2014, Greenville et al 2013, Whiteford 2013). Changes to the personal income tax have reduced the overall progressivity of the tax system. These include personal income tax cuts and tax threshold increases for the top two brackets between 2003 and 2008 and tax concessions for various forms of saving and investment, especially superannuation and capital gains tax, which favour higher income earners.

In the transfer system, allowances for the unemployed and the sick have been indexed to prices rather than community-wide incomes. This means that the people in these groups have been slipping down the income ladder for the last two decades, relative to others. In the mid-1990s a single person receiving Newstart would have been about \$10 per week (in current terms) below the tenth percentile of the income distribution, but by 2011–12 they would have been close to \$160 below that percentile. Another group who have not enjoyed the general rise in prosperity are lone parents on benefits whose youngest child is aged eight years or more, who now receive Newstart rather than the more generous parenting payment.

Chart 4.6: Average tax burden after transfers for the average worker, selected countries



Source: OECD (2014b).

Note: Figures include income tax plus social security contributions less cash benefits. Australian superannuation guarantee is not included.

Tax burden on the average worker

The OECD indicates that the average tax rate on labour income in Australia was 27.4 per cent in 2013 for an individual, compared to the OECD average of 35.9 per cent (OECD 2014b). A comparison of average tax rates for individuals and families across selected countries is in Chart 4.6. Australia's tax burden on labour income is slightly lower than in Canada, but significantly higher than in New Zealand, especially for families with children.

Workforce participation was a central focus of the Henry Review and, as explained in Chapter 2, is of even greater importance today. Australia's targeted transfer system combined with progressive marginal tax rates creates complexity and challenges for workforce participation.

Effective marginal tax rates

Effective Marginal Tax Rates (EMTRs) are produced by the withdrawal of income support transfers and the LITO as incomes rise, combined with progressive marginal tax rates as earnings increase. EMTRs may be significantly higher than either nominal statutory rates or average tax rates.

The Australian tax and transfer system can produce high EMTRs. The interaction of tax rates and transfers can be difficult to understand because there are many income support transfers which may apply to individuals and households (as shown in Table 3.2). The complexity is compounded by the withdrawal of different income transfers through various income ranges.

There is evidence that high EMTRs have an effect on individuals' decisions about whether and how much they work. Individuals and families making important work and care decisions are aware of the impact on the net wage (their disposable income after taxes and transfers).

Low income earners and women who are secondary earners in a household especially with caring responsibilities have higher labour supply elasticities. They are more sensitive to changes in their tax burden than high income earners and primary earners in a household (e.g. Dandie and Mercante 2007).

Negative incentive effects are likely to be most strongly felt among groups where there is the greatest scope to increase labour market participation to help counter the impacts of an ageing population, particularly women and part-time workers, including those transitioning to retirement.

The salience of tax rates and the elasticity of labour supply

The behavioural response of an individual to a change in their net wage from an increase or a decrease in taxes depends on the substitution and income effects for that individual. An increase in the marginal tax rate decreases the net reward from work and there is an incentive for the individual to substitute unpaid work or leisure for paid work. This is the *substitution effect*. A decrease in the tax rate may have the opposite effect, providing an incentive for the person to engage in or increase their paid work.

An increase in the tax burden of a person as a result of a higher tax rate may cause him or her to work more in order to be able to purchase the same quantity of goods. This is the *income effect*. A decrease in tax burden may instead provide an incentive for the individual to work less but still be able to purchase the same quantity of goods.

The relative importance of the substitution and income effects determines whether there will be a positive or a negative labour supply impact from a change in tax rates on work. Estimates of responsiveness or *elasticity* of labour supply take into account both of these effects. These estimates measure the percentage change in labour supply of an individual, resulting from a one per cent change in the net wage rate, for example as a result of a tax increase or a tax reduction.

Empirical studies indicate that elasticities of labour supply and sensitivity to changes in tax rates vary substantially across different individuals. The variation depends on factors such as whether an individual is the primary or a secondary earner in a household, and their responsibility to care for example for children (e.g. Dandie and Mercante 2007).

Recent international studies suggest salience of tax rates and transfers varies, as do the costs to individuals of changing behaviour such as work hours. In some circumstances, average tax rates may have more of an impact than marginal rates (see, e.g. Chetty and Saez 2013; Saez et al 2012).

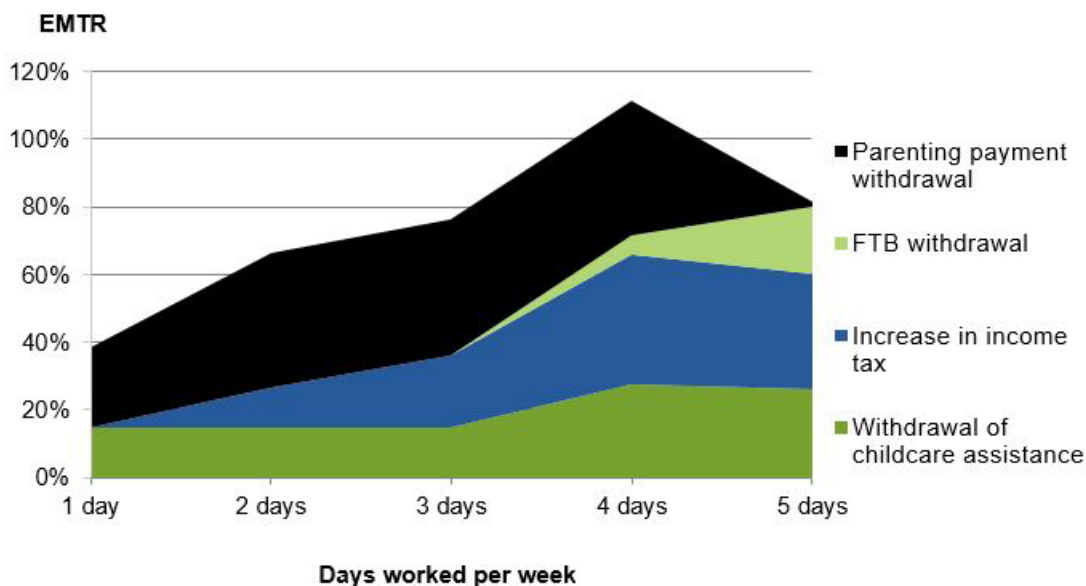
PERSONAL INCOME TAX, TRANSFERS AND SAVING continued

Chart 4.7, produced by the Productivity Commission, shows an EMTR for an illustrative individual who is a single parent with two children. It includes the combined impact of the progressive marginal tax rate structure, the withdrawal of childcare benefit and childcare rebate and the withdrawal of parenting payment and Family Tax Benefit B. The EMTR can exceed 100 per cent over certain work/wage ranges. That is, the effect of the reduction in income support and childcare payments, combined with marginal tax rates, can exceed the wage that a worker is paid over these ranges. Even at

lower ranges, the EMTR faced by the individual is quite high, ranging from just below 40 per cent to 80 per cent.

These EMTRs do not take account of non-deductible costs such as the excess childcare costs not supported by childcare assistance, or the cost of commuting to work. It is not surprising that a single parent in this situation would choose not to increase her working hours above a maximum of three days per week. Clearly, work does not pay in this case.

Chart 4.7: EMTR for a single parent with two children on \$31.50 hourly wage



Source: PC (2014). Corresponds to Cameo 1 in Box E.3, Appendix E
 Note: \$31.50 hourly wage corresponds to an annual salary of about \$62,000 (full time).

Henry Review recommendations for the transfer system

The Henry Review made numerous recommendations for reform of the transfer system and housing support (Recommendations 82 to 106). Since the Review, many of these recommendations have been progressed and a more detailed review of income support payments, the McClure Review of Australia's Welfare System (McClure et al 2014), has recently reported to government (the report is not yet released). The goals of better work and social outcomes were taken up in the McClure Review.

While noting that the broad architecture of the Australian transfer system is well targeted, the Henry Review identified a number of weaknesses including that the system is overly complex, can treat people of similar means differently, and can result in people making choices that potentially undermine long-term wellbeing, for example through high EMTRs as explained above.

Key structural recommendations of the Henry Review were that there should be three main categories of income support payment:

- > A pension category for people not expected to support themselves through paid work because of their age, a disability or the fact that they are providing full-time care for another person.
- > A participation category for people of working age expected to support themselves through paid work now or in the near future: this would include unemployed people, youth, people who are temporarily incapacitated, people with a partial capacity to work, and people who are the primary carers of dependent children. The rate of payment in this category should provide a basic level of adequacy while maintaining incentives to work. This would be less than the pension rate.
- > Student assistance for people engaged in full-time study.

The Review did not recommend full integration of the tax and transfer systems, given their different objectives. It recommended better coordination to support greater equity between transfer recipients, reducing disincentives to work and underpinning a better client experience of the systems.

Establishing adequacy benchmarks for transfer payments, especially unemployment benefit, would make the system more robust, particularly if the benchmarks were preserved through a common but sustainable indexation arrangement (Henry et al 2010a, 59). The Review noted that indexing all payments to male AWE has been projected to involve a significant increase in budgetary outlays, so it will be necessary for governments to regularly review the appropriateness of this benchmark. The Government proposed in the 2014-15 Budget reducing the indexation of the age pension to prices instead of wages; however, this would lead in the longer term to age pensioners falling further and further behind workers in income; and it seems unlikely that this will pass the Parliament.

The Henry Review also recommended that current income and assets tests for income support payments should be replaced with a comprehensive means test based on a combined measure of employment income, business income and deemed income on assets. The liquid assets waiting period and the sudden-death cut-out that applies to people on certain payments should be removed. These recommendations, if taken up, would reduce high EMTRs in some cases, assisting workforce participation.

Family and childcare policy

There is ongoing public and academic debate about the best way to provide assistance to families with children, evidenced by the contentious issue of how to design and fund an adequate paid parental leave scheme for all who need it. These policy decisions are complex and contested in an era when governments are seeking to reduce expenditures.

The Henry Review recommended that FTB A and B and related benefits should be replaced by a single family payment, covering the direct costs of raising children in a low-income family and assisting parents nurturing young children to balance work and family responsibilities. The rates of payment should increase with the age of the children to recognise the higher costs of raising older children. Assistance for families should also recognise that there are specific circumstances for which additional support is appropriate. The Review recommended that the total amount of family assistance should be withdrawn with a single means test to avoid cumulative withdrawal rates which create unnecessarily high disincentives for parents who are working. A single low withdrawal rate of 15–20 per cent is suggested.

For young people, the Henry Review recommended that youth payments should be the main form of income support from the age of 18 and should reflect the fact that most young people have lower needs than adults but need adequate assistance to participate in education and training. Dependent recipients should be subject to a parental income test consistent with that applying to family payments. Dependent older children for whom a suitable pathway may be leaving school and looking for work or combining part-time work and part-time study should have access to a youth payment, governed by strict participation requirements. Children without financial support from their families should continue to have access to a youth payment, governed by strict criteria.

The Productivity Commission has recently carried out a detailed review of childcare (PC 2014). The McClure Review recommendations on family payments (also reported to government but not yet released) are also relevant.

The Henry Review recommended that Childcare Benefit and Childcare Rebate should be combined into a single payment to parents (or centres) based on a percentage of costs. The payment should provide a high rate of subsidy for low-income families covering most of the costs of child care (up to 90 per cent) and a base rate of assistance for all families participating in work, education or training. The base rate of assistance should be set as a proportion of child care costs, with reference to the marginal tax rate faced by the majority of taxpayers. The full costs of child care should be covered for at-risk children and children facing multiple disadvantages, without participation requirements on parents.

4.4 The personal income tax base

In this section, we discuss the personal income tax as it applies to work and business income including the Henry Review recommendations. We identify gaps and complexities in the tax base that suggest directions for tax reform. We then turn to the tax treatment of personal savings and investment in section 4.4 and retirement saving in section 4.5.

Income from employment and fringe benefits

An Australian resident individual is taxed on all their income sourced from Australia or overseas, from employment or performing services. Most employment remuneration is taxed by employer withholding under the PAYG system. Gifts, inheritances and lottery or prize winnings are excluded and some income support transfers including childcare, family payments and the disability support pension are exempt from income tax. Deductions are allowed for the expenses of earning income and for some other expenses including charitable gifts.

In a comprehensive income tax, in addition to wages, salary and allowances, an individual's assessable income from employment should include the market value of fringe benefits, or non-cash benefits received by them. This supports fairness by ensuring horizontal equity between employees who are similarly situated except for the form of their remuneration. It also ensures that maximum revenue is obtained at lowest possible rates and it minimizes tax planning opportunities available to only some workers and not others, thereby building resilience of the tax system.

Most non-cash remuneration derived by employees or their associates is captured by the FBT. The FBT is levied on employers in respect of fringe benefits provided to current, former and in some cases future employees and associates of employees (such as family members). The introduction of FBT in 1986 contributed substantially to broadening Australia's personal income tax base. FBT is levied at the top marginal tax rate plus the debt levy (currently 47 per cent).

As shown in Table 3.1 above, FBT raised \$3.9 billion in revenue in 2013-14. This is only a fraction of the total \$156.3 billion raised in personal income tax. The FBT operates as a backstop to support the income tax and prevent avoidance of tax on remuneration. The economic incidence of FBT most likely falls on employees in the form of reduced wages.

While the FBT is intended to ensure a broad tax base for employment income, there is an array of tax expenditures including exemptions, concessional valuation rules and concessional tax rates in the FBT Act. The FBT benchmark comprises a tax base that includes all fringe benefits provided to an employee and recognizes a deduction to the employer for the cost of providing fringe benefits and the amount of FBT paid. The TES identifies more than 50 tax expenditures in the FBT (Treasury 2015, Part D).

Examples of FBT tax expenditures include FBT exemptions for recreational and childcare facilities on employer premises; concessional treatment for motor vehicles, meal entertainment and living-away-from-home accommodation; and salary-sacrificing computers and other work-related equipment.

Some concessions, such as the exemption for minor work-related benefits, make sense from an administrative perspective. Others have no such rationale and add substantially to the complexity of the tax system. An industry of advisors that specialize in salary packaging to take advantage of these and other tax planning opportunities has developed over time. High wage employees facing the top marginal rate on their cash salary have a substantial incentive to 'salary sacrifice' into non-cash benefits, converting ordinary wage income taxable at marginal rates into concessional treatment fringe benefits.

FBT salary packaging in the community services sector

The largest revenue foregone in FBT tax expenditures arises for fringe benefits that are either exempt or concessionally taxed for employees in not-for-profit community services, not-for-profit and public hospitals and ambulance services. These tax expenditures are estimated at \$2.7 billion in revenue foregone (see Table 3.3 above; Treasury 2015).

Concessional taxation of salary-packaged fringe benefits operates to some extent as a wage subsidy or lower tax rate for community sector workers. This is of substantial importance to many workers in that sector (NFP Tax Concessions Working Group 2013), and to cost-constrained services, hospitals and ambulances that are operated by not-for-profits or State and Territory governments.

It is a challenge to address the implications for remuneration of workers in the community and health sectors of removing salary packaging of fringe benefits. However, equal treatment of remuneration across all sectors is an important policy goal, and reform in this area would be a substantial simplification that would treat all low and moderate wage earners equally.

The Henry Review recommended that fringe benefits that are readily valued and attributable to employees should be taxed in the hands of employees like other employment income in the PAYG system but that the FBT should remain for more general, difficult to value fringe benefits.

Reforms since the Henry Review have included tightening of FBT concessions for work-related items such as computers and so-called 'in-house' fringe benefits such as staff discounts, living-away-from-home allowances and some motor vehicle fringe benefits. However, there is scope for further base broadening reform of the FBT.

Employee share and option plans

Concessions exist in the tax law for some kinds of employee share and option plans for company employees. These enable some workers to reduce their taxes on remuneration especially through deferred options or shares. They seek to achieve policy goals such as aligning the interests of employees and owners in business investment.

Employee share rules were tightened in 2009, so that the concessions and conditions were fairly limited. The Government proposes to relax these rules so as to encourage remuneration in employee shares or options in particular for start-up or early investment companies (Billson 2014). This may help support innovative companies to invest and employ people in Australia; however, it means that not all workers are taxed equally on the same remuneration. It is a tax expenditure that has a potential economic and revenue cost as it introduces a new tax planning margin into the tax system.

Tax deductions

An individual's taxable income is reduced by allowable deductions, which are primarily expenses incurred in the process of earning assessable income. Australia allows a wide range of deductions compared to other countries, in relation to income derived from employment, business or investments (we discuss investment expenses in section 4.5 below).

There is considerable interpretive flexibility regarding the scope of allowable deductions that has fuelled extensive ATO guidance, audit and litigation over many years. As a matter of principle, the income tax is intended to tax net economic gain and so expenses should be recognised. However, there are trade-offs in respect of complexity, tax planning and fairness of allowing deductions in the tax system.

The value of deductions to the taxpayer increases as their assessable income rises. For the same \$100 expense, a deduction is worth \$49 for an individual facing a 49 per cent marginal tax rate, but only \$19 for an individual facing the 19 per cent tax rate. As marginal tax rates increase, there is a greater incentive for individuals to identify and claim expenses as deductions, creating planning opportunities in the tax system.

PERSONAL INCOME TAX, TRANSFERS AND SAVING continued

Tax statistics indicate that \$19.3 billion in work-related deductions were claimed in the 2011-12 year (ATO 2014c, Table 10). Each expense requires separate identification and record keeping. They also contribute to the heavy utilisation of tax agents for completing tax returns. As the costs of administering one's tax affairs are deductible against one's tax liability, a proportion of these costs are borne by the wider community. More than 75 per cent of individuals relied on a tax agent to file their return and deductions in excess of \$2 billion were claimed by individuals for the cost of managing their tax affairs in 2011-12 (ATO 2014c, Table 10).

The Henry Review identified the breadth and complexity of Australia's work-related deductions as a problem of tax base design and called for a tighter nexus between an expense and its role in generating income (Recommendation 12).

Some options for reform of tax deductions

- > The Henry Review proposed a standard deduction that could be used by most individuals instead of itemizing their expenses (Recommendation 11). The Rudd and Gillard governments canvassed this option but their proposal was heavily criticised as inadequate and overly complex (e.g. Tran-Nam and Evans 2011) and was subsequently abandoned. It could simplify the system but would not broaden the base.
- > Cap tax deductions at a dollar level each year. A Gillard Government proposal to cap self-education expenses deductions at \$2000 on the grounds that they were being excessively utilised by high-income earners was heavily campaigned against and the incoming Abbott Government reversed the policy.
- > The Canadian approach: Employees can only deduct expenses that the employer specifically requires the employee to incur and which are specifically identified in tax law or administrative guidance.
- > New Zealand abolished work-related deductions altogether for employees in 1987, as part of a package of reforms that broadened the base and lowered personal tax rates, while also simplifying the system. Combined with the introduction in 2000 of a pre-filled 'personal tax statement', only around one quarter of New Zealand taxpayers have to file a tax return (Kerr 2012, 472).

Tax structuring using companies and trusts

Tax minimisation may be achieved through the use of income splitting with other individuals (such as family members), or through the utilization of a legal entity to generate a lower tax rate on employment, business and investment income.

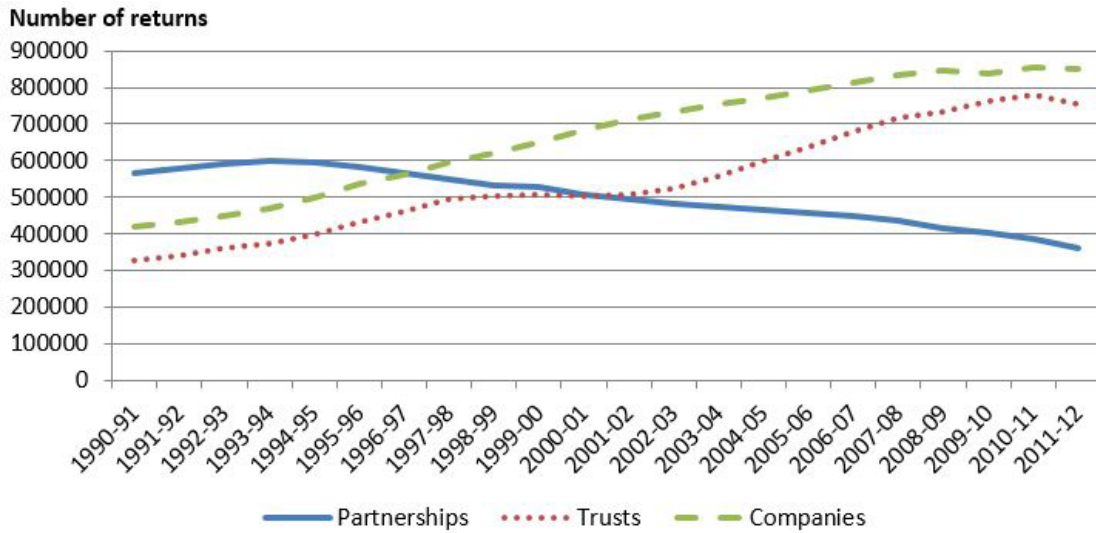
Individuals seeking to operate a business may select from alternative business structures with differing tax consequences, including a sole trader, partnership, company or trust. Many individuals, especially those who are self-employed, have the opportunity to use a company. The gap between this 30 per cent company tax rate and the top marginal tax rate of 49 per cent is a significant driver of tax planning. Other options for individuals include saving in self-managed superannuation funds (SMSFs) taxed at 15 per cent; or using trusts to split professional, business and personal services income among family members, thereby reducing the overall tax paid.

Chart 4.8 reveals that the number of companies and trusts filing tax returns has more than doubled in the last two decades, which may be an indicator of increasing tax planning. The number of SMSFs has also dramatically increased in recent years. There are now more than 500,000 SMSFs with nearly 1 million individual members.

Companies and trusts can be combined to achieve a lower tax rate on income while ensuring maximum flexibility. An illustrative business structure aimed at maximising tax benefits derived from differences in the taxation treatment of different entities is presented in Chart 4.9.

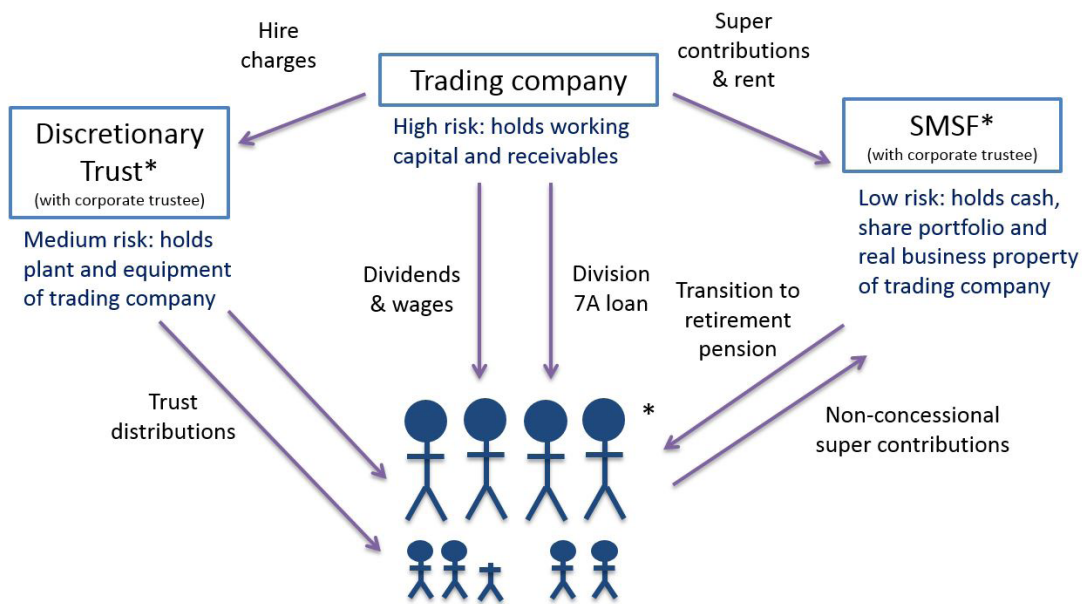
In this example, a business owner establishes a family discretionary trust as a shareholder in a business company, with trust profits distributed selectively to spouses or family members facing lower marginal tax rates. A SMSF may receive salary sacrificed superannuation contributions from the business and may hold debt-funded investment in the real property of the business, generating interest deductions and a rental return. In addition, a company could be used as a trust beneficiary 'bucket company' to cap taxation at 30 per cent, deferring the application of higher marginal tax rates until funds need to be distributed to the owners (not shown in illustration below).

Chart 4.8: Trends in legal entities filing tax returns



Source: ATO (2014c).

Chart 4.9: Illustrative diagram of a small business structure



Source: Treasury.

PERSONAL INCOME TAX, TRANSFERS AND SAVING continued

This kind of tax structuring is legal and widespread. However, where a taxpayer has a dominant purpose of obtaining a tax benefit by tax structuring, specific or general anti-avoidance tax rules may apply. For example, individuals who establish a company to provide their own personal services may be required to pay tax on the income attributed to them by specific rules.

Australia's general anti-avoidance rule in Part IVA of the Income Tax Assessment Act 1936 is widely considered to be quite robust. However, administering anti-avoidance rules is complex and resource-intensive for the tax administration and for individual taxpayers, as well as generating uncertainty. Ideally, tax law design would aim to ensure that widespread tax minimization practices are stopped by reforms to basic tax rules wherever possible.

If tax avoidance becomes widespread, this reduces the progressivity of the personal tax system and narrows the tax base, leading to higher statutory tax rates than would be necessary in the absence of tax planning opportunities. It may give rise to a number of costs borne by the whole community, including:

- > additional tax compliance and administrative costs;
- > efficiency losses through tax-driven distortions of decisions about business structures and modes of work, saving and investment;
- > the generation of wasteful and excessive profits, or 'economic rents' for facilitators of tax planning arrangements including in the professional advice industry; and
- > actual and perceived unfairness which may undermine voluntary compliance.

New empirical research into tax elasticity

New studies undertaken in other countries using administrative tax return data provide evidence that taxpayers engage extensively in tax planning and other behavior so as to reduce their tax burden (Creedy and Gemmell 2014; Slemrod and Gillitzer 2014). This research about the *elasticity* of responses to taxable income and rates is important in understanding behaviour of taxpayers in the tax system and in identifying weak points and priorities for tax reform.

For example, a recent New Zealand study examined changes to taxpayer behaviour in response to tax rate changes. New Zealand reforms in the 1980s aligned the top personal tax rate and the tax rate for trusts and companies at 33 per cent. Changes introduced from 2001 subsequently increased New Zealand's top marginal tax rate to 39 per cent and lowered the company tax rate to 30 per cent. Empirical evidence from 2002, 2005 and 2007 indicates that individual taxable income was abnormally clustered at amounts just below the top marginal rate threshold compared to 1999 when tax rates were aligned (Benge and Holland 2010; New Zealand Inland Revenue Department 2008).

In a UK study, a new 50 per cent income tax rate introduced in 2010 elicited a substantial behavioural response from high-income earners, including bringing forward the realisation of income (so it would be taxed at a lower rate), moving income overseas and converting it into other forms. As a result, the underlying revenue yield from the new tax rate was estimated at 83 per cent less than originally forecast (HMRC 2012).

Very little research into tax responsiveness has been carried out in Australia. To carry out research into the responsiveness of taxpayers to tax planning margins, changes in tax rates or concessions in the tax base, researchers require access to tax administrative data including panel data sets over a period of years of confidentialised unit record files. The TTPI aims to work with government agencies to ensure that such research is feasible, while respecting privacy and security of taxpayer information.

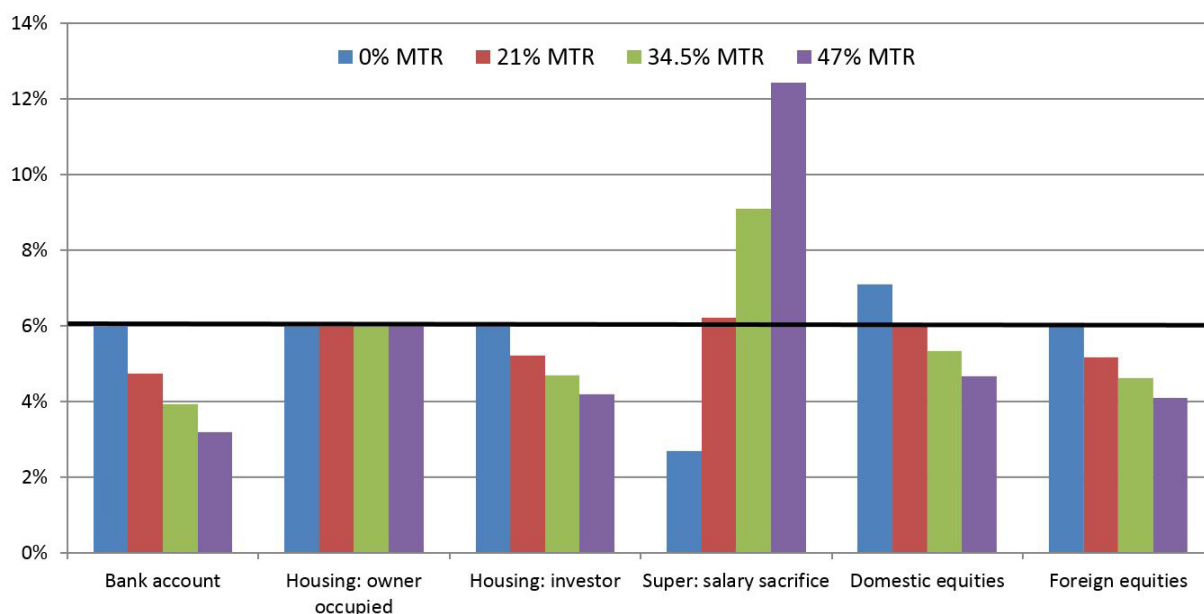
4.5 Personal taxation of saving and investment

Different forms of personal savings and investment such as financial bank deposits, shares, the family home (main residence), investment real estate and superannuation, are taxed in diverse ways. As a result, the after-tax return to different forms of saving varies dramatically, depending on the type of investment and tax bracket of the investor.

This was illustrated in the Henry Review with a stylised example of the after-tax return for an investment returning 6 per cent in various sectors (Henry 2010a, Chart A1-22). A similar example was provided in the Murray Financial Systems Inquiry Interim Report (Murray 2014a). This is reproduced in Chart 4.10.

Chart 4.10 shows that for most savings vehicles, as expected, taxation would reduce the after-tax return in line with the applicable individual tax rate. However, some investments are not taxed at all (such as the family home), while salary-sacrificed superannuation actually increases the after-tax return (i.e. provides a subsidy) for this type of investment. This stylised example does not take account of the tax deduction for interest on borrowing, or gearing investments that are purchased to gain assessable income, which also has a significant effect on the after-tax return to various forms of investment and can shelter other income from tax.

Chart 4.10: After-tax return to a 6 per cent returning investment



Source: Murray (2014a), Chart 3.2.

PERSONAL INCOME TAX, TRANSFERS AND SAVING continued

The Murray Inquiry into the Financial System concluded that the unequal treatment of different forms of saving 'distorts the asset composition of household balance sheets and the broader flow of funds in the economy'. It recommended a more neutral taxation treatment for consideration in the government's Tax White Paper process (Murray 2014b, Appendix 2).

As a consequence of the exemption or low taxation of returns to saving in the home and superannuation, the personal tax system is really a hybrid income-consumption tax base. It exhibits features of a consumption or expenditure tax in its treatment of these forms of household saving (Heferen 2012; Freebairn 2014).

A comprehensive income tax would tax all real returns to saving equally when they are derived. A comprehensive expenditure tax would not tax saving at all, but would tax all consumption when it occurs. On this basis, applying an income tax to the nominal return to saving overtaxes this deferred consumption (saving) relative to current consumption (e.g. Sorenson and Johnson 2010, 207).

Over the lifecycle, if all saving by an individual is deferred consumption, these two approaches would be equivalent from efficiency and equity perspectives. However, savings may be set aside for reasons other than future consumption. Wealth accumulation may be an end in itself, or aim to leave a bequest to children.

Not all individuals have the opportunity to save and many low income people effectively have no net assets and must spend all of their current income. The distribution of savings is highly unequal across the household income distribution. Chart 2.8 demonstrates that more than sixty percent of household assets are owned by the top 20 per cent of households, while the bottom 40 per cent own just over 5 per cent of household assets. Australia does not tax inheritance or most superannuation payments on retirement or death, so the tax system treats savers much more generously than those who cannot save. In this context, levying tax on savings income has been an important equity feature of the tax system.

Henry Review recommendations for saving

There are many possible approaches and diverse views about what is the best way to tax savings. On the basis that Australia's personal income tax should be broad-based, robust and efficient, the Henry Review recommended that the net return to saving should be taxed more consistently at individual marginal rates. However, it recommended that a lower rate be applied than for work and active business income and that the main residence remain tax-exempt.

Recommendation 14 (Henry et al 2010a):

Provide a 40 per cent savings income discount to individuals for non-business related:

- > Net interest income;
- > Net residential rental income (including related interest expenses);
- > Capital gains (and losses) ;and
- > Interest expenses related to listed shares

An approach such as the Henry Review proposal would provide a more consistent and fairer taxation of the return to savings. It would move Australia towards a 'dual income tax' model that taxes the return to savings at a lower, but comprehensive rate compared to the taxation of work and business income (Sorenson and Johnson 2010). This approach generates its own tax planning margins, especially incentives to convert work or business income to lower-taxed savings income. To some extent, these incentives already exist in Australia's tax system because of the lower taxation of capital gains.

Interest on bank deposits

Interest on financial deposits in banks and other deposit-taking institutions is taxed in the same way as income from work, at the taxpayer's marginal tax rate. However, the impact of inflation means the effective income tax rate on interest income is higher than the statutory rate (Freebairn 2014, 5). This acts as a significant disincentive to holding savings in deposits compared with other more tax advantaged savings vehicles. It is unfair because it penalises low income people whose only saving opportunity is in a financial deposit.

Dividends

Dividends are taxed at full marginal tax rates. However, dividends paid out of taxed Australian company profits to Australian shareholders may benefit from an imputation credit for company tax paid. This makes Australian company dividends an attractive investment for many individuals, as illustrated in Chart 4.10. Company-shareholder taxes are discussed in Chapter 6.

Capital gains

Capital gains tax (CGT) is levied as a component of income tax on realised gains made on the sale of assets such as shares or property. The introduction of CGT in 1985 represented a significant broadening of the personal income tax base, although the protection of pre-1985 capital gains generated complexity in the system and has likely reduced revenues. Net capital losses can only be utilised to offset other capital gains and are not able to be deducted against other forms of taxable income.

Most countries comparable to Australia have a capital gains tax, with the notable exception of New Zealand. When introduced, capital gains were taxed at the marginal tax rate with an adjustment for inflation. From 1999, CPI indexation was replaced with a 50 per cent CGT discount for gains on assets that have been held for longer than 12 months, following a recommendation of the Review of Business Taxation (Commonwealth of Australia 1999).

The TES estimates the annual revenue foregone from the CGT 50 per cent discount to be \$5.8 billion (Table 3.3; Treasury 2015). The Henry Review recognizes this as likely to be over-generous and recommends reducing it to 40 per cent and applying this consistently across various savings vehicles.

The CGT is a relatively volatile source of taxation revenue and CGT revenues have still not recovered from the effects of the GFC. CGT receipts were 0.46 per cent of GDP in 2012-13, down from a peak of 1.56 per cent of GDP in 2007-08. Even as asset prices have recovered, carried forward capital losses built up during the GFC are utilised to offset more recent capital gains (Clark and Hollis, 2013; PBO 2014a, 23). Nonetheless, the uneven distribution of capital gains between rich and poor provides a significant reason to levy tax on capital gains for reasons of fairness. Taxing capital gains is also important as it reduces planning margins (e.g. conversion of income to capital gain), protecting the broad income tax base and supporting resilience of the system.

Home (main residence) exemption

The home has a particular role in consideration of saving. By far the largest component of Australian household wealth is real estate, including the family home and investment real estate which comprise about 60 per cent of all household wealth (Finlay 2012).

Investment in the home is made with after-tax income. However, as illustrated in Chart 4.10, the return to owning your own home is entirely exempt from tax. There is no income tax on the annual benefit from living in your own home (instead of paying rent), called *imputed rent*,

and no tax on capital gains from sale of your home. Correspondingly, tax deductions for expenses such as mortgage interest and repairs and maintenance are not available for owner-occupied housing. This treatment is termed a 'pre-paid consumption tax model' that ensures effective tax rates on capital income from owner-occupied housing are close to zero (Freebairn 2014).

The TES estimates that the combined value of home ownership tax expenditures exceeds \$45 billion (see Table 3.3 above; Treasury 2015). The home is also exempt from assets tests for transfer payments, most notably the age pension.

The long-standing generous treatment of home ownership has historically been considered one of the central tenets of the 'Australian promise' that has encouraged high levels of home ownership and underpinned household wealth in Australia (Wood et al 2008). It has been criticized as leading to over-investment in owner-occupied housing in Australia (Abelson and Joyeux, 2010; Productivity Commission 2004); as unfair to those who cannot afford a home; and as undertaxing speculative gains at the top of the income distribution.

Rental losses

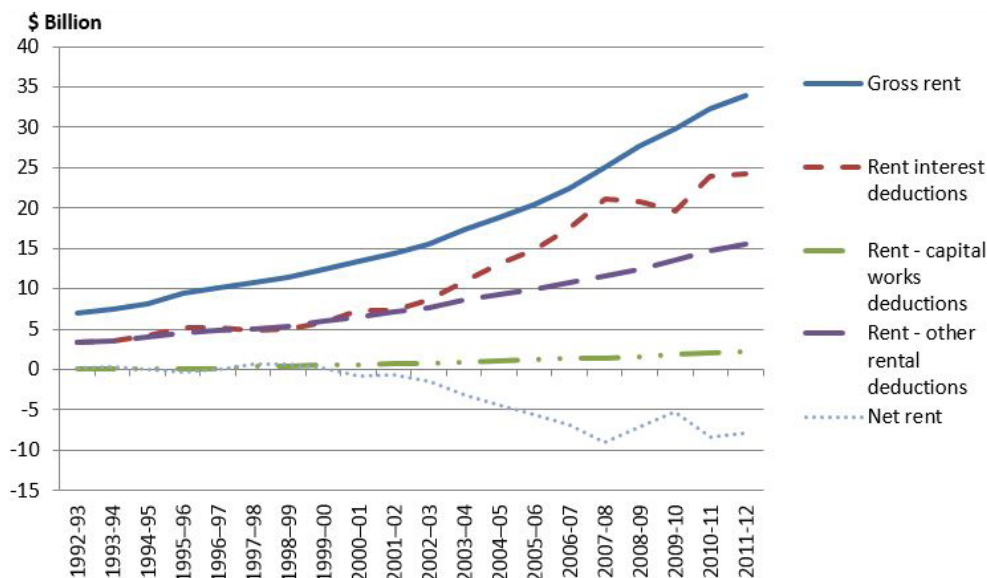
The deductibility of net losses on rental real estate or shares to shelter other work or business income from tax is commonly known as negative gearing. Interest and other expenses in excess of returns on the asset (rental or dividend income) are fully deducted against other income of the taxpayer, thereby reducing their overall tax paid. The property may subsequently be sold with only half of any capital gain subject to tax.

Allowing a full deduction for expenses including interest, when only half the gain accruing will be taxed on a realisation basis is the main mismatch associated with negative gearing. This tax advantage is not estimated as a tax expenditure, because it is a result of the ordinary income tax law rule that assessable income and deductions are pooled in determining taxable income, in combination with the 50 per cent CGT discount.

More than 1.8 million Australian taxpayers received \$34 billion of rental income for the 2011-12 income year and claimed deductions totalling more than \$41.8 billion against this income. More than half of these deductions were generated by loan interest on rental properties (ATO 2014c). Negative gearing, particularly into real property investments, has become a preferred investment method for higher income earners, either directly or via a self-managed superannuation fund. More than 65 per cent of landlords have net losses that may be used to shelter other sources of income from tax. The growing trend in rental deductions and losses is illustrated in Chart 4.11.

PERSONAL INCOME TAX, TRANSFERS AND SAVING continued

Chart 4.11: Trends in rental deductions and losses



Source: ATO (2014c).

The Murray Inquiry found that the subsidy delivered by this asymmetric tax treatment tends to encourage leveraged and speculative investment in housing, generating a potential source of systemic risk (Murray 2014b, Appendix 2). The Henry Review recommendation for savings taxation would reduce the impact of negative gearing, but would not eliminate it completely. Some have proposed other limits, for example limiting negative gearing only to new housing stock, to encourage increased supply, or quarantining expense deductions to rental income or capital gain.

Wealth taxation

The distribution of net worth is much more highly skewed than the distribution of household income, as shown in charts 2.6 and 2.8. However, when household net worth is ranked by income, net worth is less unequally distributed than income. That is, some lower income households have household wealth. The most likely factor is the lifecycle accumulation of wealth, particularly housing, so that older people who have lower than average incomes in retirement are more likely to own their homes.

Australia does not tax assets as broadly as many other countries. We have no asset taxes, apart from land tax and rates on real property. Estate and gift taxes at State and Commonwealth levels were abolished in the early 1980s. Capital gains tax does not apply to the disposal of assets on death.

The Henry Review recommended further study and consideration of options for a bequests tax (Recommendation 25). The Henry Review also recommended taxing housing through a land tax (Recommendation 52). We return to land tax in Chapter 6.

Capital gains taxed on death in Canada

Canada has a similar CGT to Australia in many respects. However, unlike Australia, Canada taxes accrued capital gains on death of the owner, which is treated as a deemed disposition. The deemed capital gain is eligible for a 50 per cent discount on tax, like other capital gains. In addition, there is a lifetime capital gains exemption of \$800,000 in 2014 and some exemptions for farms passed to children.

See <http://www.cra-arc.gc.ca/tx/ndvdl/lf-vnts/dth/dmd/menu-eng.html>.

4.6 Tax concessions for superannuation

Australia's retirement incomes system combines public provision (the age pension) with private savings through compulsory and voluntary superannuation. Tax concessions for superannuation contributions and earnings are among the largest tax expenditures incurred by the Commonwealth government, estimated to be approximately \$30 billion in revenue foregone against an income tax benchmark (see Table 3.3 above; Treasury 2015). The TES estimates that the combined cost of superannuation tax concessions will exceed \$45 billion by 2015-16 and will continue to grow over the long-term with population ageing and as the superannuation system approaches maturity.

Regulated superannuation funds, including SMSFs, are taxed at a flat rate of 15 per cent on contributions, two thirds of any realised capital gains held for more than a year and investment income. Superannuation funds can utilize exemptions (in the pension phase) and imputation credits on share investments to reduce taxes. Superannuation payouts and investment earnings received after people have retired and are drawing down their superannuation are generally tax-free. Superannuation may be cashed out as a lump sum on reaching retirement age, or may be retained as a pension generating tax exempt returns.

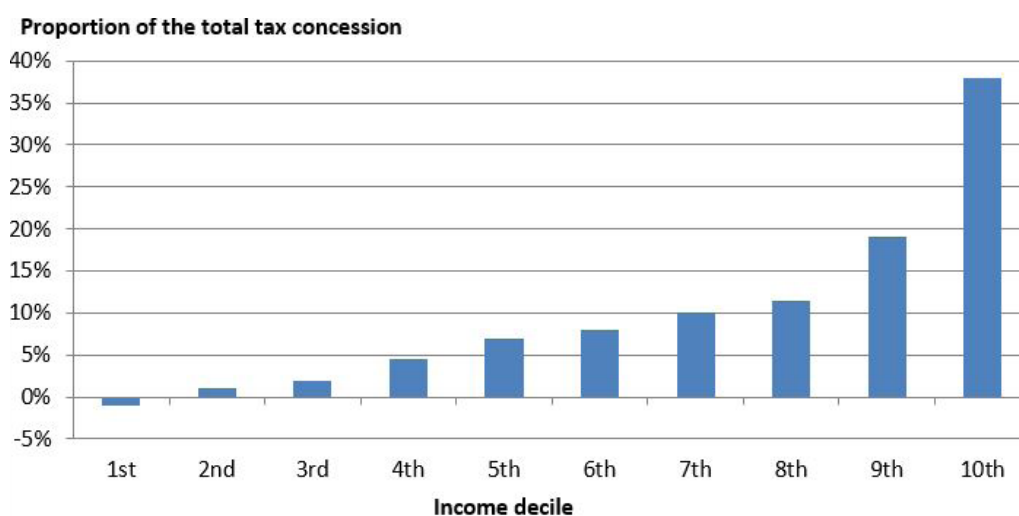
Employees may also make additional pre-tax contributions to superannuation, which are not included in the employee's personal income and are instead taxed in the superannuation fund at 15 per cent. Salary sacrifice arrangements may reduce an employee's taxable income and adjusted taxable income for transfer means testing purposes.

The taxation treatment of superannuation contributions, earnings and payouts is concessional for individuals earning more than the effective tax-free threshold of \$20,542 and increasingly as an individual's marginal tax rate increases. High income earners pay about two thirds less tax on their superannuation than on other sources of income.

In contrast, people earning less than the effective tax free threshold pay more tax on their superannuation contributions than on their personal income from work, while those on low marginal tax rates derive a much lower benefit from superannuation concessions. The bottom 50 per cent of income earners received just 13 per cent of total superannuation tax concessions (Treasury 2012).

The skewed distributional impact of superannuation tax concessions is shown in Chart 4.12, from the Murray Inquiry. It reveals that the bottom 10 per cent is actually made worse off under current superannuation tax arrangements.

Chart 4.12: Distributional impact of superannuation tax concessions



Source: Murray (2014).

PERSONAL INCOME TAX, TRANSFERS AND SAVING continued

The growing cost of tax support for superannuation is not expected to reduce appreciably the extent of reliance on the age pension. The Treasurer recently pointed out that 'despite spending billions of dollars in taxation benefits for superannuation, by 2050 the ratio of Australians receiving a full or part pension will still be around four out of five' (Hockey 2014a). This could be addressed, in part, by rules regulating access to superannuation benefits as a pension, or by changing tax settings.

Superannuation tax reform

There is increasing and widespread acknowledgement of inequities in the superannuation system; however, the pathway to reform is not straightforward. The Henry Review made significant recommendations about superannuation and the Murray Inquiry has also recommended that superannuation tax concessions be reviewed in the Tax White Paper. A key issue in the retirement savings system, including superannuation, is to be clear about the overall purpose of the system and the benchmark against which to assess tax concessions and pension conditions.

Governments have made some ad hoc attempts to address equity issues concerning the distribution of superannuation tax concessions, including introduction of a concessional contributions cap to limit benefits for contributions by high-income earners. Excess contributions were initially taxed at the top marginal rate and this was subsequently revised so that excess contributions are now taxed at the individual's marginal tax rate, plus an interest charge. The Gillard Government introduced a low-income superannuation contribution which would refund contributions tax up to a maximum of \$500 per year so that individuals on annual incomes up to \$37,000 would pay no tax on their superannuation contributions, which is expected to continue until 2017.

The Henry Review recommended abolishing the 15 per cent contributions tax and instead taxing contributions at marginal tax rates with a tax credit of 20 per cent so the majority of taxpayers do not pay more than 15 per cent tax on contributions (2010a, 84). It estimated that this approach would improve fairness and increase aggregate superannuation savings by 17.5 per cent without changing the Superannuation Guarantee rate from 9 per cent. This would result principally from lower income earners receiving a greater tax benefit than under the existing flat rate tax model.

The Review also recommended reducing superannuation earnings tax to 7.5 per cent, aimed at an effective average tax rate on earnings close to zero per cent after accounting for imputation credits for company tax paid on shares held by superannuation funds.

Consistent with the scope of its terms of reference, the Henry Review did not propose changes to the taxation of benefits received in retirement, although it did recommend including superannuation end benefits in the age pension means test on the same basis as other forms of saving (other than the family home).

In aggregate, the Henry Review's recommendations would bring the taxation of superannuation closer to a 'pre-paid' consumption tax treatment like the taxation of owner-occupied housing. This approach would entrench superannuation and savings in the family home as the most tax preferred forms of private saving, when combined with the other Henry Review recommendations for the 40 per cent savings discount, but would remove some of the most extreme inequities in the system.

CHAPTER 5 COMPANY TAX

MAIN POINTS

- > Australia's company tax is long established. Australia raises substantially more revenue than many other countries in company tax.
- > The company tax rate is 30 per cent and the effective tax rate is estimated to be close to that rate, demonstrating that the company tax has a broad base with few exemptions. The Australian nominal and effective company tax rates are higher than the OECD average including Canada and New Zealand.
- > Economic modelling of the company tax in a global economy suggests that it may deter foreign investment and so its economic incidence is shifted from capital to be borne largely by Australian workers or consumers. A reform implication of this modelling is that a lower company tax rate would lead to increased national wellbeing. This also has implications for reforming the corporate-shareholder imputation system.
- > However, the specific benefits of lowering the company tax rate are difficult to assess. Australia's company tax collects revenues from economic rents including from the resource sector. It is an important backstop to the personal income tax and the corporate-shareholder imputation system provides a significant incentive for Australian companies to pay company tax. A lower company tax rate would have implications for the boundary between the personal and corporate income tax systems, by increasing tax planning margins.
- > Tax planning margins exist for both international and domestic tax planning. Multinational enterprises carry out sophisticated tax planning that may reduce their Australian and global tax rates to zero or close to it. The OECD BEPS project internationally, and Australia domestically, are taking some steps to increase country cooperation to prevent base erosion. It is not clear how successful these efforts will be in protecting the company tax base.
- > The complexity of the company tax system is particularly important for small and medium enterprises, with current tax rules creating both planning, margins and compliance challenges.
- > There are overlaps with other business tax entity rules, especially the taxation of trusts and whether SMEs should benefit from specific tax policies.
- > As indicated by the Henry Review, further research is needed into the best long-term approach to company tax for Australia. The Henry Review considered a business level expenditure tax as worthy of future consideration.

5.1 Company tax role and revenues

Australia's company income tax is long established, dating back to 1915. Company tax provides a significant proportion of Australia's total tax revenues and is an important part of Australia's overall tax mix. There is widespread policy and academic debate about the future role and structure of company taxation in the context of the challenges of a global digital economy and declining growth and productivity identified in Chapter 2.

Company tax is levied at the rate of 30 per cent. Resident companies that are incorporated in Australia or have their central management and control located in Australia are subject to company tax on worldwide taxable profits

including capital gains. Non-resident companies are liable for company tax on Australian-sourced profits. Company losses may be carried forward indefinitely and applied against taxable income in a later year. A short-lived reform by the Rudd/Gillard Government to allow carry back of tax losses has been repealed.

Since 1987, Australia's company tax has been integrated with a shareholder dividend imputation system. A 30 per cent credit (called a franking credit) for Australian company tax paid is available on franked dividends distributed to Australian shareholders. As franking credits are valued by Australian shareholders, the corporate-shareholder imputation system affects corporate behaviour and incentives in respect of the location of investment, financing and distribution policy. These issues were identified in the Henry Review and we discuss them in section 5.4 below.

COMPANY TAX continued

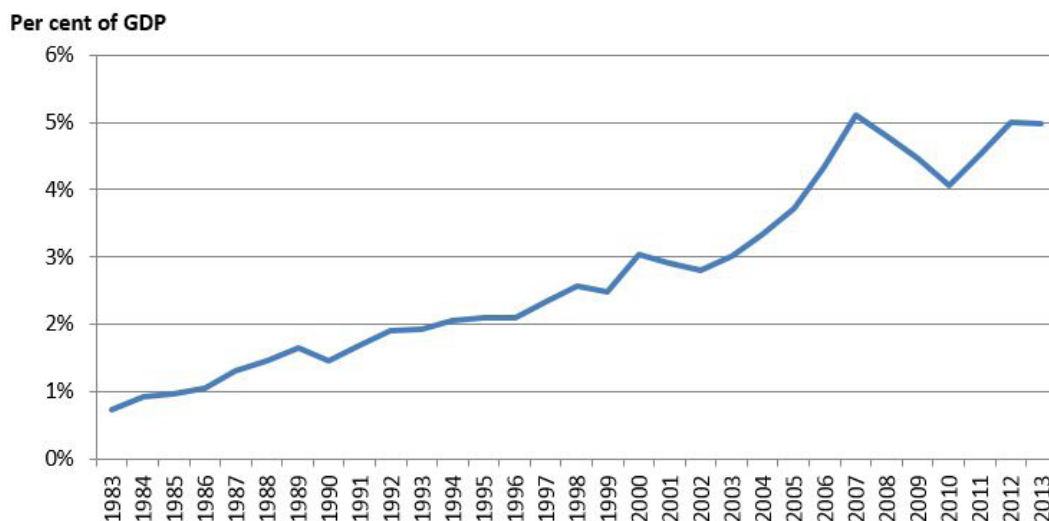
Company tax revenue

Company tax raised \$66.9 billion in 2013-14 (see Table 3.1 above). Combined with PRRT and MRRT (the latter now repealed), it contributed about 6 per cent of GDP in revenue, or more than 20 per cent of Commonwealth taxes. Actual company tax receipts, and company tax revenue as a proportion of GDP, have grown strongly since the early 1980s.

Chart 5.1 shows that company tax revenues peaked at 5.1 per cent of GDP in 2007-08 after growing at an average rate of 17 per cent in the five years prior to this peak.

The growth in company tax revenue over the last thirty years closely follows growth of corporate income as a share of GDP (PBO 2014a, 13-15). Corporate gross operating surplus (a measure of corporate profitability) has grown from 15.2 per cent of GDP in 1982-83 to 22.8 per cent of GDP in 2012-13. Incorporated entities accounted for around 75 per cent of gross business profit in 2012-13, compared with around 60 per cent three decades earlier (PBO 2014a, 14-15).

Chart 5.1: Growth in company tax as a percentage of GDP



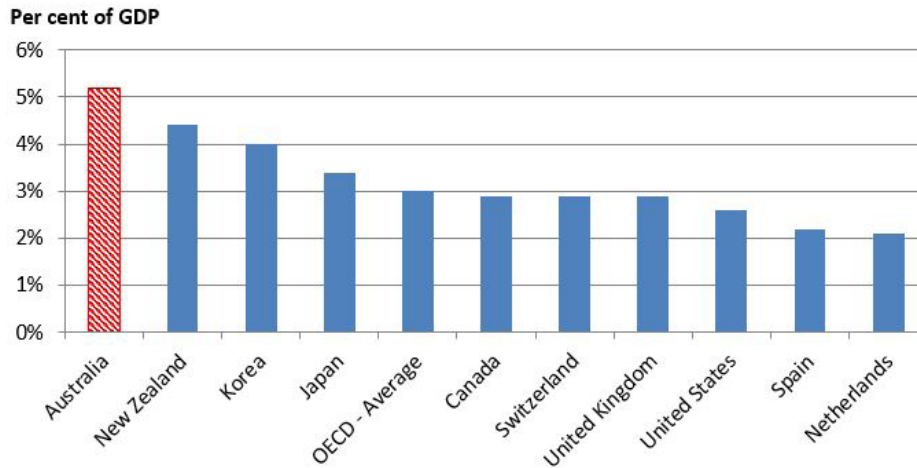
Source: National Accounts. ABS Cat. No. 5204, Table 30.

Note: The measure of corporate taxation used in the national accounts is the income receivable from resident corporations. This may exclude some revenue collected from non-resident corporations.

This upward trend in growth of company tax revenues may now have come to an end as a result of a number of factors. These now include a stock of carry-forward losses since the GFC; the challenge of the third phase of the mining boom including declining terms of trade, leading to lower nominal GDP growth and a fall in the relative profit shares of the mining sector relative to other sectors of the economy (Treasury 2013b, 4-16 to 4-19).

Australia's company tax revenue as a percentage of GDP compared with selected other countries is shown in Chart 5.2. Australia raises substantially more revenue from company tax than most comparable countries. More than half of Australian company tax revenue (\$39.92 billion in 2011-12) is raised from just over 1,000 very large companies with a turnover of \$250 million or more each year (ATO 2014c, Table 20).

Chart 5.2: Company tax level as a percentage of GDP, selected countries, 2011-2012



Source: OECD (2014d).

Company tax rate

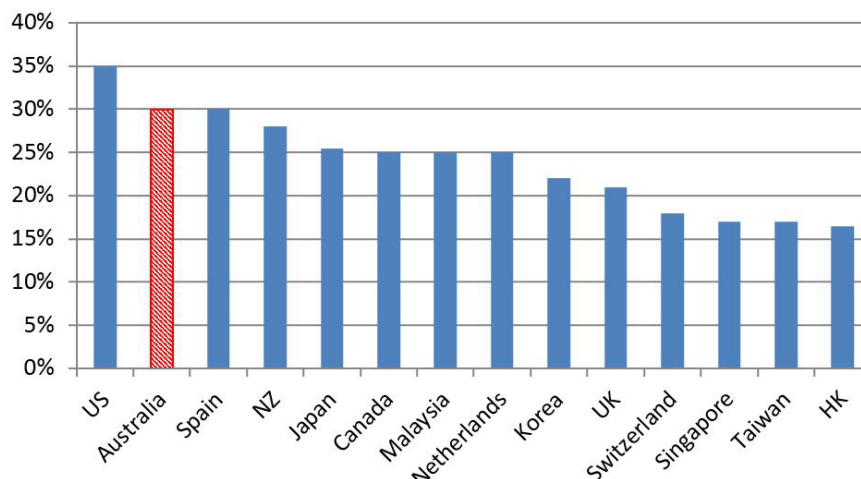
Increasing globalisation and national economic openness have coincided with a reduction in company tax rates across the globe in the last three decades. Chart 5.3 compares Australia's company tax rate with selected other countries in the OECD and the region.

In line with global trends, Australia's company tax rate has been reduced significantly since the 1980s but the current 30 per cent rate is relatively high by international standards and has been stable since 1999.

New Zealand's company tax rate is 28 per cent which is only a few percentage points below its top personal income tax rate of 33 per cent. This reduces the attractiveness of tax planning using legal entities and simplifies the tax system for business.

As is well known, the Irish company tax rate (not shown in Chart 5.3) is one of the lowest in a developed country, at 12.5 per cent, and Ireland is used as a global base by many multinational enterprises.

Chart 5.3: Statutory company tax rate, selected countries



Source: IBFD (2014).

Note: Rates in some countries are progressive and are lower for small companies. The rate for Switzerland is the average after applying canton and commune rates deductible against the federal rate. The rate for Canada combines the 15 per cent federal rate with provincial company tax rates which add about 10 per cent on average.

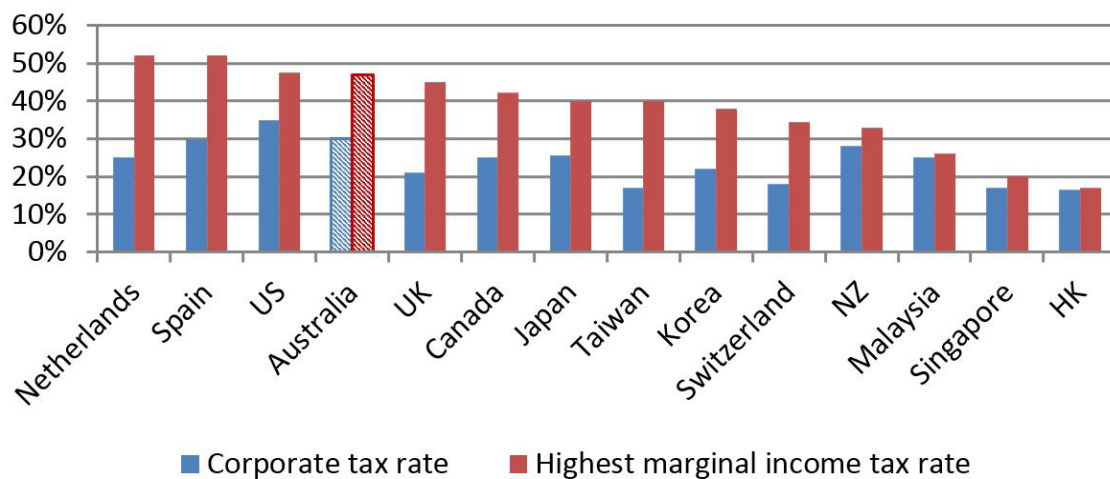
COMPANY TAX continued

The Abbott Government announced its intention in the 2014-15 Budget to lower the company tax rate to 28.5 per cent effective 1 July 2015 for companies with a turnover of less than \$50 million (Treasury 2014a). Implementing legislation has not yet been enacted.

In many countries, including Australia, the company tax rate is significantly lower than the top personal income tax rate. This creates incentives for individuals to plan their

affairs through a company, as explained in section 4.4. It also creates incentives for the retention of profits inside a company rather than distributing them as dividends to shareholders, even in a system such as Australia that provides a credit for company tax. Consequently, in some countries, a policy of lowering the company tax rate has been linked to downward adjustments to the top personal income tax rate (Auerbach 2010, 63-64).

Chart 5.4: Top personal tax rate and company tax rate, selected countries



Source: IBFD (2014).

UK and Canada reduce company tax rates

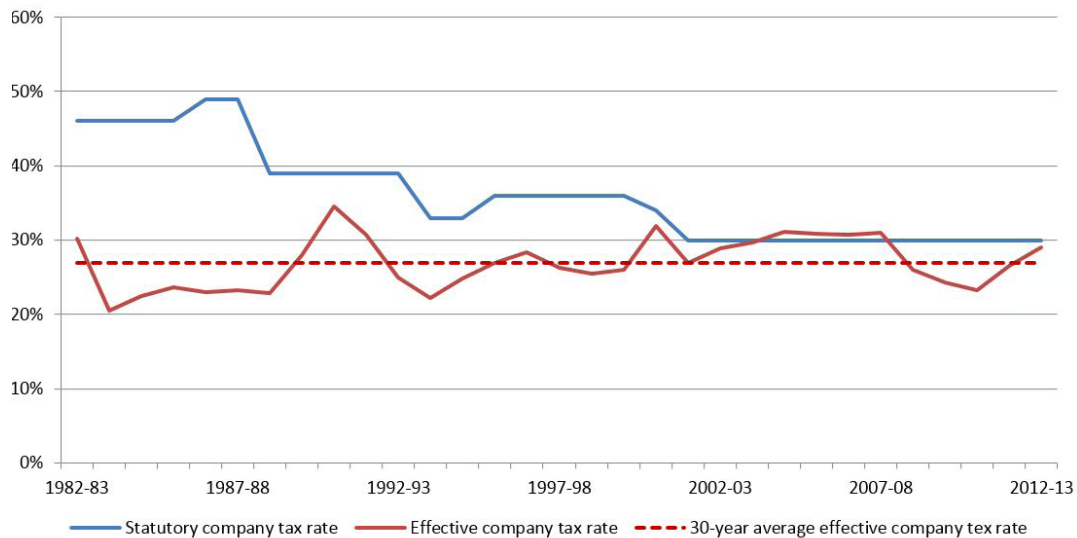
Effective 1 April 2014, the UK reduced its company tax rate to 21 per cent and proposed a 'patent box' which offers a preferential 10 per cent corporate tax rate for income from patents, designed to improve the competitiveness of the UK tax system for technology-driven companies (HM Treasury, 2013).

The Canadian federal rate of company tax was reduced in stages to 15 per cent by 2012. This is equivalent to an overall corporate tax rate of around 25 per cent, taking into account company taxes levied by the Canadian provinces (Hodge 2012).

5.2 Effective company tax rate and the tax base

It is important to understand not only the nominal tax rate but also the effective company tax rate taking account of the definition of the company tax base (taxable profit). The PBO has estimated Australia's effective company tax rate, by calculating company tax receipts as a proportion of corporate profits the economy. Chart 5.5 presents these estimates and tracks changes in the nominal and effective company tax rates over the last three decades. The chart does not distinguish between different sectors or industries.

Chart 5.5: Trends in effective company tax rate compared to statutory company tax rate



Source: PBO (2014a).

Note: The effective company tax rate is calculated as the ratio of company tax receipts (excluding capital gains tax) to net operating surplus of companies.

Chart 5.5 indicates that although Australia's statutory company tax rate has come down significantly since the 1980s, the effective tax rate has remained close to the current statutory rate of 30 per cent. This is a result of base broadening measures, including the removal of concessional investment allowances and accelerated depreciation for plant and equipment. It is consistent with trends in other countries until the 1990s, which show a close association between reductions in company tax rates and broadening of the company tax base (Loretz 2008). It may also indicate that the dividend imputation system has a significant effect in encouraging Australian companies to pay tax, so as to distribute franked dividends to shareholders.

Marginal effective company tax rate

The effective company tax rate can also be indicated by the tax wedge, or marginal effective cost of capital on corporate investment (Fullerton and King 1984). This measure produces a marginal effective company tax rate which aims to identify the tax cost of the next dollar of investment by a company, taking account of the nominal tax rate, expense and depreciation deductions and the tax treatment of debt and equity finance.

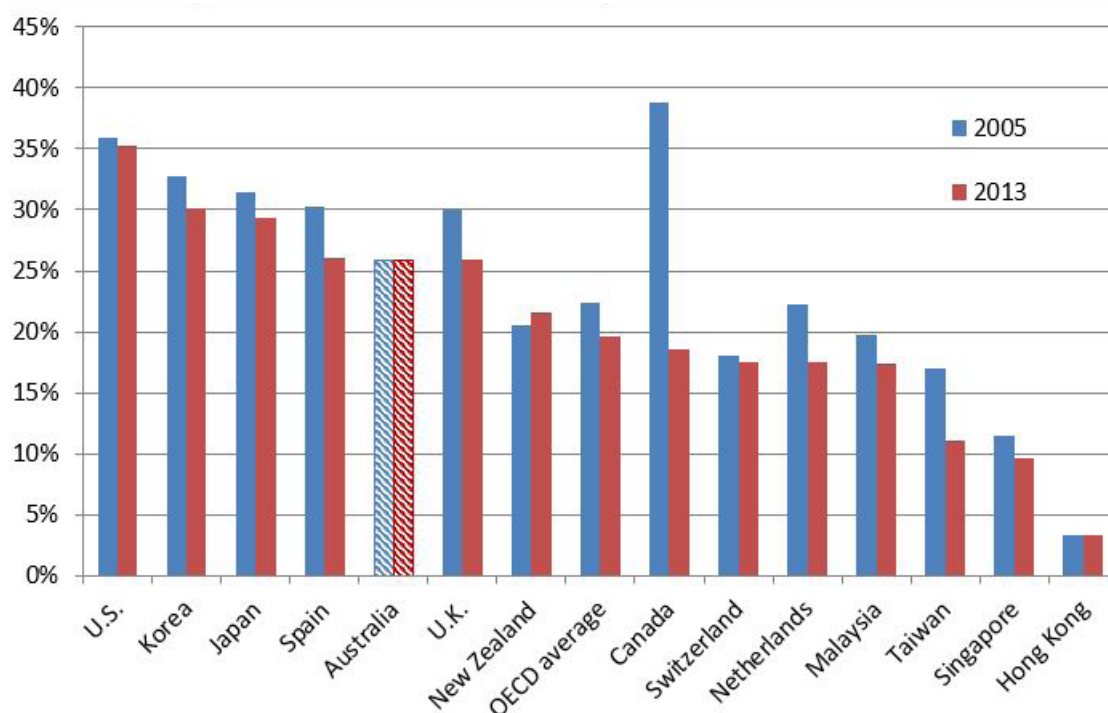
A recent comparative study of 90 countries indicates that Australia's marginal effective company tax rate is just over 25 per cent (Chen and Mintz 2013). Chart 5.6 shows Australia's marginal effective company tax rate is several percentage points higher than estimated rates for the UK, Canada and New Zealand, as well as the OECD average. Not surprisingly, it is also significantly higher than regional competitors for capital investment: Singapore, Malaysia, Hong Kong and Taiwan.

Business tax expenditures

We can examine the definition of taxable profits for a company (the business tax base), to identify concessions and to estimate the revenue foregone from these business tax expenditures.

There are more than 100 tax expenditures related to business income that can operate to reduce a company's tax liability below the statutory corporate tax rate (Treasury 2015). However, most of these reduce revenue by a relatively small amount. Table 5.1 sets out the largest estimated business tax expenditures including exemptions from interest withholding tax on certain cross-border financial securities, accelerated write-off periods for certain assets in the oil and gas industries and heavy vehicles in the transport and agriculture sectors, depreciation concessions for small businesses and research and development tax concessions.

Chart 5.6: Marginal effective tax rate on corporate investment, selected countries



Source: Chen and Mintz (2013).

Table 5.1: Largest business income tax expenditures

Tax Expenditure	Revenue Forgone (estimate \$m)
Statutory effective life caps (concessional depreciation for some equipment) (Item B73)	1945
Exemption from interest withholding tax on certain securities (Item B14)	1860
Small business—simplified depreciation rules (Item B81)	1265
Research and development tax offset (Item B80)	1070
Deduction for capital works expenditure (Item B75)	555

Source: Treasury (2015).

Note: Excise concessions such as the diesel fuel rebate were considered by the Henry Review not as a subsidy for fuel use but rather as a credit for fuel as a business input. It is not a tax expenditure in the income tax, so is not included here (Henry et al 2008a, 288).

Comparing the data in Table 5.1 with Table 3.1, it can be seen that the tax expenditures available for businesses cost much less in revenue foregone than those in the personal income tax and GST.

It should be noted that the TES does not estimate revenue foregone from Australia's international tax rules for companies, which are treated as part of the company tax benchmark. Nor does it estimate revenue foregone from difficulties in enforcing tax rules for transfer pricing or the treatment of business intangible assets. We discuss these challenges in section 5.4 below.

5.3 Company tax in a global economy

The future of the company tax is an important tax policy question for Australia that requires further research. The Henry Review considered underlying economic principles for company taxation in an international context.

Why levy company tax?

A company is a legal fiction and not a real person. Consequently, a company cannot itself bear the economic incidence of company tax but rather is a proxy or intermediary for taxation of others. Company tax may be borne by shareholders, employees or customers as explained in Chapter 1, because the economic incidence may be shifted from capital owners through wage and price effects.

The 'classical' approach to corporate taxation is a tax on income where it is earned, levied on the full return to equity after expenses are deducted. In this 'classical' system, without relief for shareholders on distributed profits or capital gains, company tax acts as a surcharge that raises the cost of capital and hence reduces the level of investment. The rate of return to an investor needs to be, at a minimum, sufficient to meet both the cost of capital and the tax liability in order for the investment to proceed.

The assumption of the 'classical' system is that the additional tax is borne by the investor. However, if capital is mobile, investment may shift and the company tax may be borne effectively by workers or customers because of lower investment.

If companies do not bear company tax, why levy it? The Henry Review acknowledged that a key function of the company tax is to operate as a backstop to the personal income tax, collecting a level of tax from the company as agent or proxy for domestic shareholders. If there was no company tax, there would be an overwhelming incentive for individuals to derive and hold returns to business and services in a company.

Even in our current system, there is a significant tax planning margin between the top personal income tax rate of 49 per cent and the company tax rate of 30 per cent that encourages derivation and accumulation of earnings inside companies. This is shown in Chart 5.4 above and discussed in Chapter 4. If the company tax rate is lowered, this tax planning incentive will increase.

Company tax is easier to administer than personal income tax. Collected by instalments throughout the year, it ensures a steady revenue stream, which is less easy to enforce for individuals in receipt of non-wage income. Company tax also operates as a charge for the benefit of public goods consumed by the company or its investors. In particular, company tax ensures that profits that are retained within companies or distributed to non-resident shareholders are subject to Australian tax (Sorenson and Johnson 2010, 206; Vann 2014).

Finally and importantly, company tax ensures that *economic rents* are taxed. These are above-normal returns in excess of the cost of capital plus compensation for risk associated with the investment. Where there are economic rents, for example from natural resource or monopoly markets, company tax may be able to be levied without affecting investment (Devereux and Sorenson, 2006).

Effects of company tax on foreign investment into Australia

There is significant debate about the 'international competitiveness' of Australia's company tax. It is argued that the statutory company tax rate may have a negative impact on Australia's attractiveness for international investment in a global economy.

As our revenue statistics and Chart 5.1 shows, Australia continues to collect company tax effectively. The policy question is whether the company tax is for the national benefit or whether it may have an effect of reducing investment into Australia to the detriment of all. While economic modelling and the empirical evidence of other countries suggests a direction for tax reform, it is not clear what would be the best way forward for Australia in this regard.

Economic models and taxes on capital

Statutory company tax rates appear to be trending downwards across the globe. There is evidence that in reducing company tax rates, governments are responding to global economic pressures including capital mobility.

Furceri and Karras (2010) draw on annual data for 30 OECD nations from 1965 to 2007 to analyse the tax structures of these countries. They find broad, statistically significant and robust empirical support suggesting that the smaller a country's size and the greater the openness of its economy, the more it relies on consumption taxes and less on income taxes including company tax.

These trends are consistent with economic modelling of the ideal tax system for a country that has a small open economy (for example, Hines and Summers 2009; Loretz, 2008). A 'small open economy' is defined as an economy in which the cost of capital is set globally. This modelling predicts that international competition will drive down company tax (and other taxes on mobile capital) to zero because capital flight will occur to lower taxed jurisdictions. Thus, a zero or low company tax would be most efficient. However, there is not universal agreement that even if capital is mobile, it would be efficient to levy zero tax on capital. Some researchers conclude that it is efficient to levy some tax on capital in a global economy but it is not clear what level is ideal (for example, Diamond and Saez 2011).

Countries are competing not only for investment but also for the ability to tax corporate profits earned on those investments (Matthews 2011, 7). A recent Treasury study suggests that as an open economy relying substantially on foreign capital investment, the final costs of company tax in Australia are borne largely by labour (Rimmer et al 2014).

The Henry Review found that there is strong evidence that company tax is a significant factor in business decisions about where to invest, how much to invest, what to invest in and where to record company profits. It concluded that Australia's company tax system likely makes it more difficult to attract foreign investment into sectors other than the resource industry—such as services and manufacturing—which have fewer location-specific advantages (Henry et al 2010a, 39).

Distortions in the company-shareholder tax system

Australia's corporate-shareholder imputation system assumes that the increased cost of capital arising from company tax is borne by the shareholder/investor. Australia reduces this 'double taxation' of corporate profits by integrating corporate and personal income taxes through a dividend imputation system that provides a credit for company tax paid. Australia's reduced CGT applicable to sale of shares also alleviates to some extent the 'double tax' on corporate profit.

A consequence of this system is that imputation credits are highly valued by Australian resident shareholders, including individuals and superannuation funds that invest the retirement savings of most Australian workers. The attractiveness of imputation credits appears to increase the incentive for Australian resident companies to pay tax in Australia (Henry et al 2010b, 155; Ikin and Tran 2013). It also may affect corporate behaviour and incentives in respect of the location of investment, financing and distribution policy.

This system creates different incentives for Australian companies with predominantly Australian shareholders, who value franking credits, and for foreign companies, or companies with predominantly foreign shareholders. In contrast to domestic shareholders, non-resident shareholders cannot access the dividend imputation system and it is not available for foreign profit of Australian companies.

Foreign investment by Australian companies is less attractive than domestic investment because there are no imputation credits for foreign tax paid. On a net basis, Australia remains a capital importer but there is now a very significant share of foreign investment by Australian companies.²⁴ To minimize their disadvantage in doing foreign investment, Australian companies may seek to fund foreign investment with debt instead of equity, while foreign companies also prefer debt-funded investment into Australia.

While a possible solution to encourage inbound investment is to lower the company tax rate, a possible solution to support outbound Australian investment is to extend the dividend imputation system to some level of foreign tax paid. Either reform would cost significant company tax revenue and requires further research.

Multinational tax planning: can countries cooperate to protect the tax base?

As stated in Chapter 2, a key challenge to the effectiveness of Australia's company tax is the global digital economy. The Henry Review was aware of the challenge of international profit shifting, which it viewed as 'an important constraint on tax policy in an open economy' such as Australia with a source-based corporate tax system (Henry et al 2014b, 155). However, in the last five years there has been a significant increase in public and policy attention paid to the tax minimization activities of multinational corporations, especially but not only 'digital' companies such as Google and Apple, including a Senate Inquiry into Corporate Tax Avoidance.²⁵

The increasing challenges of protecting Australia's company tax base in the face of the expanding role of multinational corporations, the growing digital economy and global tax competition are indicated by the BEPS project of the OECD (2013) and policy developments in Australia (Treasury 2013c).

It is difficult to assess the size and revenue impact of the BEPS problem or the efficiency costs of alternative responses. Anecdotal evidence suggests that some foreign companies are paying little or no Australian tax. This may be because of financing, transfer pricing and the increased use of payments such as royalties or service fees on business intangibles, or the out-dated nature of basic international tax concepts such as business enterprise and source of income. There are incentives for businesses with cross-border investment to 'thinly capitalize' their Australian operations, generating higher tax deductions for interest in Australia.

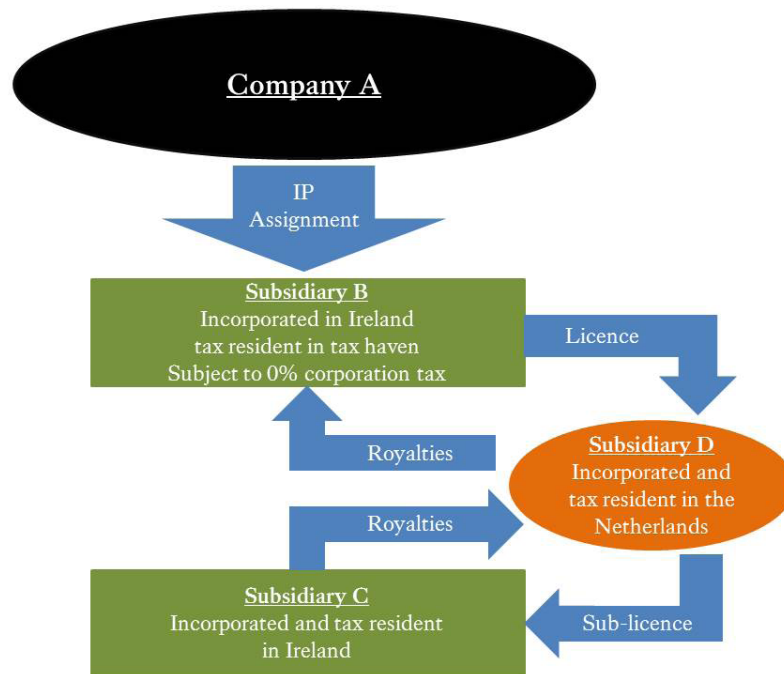
In response to these tax planning margins, the company tax law contains many rules designed to preserve its integrity by limiting the ability of companies taking advantage of inconsistencies in the treatment of company financing structures and expense deductions.

The kind of complex tax planning aimed at minimizing taxation globally is illustrated by the so-called 'Double Irish -Dutch Sandwich' tax minimisation arrangement shown in Chart 5.7. This structure capitalises on particular design features of the US tax system, on the low Irish company tax rate of 12.5 per cent and on the ability to flow through cross-border payments in the Dutch tax system. In this kind of tax structure, within the multinational corporation payments including royalties or services payments for digital intangible property, such as patents or brand names, flow from high tax to low tax or haven jurisdictions.

²⁴ ABS Cat. 5352.0 (2 May 2013) available from www.abs.gov.au.

²⁵ See www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance.

Chart 5.7: The double Irish-Dutch sandwich



Source: Image available at http://4.bp.blogspot.com/-Mt-Rl6oBvDc/UjmxK6epVII/AAAAAAAAAGU/le3_uNdNSE0/s1600/Double+Irish+Dutch+sandwich.jpg

Australia's recent leadership role as the 2014 Chair of the G20 Forum has provided added impetus to the BEPS agenda. The Government has focused on gaining international agreement on the exchange of information in relation to BEPS activities and multilateral implementation of the OECD's BEPS Action Plan (OECD 2013a). On the domestic front, reforms that have already been implemented include:

- > updating Australia's transfer pricing arrangements so that they align with standards recommended by the OECD;
- > broadening of the general anti-avoidance rule;
- > introduction of a new integrity measure to prevent 'dividend washing', a practice that allows entities through the timed sale and repurchase of shares to claim two sets of franking credits on what is effectively the same economic interest;

- > tightening Australia's 'thin capitalisation' rules by reducing the debt to equity limit to 60 per cent to address multinational profit shifting through debt loading in Australian subsidiaries; and
- > increased transparency in public reporting of multinational tax paid, effective 1 July 2015.

The Abbott Government has stepped back from or revised some tax integrity measures proposed by previous governments, citing concerns about regulatory costs and their likely effectiveness as well as a lack of evidence supporting changes (Cormann 2014).

Increasing global tax coordination may hold a solution for some of these challenges but is difficult to achieve, while it is unclear to what extent Australia as a single nation can or should influence or benefit from these developments.

5.4 Large, medium and small enterprises

Australia's company tax system contains a large number of special rules and concessions and complex integrity rules, tax administration practices and record keeping requirements. The tax treatment of a business depends to a large extent on how it is structured, for example, whether it operates as a single consolidated corporate group; as an unconsolidated group of companies; or using a mix of companies and trusts, as is common for SMEs.²⁶

Since 2002, Australian wholly owned corporate groups may irrevocably elect to be taxed as a single corporate entity under a tax consolidation regime. Chart 5.8 shows that large corporate groups elect to consolidate. Consolidated groups can carry forward and offset tax losses between companies in the group and can transfer business assets within the group without tax consequences, improving efficiency in operations.

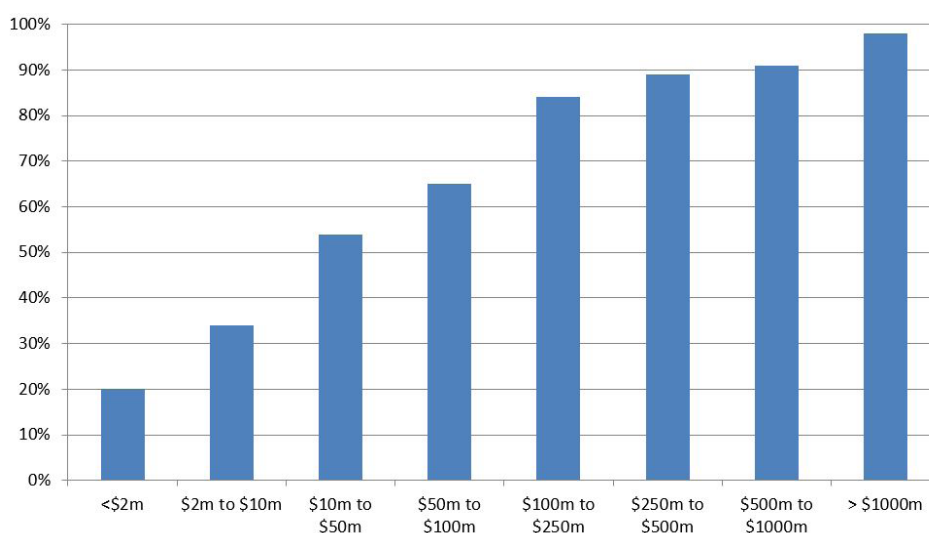
Chart 5.8 shows that while small and medium corporate groups can choose to consolidate, many do not. A primary reason is complexity and tax costs that arise when

mergers and acquisitions take place. This disadvantages smaller businesses which cannot take advantage of loss offsetting and asset rollovers.

Utilising survey data, Evans et al (2014) have estimated that the overall level of tax compliance costs for SMEs is around \$18 billion or approximately 1.2 per cent of GDP, and around 14 per cent of total tax revenue raised from the SME sector. The costs of compliance with Commonwealth, State and Territory taxes for large corporations (with annual turnover in excess of \$250 million) are in the order of \$0.40 per \$1,000 of annual turnover.

Some minor small business recommendations of the Henry Review were introduced by the Rudd/Gillard government. These included, from 1 July 2012, an instant asset write-off providing small businesses with an immediate deduction for assets costing less than \$6,500 and for the first \$5,000 of a motor vehicle, and a further reform recommended by the Henry Review allowing companies to carry back losses up to \$1 million annually (both now repeated). The Gillard Government also introduced a re-targeted and more generous research and development (R&D) tax incentive for small and medium enterprises from 1 July 2011 (Treasury 2013a).

Chart 5.8: Proportion of wholly owned groups consolidated for tax



Source: Board of Taxation (2012, 70) from ATO data for income years 2009 to 2011.

²⁶ For more detail on tax law applicable to these enterprises, see Cooper et al (2012).

The Government proposes to reduce the company tax rate to 28.5 per cent, with the primary goal of helping small business. More research and policy work is needed into whether the design of 'one size fits all' rules for all companies is the best approach for efficiency and tax system resilience. However, designing a separate tax system for small business also produces difficulties.

5.5 Taxing the return to extraction of resources

The economic return from the extraction of Australia's natural resources is taxed at the Commonwealth level through company tax and PRRT and by State and Territory governments through royalties. The States are sovereign owners of the resources in their jurisdiction including minerals, oil and gas and levy royalties which are generally based on a percentage of the value or in some cases the volume of production.²⁷ There is wide variation in royalty rates both across States and Territories and resource types.

The Commonwealth Government levies PRRT at a rate of 40 per cent on profit (resource rent) from petroleum projects, including from most offshore operations and, since 1 July 2012, in respect of the North-West Shelf and onshore petroleum and gas projects. A company's PRRT liability is deductible from its taxable income for corporate tax purposes.

In recognition of the unique features of onshore petroleum projects, the on-shore PRRT regime allows a tax credit for State and Territory royalties and other resource taxes against PRRT liabilities, and allows deductions for environmental and native title payments with a sufficient nexus to an onshore gas or oil project.

The Henry Review recommended enacting a minerals resource profits tax that would be similar to the PRRT and apply to profits above the normal rate of return, from mineral extraction in Australia. The MRRT came into force on 1 July 2012 and was repealed effective 1 July 2014 by the Abbott government, consistent with its election commitment.

The final design of the MRRT was substantially different to that envisaged by the Henry Review (Hogan 2012). It applied only to iron ore and coal and was criticized as highly complex, with significant compliance costs relative to the small amount of revenue raised (Treasury 2014a, 5-16). Rather than allowing for the abolition of mining royalties (Hogan 2012, 250-251) as envisaged by the Henry Review, the design of the MRRT created incentives for State and Territory governments to increase royalties on projects subject to the MRRT, because royalty payments were credited against MRRT liabilities; several states including Western Australia and Queensland increased mining royalties as a result.

The tax reform agenda since the release of the Henry Review has been substantially dominated by the fate of the Rudd/Gillard Government's MRRT. The prospects are, for the foreseeable future, that Australia will be reliant on the PRRT and State and Territory royalties for ensuring that the community receives an adequate return from the exploitation of the nation's mineral reserves. More research is needed into the efficiency effects and resilience of royalties, as a significant source of revenue for some State governments.

²⁷ An exception is the ACT, which does not have a minerals extraction industry.

5.6 Directions for company tax reform

The Henry Review's recommendations for company tax were aimed at reducing the overall tax burden on investment to improve Australia's attractiveness as a destination for capital, improving the efficiency of Australia's regime for charging for the exploitation of its non-renewable resources, encouraging greater innovation and entrepreneurial activity and promoting higher national incomes through a more efficient corporate tax system that supported capital investment and improved productivity.

These objectives were reflected in five key reform directions for the corporate tax system (Henry et al 2010a). Most of these reforms have not been implemented:

- > Reducing the burden of company taxation, in particular by targeting the company tax rate towards the lower end of the small- to medium-OECD economy average, aiming for a reduction to 25 per cent in the medium term (Recommendation 27);
- > Supporting innovation and corporate risk taking through more symmetric taxation treatment of gains (which are taxed as they are realised) and losses by introducing a loss carry back arrangement allowing excess losses to be realised immediately by being credited against tax paid in previous years (Recommendation 31);
- > Reducing investment biases in favour of particular assets and industries through measures such as introducing simpler and more uniform capital allowance rules that more closely match economic depreciation (the decline in the market value of an asset over a period) and rationalising capital gains tax concessions and expanding and simplifying depreciation arrangements for small businesses (Recommendations 28, 29 and 30);
- > Introducing, at the same time as a lower company tax rate, a broad-based resource rent tax levied at the Commonwealth level and shared with the States and Territories, allowing for the removal of existing inefficient State and Territory-based royalties (Recommendations 45 to 50); and
- > Given the challenges of sustaining over time an efficient and internationally competitive corporate tax system for attracting foreign capital investment, considering further the merits of a business-level expenditure tax, along with reconsideration of the long-term future of dividend imputation (Recommendations 26 and 37 to 40).

The previous government established a Business Tax Working Group to examine the possibility of a company tax cut funded from within the company tax base (BTWG 2012). It examined a range of options for fully funding a company tax cut of two to three percentage points—the level considered necessary to drive a significant investment response—with base broadening measures targeting remaining exemptions and concessions but was unable to recommend a package of reforms.

Given the current fiscal situation, lowering the company tax rate to 25 per cent seems unlikely without other major reform. The Henry Review noted 'the benefits of attracting mobile investment to Australia by reducing the company income tax rate must be balanced against the loss of tax revenue that could have been collected via the company tax from location-specific investments, such as investments in non-renewable resource projects' (Henry et al 2010b, 228).

There is limited international experience with alternative forms of corporate income taxation, such as a business-level expenditure tax. There are also clear challenges resolving practical issues such as transitioning to a new system and integration with the personal tax system, this requires further research and policy analysis in coming years.

CHAPTER 6 GST, PAYROLL AND LAND TAX

MAIN POINTS

- > State and Territory governments have broad power to tax but raise only about 18 per cent of total tax revenue. This imbalance has existed since the federation. The payroll tax, stamp duties and property taxes raise most revenue for States and Territories.
- > Nonetheless, Australia taxes the bases of consumption, payroll and land less than many comparable countries. There is scope to broaden each of these bases to improve the revenue of the States and Territories, making the tax system more efficient and resilient.
- > The GST raises about 13 per cent of total tax revenue and is provided entirely to the States and Territories, equalized for tax and expenditure capacity. The GST is Australia's only broad-based tax on consumption. It applies at a flat 10 per cent rate on a wide range of goods and services but there are exemptions or input-taxed elements making up more than half of the GST base. The rate of GST is lower in Australia than in many comparable countries.
- > Payroll tax is paid by businesses and if comprehensive, is equivalent to a tax on wages. Australia's State and Territory payroll taxes have various thresholds and exemptions which introduce distortions for business decisions and make them less efficient than otherwise.
- > Property taxes raise under 3 per cent of GDP across all governments, lower than in many other countries.
- > State and Territory property taxes are designed less efficiently than they could be. Land taxes and council rates are the most efficient taxes, according to economic models, but the base warrants reform. Stamp duties are easy to collect but their incidence is likely to deter individuals from moving when personal circumstances change, while revenues are volatile. However, reform is challenging politically and may have an impact on housing markets; a long term transition may be required. The ACT reform provides an example.
- > Insurance taxes are inefficient and create incentives to under-insure. These taxes would ideally be abolished and revenues raised through broad-based land taxes

6.1 State taxes

In spite of their broad constitutional power to tax, the States and Territories raise only about 18 per cent of total tax revenue in Australia. About 85 per cent of that proportion is raised by State and Territory governments and 15 per cent by local governments. Taxing capacity is uneven across States and Territories and as explained in Chapter 3, these governments raise only about half of their expenditures in taxation. The richest and most populous states of New South Wales (NSW) and Victoria raise by far the most tax revenues.

Chart 6.1 sets out State taxes in total and by State or Territory; royalty revenues; and GST revenue allocation, in 2012. The main tax bases are payroll tax; taxes on property transactions and land value; and motor vehicle taxes. States and territories also impose a range of other taxes including insurance levies, motor vehicle taxes and gambling taxes. Detailed information is provided in Table 6.1.

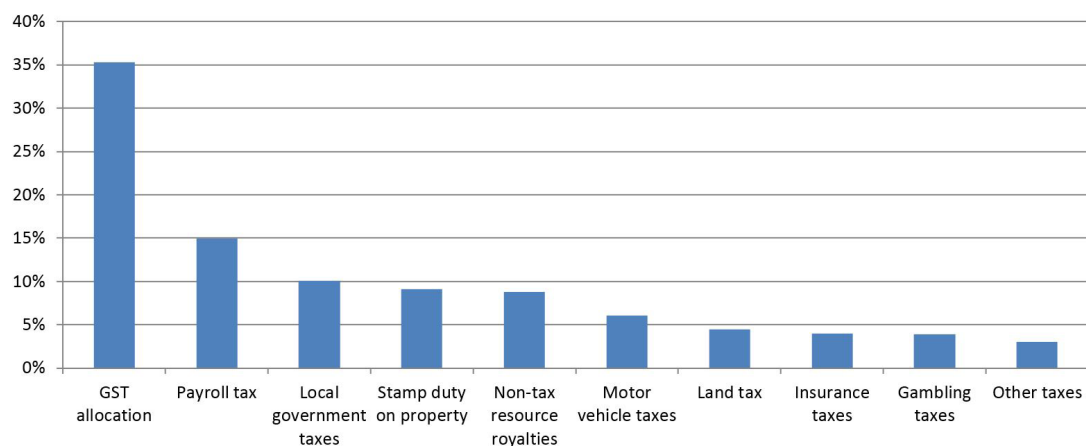
As explained in Chapter 3, the GST is collected by the Commonwealth Government with all GST revenues distributed to the States and Territories. In return for this arrangement

established in 1999, the States and Territories undertook to abolish a range of minor taxes and duties. Accommodation tax, financial institutions duty, quoted marketable securities duty and debits taxes were all abolished by 2005.

State and Territory governments subsequently agreed to abolish in stages a further tranche of taxes including stamp duties on mortgages, leases, and credit and rental arrangements. No agreement was reached on the abolition of insurance taxes, payroll tax or stamp duties on the sale of residential properties (Treasury 2007). Progress in abolishing remaining taxes has been mixed, with some listed taxes yet to be abolished.

This chapter does a survey of key issues relating to the GST and the main State tax bases of payroll tax and property and insurance tax. The chapter does not discuss in detail the issue of vertical fiscal imbalance in Australia's federation, or the formula applied to determine horizontal fiscal equalization for distribution of GST revenues. However, these issues are fundamental to the Commonwealth Government White Paper processes for reform of the tax system and of the federation.

Chart 6.1: Types of tax as a percentage of total State and local tax revenue, 2012-13



Source: ABS (2014c); Commonwealth Grants Commission (2012) Interim Report, Table 4.2; Treasury (2013d), Table 3.2.
 Note: Total State and local tax revenue for this comparison includes the GST and resource royalties.

Table 6.1: State tax revenues, with GST and royalties, 2012-13

	Total (\$m)	Proportion of total State and local tax revenue including royalties and GST	NSW (\$m)	VIC (\$m)	QLD (\$m)	SA (\$m)	WA (\$m)	TAS (\$m)	NT (\$m)	ACT (\$m)
Payroll tax	20,752	15.0%	6,953	4,751	3,740	1,077	3,415	291	205	320
Stamp duty on real property transfers	12,610	9.1%	4,568	3,332	1,887	773	1,785	139	126	231
Motor vehicle taxes	8,399	6.1%	2,728	1,811	1,995	545	1,109	151	60	132
Gambling taxes	5,439	3.9%	1,873	1,745	1,034	421	218	93	55	54
Land tax	6,193	4.5%	2,333	1,589	990	562	559	89	0	71
Insurance taxes	5,526	4.0%	2,029	1,628	670	429	576	87	42	65
Other taxes (a)	4,173	3.0%	1,502	774	742	310	417	63	2	363
Total State tax revenue	63,219	45.8%	21,986	15,630	11,058	4,117	8,079	913	490	1,236
Local government taxes (rates)	13,902	10.0%	3,624	3,890	3,023	1,238	1,695	335	97	
Total State and Local tax revenue	77,411	55.9%	25,610	19,520	14,081	5,355	9,774	1,248	587	1,236
Royalties (b)	12,171	8.8%	2,128	46	3,651	232	5,937	55	122	0
GST (equalized allocation) (c)	48,395	35.3%	14,666	10,947	9,478	4,463	2,907	1,694	2,734	984
Total State and Local Revenue including royalties and GST	138,517	100%	42,583	30,663	27,399	14,165	14,518	3,007	1,562	4,072

Source: ABS (2014c).

Notes: (a) 'Other taxes' for the ACT includes rates (local government taxes) as it has no smaller local governmental bodies that levy rates.

(b) Royalties on natural resources for 2012-13, Commonwealth Grants Commission (2012), Interim Report, Table 4.2.

(c) GST allocations for 2012-13 from Treasury (2013d), Table 3.2.

6.2 The GST: taxing consumption

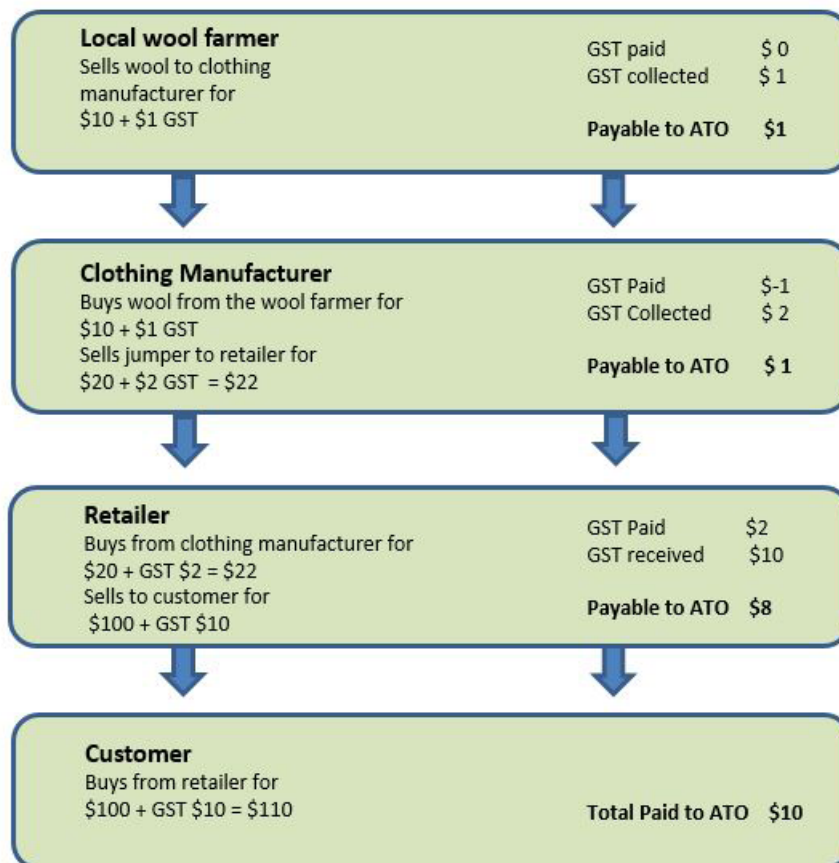
The GST was introduced in 2000 and has changed little in the last fifteen years. Total GST collections amounted to around 13 per cent of total tax revenue in 2011-12.

The GST is levied at a flat rate of 10 per cent on most goods and services consumed in Australia. GST-registered businesses generally including the GST in the price of sales to their customers while claiming credits for GST included in the price of their business purchases. Businesses with annual turnover less than \$75,000 do not need to register

for the GST. Chart 6.2 shows how GST operates through the chain of production and sale.

The economic incidence of the GST generally falls on the individual consumer. The GST is passed onto consumers in higher prices so that consumers are able to purchase less from a given disposable income. Similarly, payroll tax is passed onto employees in lower wages, thereby reducing their disposable income available for purchases (Freebairn 2014, 13). A comprehensive GST has broad economic equivalence over the long run to a tax on wages such as a comprehensive payroll tax and, internationally, social security taxes (Kesselman 2010).

Chart 6.2: How does GST work?



Source: ATO (2014d).

The GST rate and base

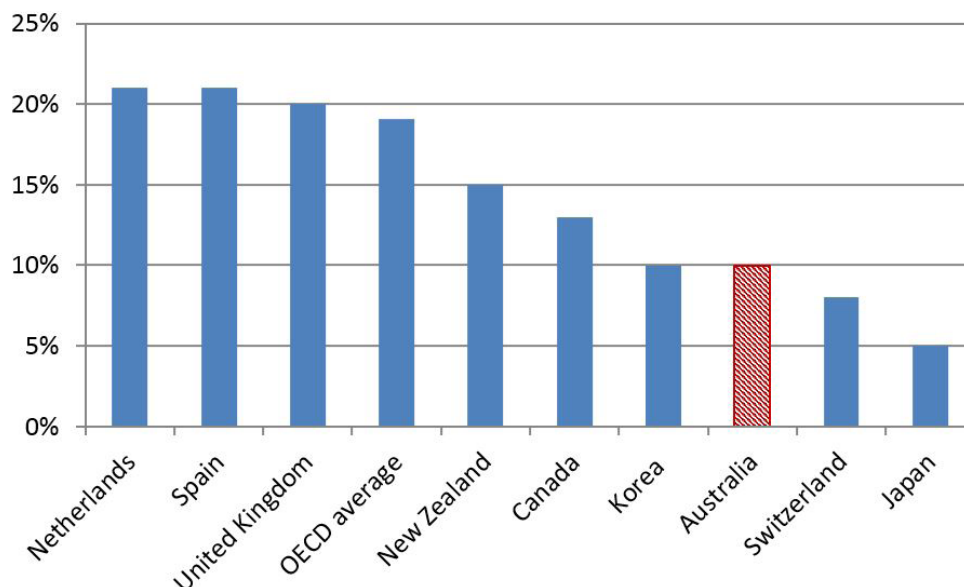
Australia's GST rate is lower than that of other countries. Chart 6.3 shows the standard GST or equivalent value added tax (VAT) rate in selected countries. Most countries have a standard rate and some zero-rated or low-rated supplies.

The OECD's VAT revenue ratio provides a measure to compare the coverage of the GST with the coverage of value added taxes in other OECD countries. The VAT revenue ratio measures the proportion of national final consumption expenditure that is covered by value added tax.²⁸ The OECD's analysis indicates that the GST covers about 47 per cent of the consumption base, less than the OECD average

of 55 per cent in 2012. Australia's GST coverage is similar to Canada but significantly lower than New Zealand's GST, which has almost total coverage of the consumption base. This is shown in Chart 6.4.

Apart from New Zealand, most value added taxes have significant exemptions in the base. However, Australia's GST base is narrower than that of many other countries. Major exclusions from the Australian GST base include basic food items, health care, childcare, education, water and sewerage services. These are shown as large tax expenditures in Table 3.1 above. In addition, there are a wide range of smaller exemptions including precious metals, cars purchased by people with disability and second-hand goods.

Chart 6.3: Statutory GST/VAT rates, selected countries, 2012

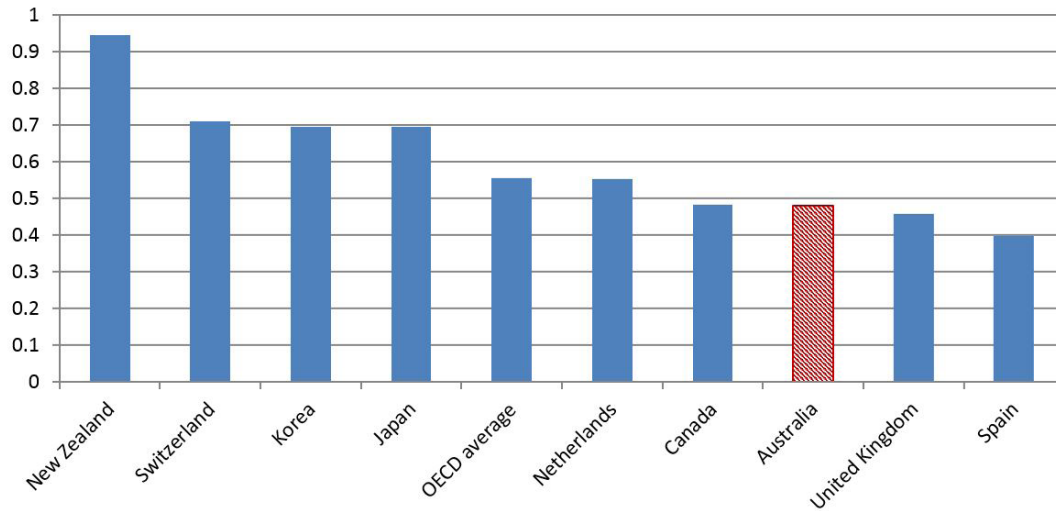


Source: OECD (2014f, 60).

Notes: Standard VAT/GST rates not reflecting exempt or concessional rates. Canadian rate of 13 per cent includes 5 per cent national GST plus 8 per cent Harmonised Sales Tax in provinces including Ontario; there are variations in other provinces. Switzerland bar shows the federal rate only; there are diverse additional rates levied by cantons.

28 The VAT revenue ratio is calculated according to the formula $VRR = \frac{VR}{(FCE - VR) \cdot r}$, where VRR is the VAT revenue ratio; VR = VAT revenue collected; VRdue = VAT revenue due; FCE = Final Consumption Expenditure; and r = Standard VAT rate. The denominator, Final consumption expenditure, in National Accounts data includes VAT revenue paid at the point of consumption and hence must be reduced by the amount of VAT paid. VAT revenue represents the amount of VAT revenue collected and, as such, takes into account actual VAT compliance. It does not represent the theoretical VAT base assuming perfect compliance. OECD (2014e).

Chart 6.4: The GST/VAT revenue ratio in selected countries, 2012



Source: OECD (2014e, 95).

Note: No value is available for the US as it does not have a national value added tax.

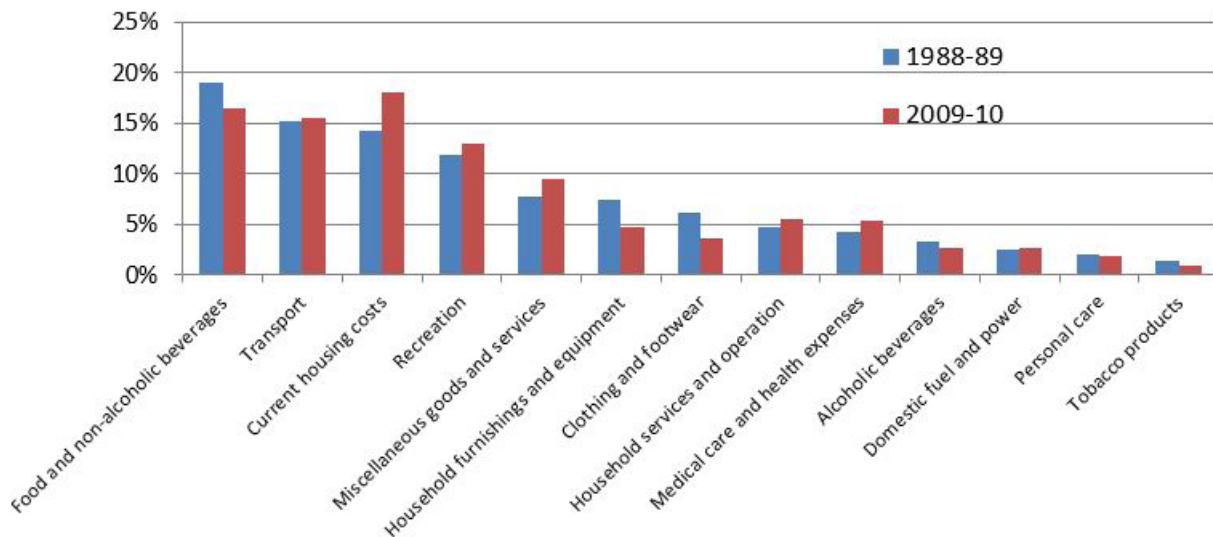
In keeping with the internationally accepted system for value added taxes, imports of goods are subject to GST. Exported goods and services, including international travel purchased in Australia, are exempt from the GST as they are not consumed in Australia. However, there is a threshold of \$1000 for GST applicable to imported goods. The rapid growth of online retailing has meant that this threshold is associated with increasing base erosion for the GST. Imported intangibles or services may escape taxation entirely (e.g. digital products such as ebooks, films and apps). Apart from the revenue concerns there has also been concern about the competitive neutrality implications for retailers. The Government has committed to consider the continuing appropriateness of the low value threshold as part of the White Paper process.

Australian households are spending proportionately more on housing, health, education and financial services than two decades ago. As a consequence, more of the consumption of Australia's households is untaxed because these goods and services are exempt from GST. Chart 6.5 shows these changing household consumption patterns. Households have increasingly spent more on services and less on goods; have saved more overall; and have shifted consumption towards tax-exempt health and education services.

The rate and base of the GST have been discussed in a number of recent reviews including the GST Distribution Review (Commonwealth Grants Commission 2012) and the review of the low-value parcel processing threshold (Low Value Parcel Processing Taskforce 2012). While these reviews have examined aspects of the GST's operation, there has not been a comprehensive policy review of the effectiveness and distributional consequences of the GST, including the extent to which the GST concessions have affected the overall fairness of the GST.

Recently, New Zealand enacted a tax reform that increased the rate of its exceptionally broad-based GST to 15 per cent. Compensation was provided through indexing transfers and credits such as the Family Working Tax Credit. While there are many differences, it is worth examining the New Zealand experience to see what lessons may apply in Australia.

Chart 6.5: Changing household consumption patterns



Source: ABS (2014d).

Distributional impact of the GST

A broad-based comprehensive GST is proportional with respect to consumption but regressive with respect to income of individuals (see Chapter 1 for an explanation of these concepts). However, there are two caveats regarding the regressive nature of the GST.

First, it is important to weigh the consequences of the overall tax and transfer system when considering fairness. A regressive tax may fund a progressive transfer system and redistributive public goods across government as a whole. Many OECD countries with significant social security systems rely substantially on regressive taxes on consumption and wages to fund these systems. Moreover, the progressive income tax can offset regressivity of the GST, in particular if progression is maintained in marginal income tax rates and the base is broadened to tax savings more effectively.

Second, there are significant exemptions in the GST base. These are widely considered to make it more progressive especially the exemption of food. However, there is evidence in a recent OECD analysis of distributional features of other VATs (excluding Australia) that a number of GST exemptions may benefit high income earners more than low income earners (OECD 201f).

Administrative and compliance costs

The GST is a complex tax that has a relatively high administrative cost compared to most other Australian taxes including the income tax. The cost of collection by the ATO, which is paid by the States, is estimated at just under \$700 million in 2014-15 (Treasury 2014a, Paper 3, Table 3.9). This is approximately 1.25 per cent of revenue collected. There is also a significant level of uncollected GST debt. The reasons for this are not fully understood. One factor may be that many collectors and remitters of GST are small businesses that may face cashflow difficulties.

Elements of the tax base, including low-value imports and financial services, are left untaxed or taxed at a lower rate than the standard rate, because the technical or administrative costs of taxing them are considered to be too great. Technical and practical difficulties arise in levying GST on the supply of some goods and services, in particular financial services, residential rental services, the sale of existing residential premises and certain charitable fund raising.

In consequence, under the current system, these supplies are 'input taxed'. The supplier cannot charge GST on the supply of the good or service and may not claim a credit for the GST paid on purchases (inputs) relating to those goods and services. There are also special rules regarding second-hand goods, gambling, land development, imports, insurance and cars. All these exceptions and special rules add complexity to the tax.

On some issues, such as the taxation of supplies of new housing (and the complex 'margin scheme' for real property developers), there has been significant litigation and uncertainty in application. Table 3.1 indicates that the TES estimate of input-taxation of financial services is estimated to have the highest revenue foregone of these various 'practical' tax concessions in the GST. Consequently, the issue of taxing financial services deserves greater research and policy attention.

Directions for GST reform

The Henry Review was precluded by its terms of reference from recommending changes to the rate or base of the GST. However, it provided commentary and related findings on three main issues that relate clearly to broad based consumption taxation.

First, the Henry Review found in favour of increasing emphasis on consumption taxation within the overall architecture of the tax system. This direction would be consistent with trends in other countries. There are some suggestions that value added taxes may be a substitute for company taxes and 'policy-makers can potentially shift from corporate taxation towards consumption taxation as a response to tax competition' (Loretz 2008, 651).

Second, the Henry Review considered financial services and canvassed a possible approach to the taxation of value added in the financial industry. This could enable the current input taxation of this sector to be replaced by full GST treatment. The approach measures value added as the sum of factor incomes in the sector rather than as the margin between sales and purchases (which does not work satisfactorily with finance), producing a more reliable measure of the same margin. The application of GST to financial services warrants research and policy development.

Third, the Henry Review discussed the technical and conceptual benefits of an alternative tax on consumption to the GST. This is a destination cash flow tax on business that would represent a substantial, broad-based reform of the GST and/or State payroll taxes. Apart from its potential for greater economic efficiency, this model of value added taxation would utilize the administrative and compliance advantages of 21st century, computer-based business systems. The Henry Review suggested that this form of taxation could be a more efficient tax base required to meet future needs for State governments. Improvements to payroll tax as an effective business tax at the State level would likely help improve revenue collection and efficiency.

The various concerns about administration, complexity and compliance in the GST system suggest that, if other tax base options become available and more easily administered in future, then these are worthy of further research and policy consideration. The tax policy goal is efficient, effective and fair taxation of consumption, a matter which is also being explored by other country governments.

6.3 Payroll tax

The most important State tax in terms of revenue collection is payroll tax (leaving aside the GST). This raises much more revenue in the most populous and industrialised states (NSW and Victoria) than in smaller, agricultural or resource-rich states. In Australia, payroll taxes do not directly fund social security obligations of government and consequently are not levied at the very high rates at which they are imposed in other countries.

Payroll tax has been harmonized in all states except Queensland. It is levied on the total payments for employee wages of employers, over specified thresholds (including wages, fringe benefits, bonuses and commissions). Nonetheless, the payroll tax is increasingly weakened through tax competition, producing increases in the threshold for taxation, variable rates and special exemptions. Most small businesses (and hence a large number of employees) are exempt from payroll tax because of the minimum threshold and it is in respect of the threshold that we see most payroll tax competition emerging.

As explained in section 6.2, the long-run economic incidence of a broad-based payroll tax is similar to that of a broad-based tax on consumption: it falls on labour income or wages. However, current Australian payroll taxes are not comprehensive. The concessions in the payroll tax base introduce distortions in the allocation of labour across the economy and render the incidence of the payroll tax more on businesses than on wages.

In spite of declining effectiveness, payroll tax remains an important State tax base. As technology improves, there is scope for further research to examine feasibility of broadening the payroll tax base, or levying it on a comprehensive national tax base, possibly through the Commonwealth PAYG wage withholding system, on behalf of the States.

Table 6.2: Payroll tax rates, base and thresholds across States

	Flat rate	Method of calculation	Exemptions
New South Wales	5.45%	Single marginal rate	First \$750000 exempt
Victoria	4.90%	Single marginal rate	First \$550000 exempt
Queensland	4.75%	Deduction system	First \$1100000 exempt. For payrolls between \$1100000 and \$5500000, a deduction of \$1100000 reducing by \$1 for every \$4 the payroll exceeds \$1100000. No deductions for payrolls over \$5500000
Western Australia	5.5%	Single marginal rate	First \$750000 exempt
South Australia	4.95%	Single marginal rate	First \$600000 exempt
Tasmania	6.1%	Single marginal rate	First \$1250000 exempt
Northern Territory	5.5%	Deduction system	First \$1500000 exempt. For payrolls between \$1500000 and \$7500000, a deduction of \$1500000 reducing by \$1 for every \$4 the payroll exceeds \$1500000. No deductions for payrolls over \$7500000
Australian Capital Territory	6.85%	Single marginal rate	First \$1750000 exempt

Source: NSW Treasury (2014, 13).

6.4 Taxes on land

Australia relies less on property taxes overall than some comparable countries. This is shown in Chart 6.6, which presents an overall picture of tax on property as a proportion of GDP.

State and Territory governments levy a stamp duty on transfers of land and all except the Northern Territory levy land tax on the aggregate holding of unimproved land value that is owned by a taxpayer in the jurisdiction.

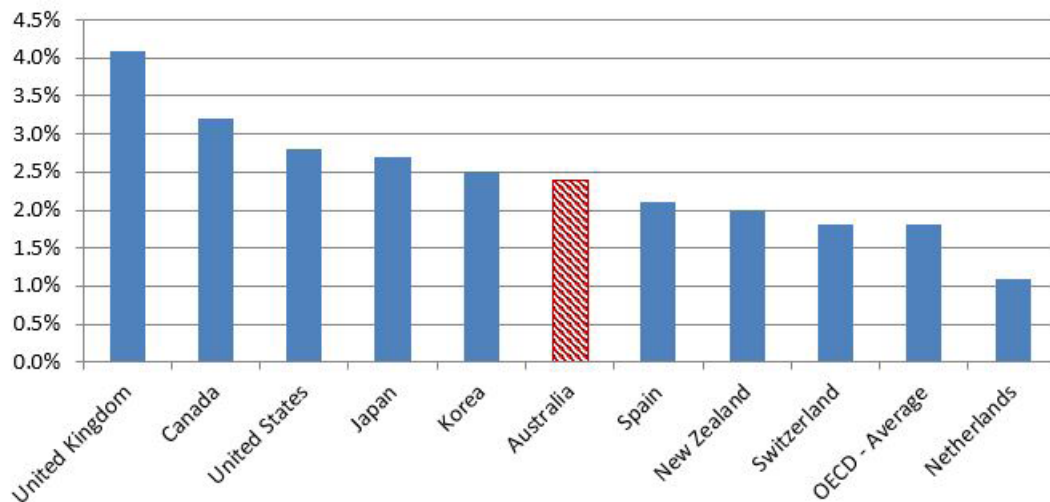
Duty is usually payable by the purchaser calculated on the sale price of the property (or market value if higher). Duty rates are progressive, for instance they range in NSW from 1.25 to 7 per cent (over \$3 million in value) and in Victoria from 1.4 to 5.5 per cent (on total value, if over \$960,000). The base includes the purchase of a home which is to be the main residence. There has been a significant increase in duty revenues for all states over the last decade as house prices have risen substantially in many locations. However, revenues are highly volatile. Some concessions apply for first home buyers although economists suggest that this likely benefits existing land owners through increased house prices.

The Henry Review recommended that stamp duties be replaced over time by more efficient annual land taxes, a policy approach that has been taken up by the ACT government (Recommendations 51-54).

Land tax is levied by all States and Territories except the Northern Territory. This is a less efficient base than the one developed and advocated by the Henry Review, essentially due to its substantial exemptions based on land use and its step-scale land-holding aggregation features. A more efficient tax would be one more akin to existing local government rates (Wood et al 2009).

States also levy a variety of mineral resource royalties. Royalties are intended as a price for access to a non-renewable resource. States apply a range of royalties including a fixed rate per unit (e.g., tonne) of production; ad valorem royalties as a percentage of value or price of resources or profit based royalties. Table 6.1 indicates the relative importance of royalties for revenue raising. Although not as large as most State tax bases, royalties are particularly important in the resource-rich states of Western Australia and Queensland.

Chart 6.6: Property tax as a proportion of GDP, selected countries



Source: OECD (2014f).

Local government taxes

Local governments are generally statutory bodies incorporated by under State Constitutions and Local Government Acts. They exercise delegated State legislative power to levy rates (property tax) on immovable property. Rates are charged on the value of residential and commercial immovable property in the jurisdiction. Councils apply a variety of different valuation methods including unimproved value, capital improved value and rental value and rates also vary by Council and use of property.

On average, local governments fund most of their expenditures from own-source revenue, although self-funding capacity is highly variable across councils and in particular, rural and remote councils are heavily reliant on grants. Overall, only 37 per cent of council expenditures funded by rates. Other own-source funding comprises fees and charges, developer charges, fines and investment revenue. The balance comes from government grants from State and Commonwealth governments.

Property tax reform in the Australian Capital Territory

The ACT levies conveyance duty and general rates on residential property, as well as land tax on commercial and rental property; it does not have a separate Council rates structure. Following recommendations of the ACT Taxation Review (2012) and commencing in its 2012-13 Budget, the ACT introduced an ambitious tax reform agenda to make property tax fairer, simpler and more efficient in future.

The ACT has begun a transition from duties on residential property to general rates and land tax. The ACT Taxation Review recommended that the benefits of this transition will overall result in a fairer system that has better allocation of housing stock and investment and enhanced ability of individuals to exercise housing choices (2012, 140).

Commencing 4 June 2014, the ACT reduced conveyance duty rates and introduced a flat rate of 5.25 per cent for high value properties. In 2014-15 it will increase general rates on residential and commercial properties by around 10 per cent, while making the rates structure progressive. Further rate changes will take place over coming years. To minimize the cost to revenue, fairness and economic impact, the reform transition may take up to 20 years. The ACT also proposes to abolish duty on insurance from 1 July 2016.

CHAPTER 7 TAXES TO ENHANCE SOCIAL AND MARKET OUTCOMES

7.1 Selective taxes

The Henry Review devoted substantial attention to the use of *selective taxes* as a way for governments to intervene in markets to achieve more equitable or efficient outcomes. The Henry Review considered that selective (narrow-based) taxation may be appropriate to correct for negative social or economic costs that are not adequately factored into private transactions.

A *selective tax* is simply a tax that targets a particular commodity, activity or type of taxpayer. Some selective taxes may also aim to capture economic rents derived by a particular industry or sector, for example the resource sector or gambling industry. The Henry Review considered selective taxes including taxes to improve the environment, road transport taxes, and taxes on alcohol, tobacco and gambling.

The Henry Review recommended adoption of user charging in some cases where governments provide a specific good or service and this can be properly priced. It observed that public goods should generally be financed through general taxation but government costs associated with administration and enforcement of regulation for specific sectors could be recovered by targeted charges or taxes (Henry et al 2010b, 339). Cost recovery taxes or user charges need to be subject to regular and systematic review to ensure that they properly reflect the cost of the service or good.

Selective taxes may be highly effective in increasing the price of activities that generate negative externalities that affect society as a whole. However, they present design challenges in accurately identifying the source and economic cost of the negative externality and hence the appropriate base and rate for the tax. Poorly designed selective taxes risk not achieving intended societal outcomes while still detracting from economic efficiency. They need to be weighed against other alternative policy levers that have the potential to achieve the desired behavioural change.

The Henry Review supported the use of selective taxation or pricing to address negative spillovers or externalities for the environment. On this basis, the Review supported the CPRS (now repealed) as an effective market-based mechanism that would be 'the most cost-effective way to reduce Australia's carbon emissions' (Henry et al 2010b, 343).

On the other hand, the Henry Review generally opposed the use of tax concessions with environmental objectives which 'tend to lack transparency, be poorly targeted, impose costs on all the community rather than just polluters and reduce the efficiency of the taxation system' (Henry et al 2010b, 353).

Henry Review principles for taxes to improve the environment

Environmental taxes (or emissions trading schemes) should:

- > Be used to address environmental objectives, rather than to raise revenue;
- > Have their revenue recycled to reduce the associated tax (and transfer) distortions, should governments wish to avoid increasing the aggregate burden of tax; and
- > Be integrated with existing taxes and transfers.

An environmental tax is more likely to be appropriate in situations where:

- > Environmental damage due to economic activity is relatively constant;
- > The factors causing the environmental damage are measurable/verifiable by both the tax authorities and the agent causing the damage...;
- > The only cost-effective way the taxpayer can reduce their tax liability is to reduce the activity causing the damage (rather than, say, simply dumping waste illegally); and
- > Other instruments (such as spending and regulation) have been considered and found to be more costly.

Henry et al 2010b, 353; Recommendations 58, 59 and 60

7.2 Road transport taxes

The Henry Review strongly supported the development of road pricing or transport taxes to aid future transport challenges. In particular, the Review supported road network charges for commercial or heavy vehicle use (such as freight trucking). These charges should be used to correct market failures in the transport sector. Recommendations 61 to 67 addressed road transport taxes including congestion charging and heavy vehicle road pricing. In exchange for a comprehensive reform introducing road use charges, it was suggested that taxes such as motor vehicle registration and stamp duties could be abolished.

The development of effective road transport taxes calls for substantial further research and policy development. The Henry Review observed that the challenge of comprehensive transport tax reform is ‘formidable’ requiring coordination across all levels of government, but would promote the best investment in and use of roads, lift national productivity and improve wellbeing (Henry et al 2010b, 373-4). There are signs that some State governments are interested in reform; for example, the South Australian State Government has said that it will consider road transport charges for heavy vehicles as part of a tax review in 2015.²⁹

7.3 Alcohol, tobacco and gambling

The Henry Review made recommendations to improve alcohol, gambling and tobacco taxation in Australia (Recommendations 71 and 72, 76 to 78).

A key reform proposal that has not yet been implemented is comprehensive and consistent alcohol taxation, on the basis of volumetric alcohol content ‘across all forms of alcohol, regardless of place, method or scale of production’. This would best support revenue and social policy goals.

The Henry Review found that current tax and subsidy arrangements for alcohol are ‘complex and distort production and consumption decisions with no coherent policy justification’ (Henry 2010b, 438). It was particularly critical of the current wine equalization tax. The need for reform of Australian alcohol taxation has been supported by recent health and economic modelling (for example, Doran et al 2013).

Increasing tobacco prices through taxation is one of the most effective measures that can be taken to reduce premature death and disease due to smoking, to reduce consumption and deter young people from starting smoking.³⁰ In respect of tobacco taxation, the Henry Review recommended an increase in the tobacco excise and its indexation to average weekly earnings instead of the consumer price index. These recommendations have been implemented. The indexation method for tobacco taxation has been changed effective 1 March 2014. Excise rates were increased by 25 per cent in 2010 and commencing from 1 December 2013, four staged 12.5 per cent increases are being implemented (to be completed on 1 September 2016).

Increased taxes on tobacco bring with them an increased risk and reward for smuggling and black market production and sales. These cause increased administrative costs and policing and criminal law costs, which should be monitored to ensure that taxation is at an optimal level.

In respect of gambling taxation, the Henry Review recognized that gambling taxes constitute an important revenue source for many State governments (as shown in Table 6.1 above). Unlike its stance on tobacco taxation, the Henry Review noted that the social policy argument for gambling taxation is not clear and emphasized that regulatory goals in relation to gambling should be distinguished from taxation of the gambling industry to raise revenue. It recommended that States should review gambling taxation to ensure it is consistent with social policy goals and raises adequate revenue from economic returns. Further research is needed into the merits, economic and distributional aspects of gambling taxation in general, and specific types of gambling taxes, as opposed to other approaches to regulation and licensing of gambling activity.

In general, the Henry Review opposed other forms of selective taxation such as luxury taxes, which it argued are inefficient, ineffective and arbitrary. In general, luxury goods are substitutable—if one is taxed, demand may shift to another good. Australia has few luxury taxes. The Review recommended that the luxury car tax be abolished (Recommendation 80).

29 <http://www.abc.net.au/news/2014-11-10/new-road-transport-charges-proposed-for-sa-heavy-vehicles/5878398>.

30 See Department of Health, <http://www.health.gov.au/internet/main/publishing.nsf/Content/tobacco-tax>.

7.4 Financial transactions tax

One type of selective tax that has received significant attention since the GFC is a financial transactions tax. In the European Union, eleven countries agreed on 14 February 2013 to introduce a tax on a range of financial transactions on a harmonized basis, as proposed by the European Commission.³¹ The countries are Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia. Annual revenues of such a tax have been estimated to be as much as EUR 30 to 35 billion, or 0.4 per cent of the GDP of the participating member states. However, there remains significant controversy.

This EU proposal and the enhanced cooperation approach of the eleven countries have not proceeded beyond the Council Working Group at this stage. They have been criticized as contrary to international tax rules (including a challenge from the United Kingdom) and even if they are legislated, the start date is currently deferred until 1 January 2016.

The Henry Review considered the case for a tax like the Financial Transactions Tax, on financial or currency dealings (known as a Tobin Tax). The policy goals of such a tax must be carefully defined. The goal of a Tobin Tax on currency or speculative financial dealings is to dampen speculative dealings, to put 'stand in the wheels' so as to stabilise the financial system. If the transaction tax succeeded, it would raise very little revenue.

On the other hand, it has been suggested that a Tobin Tax or Financial transactions tax could raise revenue to fund global public goods. However, unless they are levied on a global and comprehensive basis, such taxes could likely be avoided through the use of untaxed jurisdictions or tax havens. They would be unlikely to raise the revenue anticipated and could be inefficient and have unintended effects.

³¹ See European Commission, http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm.

CHAPTER 8 DIRECTIONS FOR REFORM

Much of the recent commentary and analysis about reform of the Australian tax system has focused selectively on ‘priority’ areas for reform. The Henry Review addressed the overall Australian tax system including Commonwealth, State and local taxes and sought to take into account interactions between different taxes and in the tax and transfer system. It then identified a broad set of taxation arrangements to position Australia for dealing with the social, economic and environmental challenges for the next forty years.

Overall, Australia raises less revenue through taxation than many comparable countries, including Canada and New Zealand, as a percentage of GDP. There is scope, and likely the budgetary need, to increase Australia’s tax take in the future to deliver the goods, services and fair support for those in need that the Australian people expect from government.

The Asprey Review observed that it will always be necessary for governments to utilise a variety of taxes to meet revenue needs. Multiple sources of tax revenue ‘have to be seen to be supplementing each other and their interactions—and sometimes their conflicts—have to be reckoned with’ (Asprey et al 1975, 11). The system-wide approach taken in the Henry Review remains an important guide to tax reform. Taxes should be collected across all tax bases of income, consumption and wealth, and all factors of production including labour, capital and land; however, the global context in which Australia operates and the increasing mobility of labour and capital must be considered in tax system design.

The challenges identified by the Henry Review remain and are discussed in Chapter 2 of this report. The global digital economy, changes in work and consumption patterns, and lower productivity have become more acute in the past five years. The context for tax reform has also become more challenging, as governments do not have fiscal surpluses to return to taxpayers in compensation for tax system changes.

The Henry Review identified key policy and research directions but did not present a package or detailed prescriptions for reform. Its overall approach of broadening the personal income tax base and the consumption tax base, potentially lowering rates, and shifting towards a broad-based land tax remain of crucial relevance.

The goal of increasing workforce participation has become central. Consequently, the way in which the tax and transfer system affects incentives to join or increase engagement with the paid workforce is a critical issue for any future tax reform. The Henry Review tended towards a flatter structure with a moderately high top rate but did not express a concluded view on the ideal progressivity of tax rates. More flexible, temporary and short-term connections of employees to formal employment arrangements cause difficulties for our PAYG system, which depends on withholding from employers and other intermediaries. Complex and differential tax treatment of work, savings and assets generate incoherence and revenue leakage.

The Henry Review raised the issue of how to simplify and manage the many complex boundaries and interactions in the tax system. One of the most important goals in considering reform of the personal income tax is a review of the taxation of savings and investment. Removing distortions in savings decisions and taxing those who have assets more comprehensively will improve efficiency, fairness and resilience in the tax system. The tax treatment of retirement savings and the interaction between this and the age pension requires reform for revenue sustainability and fairness reasons.

In company tax, key tax research and policy areas are level, rate and base of company taxation and how corporate-shareholder taxation should operate, including the imputation system. The case for providing a lower company tax rate must be examined and efficiency gains weighed with other functions of the company tax. The tax treatment of multinational companies whether Australian or foreign owned will be an ongoing issue. Given rapidly changing global business practices and continuing financial innovation, the costs and benefits of utilising complex integrity measures to shore up the company tax system needs further consideration.

The tax treatment of small business including whether there is a case for lower rates or a different tax system for small business relative to large business should be considered. This is important because of high compliance and administration costs generated by business tax structuring combining trusts and private companies, and the close interaction between the personal income tax and company tax system for privately owned enterprises.

The GST is Australia's broad-based consumption tax. However, less than half of the potential tax base is taxed and Australia's GST has a standard rate that is substantially lower than the rate in many comparable countries. To strengthen the system as a whole and to fund the goods and services that the public wishes government to deliver, we need to examine how to improve our taxation of consumption whether by broadening the base or increasing the rate.

State taxes, especially property taxes and payroll taxes, warrant significant reform but this is challenging for political, fairness and revenue reasons. The largest economic benefit is likely to be gained by eliminating duties on real property, increasing broad-based land tax. As illustrated by the ACT reform discussed in Chapter 6, this may require a long transition and may cost revenue in the short term. There is potential for more efficient national tax bases to be used for benefit of the States, especially payroll tax; such a reform would potentially need to be done in conjunction with a broader reform of the federation.

This report has aimed to discuss the key directions for tax reform that arise out of the Henry Review, which remain of key relevance in today's tax reform debate. Significant research and policy analysis is needed on future options for tax reform. Tax reform has potential to enhance Australian economic prosperity and support income-enhancing investment, innovation and productivity growth in Australia. It can also contribute to improving fairness and resilience of the system for the future.

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APPENDIX

Recommendations of the Henry Review

Review of Australia's Future Tax System (Henry et al 2010b, Chapter 12).

Part One—A tax and transfer system for the 21st century

Recommendation 1: Revenue raising should be concentrated on four robust and efficient broad-based taxes:

- > personal income, assessed on a more comprehensive basis;
- > business income, designed to support economic growth;
- > rents on natural resources and land; and
- > private consumption.

Additional specific taxes should exist only where they improve social outcomes or market efficiency through better price signals. Such taxes would only be used where they are a better means to achieve the desired outcome than other policy instruments. The rate of tax would be set in accordance with the marginal spillover cost of the activity.

User charging should play a complementary role, as a mechanism for signalling the underlying resource cost of publicly provided goods and services.

With both specific taxes and user charges, revenue would be a by-product of the tax or charge, not the reason for it.

Other existing taxes should have no place in the future tax system and over time should be abolished.

A—Personal taxation

A1—Personal Income tax

Recommendation 2: Progressivity in the tax and transfer system should be delivered through the personal income tax rates scale and transfer payments. A high tax-free threshold with a constant marginal rate for most people should be introduced to provide greater transparency and simplicity.

Recommendation 3: The primary unit in the personal tax system should continue to be the individual, and subsidies for dependants through the tax system should be restricted (see Recommendation 6a). However, there could be a case for optional couple assessment for people of late retirement age.

Recommendation 4: Income support and supplementary payments should be tax-exempt.

- > Family assistance should remain exempt from tax because it addresses direct costs associated with children.
- > Government payments that are similar in nature to income support, such as scholarships, should be exempt from tax to align their treatment with that of income support.

Recommendation 5: The Medicare levy and structural tax offsets—the low income, senior Australians, pensioner and beneficiary tax offsets—should be removed as separate components of the system and incorporated into the personal income tax rates scale. If a health levy is to be retained, it could be applied as a proportion of the net tax payable by an individual.

Recommendation 6: To remove complexity and ensure government assistance is properly targeted, concessional offsets should be removed, rationalised, or replaced by outlays.

- > The existing dependency offsets should be replaced with a single dependant tax offset where one of the following circumstances apply:
 - > the dependant is unable to work due to disability or carer responsibilities; or
 - > either the taxpayer or dependant has reached Age Pension age.
- > The zone tax offset should be reviewed. If it is to be retained, it should be based on contemporary measures of remoteness.
- > The mature age worker, employment termination payment, overseas civilian, entrepreneurs', and notional tax offsets should be removed (see Part Two Annex A1). The education tax refund should be replaced as part of the single family payment, but as a back-to-school (lump-sum) amount.
- > The overseas forces tax offset should be replaced by adjusting remuneration to maintain net incomes.
- > Averaging tax offsets for primary producers, the offset for 'special professionals' and the lump sum payment in arrears tax offset should be retained to minimise the extent to which the timing of such income influences tax liability (see Part Two Annex A1).

Recommendation 7: Consistent with recommendations by the National Health and Hospitals Reform Commission:

- > The medical expenses tax offset should be removed following a review of the scope and structure of health safety net arrangements.
- > The Medicare levy surcharge and assistance for private health insurance should be reviewed as part of the package of tax and non-tax policies relating to private health insurance. The Medicare levy surcharge lump sum payment in arrears tax offset should be retained if the Medicare levy surcharge is retained (see Annex A1). Assistance, if retained, for private health insurance should be provided exclusively as a direct premium reduction.

Recommendation 8: All forms of wages and salary for Australian resident taxpayers should be taxable on an equivalent basis and without exemptions.

- > Private education payments provided in respect of employment or as an incentive to undertake employment and employment-related payments should be assessed as income and taxed at marginal tax rates.
- > The broad exemptions for foreign employment income should be removed and such income should be taxed at marginal tax rates.
- > Defence and disciplined forces payments should be taxable and direct remuneration increased for affected personnel.

Recommendation 9: Fringe benefits that are readily valued and attributable to individual employees should be taxed in the hands of employees through the PAYG system. Other fringe benefits, including those incidental to an individual's employment, should remain taxed to employers at the top marginal rate (and non-reportable for employees). The scope of fringe benefits that are subject to tax should be simplified.

- > Market value should generally be used to value fringe benefits (with an appropriate adjustment for employee contributions).
- > The current formula for valuing car fringe benefits should be replaced with a single statutory rate of 20 per cent, regardless of the kilometres travelled.
- > All fringe benefit tax (FBT) exemptions should be reviewed to determine their continuing appropriateness. To improve simplicity, consideration should also be given to excluding fringe benefits from tax where the costs of compliance outweigh equity and tax integrity considerations. The broad definition of fringe benefits in the FBT law could be reviewed to exclude essential workplace items such as chairs, stationery and toilets.
- > For fringe benefits that are taxed in the hands of employers, a small *de minimis* threshold, below which fringe benefits are exempt from tax, should apply. The threshold could vary depending on the number of employees within an organisation.
- > Not-for-profit entities' FBT concessions should be reconfigured (see Part Two Section B3). The FBT exemptions for members of the Defence force should be replaced with direct remuneration increases for affected personnel (see related Recommendation 8c).

Recommendation 10: Consideration should be given to a revised regime to prevent the alienation of personal services income that would extend to all entities earning a significant proportion of their business income from the personal services of their owner-managers, whether in employee-like or non-employee-like cases. This regime may also apply an arm's length rule to deductions arising from payments to associates to ensure deductions reflect the value of services provided.

Recommendation 11: A standard deduction should be introduced to cover work-related expenses and the cost of managing tax affairs to simplify personal tax for most taxpayers. Taxpayers should be able to choose either to take a standard deduction or to claim actual expenses where they are above the claims threshold, with full substantiation.

Recommendation 12: There should be a tighter nexus between the deductibility of the expense and its role in producing income.

Recommendation 13: Gift deductibility should be retained, with the deductibility threshold raised from \$2 to \$25.

Recommendation 14: Provide a 40 per cent savings income discount to individuals for non-business related:

- > net interest income;
- > net residential rental income (including related interest expenses);
- > capital gains (and losses); and
- > interest expenses related to listed shares held by individuals as non-business investments.

In conjunction with introducing the discount further consideration should be given to how the boundaries between discounted and non-discounted amounts are best drawn to achieve certainty, reduce compliance costs, and prevent labour and other income being converted into discounted income. Further consideration should also be given to addressing existing tax law boundaries related to the treatment of individuals owning shares in order to address uncertainties about when the shares are held on capital account (and subject to capital gains tax) and on revenue account (and taxed as ordinary income).

Recommendation 15: When the 40 per cent savings income discount is introduced a smooth transition should be provided to minimise any disruption that may arise. The transition to a savings income discount for net residential rental income should only be adopted following reforms to the supply of housing (Part Two Section E4 Housing affordability) and reforms to housing assistance (Section F5 Housing assistance).

Recommendation 16: As part of the consideration of alternative company tax income arrangements and dividend imputation (see Recommendations 26 and 37), consideration should be given to extending the discount to other savings income.

APPENDIX continued

Recommendation 17: The capital gains tax regime should be simplified by:

- > increasing the exemption threshold for collectables and exempting all personal use assets;
- > rationalising and streamlining the current small business capital gains tax concessions by:
 - > removing the active asset 50 per cent reduction and 15-year exemption concessions;
 - > increasing the lifetime limit of the retirement exemption by permanently aligning it with the capital gains tax cap for contributions to a superannuation fund; and
 - > allowing taxpayers who sell a share in a company or an interest in a trust to access the concessions via the turnover test.
- > removing current grandfathering provisions relating to assets acquired before the commencement of capital gains tax, with a market value cost base provided for those assets when the exemption is removed, or before the end of previous indexation arrangements. A relatively long lead-time should be provided before these removals take effect; and
- > rewriting the capital gains tax legislation using a principles-based approach that better integrates it with the rest of the income tax system.

A2—Retirement incomes

Recommendation 18: The tax on superannuation contributions in the fund should be abolished. Employer superannuation contributions should be treated as income in the hands of the individual, taxed at marginal personal income tax rates and receive a flat-rate refundable tax offset.

- > An offset should be provided for all superannuation contributions up to an annual cap of \$25,000 (indexed). The offset should be set so the majority of taxpayers do not pay more than 15 per cent tax on their contributions. The cap should be doubled for people aged 50 or older.
- > An annual cap on total contributions should continue to apply.
- > The offset should replace the superannuation co-contribution and superannuation spouse contribution tax offset.
- > Compulsory superannuation contributions made by employers should not reduce eligibility for income support or family assistance payments. They should also not form part of the calculation for child support.

Recommendation 19: The rate of tax on superannuation fund earnings should be halved to 7.5 per cent. Superannuation funds should retain their access to imputation credits. The 7.5 per cent tax should also apply to capital gains (without a discount) and the earnings from assets supporting superannuation income streams.

Recommendation 20: The restriction on people aged 75 and over from making contributions should be removed. However, a work test should still apply for people aged 65 and over. There should be no restrictions on people wanting to purchase longevity insurance products from a prudentially regulated entity.

Recommendation 21: The government should support the development of a longevity insurance market within the private sector.

- > The government should issue long-term securities, but only where this is consistent with its fiscal obligations, to help product providers manage the investment risk associated with longevity insurance.
- > The government should make available the data needed to create and maintain a longevity index that would assist product providers to hedge longevity risk.
- > The government should remove the prescriptive rules in the Superannuation Industry (Supervision) Regulations 1994 relating to income streams that restrict product innovation. This should be done in conjunction with the recommendation to have a uniform tax on earnings on all superannuation assets.

Recommendation 22: The government should consider offering an immediate annuity and deferred annuity product that would allow a person to purchase a lifetime income. This should be subject to a business case that ensures the accurate pricing of the risks being taken on by the government. To limit the government's exposure to longevity risk, it should consider placing limits on how much income a person can purchase from the government.

Recommendation 23: The government should help make people more aware of the retirement income system, and therefore better able to manage their superannuation, by increasing the regularity of superannuation guarantee contributions, making it easier for people to manage their superannuation and providing people with a single point of contact for government agencies.

- > Superannuation guarantee contributions should be paid at the same time as wages. This should be introduced over time so businesses can adjust their cash flows. As a first step, larger businesses (that is, businesses required to lodge their business activity statements on a monthly basis) should be required to pay superannuation guarantee contributions at least monthly.
- > Employers should report superannuation contributions to their employees when a contribution is made.
- > There should be a method of linking superannuation records, such as client identifiers like the tax file number, to make it easier for people to manage their superannuation.

- > A superannuation portal where people can interact with government agencies and get information on retirement incomes should be developed. Over time this portal should evolve, subject to suitable safeguards, so that people can manage all their superannuation through one channel.

Recommendation 24: The preservation age for Service Pensioners should remain at 60 as it is already legislated to align with the eligibility age for that pension. An increase in the preservation age should apply to people who currently have a legislatively prescribed retirement age.

A3—Wealth transfer taxes

Recommendation 25: While no recommendation is made on the possible introduction of a tax on bequests, the Government should promote further study and community discussion of the options.

B—Investment and entity taxation

B1—Company and other investment taxes

Recommendation 26: The structure of the company income tax system should be retained in its present form, at least in the short to medium term.

A business level expenditure tax could suit Australia in the future and is worthy of further consideration and public debate. It is possible that other economies will move towards such systems over coming years and it could be in Australia's interest to join this trend at an early stage.

Recommendation 27: The company income tax rate should be reduced to 25 per cent over the short to medium term with the timing subject to economic and fiscal circumstances. Improved arrangements for charging for the use of non-renewable resources should be introduced at the same time.

Recommendation 28: The capital allowance arrangements should be enhanced and streamlined to ensure effective rates more closely match rates of economic depreciation, and to reduce administration and compliance costs overall. This should include:

- > allowing low-value assets (assets costing less than \$1,000) to be immediately written-off; and
- > reviewing the impact of special provisions applying to different investments in agriculture and statutory effective life caps and other concessional write-off provisions.

Recommendation 29: The capital allowance arrangements for small business should be streamlined and simplified, by:

- > allowing depreciating assets costing less than \$10,000 to be immediately written-off; and
- > allowing all other depreciating assets (except buildings) to be pooled together, with the value of the pool depreciated at a single declining balance rate.

Recommendation 30: The small business entity turnover threshold should be increased from \$2 million to \$5 million, and adjustments to the \$6 million net asset value test should be considered.

Recommendation 31: Companies should be allowed to carry back a revenue loss to offset it against the prior year's taxable income, with the amount of any refund limited to a company's franking account balance.

Recommendation 32: If earlier access to tax benefits from exploration expenses (relative to other expenses) is to be provided, it should take the form of a refundable tax offset at the company level for exploration expenses incurred by Australian small listed exploration companies, with the offset set at the company income tax rate.

Recommendation 33: Financial institutions operating in Australia should generally not be subject to interest withholding tax on interest paid to non-residents.

Recommendation 34: Consideration should be given to negotiating, in future tax treaties or amendments to treaties, a reduction in interest withholding tax to zero so long as there are appropriate safeguards to limit tax avoidance.

Recommendation 35: Taxation arrangements applying to Australian managed funds and related services should be improved to provide greater certainty that conduit income will not be subject to Australian tax.

B2—The treatment of business entities and their owners

Recommendation 36: The current trust rules should be updated and rewritten to reduce complexity and uncertainty around their application.

Recommendation 37: Dividend imputation should be retained in the short to medium term, but for the longer term, consideration should be given to alternatives as part of a further consideration of company income tax arrangements.

Recommendation 38: A flow-through entity regime for closely held companies and fixed trusts should not be adopted for now, but would merit further consideration if there is a move away from dividend imputation in the long run.

Recommendation 39: While dividend imputation is retained, imputation credits should continue to be provided only for Australian company income tax. Dividend streaming and franking credit trading practices should, in general, continue to be prohibited.

Recommendation 40: If increased integration of the Australian and New Zealand economies is desired, a broad examination of the appropriate degree of harmonisation of business income tax arrangements between Australia and New Zealand should be undertaken.

B3—Tax concessions for not-for-profit organisations

Recommendation 41: Consistent with the recommendations of previous inquiries, a national charities commission should be established to monitor, regulate and provide advice to all not-for-profit (NFP) organisations (including private ancillary funds). The charities commission should be tasked with streamlining the NFP tax concessions (including the application process for gift deductibility), and modernising and codifying the definition of a charity.

Recommendation 42: Categories of NFP organisations that currently receive income tax or GST concessions should retain these concessions. NFP organisations should be permitted to apply their income tax concessions to their commercial activities.

Recommendation 43: NFP FBT concessions should be reconfigured.

- > The capped concessions should be phased out over ten years. In the transition period, the value of the caps would gradually be reduced. Reportable fringe benefits for affected employees (that is, those benefits that are easily valued and attributed) would be exempt from tax up to the relevant cap, and taxed at the employee's marginal tax rate above the cap. The market value of these benefits would be taken into account for transfer payment purposes. Non-reportable fringe benefits would be taxable for NFP employers.
- > The FBT concessions should be replaced with direct government funding, to be administered by relevant Australian government portfolio agencies or the charities commission. All NFP organisations eligible for tax concessions should be able to apply to the relevant body for funding for specific projects or for assistance with the costs of recruiting specialist staff.

Recommendation 44: Simple and efficient tax arrangements should be established for clubs with large trading activities in the fields of gaming, catering, entertainment and hospitality. One option is to apply a concessional rate of tax to total net income from these activities above a high threshold. For clubs below the threshold, no tax would be applied to income from these activities.

C—Land and resource taxes

C1—Charging for non-renewable resources

Recommendation 45: The current resource charging arrangements imposed on non-renewable resources by the Australian and State governments should be replaced by a uniform resource rent tax imposed and administered by the Australian government that:

- > is levied at a rate of 40 per cent, with that rate adjusted to offset any future change in the company income tax rate from 25 per cent, to achieve a combined statutory tax rate of 55 per cent;
- > applies to non-renewable resource (oil, gas and minerals) projects, except for lower value minerals for which it can be expected to generate no net benefits. Excepted minerals could continue to be subject to existing arrangements if appropriate;
- > measures rents as net income less an allowance for corporate capital, with the allowance rate set at the long-term Australian government bond rate;
- > requires a rent calculation for projects;
- > allows losses to be carried forward with interest or transferred to other commonly owned projects, with the tax value of residual losses refunded when a project is closed; and
- > is allowed as a deductible expense in the calculation of income tax, with loss refunds treated as assessable income.

Recommendation 46: The resource rent tax should not provide concessions to encourage exploration or production activity at a faster rate than the commercial rate or in particular geographical areas, and should not allow deductions above acquisition costs to stimulate investment.

Recommendation 47: Existing projects should be transferred into the proposed system with an adjustment, as appropriate, to the starting base for the allowance for corporate capital. The Australian government should set out a time-frame to implement the resource rent tax and provide guidance at the time of announcement on how existing investments and investment in the interim will be treated under the resource rent tax.

Recommendation 48: The Australian and State governments should negotiate an appropriate allocation of the revenues and risks from the resource rent tax.

Recommendation 49: The Australian and State governments should consider using a cash bidding system to allocate exploration permits. For small exploration areas, where there are unlikely to be net benefits from a cash bidding system, a first-come first-served system could be used.

Recommendation 50: The Australian and State governments should abolish fees and stamp duties on the transfer of interests in a resource project except those related to administrative costs.

C2—Land tax and conveyance stamp duty

Recommendation 51: Ideally, there would be no role for any stamp duties, including conveyancing stamp duties, in a modern Australian tax system. Recognising the revenue needs of the States, the removal of stamp duty should be achieved through a switch to more efficient taxes, such as those levied on broad consumption or land bases. Increasing land tax at the same time as reducing stamp duty has the additional benefit of some offsetting impacts on asset prices.

Recommendation 52: Given the efficiency benefits of a broad land tax, it should be levied on as broad a base as possible. In order to tax more valuable land at higher rates, consideration should be given to levying land tax using an increasing marginal rate schedule, with the lowest rate being zero, with thresholds determined by the per-square-metre value.

Recommendation 53: In the long run, the land tax base should be broadened to eventually include all land. If this occurs, low-value land, such as most agricultural land, would not face a land tax liability where its value per square metre is below the lowest rate threshold.

Recommendation 54: There are a number of incremental reforms that could potentially improve the operation of land tax, including:

- > ensuring that land tax applies per land holding, not on an entity's total holding, in order to promote investment in land development;
- > eliminating stamp duties on commercial and industrial properties in return for a broad land tax on those properties; and
- > investigating various transitional arrangements necessary to achieve a broader land tax.

D—Taxing consumption

Recommendation 55: Over time, a broad-based cash flow tax—applied on a destination basis—could be used to finance the abolition of other taxes, including payroll tax and inefficient State consumption taxes, such as insurance taxes. Such a tax would also provide a sustainable revenue base to finance future spending needs.

D1—A cash flow tax

No recommendations in this section.

D2—The goods and services tax

Recommendation 56: The Government should consider making greater use of GST-free business-to-business transactions or reverse charging, provided the potential compliance cost savings outweigh the additional complexity costs and risks to revenue.

D3—Payroll tax

Recommendation 57: State payroll taxes should eventually be replaced with revenue from more efficient broad-based taxes that capture the value-add of labour.

D4—Taxing financial services

No recommendations in this section.

E—Enhancing social and market outcomes

E1—User charging

No recommendations in this section.

E2—Taxes to improve the environment

Recommendation 58: Once the Carbon Pollution Reduction Scheme (CPRS) is operational, additional measures which seek to reduce emissions (in sectors covered by the CPRS), and which are not justified on other grounds, should be phased out.

Recommendation 59: The industry assistance arrangements introduced in consequence of the CPRS should be regarded as transitional. The Government's policy is to commission an independent review of the CPRS, including in relation to emissions-intensive trade-exposed (EITEs) assistance, every five years starting in 2014. To complement this, the Productivity Commission should be asked to undertake and publish an annual review of CPRS-related assistance arrangements for the life of the CPRS to provide a basis for future decisions on assistance policy. To assist the Productivity Commission, an Associate Commissioner with appropriate knowledge and industry expertise should be appointed to the review.

Recommendation 60: The government should continue to monitor tax concessions aimed at supporting environmental outcomes, and consider replacing them with targeted spending programs where this would be a more effective and efficient method of achieving the appropriate environmental outcome.

E3—Road transport taxes

Recommendation 61: 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. The use of revenues should be transparent to the community and subject to further institutional reform.

Recommendation 62: The Council of Australian Governments (COAG) should accelerate the development of mass-distance-location pricing for heavy vehicles, to ensure that heavy vehicles pay for their specific marginal road-wear costs. Revenue from road-wear charges should be allocated to the owner of the affected road, which should be maintained in accordance with an asset management plan. Differentiated compliance regimes to enforce this pricing policy may need to be considered to balance efficiency benefits from pricing against the costs of administration and compliance for some road users.

Recommendation 63: States should improve compulsory third party insurance to better reflect individual risks.

Recommendation 64: On routes where road freight is in direct competition with rail that is required to recover its capital costs, heavy vehicles should face an additional charge on a comparable basis, where this improves the efficient allocation of freight between transport modes.

Recommendation 65: Revenue from fuel tax imposed for general government purposes should be replaced over time with revenue from more efficient broad-based taxes. If a decision were made to recover costs of roads from road users through fuel tax, it should be linked to the cost of efficiently financing the road network, less costs that can be charged directly to road users or collected through a network access charge. Fuel tax should apply to all fuels used in road transport on the basis of energy content, and be indexed to the CPI. Heavy vehicles should be exempt from fuel tax and the network access component of registration fees if full replacement charges are introduced.

Recommendation 66: 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. The administrative costs of providing government services should be recovered through user charges where applicable. Quantity limits on taxi licences should be phased out.

Recommendation 67: Governments should continue to reform road infrastructure provision, applying economic assessment to investments comparable to that for other forms of infrastructure.

Recommendation 68: 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. COAG should nominate a single institution to lead road tax reform, and ensure implementation of this agreement.

E4—Housing affordability

Recommendation 69: COAG should place priority on a review of institutional arrangements (including administration) to ensure zoning and planning do not unnecessarily inhibit housing supply and housing affordability.

Recommendation 70: COAG should review infrastructure charges (sometimes called developer charges) to ensure they appropriately price infrastructure provided in housing developments. In particular, the review should establish practical means to ensure that these charges are set appropriately to reflect the avoidable costs of development, necessary steps to improve the transparency of charging and any consequential reductions in regulations.

E5—Alcohol taxation

Recommendation 71: All alcoholic beverages should be taxed on a volumetric basis, which, over time, should converge to a single rate, with a low-alcohol threshold introduced for all products. The rate of alcohol tax should be based on evidence of the net marginal spillover cost of alcohol.

Recommendation 72: The introduction of a common alcohol tax should be accompanied by a review of the administration of alcohol tax, to ensure that alcohol taxpayers do not face redundant compliance obligations.

E6—Tobacco taxation

Recommendation 73: The existing regime for tobacco taxation in Australia should be retained, with the rates of tax substantially increased, depending on further evidence on the costs of harm from tobacco smoking.

Recommendation 74: Tobacco excise should be indexed to a broad measure of wages rather than CPI.

Recommendation 75: There should be no duty free allowance on tobacco for international travellers entering Australia.

E7—Gambling taxation

Recommendation 76: Gambling taxes should be reviewed to ensure that they are focused on recouping economic rent generated by government restrictions on the supply of gambling services or are being used efficiently to impose such restrictions.

Recommendation 77: Governments should eliminate gambling tax concessions for particular types of gambling business, such as clubs. If governments wish to subsidise particular types of businesses, they should do so through direct expenditures.

Recommendation 78: Governments should consider the allocation of responsibilities for the regulation and taxation of gambling, with a view to minimising conflicts in policy-making between revenue-raising and addressing problem gambling.

E8—Rationalising other taxes

Recommendation 79: All specific taxes on insurance products, including the fire services levy, should be abolished. Insurance products should be treated like most other services consumed within Australia and be subject to only one broad-based tax on consumption.

Recommendation 80: The luxury car tax should be abolished.

Recommendation 81: Governments should undertake a systematic review of existing and potential user charges and minor taxes against the principles set out in this report. This should be coordinated with the introduction of the system wide Tax and Transfer Analysis Statement proposed in Recommendation 132.

F—The transfer system

F1—Income support payments

Recommendation 82: There should be three categories of income support payments:

- > A pension category for people who are not expected to support themselves through paid work, whether because of their age, disability or because they are providing full-time care for a person with disability (or frail aged). This pension would be paid at a rate that provides a basic acceptable standard of living, having regard to prevailing community standards.

- > A participation category for people of working age who are expected to support themselves through paid work now or in the near future. This would cover the unemployed including youth (both under and over 18), those who are temporarily incapacitated, people with a partial capacity to work and primary carers of dependent children. The rate of payment, for those who are expected to work, should provide a basic level of adequacy while maintaining incentives to work. This would be less than the pension rate. Parents on income support would receive a higher total level of payment. Unemployed youth aged less than 21 would be paid no more than full-time students to avoid creating incentives to leave full-time study for unemployment.¹
- > A student assistance category for people engaged in full-time study. Students aged 21 and over would continue to be paid at a lower rate than the unemployed and at the same rate as younger students in similar circumstances. Some students have the capacity to work part-time to supplement their income support. Other students could be given the ability to borrow against future income to supplement their student assistance.²

Recommendation 83: There should be a more consistent approach to payment relativities within each of the three categories of payment based on the single to couple pension relativity. A more consistent approach would mean an increase to base rates for single income support recipients in the participation and student assistance categories. However, a lower relativity for singles in these categories without children may be warranted given their greater capacity to share accommodation.

Recommendation 84: Payments and income test parameters should be indexed in a consistent way to maintain relativities across the three payment categories and to reflect changes in community standards. Governments should regularly review indexation as community standards are likely to be affected by significant changes in the composition of the workforce and household incomes in coming decades. The current community standard for pensions is set by reference to Male Total Average Weekly Earnings. Indexing all payments to this standard has been projected to involve a significant increase in budgetary outlays over the coming decades so it will be necessary for governments to regularly review the appropriateness of this measure and the level of the benchmark.

¹ Rates of payment for participation category customers aged less than 21 are discussed in Section F3 Family and youth assistance.

² Rates of payment for student assistance category customers aged less than 22 are discussed in F3 Family and youth assistance.

APPENDIX continued

Recommendation 85: Income support arrangements for parents should support and encourage participation in work while maintaining adequate levels of assistance to families. As a condition of payment parents should be required to look for part-time work once their youngest child turns four. Parents would receive supplements as follows:

- > For couples and single parents with a youngest child under six years, the amount of the supplement should be set such that the total support for single parents on income support will be equivalent to the maximum rate of pension. The supplement would be paid through the family payment system.
- > For single parents with a youngest child aged six or older, the supplement should be paid at a substantially lower rate through the family payment system.
- > For couples with a youngest child aged six years or older, the lower rate supplement should be paid through the income support system.

Recommendation 86: People with disability who have a partial capacity to work, excluding people receiving Disability Support Pension (DSP), should have a part-time work requirement. They should be subject to a means test or payment arrangements that provide an incentive to work part-time and that recognises that they face higher average costs of work. This could also be achieved by an in-work supplement and/or an earnings disregard in the means test.

Recommendation 87: Students should have access to an income test that facilitates significant part-time work at a level that does not compromise educational outcomes. Adults requiring additional income should be able to borrow to top up their student rate of income support to the level of the participation payment rate. The feasibility of using the existing income-contingent loans scheme and the potential impact of it on access to higher education of students from a low socioeconomic background should be examined.

F2—Means testing

Recommendation 88: The current income and asset tests for income support payments should be replaced with a comprehensive means test based on a combined measure of employment income, business income and deemed income on assets. The comprehensive means test would:

- > extend deemed income on assets in addition to financial assets, including superannuation income streams, rental housing and other asset classes (whether income-producing or not). Superannuation income streams where deeming income would be difficult to apply would be tested on gross income but with an actuarially fair deduction for capital;
- > have low and high deeming rates based on the returns expected from a portfolio of assets held by a prudent investor. These rates should be set by reference to an appropriate benchmark;

- > continue the means test exemption for owner-occupied housing up to a high indexed threshold;
- > set a high capped exemption for personal-use assets;
- > retain the current concessional treatment of employment income for certain allowances and pensions;
- > have different free areas for pensions and allowances; and
- > remove the liquid assets waiting period and the sudden-death cut-out that applies to people on certain payments.

Recommendation 89: Means testing for family assistance payments should be based on the same measure of taxable income as for income tax, including fringe benefits. However, payments should not be reduced as a result of the inclusion of compulsory superannuation contributions in taxable income. Consideration should be given to aligning the definitions of income and periods of assessment for family assistance payments more closely to those that apply to income support payments. However, this should not include deeming income on assets.

F3—Family and youth assistance

Recommendation 90: Current family payments, including Family Tax Benefit Parts A and B, should be replaced by a single family payment. The new family payment should:

- > cover the direct costs of children in a low-income family (that is, the costs associated with food, clothing, housing, education expenses); and
- > assist parents nurturing young children to balance work and family responsibilities.

Recommendation 91: The direct cost of children component of family assistance should be a per child payment.

- > Rates of payment should increase with the age of the children to recognise the higher costs of older children. Three rates of payment should apply: for 0–11 year olds; 12–15 year olds and 16–18 year olds while in secondary school. These age bands would appropriately accommodate the increasing costs of children (this would require higher payments rates for 12, 16 and 17 year olds). The Baby Bonus should be abolished and a small supplementary payment, reflecting the direct costs of a new-born baby, should be paid over the first three months.
- > A shared-care rate to recognise the higher costs of separated families should be considered, taking into account interactions with child support as well as other income support payments.
- > Additional payments for larger families, including the Large Family Supplement, the Multiple Birth Allowance for children over one year, and higher thresholds for larger families should be reconsidered as the case for these payments is not strong.

Recommendation 92: A supplement for parents nurturing young children (aged under six years) should be provided as a per-family payment, means tested on family income in addition to the recently announced Paid Parental Leave arrangements.

- > The maximum rate of the supplement should be set such that the total support for single parents wholly reliant on income support is equivalent to the maximum rate of pension.

Recommendation 93: For single parents with children aged six or older, a parental supplement (which should be considerably smaller than under Recommendation 92), should be paid through the family payment system.

Recommendation 94: For couples with children aged six or older, a parental supplement at the same rate as for single parents should be paid through the income support system (See Part Two Section A1 Personal income tax).

Recommendation 95: Assistance for families should also recognise that there are specific circumstances, such as parents caring for disabled children and foster care children with higher needs, for which additional support beyond the early years is appropriate.

Recommendation 96: The total amount of family assistance should be withdrawn with a single means test to avoid cumulative withdrawal rates which create unnecessarily high disincentives for working. A single low withdrawal rate of 15–20 per cent would be appropriate to minimise workforce disincentives.

Recommendation 97: While family payments should be the main form of assistance for families with children up to the end of secondary school, or the school year in which they turn 18 (the earlier of the two), youth payments should be available to older children in some circumstances.

- > Dependent older children for whom a suitable pathway may be leaving school and looking for work or combining part-time work and part-time study should have access to a youth payment, governed by strict participation requirements.
- > Children without access to financial support from their families should continue to have access to a youth payment, governed by strict criteria.

Recommendation 98: Youth payments should be the main form of income support from the age of 18 until the age of independence.

- > Family payments should not be provided for those aged 18 and over unless they are completing secondary school in the year they turn 18.
- > Youth payment rates should reflect the fact that most young people have lower needs than adults but need adequate assistance to participate in education and training.

- > Dependent youth payment recipients should be subject to a parental income test consistent with that applying to family payments. Family means tests should be designed so that families with dependent children in both the family payments and youth payments system are not disadvantaged.
- > The age of independence should be aligned for full-time students and non full-time students.

F4—Child care assistance

Recommendation 99: Child Care Benefit and Child Care Rebate should be combined into a single payment to parents (or to child care centres) in respect of each child based on a percentage of child care costs. The payment should have the following features:

- > a high rate of subsidy for low-income families that covers most of the costs of child care (up to 90 per cent). This would involve a small co-payment for low-income families;
- > a base rate of assistance for all families that use child care to facilitate parental engagement in the workforce. The base rate of assistance should be set as a proportion of child care costs, with reference to the marginal tax rate faced by the majority of taxpayers. (Based on the indicative personal income tax rates scale in Part Two Section A1, this would indicate a rate of assistance of 35 per cent);
- > access to the base rate of assistance subject to a requirement that parents participate in work, education or training. Where parents are not participating, the maximum rate of assistance should be available for a limited number of hours. The number of hours subsidised without a participation requirement should be the same as the number of hours of universal access to pre-school (15 hours by 2013); and
- > coverage of the full costs of child care for at-risk children and children facing multiple disadvantages, without participation requirements on parents.

Recommendation 100: The child care payment should be means tested down to the base rate of assistance based on family income and should have regard to the interaction with other means tested payments (income support and family payments) and marginal tax rates, to ensure that effective marginal rates of tax are not excessive.

Recommendation 101: The fringe benefits tax exemption for child care facilities provided on an employer's business premises for the benefit of employees should be removed.

F5—Housing assistance

Recommendation 102: The maximum rate of Rent Assistance should be increased to assist renters to afford an adequate standard of dwelling. To ensure that Rent Assistance can be maintained at an adequate level over time, the rent maximum should be indexed by movements in national rents, which could be measured by an index of rents paid by income support recipients.

Recommendation 103: To better target an increase in the maximum rate, Rent Assistance should be part of the income support system, with eligibility based on rent paid and the income support means test, rather than on eligibility for another payment (for example, Family Assistance).

Recommendation 104: Mechanisms should be developed to extend Rent Assistance equitably to public housing tenants along with removing income-linked rent setting in public housing.

Recommendation 105: A high-need housing payment should be paid to social housing providers for their tenants who have high or special housing needs or who may face discrimination in the private market. This payment should be funded by the Australian government. The Commonwealth and the States should retain the option of providing capital for social housing construction.

Recommendation 106: Income-linked rents should be phased out in social housing, with providers charging their tenants rents linked to the market rate, with existing rent-setting for current tenants phased out using grandfathering or other transitional arrangements. However, continued use of income-limited rents is appropriate in some circumstances, such as in remote Indigenous communities.

F6—Transfers tied to goods and services

Recommendation 107: The Productivity Commission, constituted to include an appropriately qualified and experienced member, should review concessions across all levels of government and provide recommendations for consideration by COAG.

Recommendation 108: The Productivity Commission should examine the principles of public service delivery and the mechanisms that are available to governments to deliver public services and their implications for financial arrangements in the federation. The findings of this study should be considered by COAG.

F7—Funding aged care

Recommendation 109: There is considerable scope to align aged care assistance with the principles of user-directed funding to provide assistance in line with recipients' needs, enable their choice of care and support the fiscal sustainability of the aged care sector. However, effective user-directed funding is significantly limited by regulations that govern supply and price, reforms to which would have complex sequencing and transition issues. As such, the Productivity Commission should consider this potential reform direction in its upcoming inquiry into aged care.

Recommendation 110: It is important for governments to determine what an adequate level of aged care should be, the necessary pricing and regulatory arrangements to deliver it, and the most sustainable funding arrangement to ensure access by those who cannot afford it. Given this, and noting that the Productivity Commission will be inquiring into the disability insurance scheme, its consideration of aged care should include the potential for insurance to play a role in helping to fund aged care as Australia's population ages.

G—Institutions, governance and administration

G1—A responsive and accountable tax system

Recommendation 111: The government should establish a more transparent means of dealing with community ideas about the tax system by extending the Tax Issues Entry System website and further developing its use.

Recommendation 112: The government should commit to a principles-based approach to tax law design as a way of addressing the growing volume and complexity of tax legislation, and as a way of helping those laws to be interpreted consistently with their policy objectives.

Recommendation 113: The Board of Taxation should be empowered to initiate its own reviews of how current tax policies and laws are operating, in consultation with the government. This would be in addition to reviewing matters referred to it by the government, though it should not engage in substantive policy development unless requested by the government.

In giving effect to these changes to the nature and functions of the Board, the government should ensure that the Board has adequate resources (including its own permanent secretariat). The government should also consider:

- > how to manage the increased workload for the Board, including whether the Board would require further members and/or members who can devote more time to the Board;

- > whether the Secretary to the Treasury, the Commissioner of Taxation, and the First Parliamentary Counsel should be appointed as advisers to the Board, rather than as members; and
- > whether the Inspector-General of Taxation, the Auditor-General, the Commonwealth Ombudsman and the Chair of the Tax Practitioners Board should be appointed as advisers to the Board of Taxation.

Recommendation 114: Information or advice provided by Treasury to assist the ATO in determining the purpose or object of the law, or materials used by the ATO to determine policy intent (other than correspondence with or from government) should be made public.

Recommendation 115: A board should be established to advise the Commissioner of Taxation on the general organisation and management of the ATO. The board would not be a decision-making body and would have no role in interpreting the tax laws or examining individual taxpayer issues. The government would appoint members to the board.

Recommendation 116: The government should clarify that the role of the Inspector-General of Taxation is to examine systemic tax administration issues that affect businesses.

Recommendation 117: The government should ensure that sufficient resources are devoted to the functions of the Inspector-General of Taxation, the Australian National Audit Office and the Commonwealth Ombudsman, recognising their importance in maintaining a fair and efficient tax system.

Recommendation 118: The Joint Committee of Public Accounts and Audit should examine reports of the Inspector-General of Taxation and the Commonwealth Ombudsman, and monitor the ATO's implementation of the recommendations in those reports.

G2—State tax reform

Recommendation 119: Reforms to State taxes should be coordinated through intergovernmental agreements between the Australian government and the States to provide the States with revenue stability and to facilitate good policy outcomes.

G3—Local government

Recommendation 120: States should allow local governments a substantial degree of autonomy to set the tax rate applicable to property within their municipality.

Recommendation 121: Over time, State land tax and local government rates should be more integrated. This could involve:

- > moving to a joint billing arrangement so that taxpayers receive a single assessment, but are able to identify the separate State and local component; and
- > using the same valuation method to calculate the base for local government rates and land tax (with this method being consistent across the State).

G4—Client experience of the tax and transfer system

Recommendation 122: A tax and transfer client account should be developed, based on customer research and with customer input into its design. The account should include at least the following features:

- > Up-to-date presentation of income earned from all sources, taxes withheld, tax liabilities incurred, transfers received and information flows from third parties;
- > complete information from past periods;
- > an optional single point for updating personal information, undertaking transactions, and reporting information or making applications, with extensive pre-filling of forms based on information previously provided; and
- > the ability to test the impact of hypothetical changes in circumstances.

Recommendation 123: Pre-filled personal income tax returns should be provided to most personal taxpayers as a default method of settling their tax affairs each year.

Recommendation 124: Existing tax and transfer provisions should be reformed to support improvements in client experience, including greater alignment of income definitions and reporting, rationalising of personal tax deductions and offsets, and streamlining of mandatory administrative requirements. Future new policy proposals should be subject to comprehensive, published expected impact assessments on client experience systems and outcomes.

Recommendation 125: Where possible, information required for determining tax liabilities and transfer entitlements should be collected from third parties, including employers, government agencies, financial institutions, and share and property registries.

- > Over time, electronic provision of this information by third parties should be made mandatory.
- > To reduce current and minimise new compliance costs, reporting obligations should as far as possible be aligned with existing information concepts and systems of third parties, and facilitated through electronic interaction with information held in the 'natural systems' of those entities.

Recommendation 126: Further approaches (extension to and approaches which build on Standard Business Reporting) should be pursued to reduce the compliance costs associated with business interactions with government.

Recommendation 127: The government should assist small businesses to be 'business ready' when they begin business. This could be achieved through education and financial assistance, which may include assistance to small business to get ready for Standard Business Reporting (SBR).

Recommendation 128: Common information standards, leveraging from the standards and governance put in place by the SBR Program, be developed and adopted to support system interoperability between tax and transfer agencies, and between those agencies and third parties, such as employers.

Recommendation 129: A modern privacy and secrecy framework be developed and adopted that maintains and streamlines protection of personal information held by government agencies, and facilitates exchange of information (other than an individual's health information) between agencies to support improved client experience of the tax and transfer system.

Recommendation 130: A method of linking records, for example by linking existing client identifiers, be developed to facilitate development of a single client account for tax and transfer financial information. This would allow better service delivery by supporting interoperability and data exchange between the appropriate government agencies, and flows of tax and transfer information from third parties to those agencies. Information should not include individual health information.

Recommendation 131: A high level taskforce be established, under central agency leadership, to progress a whole of government approach to improving the client experience of the tax and transfer system, with:

- > membership from relevant agencies, the private sector and client representatives;
- > terms of reference requiring the taskforce to:
 - > develop, consult, oversee and regularly report to government and Parliament on a whole-of-system reform of the administrative arrangements and technologies that deliver the client experience of the tax and transfer system;
 - > position these reforms within the overall government initiative to improve the relationship between it and citizens; and
 - > lead consultations with relevant stakeholders, including citizens, privacy advocacy groups, professional associations, financial institutions and employers.
- > a mechanism for capturing feedback from citizens on government service delivery, including both current administration and new proposals.

G5—Monitoring and reporting on the system

Recommendation 132: The government should, every five years, publish a Tax and Transfer Analysis Statement that analyses and reports on the overall performance and impact of the system, including estimates of efficiency costs and distributional impacts.

Recommendation 133: The Australian and the State governments should systematically collect data on aspects of existing taxes and transfers—including compliance cost data—according to consistent and transparent classifications and concepts, and make this information—including confidentialised tax unit records—freely available for further analysis and research.

Recommendation 134: The government should support one or more institutions to undertake independent policy research relevant to the Australian tax and transfer system.

Recommendation 135: The Australian government should ensure that the rules governing the development of the Budget encourage trade-offs between tax expenditures and spending programs. Budget decision-making processes should measure and treat tax expenditures and spending programs symmetrically, to ensure that there is no artificial incentive to deliver programs through one mechanism rather than another.

Recommendation 136: The government should introduce legislation to amend the *Charter of Budget Honesty Act 1998* to recognise the publication of detailed information about tax expenditures in a Tax Expenditures Statement separate from the Mid-Year Economic and Fiscal Outlook (MYEFO). However, the Tax Expenditures Statement should continue to be released by the end of January in each year, or within six months of the last Budget, whichever is later.

Recommendation 137: The government should ensure that reporting standards are independently developed for the identification and measurement of tax expenditures in the Tax Expenditures Statement. In addition, the standards should establish a basis for reporting the broader economic and distributional effects of tax expenditures in the periodic Tax and Transfer Analysis Statement (see Recommendation 132).

Recommendation 138: The Council of Australian Governments should examine the ways in which the States could uniformly report tax expenditures annually according to the independent standards developed under Recommendation 137.

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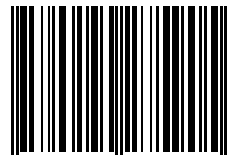
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