

Australian Tax Reforms: Past and Future

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Abstract

Tax reform is under consideration again in Australia following the Government's establishment of the Review of Australia's Future Tax System. This paper provides a broad survey of past reform and future opportunities in Australia. Over the past 25 years, Australian tax reform has been based on two main economic propositions – that taxes should fully fund general government expenditures over the economic cycle and that tax neutrality, through broader tax bases and lower rates, minimises adverse effects on economic efficiency. Equally, tax and transfer arrangements have continued to be based heavily on income, and on delivering steep progressivity. The intrinsic complexities and idiosyncrasies of the income base and progressive rates provide ongoing fertile ground for reform-minded policy attention. The consequences of heavily working this tax base underpin much of the review task – addressing high marginal tax rates, relatively high taxes on capital and saving relative to labour and current consumption, and ever-increasing complexity and compliance cost. The implications for tax design of a range of 21st century developments will also be considered. These include the long-run competitiveness of the Australian economy in a restructuring world economy, the threats and opportunities of technological innovation, and concerns about the performance of specific markets, such as for household savings, affordable housing and transport infrastructure. Taking a system-wide approach, with a renewed interest in simpler tax arrangements, the Future Tax System Review may well open a wider approach to tax reform than has hitherto been attempted in Australia.

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Australian Tax Reforms: Past and Future

Introduction

This paper provides a general survey of past tax reform and future reform opportunities in Australia.

Part 1 deals with the reforms of the past 25 years beginning in 1983¹. Part 2 looks forward from the establishment in 2008 of the Australian Government's Review of Australia's Future Tax System.

Tax reform is often usefully framed by axioms like efficiency, equity, adequacy and simplicity. But the conception and interpretation of these are always in flux as well as conflict. It is probably not possible to make much sense of them outside a clear and continually updated understanding of the emerging social and economic context.

Indeed, the history of tax reform is very much a history of struggle to respond to new circumstances – new skills or technologies, new roles of government, new awareness or conceptions of societal needs, and new forms of economic competition. For the most part, it is a struggle to catch up with wider social and economic changes that are well underway. I will attempt to give some flavour of this in the Australian case.

The presentation is structured mainly along thematic rather than chronological lines. It does not seek to define “tax reform” or to distinguish it from broader “tax change”. Public policies are always changed for the better in at least someone's mind. It is not unusual to see one tax change undo another, with both called reform in their time. In at least some cases, this is a perfectly sensible policy response to changing circumstances.

Part 1: The Past 25 Years

In 1983 Australia emerged from a severe global economic recession (exacerbated by local droughts) with a new appetite for social, political and economic change. Tax reforms beginning in the 1980s went hand in glove with wider economic and financial system reforms; all three were motivated by the depth of concern that Australia had lost its economic way and needed to become more adaptive and dynamic.

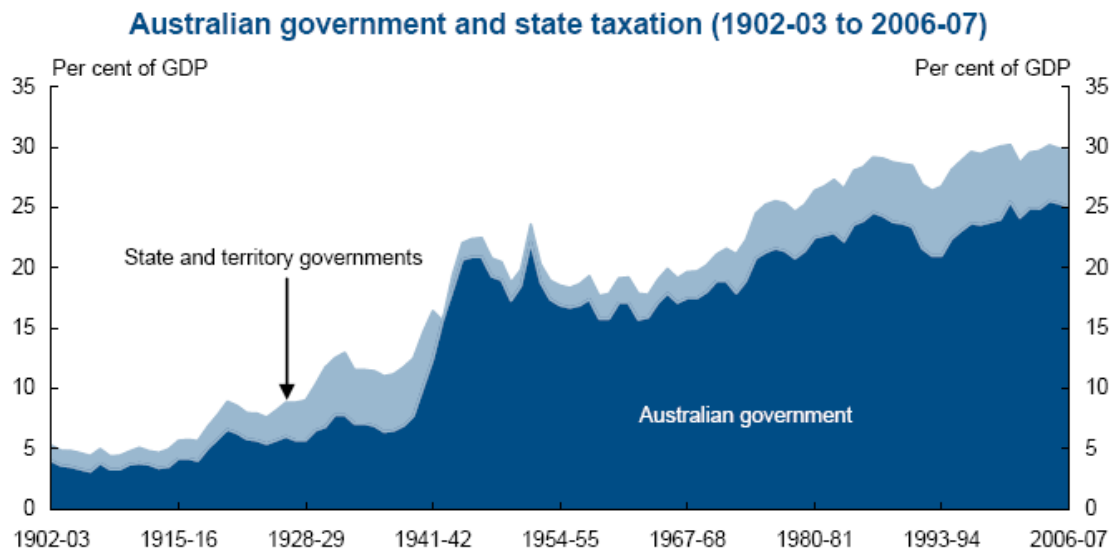
Reform directions had already been identified in blueprints drawn up by two major public studies – the Asprey Taxation Review 1975 and the Campbell Financial System Inquiry 1981. But

¹ 1983 marked the first year of the tax reforming Hawke-Keating Labor Governments, which were succeeded by the similarly reform-minded Howard Coalition Governments of 1996-2007.

neither of these works had prompted significant immediate action. That changed as the 1980s unfolded.

Earlier foundations

Australia's tax system like those of other developed countries was built over the course of the 20th century to meet the public revenue needs of major wars and the steadily expanding welfare state. In essence, by the latter part of the century this meant that the revenue yield of the tax system was ramped up several fold to about one third of GDP.



Source: Budget Papers; ABS (2008a); ABS (2007a).

But throughout this period, the Australian tax-transfer arrangements lacked two key features of the template that was established in nearly all other developed economies.

1. Australia had no universal social insurance scheme or associated social security taxes.
2. There was no broadly based consumption tax.

Instead, Australia relied overwhelmingly on the income tax, supported by a ramshackle range of narrowly based sales and transaction taxes. The burden of income tax is significantly moderated by Australia's extensive use of means tests on pensions and other cash benefits – as a result the Australian system exhibits a comparatively very low rate of tax-transfer 'churn' (that is, those who pay tax receive relatively little in cash benefits and those who receive cash benefits pay relatively little tax).

The political economy of reform

The Australian Constitution, formulated at a time of much smaller government, unintentionally and often through indirect means has resulted in a major imbalance between Commonwealth and State taxing and spending powers. Over the course of the 20th century as social spending increased the Commonwealth became financially dominant over the States.

The Constitution directly reserves duties of customs and excise to the Commonwealth, and this has been interpreted as preventing the States from imposing volumetric and other taxes based on sales of goods. Less directly, using other powers, since the Second World War the Commonwealth has also retained sole jurisdiction of the income tax. While both levels of government shared in the expansion of social spending², only the Commonwealth had access to the required large tax bases, on income and expenditure, to fund it.

Overwhelmingly then, the Australian tax system is determined by the Commonwealth. The Commonwealth is a bicameral parliamentary democracy. The executive arm is formed in, and effectively headed by a member of, the lower house. Elected every three years, it is rare for the executive party to have a majority in both houses. The delivery of economic and taxation reform is a leadership task mediated by these arrangements.

The result has been a peculiar political economy in which most reform has been pursued through either of two different pathways. Sometimes it has followed the traditional mode of deliberative analysis and persuasion, with proposals developed by reference to 'public interest' considerations, by expert bodies, using open consultative processes. Other times, the executive has used its bureaucratic advisers to develop behind-doors, in-house reform packages, akin to the semi-secretive budget formulation process. The resulting proposals each then take their chances through the political processes of the parliament, relying on these different sources of momentum. The former relies mainly on the good standing of the preceding deliberative process. The latter depends more on community acceptance of the need sometimes to allow governments a right to set a course and lead through difficult times or challenges.

As in any democratic system, the results are mixed. In Australia, the deliberative persuasion model began with the Asprey and Campbell reports. In 1985 a community tax summit was attempted (following an earlier 'economic summit' in 1983). In the late 1990s, the Business Tax Review committee chaired by John Ralph developed business tax proposals and following that a

² Generally, the Commonwealth provides most cash pensions and benefits. The States-Territories provide most direct public health (mainly hospitals), school education and welfare services.

standing Board of Taxation was established. The Board, in relatively contained spheres determined by Government, has undertaken a series of successful detailed policy reviews.

The ‘in house secret’ package approach featured in three main events. Following the perceived failure of the 1985 tax summit to deliver preferred reform (including a broadly based consumption tax), the Government prepared an alternative “Reform of the Australian Tax System” package. This brought a personal tax cut, capital gains tax, fringe benefits tax and full dividend imputation. In 1988 a second package was presented, having been developed almost entirely behind closed doors. It brought major reforms to company taxes (including base broadening and a large reduction in the tax rate to 39 percent) and a new approach to taxing occupational superannuation.

Perhaps the pinnacle of the secretive executive package approach was the development of the “New Tax System” including the GST in 1998. Although the Government signalled its intent to consider tax reforms, this package was developed in extraordinary secrecy and then launched immediately prior to calling an election. The political shock tactic worked and the resulting mandate for this reform was enough to carry most of it through to implementation in 2000.

The tax mix

Throughout, Australia has remained very loyal to the income tax.

When the GST was introduced in 2000, it primarily replaced other indirect taxes, and resulted in only a small net shift from direct to indirect taxes. In the 1970s, both Commonwealth and state governments abandoned estate and gift taxes, although property and property transfer taxes remain significant revenue sources for the States. Sustaining the central role of the income tax has involved much of the tax reform task of the past 25 years. In particular, there has been an active program of base broadening in relation both to labour and capital incomes. Tax avoidance and evasion have been tackled by a range of measures.

Particularly important have been the fringe benefits and capital gains taxes, both introduced in the mid 1980s.

The income tax provides about 70 per cent of the tax revenues of the national government. In addition, a general revenue payroll tax provides 26 percent of State-local tax revenues.

Business tax rates and base

Income tax collections from companies provide a relatively large share of total tax receipts in Australia – about 20 percent in 2007-08. This reflects a high share of company income in total

income, whereas the effective average tax rate on company income is fairly typical at around the average of other nations.

Effective tax rates have also been relatively stable over the past 25 years. This is despite the reduction in the statutory rate from 46 percent in the mid 1980s to 30 percent today. The effective rate has been maintained through imposing a more comprehensive tax base. The main changes have included:

- Tax on previously exempt activities (such as gold-mining) and foreign source income
- Capital gains taxes (for companies this is imposed on full nominal gains at statutory rates)
- Reduction of accelerated depreciation for most investment in plant and equipment (although depreciation arrangements have changed on several occasions, sometimes in response to the economic cycle).

In addition, company tax collections have likely benefited from stronger anti-avoidance provisions both of general (anti-scheme) and specific kinds. The latter have included thin capitalisation rules for inwards foreign investment in Australia, anti-dividend streaming provisions (and other transfer pricing and profit shifting measures), and tight rules preventing tax benefits for public infrastructure investment. In addition, the dividend imputation system has probably had 'integrity benefits' in favouring the recognition of profits in Australia rather than abroad.

The company tax base also retains generally longstanding provisions which are sometimes concessional and sometimes base broadening (relative to commercial measures of profits or many overseas tax bases). The main concessions are for certain classes of capital expenditure, particularly on industrial research and development, mining and petroleum resource exploration, some agri-businesses and film-making. Many of these have been the subject of regular reviews and 'reforms'.

Longstanding provisions that maintain a broad base include limited access to tax benefits for losses (company grouping was introduced in 1984, and fully consolidated assessment of company groups subsequently, but no loss carry-back provisions have been introduced); the absence of write-offs for purchased goodwill; and no deductions for general provisions for bad debts.

Over the past 25 years, Australia has paid considerable attention to strengthening the taxation arrangements for foreign source income, moving from a generally exempt treatment prior to the 1985 reforms to the foreign tax credit system. Strong anti-deferral rules were also introduced for passive investments made overseas. The new international tax arrangements often have been criticised as unduly complex and as standing in the way of Australian companies engaging internationally, or of Australia becoming an attractive place to base regional investments. Concessions have been made over more recent years to reduce the complexity and adverse effects of these provisions, notably following a review of international tax arrangements undertaken by the Treasury and Board of Taxation in 2003.

Personal income tax and transfers

Tax reforms have often set out to reduce personal tax rates. However, with largely unchanged revenue needs and with inflation continually raising the effective rates of tax on a progressive nominal system, the actual changes achieved over the last 25 years have in many respects remained modest. The basic scales currently applying are set out in the following table.

Personal Tax Scales

From July 2008		From July 2009		From July 2010	
Taxable income (\$)	Rate %	Taxable Income (\$)	Rate %	Taxable Income (\$)	Rate %
0 – 6,000	0	0 – 6,000	0	0 – 6,000	0
6001 – 34,000	15	6001 – 35,000	15	6001 – 37,000	15
34,001 – 80,000	30	35,001 – 80,000	30	37,001 – 80,000	30
80,001 – 180,000	40	80,001 – 180,000	38	80,001 – 180,000	37
180,001 +	45	180,001 +	45	180,001 +	45

Note: The medicare levy and low income tax offset are not reflected in this table. Source: Architecture of Australia's Tax and Transfer System, Australian Treasury, 2008

There has been clear progress on reducing the top personal tax rate. This was 60 percent in the early 1980s and is now 46.5 percent (including the Medicare levy). Moreover, the income level at which the top rate commences at \$180,000 is now over three times average earnings, about twice the level of the early 1980s.

In the 1985 tax reform, the top personal tax rate was aligned (at 49 percent) with the company tax rate. However, this alignment lasted only 2 years – such a high company tax rate proved unsustainable and the rate was reduced to 39 percent in the 1988 business tax reform (without a matching reduction in the personal tax rates).

It has proven more difficult to substantively reduce marginal tax rates on average incomes. For much of the period, Governments struggled to ensure that the 30 percent ‘standard’ rate applied at average earnings rather than one or other of the higher rates. This was a particular goal of the 1980s reforms and adjustments in the 1990s, but in reality it has not been fully sustained.

With the introduction of the GST, income tax rates were cut but of course the GST imposed some additional tax at the time income is spent. Also, the tax scale has been considerably complicated by the increasing use of the low income tax offset (LITO), similar offset devices for pensioners, and the means tested family tax benefit system.

The LITO has the effect of increasing the tax free threshold to \$14,000. This threshold is very similar to that which applied in 1985 – around 23 percent of average full, ordinary-time earnings. However, the LITO (like many other offsets and benefits) is withdrawn as incomes rise, and this effectively increases the marginal tax rate. The effective marginal tax rate for singles on average earnings is thus 35.5 percent, and it is higher again for seniors and for many with families.

Another key theme of personal tax reform has been the broadening of the tax base. The 1985 reform abolished tax deductions for business entertainment and introduced a comprehensive fringe benefits tax imposed on employers at the top personal tax rate. Fringe benefits in excess of a \$1000 threshold are now also separately calculated for each employee and included in income measures for means tests. Capital gains tax was also introduced, initially on a base indexed for inflation but subsequently on a nominal base reduced by a flat 50 percent.

One further important factor in the history of the personal tax system has been the increasing emphasis given to family assistance. The tax unit has long been individual rather than family based (although in contrast most means tests operate on family income) and assistance for children shifted from a predominantly tax to a transfer basis from the 1970s. The levels of this assistance have increased considerably, with three major programs – for dependent children,

for single income families and for child care³. In addition, a cash 'baby bonus' was introduced by the Howard Government (at \$5000 it has been means tested by the Rudd Government).

Family assistance is means tested on a family income basis – its payment reduces effective average tax rates but increases (typically by 20 or 30 percentage points) effective marginal tax rates over significant income ranges. For families, effective marginal tax rates very often exceed 50 percent.

Entities and integration

Until 1987, Australia had a classical system of company taxation, with company income taxed at the company level and then taxed again when paid as dividends to shareholders. With personal tax rates as high as 60 percent, and a company tax rate of 46 percent, not surprisingly this generated many problems, and some equally problematic attempts to legislate to overcome them.

Dividend imputation was introduced in 1987 along with alignment of the company and top personal tax rates. Dividends are franked with credits only to the extent that Australian company tax is paid.

Dividend imputation has survived since 1987 but the alignment of tax rates has not. International competitiveness pressures very quickly saw the company tax rate falling, with the first change to 39 percent coming as early as 1989. Subsequently, further reductions have reduced the rate to its present level of 30 percent.

Many of the pressures on the original system continue today. The three main forms of entity – partnership, trust and company – each have their own tax features. Partnerships and trusts generally are pass-through entities for income, while companies are not. On the other hand, only partnerships can pass through net tax losses, while trusts and companies cannot. Imputation credits apply only for Australian company tax payments and fully benefit only Australian resident shareholders, generating a new range of arbitrage difficulties.

Retirement income policy

Australia introduced a national age pension in 1909. Subsequently, as income taxes developed policy also supported occupational superannuation schemes through income tax concessions. However, the provision of superannuation benefits was essentially an employer prerogative covering only a minority of employees.

³ Maximum payments for young children are \$4,631 per child, reducing to \$1,945 for those on middle incomes.

In the 1980s, three concerns separately emerged - about the adequacy of the age pension as a retirement income, about the need to restrain nominal wage growth, and about the low apparent level of national savings. Almost by accident, the development of occupational superannuation arrangements emerged as a key policy response to all three concerns.

The longstanding tax concessions for lump sum superannuation benefits were targeted in policy reforms adopted by the new Hawke Government in 1983. This led to trade union objections, and in subsequent consultations superannuation emerged as a policy instrument of renewed interest to both the Government and trade unions, who were closely coordinating policies through a series of “prices and incomes accords”. Occupational superannuation was extended through awards to nearly all employees. It was seen as a way of improving retirement incomes, of increasing national savings, and as supporting nominal wage restraint (in the then largely centralised wage setting processes).

Subsequent reforms to superannuation arrangements have essentially built on these initial directions. The Government introduced a tax-based arrangement (termed the ‘superannuation guarantee’) to better enforce employer contributions and to increase them to 9 percent of wages. Through several steps the tax treatment of superannuation also changed. A flat rate of 15 percent tax was applied in 1988 to the income of superannuation funds (including contributions received). This tax brought with it entitlement to dividend imputation credits, strengthening the economic impact of that scheme. Initially, the tax on funds was offset by equivalent reductions in tax on superannuation benefits, but in 2007 the complexity of these arrangements was overcome by abolishing tax on superannuation benefits taken by those aged 60 or more.

Australia is said now to have a three pillar retirement income system. The first pillar is a means tested age pension as a universal minimum income safety net. The second pillar is a compulsory contributory scheme based on employee earnings. The third pillar is tax-advantaged voluntary saving which is also delivered through superannuation funds.

While the volume of superannuation saving has grown rapidly since the superannuation guarantee was introduced, the scheme has not to date resulted in any noticeable change in Australia’s aggregate national or household savings rates. On the other hand, substantially improved retirement incomes are projected for most Australians as the scheme matures. The age pension alone would deliver an expenditure replacement rate in retirement of about 35 percent of pre-retirement expenditure for persons on average earnings, but when fully mature, the SG combined with continuing part pension delivers nearly double this (Future Tax System Review, 2008b).

Sectoral Policies

Throughout the past 25 years there have been a considerable number of tax changes directed at particular industries. These are often criticised as adding to tax system complexity, although it is a moot point whether that complexity is any greater than would apply to alternative sectoral policy instruments, or whether such alternatives would work as effectively in other ways.

Among the more notable matters addressed in the period have been:

- Offshore petroleum resources. A resource rent tax was introduced in the 1980s to provide a more economically efficient secondary resource tax than royalties (which still exist for most other natural resource extraction industries).
- Residential real estate. Amortisation deductions for construction costs were introduced in the 1980s, but in addition a brief experiment in limiting access to loss deductions (termed 'negative gearing') was attempted in the 1987-89 period.
- Offshore banking units (OBUs) and venture capital. A range of tax concessions including a 10 percent tax rate on OBU profits were introduced in the early 1990s. Australian tax policies have displayed considerable ambiguities over the years in approaches to financial system development –sometimes offering concessions while also adopting demanding general rules, particularly for offshore investment.
- Business Tax Expenditures: Australia annually publishes a statement of tax expenditures (now required under the Charter of Budget Honesty Act). Sectoral business examples include concessions for small business, film production, agriculture and forestry investment schemes, infrastructure investments (now generally abolished), and research and development (most recently both a 125% deduction for expenditures and a premium deduction of 175% for increasing expenditure).

Indirect and State taxes

Until 2000, Australia imposed wholesale sales taxes at a range of different rates on a large but incomplete range of goods. Like other single stage taxes this had relatively low administrative and compliance costs, but produced economically inefficient cascading effects on prices including exports and import-competing products. Economic costs were increased by the high rates made necessary by the narrow base, the omission of the retail margin from the tax base, and the exclusion of services more generally. The long-run structural shift in the economy from taxable goods to untaxed services meant that revenue was not robust.

The wholesale sales tax was replaced in 2000 by a single rate, 10 percent goods and services tax (GST) on the value added tax model. The base is broad although there are several exclusions, for certain basic foodstuffs, water, and health and education services. Financial services generally are input taxed.

The GST also replaced some inefficient state taxes and was offset by reductions in some other indirect taxes (including fuel and gambling taxes). Thus it was mainly introduced as an indirect tax reform. Its total revenues exceeded that of the taxes it replaced and this allowed for two further types of policy adjustment:

- A modest reduction in personal income taxes; and
- Compensation payments for various low income earners and, for first home-buyers, for the net price effects of the GST on housing.

A range of secondary, specific indirect taxes continue to provide substantial revenues. At the national level excises (or near substitutes) are imposed on road and aviation fuels, tobacco products, alcoholic beverages and the value above a threshold of higher priced motor cars. In most cases these are general revenue taxes, with the main exception being the fuel tax paid by large trucks which is a de facto road user charge. There are also a range of minor taxes – some hypothecated commodity taxes used for joint industry purposes, some remaining customs duties (although industry protection through protective tariffs has been greatly reduced) and some environmental taxes such as the aircraft noise and product stewardship for oil levies. Each of these taxes has been subject to reviews and reforms over the past 25 years, but few that have greatly changed their basic form or incidence.

The Australian Constitution reserves excises to the Commonwealth and High Court decisions have resulted in the States losing access to fuel, tobacco and alcohol licensing charges (which had been linked to sales). The States have retained taxes only on payrolls, property, and a range of stamp duties or like instruments. The duties on some financial products (notably insurance) and on conveyances have grown in revenue significance, and with that in their likely distorting economic effects. Apart from recent efforts to harmonise tax bases and other administrative arrangements (and the abolition of some financial taxes with the introduction of the GST), there has been little substantive reform attempted in relation to these State taxes.

Administration and compliance

Early in the 1980s, apparently widespread tax avoidance and evasion were central concerns of Government. Australia had experienced serious tax evasion in the 1970s and this undermined

public trust in the tax system. Radical changes in tax law emerged from these concerns – including retrospective measures to recover the gains from “bottom of the harbour” schemes, the enactment of new general anti-avoidance provisions targeting “tax schemes”, and the introduction of new tax withholding requirements on contractor payments in prescribed industries.

But none of these were ultimately as important as the decision later in the 1980s to shift to a “self assessment” system. This change shifted much of the compliance obligation to “get it right” from the tax authorities to taxpayers. The Tax Office resources previously used to make binding assessments were shifted in large part to alternative compliance enforcement strategies. This set in train a long series of changes in the relationship between tax authorities and taxpayers.

The key features of this change included:

- An increase in real and perceived costs and risks for taxpayers, occasionally balanced by reforms aimed at reducing these costs and uncertainties
- An increased demand for the Tax Office to clarify requirements – leading to the evolution of large-scale arrangements for both public and private rulings, massively increasing the volume of written tax guidance (and with that the perceived complexity of tax laws)
- The development of large scale audit and compliance programs, particularly directed at larger businesses and high-wealth individuals

In parallel with these changes, the tax system became ever more complex. There were many drivers of these trends, including the problems of tax law drafting in the context of sometimes literalist court interpretations, and the intrinsic compounding problems of increasing policy complexity and multiple objectives. Arguably, too much weight has also been placed on the precision of income and other tax base measurements. Policy architecture itself played a key part, with politicians often showing very little interest in the problems of compounding complexity.

Part 2: Australia’s Future Tax System Review

The Australian Government announced a comprehensive review of the tax and transfer systems in the May 2008 Budget speech. The Review is being conducted by a panel of five members⁴ supported by a secretariat based in the Treasury. The terms of reference are wide although

⁴ Panelists: Ken Henry, Jeff Harmer, John Piggott, Heather Ridout, Greg Smith

there are two main exclusions, relating to the GST rate and base and the tax treatment of most superannuation benefits. The main report is due in December 2009, but an earlier report on the retirement income system will be provided in March 2009 (ahead of anticipated consideration of pension policies).

Political Economy

A review of the tax system was one of many recommendations emerging from a community summit held in Australia in April 2008. The “Australia 2020 summit” was convened by the incoming Rudd Labor Government to harness ideas from a wide cross-section of the community for Australia’s longer term public policy goals. The ‘economic stream’ at the summit called for Australia to aspire to a position in the top 5 in world per capita income by 2020, and a review of tax policy was seen as one of many requirements to deliver that outcome.

The Review was announced shortly after the summit. The inclusion of transfers in its terms of reference in part reflected the increasing integration of the tax and transfer systems and partly a separately emerging debate about the adequacy of pensions. The Government has also established a review of the adequacy of the age, carer and disability support pensions, and this is being conducted separately by a member (Jeff Harmer) of the broader tax-transfer Review.

The scope of the Review is very wide-ranging. As such it is more akin to the large scale Asprey and Campbell reviews rather than the narrower assessments that underpinned the development of specific reform packages undertaken over the past 25 years.

However, the review process is an unusual amalgam of the two approaches to the delivery of reform proposals outlined in Part 1 of this paper. The review panel has members both internal and external to the Government’s advising departments; it is chaired by the Treasury Secretary (Ken Henry) and includes the Secretary of the Department of Families, Housing, Community Services and Indigenous Affairs (Jeff Harmer). The other three members are independently engaged. While the Review is consulting widely on issues and broad options, and is releasing discussion papers and commissioned studies, its final recommendations and reports will be developed *in camera* and provided directly to Government.

The review of Australia’s Future Tax System is still at a relatively early stage. It is currently pursuing research and consultations on the basis of two consultation papers issued in December 2008 – one addressing the whole tax-transfer system and the other the retirement income system (Australia’s Future Tax System Review 2008 (a) and (b) respectively). The Government has requested a report on retirement incomes separately by March so that it can give early consideration to the pension adequacy issue.

Over the next six months or so the Review will conduct detailed consultations on issues, receive and publish the results of commissioned studies, and convene a policy conference in mid-year. It will then develop its findings and prepare its main report by December.

In this context, it is too early to predict outcomes and the following presents just one view of some of the issues that are likely to be covered.

The legacies of past reform

As described in Part 1, Australia has pursued an extensive tax (and transfer) reform agenda over the past quarter century, and on that foundation it is perhaps surprising that a comprehensive review is thought necessary at this time. However, there are many features of the tax and transfer systems that have been left substantially untouched by past reform. It is also arguable that some aspects of reform should be revisited in the light of experience and in the context of the new pressures or opportunities presenting in the 21st century.

Among the many legacies of past reform are the following continuing features of the system:

- There has been no substantive change in the aggregate tax burden. Commonwealth tax revenues have been around 26% of GDP throughout the period while the State-local sectors collect a further 6 percent of GDP.
- There has been no substantive shift from income to consumption tax. The introduction of the GST increased indirect taxes only from 21% to 25% of Commonwealth revenues. Other aspects of the Commonwealth indirect tax base have been subject to erosion – customs duties have fallen with the continuing shift away from protective tariffs and tobacco, alcohol and fuel excise bases have declined relative to total consumption.
- Income taxes, including capital gains taxes, continue to be considerably distorted by the effects of inflation, and by the effects of longstanding non-neutralities arising from features such as the admixture of accruals and realisations bases for the assessment, the capital-income distinction and international issues.
- There has been no improvement, and probably considerable decline, in overall tax system operating efficiency, and substantial erosion of simplicity, transparency, and certainty. This is equally true of the transfer system, particularly its complex array of means testing provisions which for many operate in parallel with income tax obligations.
- High reliance on capital taxes relative to labour taxes has continued, with strong growth in company tax collections associated with the economic fortunes of a long expansion devoted largely to personal tax cuts.
- No meaningful steps have been taken to reform state taxes or to fix jurisdictional imbalances in tax assignment.

- A number of sectoral areas have arguably been neglected and now show signs of stress or of missed opportunities. In particular, there are problems in the way that markets for transport and other public infrastructure, and housing, have developed (or not developed).

Until the recent world financial and economic difficulties, with strengthening terms of trade Australia has enjoyed a very long and strong growth experience, both absolutely and relative to OECD peers. The issues noted above have not been particularly pressing in that context. However, the new and more challenging circumstances that lie ahead, assuming they largely reflect longer term structural trends and conditions, may expose some of the weaker spots in the Australian policy fabric. This may require that Australia more assiduously seek to optimise its tax-transfer arrangements, particularly to maintain the high rate of private investment and per capita growth that most Australians aspire to and depend upon – and which may be essential for dealing effectively with the challenges of population ageing, climate change and a range of international pressures.

The potential weak spots that have steadily emerged over the past few decades, while often contested, may include:

- the substantial shortfall in national savings relative to investment, reflecting in substantial and increasing net international indebtedness;
- a very large increase in household indebtedness;
- a significant decline in housing affordability;
- significant shortfalls and inefficiencies in social and economic infrastructure investment;
- pressures on Australia's attractiveness for foreign direct investment particularly as the terms of trade return to longer term trends; and
- weaknesses in the performance and outcomes of federal arrangements.

These issues generally have many sources other than the tax transfer system alone. However, they combine to demand more of the tax-transfer system – to improve its social and economic outcomes and to reduce its burden as an administrative and compliance system.

Some of the main issues that are being considered in the Future Tax System Review are discussed briefly in the following sections. At the time of writing, however, the Review panel has not formed any conclusions or made any recommendations about specific reform issues.

Reducing the aggregate tax burden

The terms of reference for the Review require that no assumption of smaller government be made but it is left unstated whether this is to be interpreted in absolute or relative terms. It would be possible for the aggregate tax burden to fall while the absolute size of government expenditures is sustained or continues to grow – provided that the aggregate economy (and hence tax bases) grows faster than the rate of government spending. The tax to GDP ratio would then fall over time.

The particular appeal of this observation is that there may be tax structures and arrangements that promote faster economic growth without reducing revenue adequacy. OECD surveys of this issue point strongly to the view that faster economic growth is associated with lower shares of capital taxation in the overall revenue mix, although the same studies caution about the application of this cross-country finding to policies in any individual country (Arnold, 2008).

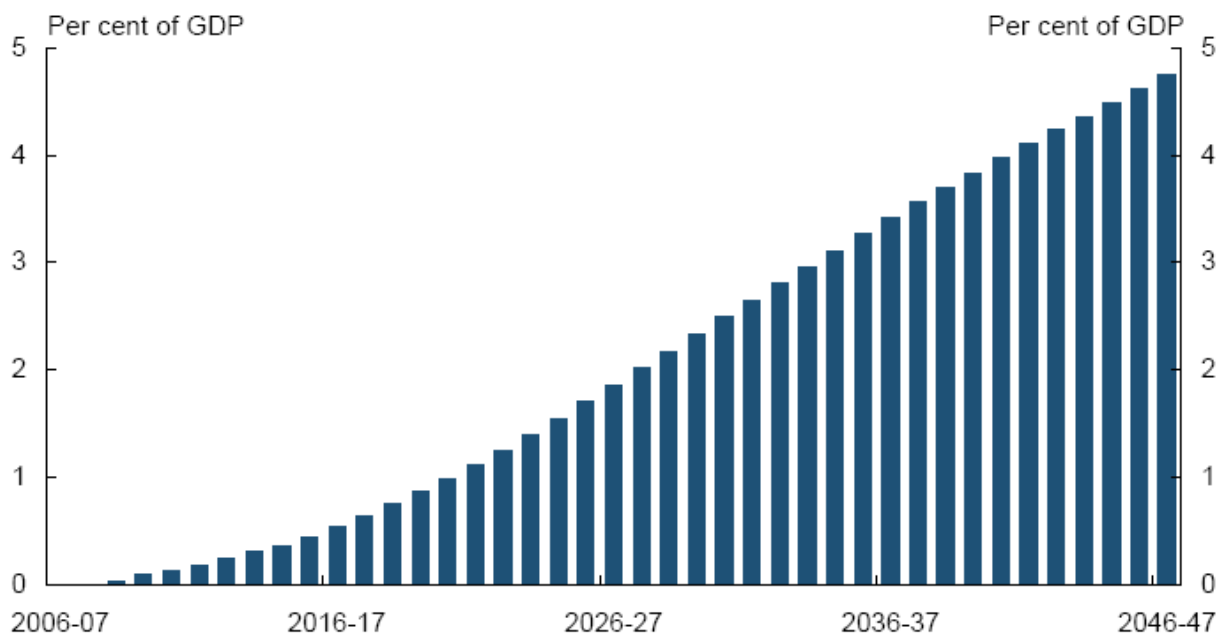
Securing adequate long term revenues

The idea that economic growth could be faster than growth in government spending confronts the evidence of intergenerational studies. The Australian Government has now published two “Intergenerational Reports”, most recently in 2007 (Costello, 2007). These studies show that on current demographic trends and policies, aggregate national government spending likely will increase considerably as a share of GDP.

The following chart shows the latest projected increases in Australian Government spending over the long term, expressed as a share of GDP. There is, of course, considerable uncertainty surrounding projections of this kind. However, it should also be noted that these figures do not include State and local sector spending increases in related areas such as disability services. The main drivers of the increases facing the Commonwealth are:

- Population ageing; and
- Trends in health spending (particularly pharmaceuticals)

Projected Increase in Australian Government Spending



Source: Intergenerational Report 2007

Business taxation – form, base, and rates

After mixed results from past rounds of business tax reform, considerable ground remains for reconsideration of business taxes in the present Review. As noted above, a key driver is evidence that capital taxation is associated with lower economic growth. A specific key driver is the desire to sustain international economic competitiveness.

At the broadest level, there are three interconnected issues.

First, what is the appropriate tax base? In particular, the Review is interested to consider the relative merits of income and expenditure (or cash-flow) tax bases. Even if an income base is retained, it is clear that most countries have substantial concessions for physical investment. Moreover, there are large parts of investment spending (particularly relating to intangibles) that are already expensed, raising tax neutrality questions.

Second, what is the appropriate statutory tax rate? The statutory rate particularly affects marginal decisions and issues like profit shifting. Debate on this issue has long focused on international comparisons – not necessarily very helpful given the wide range of rates in place.

Some look at international averages: Australia appears to have a rate that is slightly above the unweighted average of OECD countries but below if rates are weighted by economic size⁵.

Third, what tax should apply to distributions of profits? Most company tax systems have moved away from imputation arrangements. A particular point of stress arises in the treatment of the increasingly international operations of companies which reduces franking capacity.

These issues are closely interconnected with one another. In addition they are connected with the design of the personal tax system. Increasingly the common pattern internationally is to set the rate of company tax below the top personal tax rate and to give partial relief, but not imputation, for dividends. The income (rather than expenditure) base is retained in most countries, but with considerable diversity in the detailed specifications of the base.

Australia's Review will look closely at these issues. In doing so, it will be necessary to have regard to international policy settings and tax treaties, and of course Australian choices potentially may have particular relevance in New Zealand and to the Australia-New Zealand economic relationship.

Delivering radical simplification

Radical simplification of tax and transfer systems is probably only possible in the context of a very wide-ranging review of the kind now underway.

Simplification of the tax transfer system could serve three main purposes – to reduce the resource costs of administration, compliance and business and financial planning; to improve transparency and hence political understanding of the system; and to reduce risk and uncertainty for taxpayers and transfer recipients.

There are many drivers of complexity. The Australian system is thought to be among the most complex in the world, and perhaps the main reason for this is the very heavy, comprehensive, multiplicative and precise roles in Australia given to income assessment. In part, this reflects the exceptional political focus in Australia on vertical equity questions, even to the point that many horizontal equity measures have vertical equity rules (means tests) imposed upon them. It also reflects the complex objectives and ad hoc development of the various separate elements of the system. In practice, also, income has proven to be a very slippery concept.

⁵ Simple OECD averages give undue weight to the large number of small European members. Weighting by economic size increases average tax rate measures because statutory company tax rates at combined levels of government in the largest OECD economies, the US and Japan, are relatively high, both exceeding 30 percent.

Reflecting the ‘root and branch’ ambitions of the review, the question arises as to whether radical simplification is possible. Any approach to this has to have very strong regard to the three purposes of simplification. It is not desirable to pursue simplification options that merely achieve one purpose at the expense of others. For example, new technologies might mean that complex taxes could be assessed and collected by tax collecting agencies without much direct work or involvement from taxpayers – but this might mean that the lack of transparency and taxpayer risks are even worse, and that administrative costs are higher.

For individuals and households, the Review is looking at the issues from the principal viewpoint of ‘client experience’. In doing so, however, the preferred approach is to look at issues as part of the overall assessment of the system rather than to treat it only as a distinct line of work. This aims at ensuring that all of the ‘moving parts’ of the system are considered in the simplification context. In considering the income base, for example, questions that need to be considered include whether a single base could serve all taxes and transfers, and whether some parts of the system would work better with simplified schedular arrangements rather than the current comprehensive approach.

The complexity of business taxes is also likely to demand considerable further work for the review. Again, a holistic approach is intended, with answers dependent on fundamental questions including the role of capital taxes in the overall system.

The federation

The Australian federation provides a further range of unique issues. The Australian arrangements are characterised by unusually high levels of both vertical fiscal imbalance and horizontal fiscal equalisation. One of the key effects has been that the States and Territories heavily work some of the few tax bases that they have retained – Australia has high rates of general revenue payroll, insurance and property conveyance taxes. The application of high tax rates on these bases is widely criticised as causing considerable economic inefficiencies.

Some of the more distorting State taxes were abolished as part of the new federal arrangements introduced with the GST in 2000. At issue is whether further progress could be made in addressing the fundamental problems with the revenue bases of the States (and local government, which relies heavily on property based revenues).

Addressing environmental, infrastructure and housing affordability issues?

One approach to tax reform is to focus on core principles and to make changes that move policy towards ‘first best’ economic neutrality outcomes. In practice, however, the application of core principles to tax systems confronts two broad types of constraint:

- Some areas of economic activity are characterised by severe market failure and in these cases there may be a case for designing taxes that seek to correct (not necessarily perfectly) for the failures. The environment provides many case studies, with significant external costs or benefits adversely affecting market performance.
- Another constraint is that the neutrality of taxes, particularly income taxes, is often particularly elusive, for political or practical reasons. For example, no real-world income tax has neutral impacts on housing markets, and none perform neutrally in the presence of inflation. In this setting, the pursuit of first best policies may not always assure first best results.

Compared with tax reform over the past 25 years, tax design in the 21st century may have to take greater account of these constraints and the problems they generate.

In relation to the first, the main current development in Australia is the response to the greenhouse gas problem. The core approach is an emission trading reduction scheme, using the cap-and-trade mechanism. This approach has implications for other areas of tax policy, including petroleum fuel taxes. In addition, other tax issues also arise in relation to the sourcing of fuels, the encouragement of energy conservation measures, or of other ‘carbon’ pollution reducing technologies.

The second constraint also suggests that a more flexible ‘problem response’ approach to tax design may be needed. The nominal income tax appears to work comparatively poorly in relation to certain long term investments including infrastructure and housing. Part of the problem is that a significant part of the return on these investments is capital growth which is not taxed unless and until realisation, while nominal interest deductions are allowed. A further problem is that housing and many infrastructure markets are characterised by a mixture of taxed and untaxed arrangements, leading to a range of distortions.

It is not certain what part tax arrangements play, but significant problems are now presented in both infrastructure and housing markets in Australia. There are apparent shortages of supply relative to demand in each case. Infrastructure bottlenecks exist in several sectors, and housing affordability has deteriorated considerably. The present Review will be looking at areas such as these to see what part, if any, tax reforms could play in delivering better outcomes.

In the case of housing affordability, transfers also play a significant part – rent assistance is provided in a range of forms, separately for private and public tenants, and first home buyers obtain both grants and transfer tax concessions.

Retirement incomes

The development of Australia's three-pillar retirement income system over the past 25 years leaves several key issues for consideration. The most significant of these relate to adequacy and fiscal affordability.

The adequacy issue relates to three main concerns.

- First, compulsory superannuation obligations apply only to employees. There is a question whether arrangements of some kind should be extended to the self-employed.
- Second, the notion of retirement income adequacy is based on current policies for public and private consumption. In the future, public consumption spending on health and welfare is projected to grow very rapidly. There is a question whether retirement incomes (or some alternative arrangement) should be sufficient to contribute to that increased cost.
- Third, just as the share of the population of retirement age increases, community expectations for retirement living standards is also increasing. In addition, life expectancies continue to rise, and greater longevity means that retirement savings must service a longer period of retirement. These raise the question as to the adequacy of the age pension and of superannuation saving based on the 9 percent of earnings benchmark. They also raise issues about the forms of retirement income provision that are made available (or perhaps encouraged or mandated).

The affordability issue is also critical. Policy changes over recent years have generally raised fiscal costs. Superannuation has a high tax expenditure cost relative to an income tax benchmark, and the decision to exempt final benefits completely further raised this cost. The Senior Australians Tax Offset effectively raised the tax free threshold for retirees to very high levels. Age pensions have been increased, and means tests softened, with the income taper rate reduced from 50 to 40 per cent (although inflation and other factors have substantially changed the role of assets tests as well). The income test applying to superannuation savings is unusually concessional, with much of the measure of income derived from superannuation balances excluded from assessment.

The future cost of the age pension and of superannuation tax concessions will continue to grow as a share of GDP and in addition projected expenditures on health and welfare costs of the aged will also grow considerably.

The adequacy and affordability issues combine to raise questions about the need for further reform of retirement arrangements. A wide range of parameters could be adjusted to achieve better and more sustainable outcomes. These include the population coverage of the superannuation guarantee, its rate, its taxation arrangements, retirement ages, interaction with the age pension and options for better dealing with health, welfare and longevity costs.

Again, comprehensive review is necessary with an emphasis on looking at the ways in which the tax and transfer elements of the system are integrated, and at the ways in which retirees (and those saving for retirement) actually experience and respond to the system as a whole.

Tax-transfers based on equity, progressivity and work incentive

The Australian tax and transfer systems have evolved complex interactions – complex both to administer and comply with and in their effects on household incentives. The income tax is based on the individual as the unit, but family assistance and some tax provisions have adopted a family (couple) basis, and the family has long been the unit for setting and means testing social assistance payments. The tax scales are no longer a reliable guide to effective marginal tax rates, because a range of tax offsets are effectively means tested as well – clawed back as incomes increase. Such offsets are now more important than the tax scales in delivering tax-free thresholds.

As a result, effective marginal tax rates in the tax-transfer system are both high and complicated, and look very little like a standard progressive structure for many household types. Notwithstanding this, average effective tax rates remain classically progressive.

There is concern that these arrangements have adverse impacts on workforce participation. Similarly, there are considerable issues relating to incentives for saving (for example, effective marginal tax rates for retirement saving often exceed 50 percent).

This raises several potential reform questions:

- Should the tax and transfer systems be fully integrated, administratively and in the measures of income that they use for various purposes?
- Should the current mix of individual and family units for assessing different aspects of the system be retained, or would a family basis (perhaps optionally) serve better across the board.
- Do high effective marginal tax rates matter and if so how can or should they be reduced or smoothed?

- Is there scope (or net benefits) for flat (marginal) rate taxation over considerable ranges, with progressive allowances, given the absence already for many households of a progressive effective marginal rate scale?

Concluding Comments

Comprehensive policy reviews are worth doing if they open possibilities for beneficial change that incremental processes cannot deliver.

They might do this in a number of ways – improving understanding of the challenges facing the economy and society; renewing the system-wide vision so that program objectives are clarified and better aligned; reconciling or balancing competing interests through being able to adjust more moving parts; and lengthening policy time horizons to increase focus on investment in critical structural requirements.

While the present review is at an early stage, it is certainly the goal of the Panel to contribute in each of these ways. Of course, whether and when such a review ultimately produces any of these results depends both on how well it is done and on the future priorities and circumstances of government.

Circumstances have clearly changed substantially since the Review was first proposed and announced. Financial, economic and fiscal conditions are now much more challenging. Yet Australia and New Zealand have relatively strong track records in pursuing major structural reforms in the aftermath of adverse economic times – perhaps a defining feature of Antipodean political economy over much of the last 25 years.

So while circumstances have changed, there does not appear to be any diminution of the motive forces that led to the establishment of the Review, or of interest in genuine reform. In that setting, we are looking forward to a very interesting and exciting year.

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