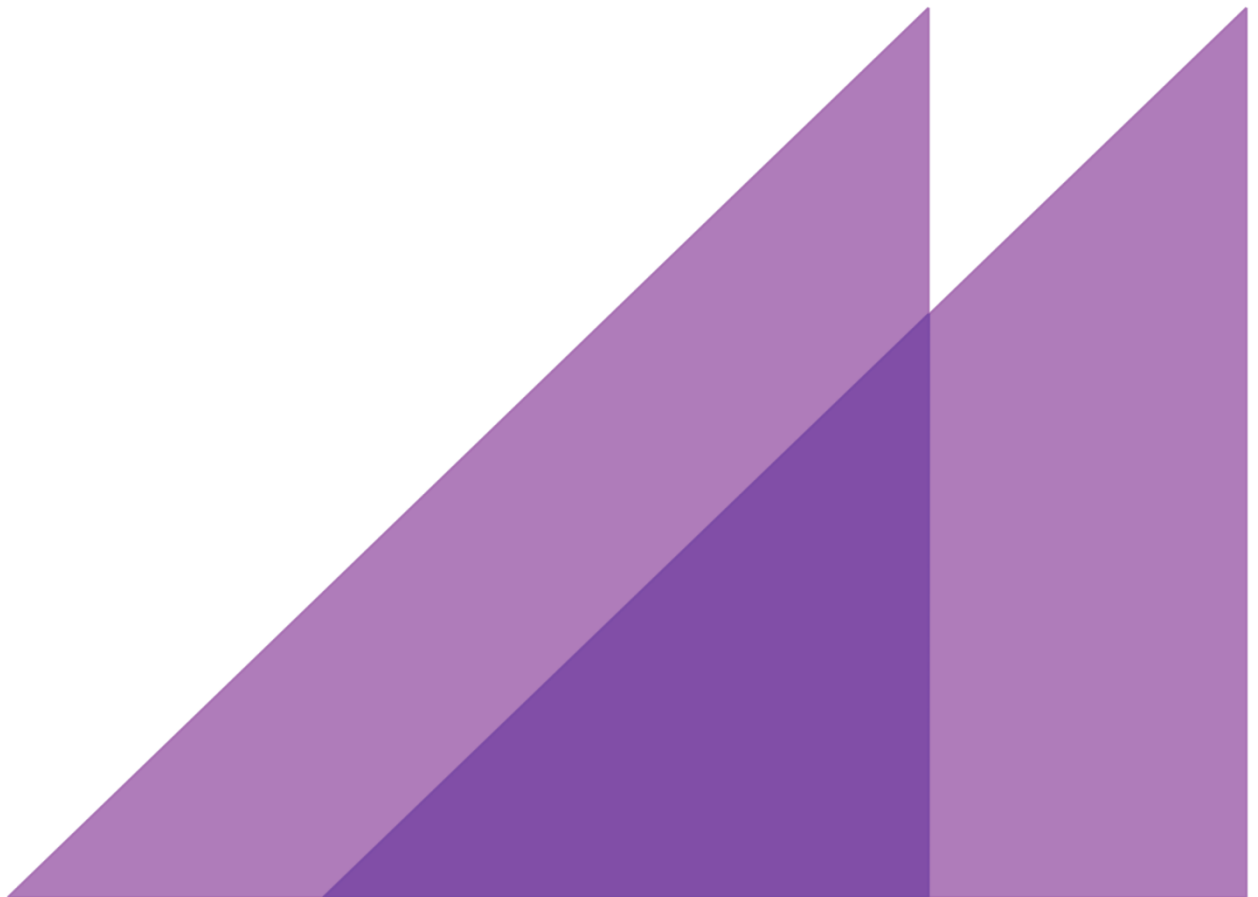


REPORT TO
PROPERTY COUNCIL OF AUSTRALIA

1 MAY 2015

MODERNISING AUSTRALIA'S TAX SYSTEM





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Acronyms

ABS	Australian Bureau of Statistics
ACT	Australia Capital Territory
ANTS	A New Tax System
ATO	Australian Taxation Office
BCA	Business Council of Australia
CGC	Commonwealth Grants Commission
CGT	Capital Gains Tax
CIE	Centre for International Economics
COAG	Council of Australian Governments
CTA	Corporate Tax Association
CV	Coefficient of Variation
FDI	Foreign Direct Investment
GCI	Global Competitive Index
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GST	Goods and Services Tax
HFE	Horizontal Fiscal Equity
MEB	Marginal Excess Burden
NCP	National Competition Policy
NSW	New South Wales
NT	Northern Territory
OECD	Organisation for Economic Co-operation and Development
PC	Productivity Commission
QLD	Queensland
R&D	Research and Development
SA	South Australia
TAS	Tasmania
UK	United Kingdom
Vic	Victoria
WA	Western Australia
WEF	World Economic Forum
WST	Wholesale Sales Tax

Executive summary

The need for substantive and strategic tax reform is an issue of increasing importance. Escalating global competition, an ageing population and Australia's weakening terms of trade are eroding productivity and living standards. A competitive tax system is critical to meeting these challenges and capturing opportunities.

In addition, an assessment of Australia's existing taxes against 'good' tax policy principles highlight that few are efficient, simple, transparent and equitable. This reliance on inefficient taxes is holding back the economy and national productivity. It is not addressing Australia's economic challenges nor meeting the market opportunities.

Improving the structure of the tax system by replacing inefficient taxes with a suite of efficient taxes will assist with streamlining administration, restore the integrity of the tax system, reduce its complexity and business compliance costs, and drive additional economic growth.

The upcoming Commonwealth Government tax review provides an opportunity to reinvigorate the debate in light of pressing needs and the Government's recent announcement of their intention to deal with the inefficient legacy issues of Australia's tax system.

A tax system should be efficient, equitable, simple, competitive, and stable, and ensure adequate revenues are collected in order to meet the needs and expectations of the community. This report seeks to bridge the gap between the recognised need for tax reform and the actual commitment to change by showing that Australia would be better off with a better taxes.

What is the current state of Australia's taxation system?

The Commonwealth raised \$338.4 billion in taxation revenues in 2012-13. The main sources of revenue were personal income tax, company income tax and the goods and services tax (GST). Together, these taxes account for around 85 per cent of the Commonwealth's taxation revenues.

State and territory tax revenue collected in 2012-13 totalled \$63.5 billion. In contrast to the Commonwealth where the majority of revenues are raised from only a handful of bases, state/territory governments raise their taxes from a variety of sources.

There are a myriad of state/territory taxes. The main categories of state/territory taxation include: property, payroll, financial and capital transactions, insurance, the provision of goods and services (excise and levies, gambling), use of goods and performance of activities (e.g. motor vehicle registration) and franchises. Each state/territory tax is unique in terms of its coverage (i.e. tax base), marginal tax rate/s and amount of revenue it generates. These different design characteristics make the tax system complex for those businesses operating in different jurisdictions.

There is an over-reliance on property taxes by state/territory governments. In 2012-13, state/territory taxes on property made up around 34.1 per cent of the total tax revenue of state/territory and local governments.¹ In addition, the property sector contributes to Commonwealth taxation revenues through company taxation, personal income tax, the GST and other taxes.

The property sector is one of the most heavily taxed sectors of the Australian economy, paying proportionately higher taxes than other sectors. ACIL Allen Consulting (2015) found that non-residential building construction is the most heavily taxed sector, with an average total tax burden of 39.7 per cent and the residential building construction being the third most heavily taxed sector among Australia's largest sectors (those with value added higher than \$10 billion), with an average total tax burden of 33.1 per cent of the value of output.² This compares with an economy-wide average of 21.0 per cent.

The taxes paid by the property sector are needlessly inefficient and complex. Taxes on commercial property stall transactions, needlessly increase prices, and draw critical funds away from investment. Taxes on new homes suppress economic activity and erode housing affordability. Many of the taxes on new housing are highly inefficient, and considerable economic gains can be made from abolishing them completely.

What are the deficiencies with Australia's existing tax system?

There are several key problems with Australia's existing taxation system. It is:

- *Out of date* – incremental and ad-hoc changes have been made however they have failed to address the challenges facing Australia as a whole.
- *Ineffective in raising sufficient revenues to sustainably meet the community's needs* – since the Global Financial Crisis (GFC), Australia's ability to raise revenue has become structurally impaired, evident by the continual budget deficits.
- *Inefficient, inconsistent and incoherent* – Australia's tax system is needlessly inefficient and inconsistent due to the high dependence on a range of narrow based taxes. This is exacerbated by the base of the relatively efficient taxes being continually eroding due to large and growing tax concessions and exemptions. Property-related taxes such as stamp duty on conveyances is particularly inefficient, creating significant distortions in the economy.
- *A barrier to exports and investment* – Australia has a less competitive tax base compared to countries such as Singapore and Taiwan with a relative high company tax rate, a heavy dependence on company taxation and a lower reliance on consumption taxation.
- *Unfair* – Many taxes are applied by individual states/territories unequally to different goods, transactions, household types and business practices. This is aggravated by the range of inconsistent tax treatments between states/territories.

¹ Taxes on property include revenue from land tax, stamp duties on conveyances, municipal rates, government borrowing guarantee levies and other (metropolitan improvement rates, property owner's contributions to fire brigades and taxes on immovable property n.e.c). Other includes financial institutions transactions taxes & other stamp duties (stamp duty on shares and marketable securities and other stamp duties on financial and capital transactions). Royalties are not part of state tax revenues as they are considered income, and hence, reported under property income. If developer/infrastructure charges are included, then this share increases to around 46 per cent.

² These estimates of the total tax burden of an industry include the direct tax burden in producing a commodity or service (including net taxes on products, other net taxes on production, income taxes on labour and income taxes on capital), the indirect tax burden in producing a commodity or service (which reflects the taxes embedded in intermediate inputs used by the sector) and taxes charged on the industry and final use of the product (e.g. in the case of residential construction, these taxes include stamp duty and GST).

What is needed from the next round of taxation reform?

Different overarching objectives and goals of the tax system result in different proposed tax changes and ultimately different taxation outcomes. This is highlighted by the previous reviews and reports on Australia's tax system which have presented different visions for Australia's taxation system.

In order to identify what changes to Australia's tax system are necessary, it is critical to assess the existing tax base and any proposed tax changes against a set of 'ideal' tax principles, which would in turn, lead to a more efficient, productive, resilient and equitable Australian economy. Tax modernisation principles which should be adopted to guide a consistent and transparent platform for reform include:

- *Stability* – The central purpose of taxation is to fund Government expenditure on public services. In order to fulfil this purpose a tax must be sustainable, in that it grows in line with economic growth, and reliable, in that revenues are not subject to wide fluctuations
- *Efficiency* – An efficient taxation system minimises the distortionary effects and unnecessary influences of taxes on the behaviour of consumers and producers
- *Equity* – In-principle, taxes should be both horizontally and vertically equitable. Horizontally equitable taxes tax people in similar financial circumstances in the same way. Vertically equitable taxes are progressive, imposing higher taxes on individuals with greater capacity to pay
- *Simplicity* – Taxes should be simple, transparent, practical and enforceable, with minimal administration and compliance costs
- *Competitiveness* – Taxes should be aimed at improving competitiveness of Australian businesses both domestically and internationally
- *Revenue adequacy* – Tax reform measures should aim to minimise significant impacts to the economy by avoiding sudden large-scale expenditure cuts.

Application of these principles recognise that:

- A stable and predictable tax base is important for better planning by governments and for ensuring governments' financial commitments can be met both now and into the future
- Taxes are relatively inefficient and distort economic activity when levied on a narrow base at a higher rate, compared to taxes levied on a broader base at a lower rate
- Equity of taxation involves assessing taxes in terms of horizontal equity and vertical equity impacts, with a trade-off between them existing
- Taxes reduce the competitiveness of businesses in small open economies such as Australia which rely on capital investment funds from both domestic and overseas investors
- Complex tax systems place compliance and administrative costs on government and the private sector; a simple tax system is desirable
- Revenue adequacy must be considered from a 'whole-of-system' perspective.

What are ‘good’ and ‘bad’ taxes?

Assessing taxes individually against these tax design principles gives critical signals as to which taxes should be reformed and the priorities for an optimal tax reform package.

The assessment highlights that the existing taxes which are complex, unstable and inefficient are generally characterised by:

- narrow tax bases
- high tax rates
- complicated and differentiated rate schedules.

These undesirable characteristics are prevalent throughout the state/territory tax systems. There is a high reliance on narrowly based stamp duties on conveyances. The inadequate design of land tax and payroll tax, as well as the granting of exemptions, erodes the efficiency and effectiveness of these taxes, and creates significant inefficiencies for the market.

Business-related taxes influence the structure, costs and investment decisions of companies, and thus directly impact on competitiveness. State/territory taxes and the Commonwealth’s company taxation pose particular challenges to the competitiveness of Australia.

Many state/territory taxes are origin taxes levied at a point along the production chain, as opposed to being levied at the point of consumption. These taxes increase the cost of production in Australia and disadvantage Australian based firms in competition with overseas markets.

The differing operation and structure of state/territory taxes also provide barriers and impediments to competition that is difficult to quantify. A business operating in just one state or territory in Australia can be required to comply with up to 15 separate business-related taxes.

If that business competes nationally by spreading its operations to cover Australia, the total number of individual state taxes increases to more than 150 taxes. This is in addition to the 20-odd business taxes levied at the national level. This complexity is a hindrance and cost to conducting business in Australia.

On the other hand, Commonwealth taxes generally perform better than taxes imposed by the states/territories, partly due to being broader-based than state/territory taxes. Personal income taxes and the GST perform well against the tax design principles.

The analysis in this report highlights that Australia will be better off with more efficient taxes. Reducing dependence on ‘inefficient’ taxes and increasing revenue from ‘efficient’ taxes will produce an economic gain and boost economic growth. Replacing inefficient taxes with efficient taxes should be an overall goal for strategic and targeted tax reform.

Abolishing the ‘bad’ state/territory taxes will increase state/territory reliance on Commonwealth revenues. As such there is a need for cooperation and collaboration between the Commonwealth and state/territory governments in order to achieve meaningful reform.

What are Australia's taxation reform priorities?

Applying the tax design principles highlights the following tax reform priorities:

- State/territory taxes can be improved considerably by abolishing the 'worst' taxes (such as stamp duty on conveyancing, insurance taxes, and taxes contributing to fire and emergency services) and replacing them with more efficient taxes (such as GST)
- Broadening the existing tax base and lowering tax rates can improve the overall efficiency of the tax system by reducing distortions and boosting productivity
- The need to raise sufficient revenues to meet future expectations and needs of the community.

What tax reform packages are proposed?

To illustrate the large gains from tax reform, three tax reform packages were constructed.

The three scenarios highlight that tax reform can be advanced via a number of ways:

- **Tax reform package 1** focuses on abolishing the more inefficient state/territory taxes and replacing the revenue source with an increase in the GST rate to 12.5 per cent and abolishing the fresh food, education and health GST exemptions
- **Tax reform package 2** focuses on driving business investment by abolishing the more inefficient state/territory taxes and reducing the corporate tax rate to 25 per cent and replacing the revenues source with an increase in the GST rate to 15 per cent and abolishing the fresh food, education and health GST exemptions
- **Tax reform package 3** focuses on driving economic growth by increasing the efficiency of the existing tax system by abolishing the worst state/territory taxes, reducing the corporate tax rate to 27 per cent and re-designing existing taxes (payroll, land tax) to make them more efficient. The sources of revenues abolished are replaced by a proposed increase in the GST rate to 12.5 per cent and abolishing the fresh food, education and health GST exemptions.

The three scenarios all show that change is worthwhile, Australia would be better off with better taxes and that there is a capacity to pay for change by providing offsets to vulnerable taxpayers impacted by any tax changes.

Why was the modelled Tax modernisation reform package selected?

Tax reform package 3 was selected as the preferred package to be modelled in detail as it provides governments with an increased and more stable tax base while, more importantly, reducing distortions from taxation and driving growth in the economy by the most.

The modelled Tax modernisation package is outlined in more detail in Table ES 1 below.

Table ES 1 **Tax modernisation reform package**

Taxes	Proposed change
Stamp duties on conveyances	Abolish
Car parking levy	Abolish
Insurance taxes	Abolish
Fire services & emergency levies	Abolish
Motor vehicle taxes	Retain
Payroll tax	Abolish exemptions and apply flat rate (the rate will be reduced until revenue neutral)
Land tax	Abolish exemptions, no tax-free threshold and apply flat land tax rate of 0.25%
Company income tax	Reduce rate to 27%
GST - broaden base	Abolish exemptions (fresh food, education and health)
GST - rate	Increase rate to 12.5%
Alcohol taxes	Reform Wine Equalisation Tax (WET)

Source: ACIL Allen Consulting, 2014.

The tax changes have been proposed as a package and ***need to be implemented as a whole to realise the efficiency gains***. The interrelationship between the individual tax changes is clearly highlighted by the changes to stamp duties and land tax. Abolition of stamp duties on conveyances removes the largest existing distortion imposed by the existing tax system and produces the largest direct economic gains from any of the tax changes. The proposed land tax change cannot be implemented unless the low rate universal land tax system is introduced in conjunction with the abolition of stamp duties because otherwise the already highly taxed property sector would be more over-burdened by tax, and the reduction in state/territory revenue would otherwise not be sufficiently offset.

What are the benefits from tax reform?

To evaluate the economic gains from tax reform for the Australian economy, a computable general equilibrium (CGE) analysis of the modelled Tax modernisation reform package (the preferred tax reform package out of the three proposed) was undertaken.

By substituting state/territory tax revenues, the Commonwealth shoulders most of the revenue burden of the proposed tax reform. However, the modelled Tax modernisation reform package increases the overall tax revenue collected by just over \$6 billion in the first year of implementation of the entire package.

The analysis also highlights that the following economic gains can be achieved from targeted and strategic tax reform:

- Shifting the composition of taxes from inefficient state/territory taxes to more efficient Commonwealth taxes is forecast to improve many key economic outcomes. The analysis highlights that abolishing stamp duty on conveyances and replacing it with a low rate universal land tax will remove most distortions and result in an economic efficiency gain.

- Adopting a portfolio of tax changes that remove and reduce inefficient state/territory taxes and introduce increased GST will lift economic activity. The analysis indicates that GDP is higher by 0.5 per cent per annum for the 10 years after the tax reforms are introduced. In dollar terms, this means Australia's GDP is \$39.865 billion higher over the 10 years to 2024 relative to the base case where there are no tax reform changes.
- Much of the boost to GDP stems from the significant increase in investment as a result of abolishing the inefficient taxes which are largely imposed on business. Abolishing these taxes reduces impediments to investment in land, buildings and other assets. This allows businesses to pass reductions in the cost of doing business to both domestic and overseas consumers. Ten years after the proposed changes, investment is estimated to be 2.6 per cent higher.
- Government consumption (including investment and transfer payments), increases by 1.0 per cent. On an annual basis this is equivalent to increasing government spending by \$8 billion in 2014 which would assist with funding the services and programs provided to the community by government. This higher expenditure is consistent with a larger economy which is brought about by a more efficient tax system.
- Real incomes, which measure the ability of individuals to purchase goods and services, increases by \$6.0 billion annually. Real incomes increase because the tax changes boost investment and increase overall output. The impact is equivalent to increasing the average income of all Australians by about \$260 per person per annum.

The analysis shows that the business and community can be better off even where the overall size of the tax burden increases marginally. This is because the tax reform changes reduce the inefficiencies of the tax system. And, as a result, business profitability improves which leads to greater economic activity, and more investment. This effect is magnified by the large scale of the tax reforms proposed.

How to build a practical pathway to tax reform?

Until now, the analysis has deliberately assessed the Tax reform package in isolation from transitional and compensation arrangements. However it is necessary to recognise the need for a well-designed and negotiated pathway to transition into the package from a 'good' idea into 'good' practice.

There are clear economic gains from well-designed and target tax reform, however implementing reform is always challenging.

There are lessons to be learned from previous 'successful' and 'unsuccessful' attempts at reform. Experience has shown the need to obtain commitment from the states/territories to implement reform. Without this commitment, there is the danger of states/territories competing in a race to the bottom.

To successfully implement a coordinated reform agenda with a broad tax reform package, the package should:

- prioritise reforms – generally this will involve reforming taxes with the largest economic benefits
- be fully funded
- where possible, enhance the efficiency of the existing taxes
- phase in tax reform (e.g. broadened taxes) to ease transition
- be associated with a compensation package designed to neutralise the adverse consequences of tax reform
- provide commitment to further longer term reforms.

How to keep tax reform on track?

An overall package of tax reform must be backed up by a strong framework to implement and maintain the reforms. The states/territories do not have sufficient fiscal incentive to realise tax reforms unilaterally – cooperation and agreement is vital.

An agreement between governments to reform inefficient taxes is needed to ensure full implementation. This agreement needs to outline: clear timelines, measurable outcomes, financial incentives associated with both good and bad performance, measures to guard against backsliding and an independent review and assessment.

1 Introduction

1.1 This report

ACIL Allen Consulting (ACIL Allen) was commissioned by the Property Council of Australia (Property Council) to assess the extent to which the current tax system undermines competitiveness and productivity; and produce a *Tax Modernisation White Paper* (White Paper) that outlines a program for reforming Australia's taxation system.

The 2013 election of a new Federal Government presented an opportunity to reinvigorate the tax reform debate. Significant funding cuts made to education, healthcare and unemployment support announced in the 2014-15 Commonwealth Budget has jump-started this discussion, with stakeholders keeping a close watch on how the tax and transfer system will evolve to meet key challenges of the 21st century, including:

- an increasingly globalised world and economy, with closer integration of economies, increased competition and opportunities
- the ageing of the population, which will reduce some tax bases and increase the costs of health, aged care and the welfare system
- environmental challenges
- technological advances, especially in digital electronics and communications. Such advances create both opportunities as challenges as new competition and markets open
- an unsustainable tax base to fund government activities which has been exacerbated by the continued slowdown in Australia's mining boom.

Meeting these challenges will protect and enhance Australia's nation-wide prosperity.

The focus of the analysis is on taxes that impact upon the efficiency of business practices at the expense of a more efficient and productive Australian economy. This report also considers the impact of various taxes that exist at both the Commonwealth and state/territory levels, and assesses their effectiveness using an evidenced-based approach to principles of good tax reform.

Specifically, the Property Council of Australia requested that this report:

- a) identify existing taxes at both Commonwealth and state levels and characterise them in terms of their tax base, revenue raised and administration/implementation
- b) extend the methodology used in the *ACT Taxation Review* (Quinlan Review) to evaluate the effectiveness of various taxes in raising revenue while minimising market distortions and productivity loss
- c) propose an alternative Australian taxation system through a 'package' of reforms
- d) demonstrate the impact of the proposed reform scenario on the Australian economy in terms of expected benefits accrued from a modernised tax system
- e) provide a comprehensive plan for implementing the proposed reform scenario, taking account of staging, vulnerable social groups and political challenges for taxation reform.

It is expected that this report will be used to inform industry and governments' approach to the Commonwealth Government's White Paper process on reforming both Australia's tax system and the federation (to be completed by the end of 2015). Where appropriate the report can help the Council of Australian Governments (COAG).

1.2 The need to modernise the tax system

Tax reform is not an end in itself. It is an indispensable part of a broad, coordinated set of changes that is designed to achieve stronger more sustainable economic growth, higher productivity, greater competitiveness and higher living standards. Reform also seeks greater coherence in the overall, nationwide approach to taxation, which provides more consistency, security and simplicity.

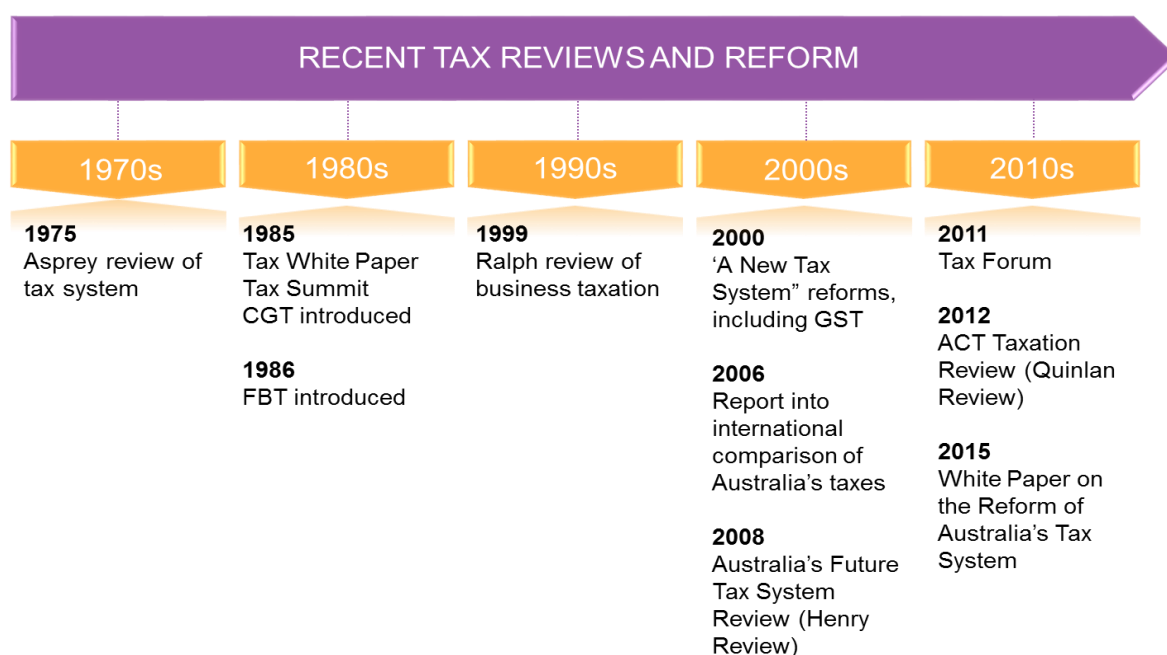
1.2.1 Australia's tax system is out of date

The ground on which Australia's economy and society stands is subject to major tectonic shifts and pressures that is also shaping what is taxed and what is able to be taxed in future. For example, new technologies are changing the delivery of certain goods and services from the physical to the electronic (i.e. music/books) which can make it difficult to tax under the existing tax regimes and international arrangements. On the other hand, technology can improve the way in which government can charge for spillover costs (i.e. electronic tagging of vehicles and GPS technology could allow congestion charging in cities and road-use charges for heavy vehicles).

The last constructive changes to the tax system occurred 15 years ago, when the goods and services tax (GST) was introduced, and a number of taxes, in particular the Wholesale Sales Tax (WST), were abolished. The previous round of tax reform was 15 years earlier to this when, among other things, dividend imputation and the Fringe Benefits Tax (FBT) were introduced. Both sets of reforms were in response to a pressing need to update the entire tax system and mitigate existing tax bases which were eroding.

Australia's tax system has been subject to major reviews and discussions at least every decade since the 1970's (see Figure 1). The latest major review (Australia's Future Tax System Review — also known as the Henry Review) recognised the problems with existing state taxes and clearly flagged the need for state tax reform. The Henry Review is a useful starting point to inform the tax debate, but there is considerable work to be done as the economy is substantially different in a post-GFC environment.

Figure 1 Tax reviews and reform timeline



Source: BCA 2014 and ACIL Allen Consulting.

While there have been few systematic changes to the tax base in recent years, Governments have primarily engaged in incremental change of existing taxes or the introduction of additional minor taxes. The states and territories regularly change the rates that apply to their taxes as their budget circumstances change. Revenue measures regularly feature in budget statements.

While there have been many changes to taxes over time, it is not clear that incremental and *ad hoc* changes have left the tax system at large in better shape.³ Continual change, especially change that does not seek to improve the system as a whole, has introduced additional problems and raised the need to adjust the whole system.

The underlying need for reform has many dimensions. Key factors are discussed below.

1.2.2 The current tax system is ineffective in raising sufficient revenues to meet community needs

It has become clear that since the global financial crisis (GFC) the Australian Government's ability to raise revenue has become structurally impaired which is highlighted by how our revenues are not sustainably funding the expenditure of government; the deficits now evident are not a cyclical phenomenon. Furthermore, demographic changes from retiring baby boomers who require increased public assistance and care, will place further pressures on government budgets.

³ The introduction of the mining tax is a single example of an incremental tax change which has not improved the overall taxation system. Due to the minimal revenues raised by the final version of the mining tax, some stakeholders have claimed that the tax has cost more to develop, introduce and administer than the level of revenues that it will raise.

While the Commonwealth Government has promised to cut back on spending, it has also promised to implement important but costly social programs (including the Disability Care and the Gonski education reforms), as well as spending on large infrastructure projects. All of this will have to be paid for, somehow.

Similarly, the state and territory governments have made commitments to provide services and meet growing demand for infrastructure. Yet their existing tax revenue base is inadequate. Despite the introduction of the GST revenue sharing arrangements between the Commonwealth and state/territory governments, the states/territories remain reliant on volatile and unpredictable taxes for a large share of their own source revenues. Volatility in the revenue base is problematic for fiscal management and is a key risk to achieving budget targets.

The 2014-15 Commonwealth Budget raised a number of issues regarding the capacity of Australia's existing tax base to raise sufficient revenues to fund essential government services (i.e. health and education), infrastructure requirements and social security net into the future. Other developments, including Australia's ageing population, have already started to reduce workforce participation and this is expected to continue. The ageing population will also increase the pressure on governments' outlays due to increased health, aged care and pension expenditure. In 2010, the Henry Review indicated:

To highlight the scale of the fiscal challenge, financing the projected increases in Australian and State government spending would be equivalent to the entire revenue raised by the GST.

Henry Tax Review, 2010.

The size of governments' expenditures obviously impact upon the amount of taxes that need to be collected. Due to the need to fund government services, infrastructure and the social security net with an ageing population, Australia needs a tax revenue base that can sustainably fund these requirements. Tax reform is needed so that the tax and transfer systems can meet the key challenges of the 21st century and also contribute to the economic growth and prosperity of the Australian economy.

When responding to volatility and cyclical factors the state governments introduce *ad hoc* changes in the tax base which may meet their tax and fiscal objectives in the short term, but which also lock in additional complexities and inefficiencies for businesses and the community in the long term.

1.2.3 The tax system is inefficient, inconsistent and incoherent

The need for tax reform is not just about revenue raising. The taxes that we are using in Australia are needlessly inefficient.

The Commonwealth taxes goods and services in a way that it results in capital being more heavily taxed and the consumption of goods and services being more lightly taxed, while income tax rates are relatively high because of the myriad of deductions, exemptions and rebates which exist. Australia relies on foreign investment yet taxes earnings on foreign capital at a high rate, despite the fact that taxing a narrow base at high rates is inefficient.

In addition, over the years the bases of the relatively more efficient taxes have been eroded. The Commonwealth Government has admitted to large and growing tax expenditures, particularly in relation to the GST and the retirement income system. In 2012-13, GST exemptions are estimated to cost more than \$21 billion in foregone GST revenue per annum, compared with GST revenues of \$50.3 billion collected.

The states/territories rely on inefficient taxes, such as stamp duties on transactions, and imperfect payroll taxes. The distortions and inconsistencies are particularly evident when looking at the impact of the range of taxes that apply to property transactions.

These property taxes place a significant tax wedge into the ability of the economy, the community and individual households to adjust to the major underlying changes that are in progress.

Taxes that apply to buying and selling of homes impede the ability of people to change their housing portfolio as their life circumstances change. 'Empty nesters' face significant costs to sell their family home when a large house is no longer needed, or people relocating to find employment face higher taxes to buy a property in the place where they have found a new job.

Many of the taxes that the state/territory governments rely upon are inefficient and hold back the broader economy. Broad-based taxes which have the potential to be efficient — such as land and payroll taxes — have had their bases eroded over time through competition between states and the granting of ad hoc concessions and exemptions.

Achievement of a better tax system points to the need to change Commonwealth-State financial relations. Because the states and territories have so few opportunities to raise the revenue they need, they rely on inefficient taxes. More efficient taxes are within the domain of the Commonwealth Government but the Commonwealth Government does not have the power to adjust or remove inefficiencies in the taxes that the states levy.

1.2.4 The tax system penalises exports and discourages investment

Tax settings will be of increasing importance for decisions regarding where capital will be invested, especially for small open economies like Australia. The long term trend in the global economy since 2000 has been towards lower statutory company tax rates, particularly for smaller open economies as countries compete to attract investment and employment.

Company tax rates matter for investment decision, particularly in relation to decisions by firms about where to declare profits and pay tax. Currently Australia has a less competitive tax base than it should be. Australia's current 30 per cent company tax rate ranks sixth highest within the OECD. This concern is voiced by Australia's business leaders:

If Australia's tax rate is uncompetitive and it's increasingly uncompetitive, then capital will flow to other markets and we won't get the investment in productive assets that will improve economic growth and the creation of jobs and wealth creation in Australia.

Richard Goyder, CEO of Westfarmers, 2014

With increased globalisation, labour choices about where to work will also become increasingly sensitive to taxation. Currently, Australia has one of the highest personal tax rates at 45 per cent while the OECD average being around 41.5 per cent.

Increased competition for mobile capital will ensure that there is global pressure to reduce company tax rates, with implications for base erosion and profit shifting (between countries). This is particularly the case for Australia which currently has both a higher reliance on corporate tax revenues and a higher corporate tax rate relative to its peers.

Lower tax rates on mobile factors of production will encourage investment and facilitate economic growth. As capital investment increases, this increases labour productivity and overall economic growth. Increased globalisation highlights the need for the Australian tax system to rely less heavily on taxes levied on mobile capital, in order to encourage investment, increase productivity and foster economic growth.

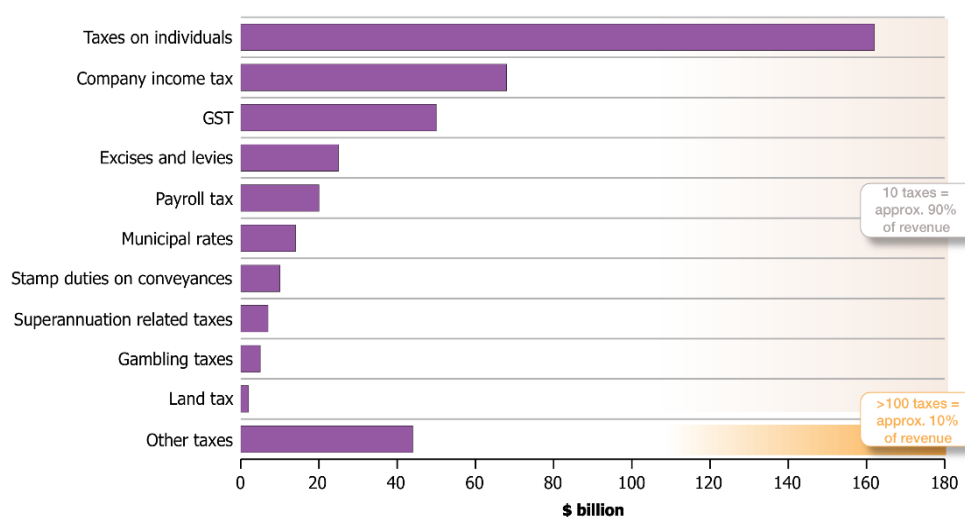
1.2.5 The current tax system is unfair

Many state/territory taxes are applied unequally to different goods, transactions, household types and business practices which is unfair. The same business, asset or employee is taxed at different rates or not at all when it is owned by or employed by different groups. The differences in tax treatment between states impacts significantly upon businesses that trade or invest Australia wide. It often has very little real purpose and often brings about significant costs to the community at large through reducing employment and investment opportunities.

1.2.6 The current tax system is complicated and reduces accountability

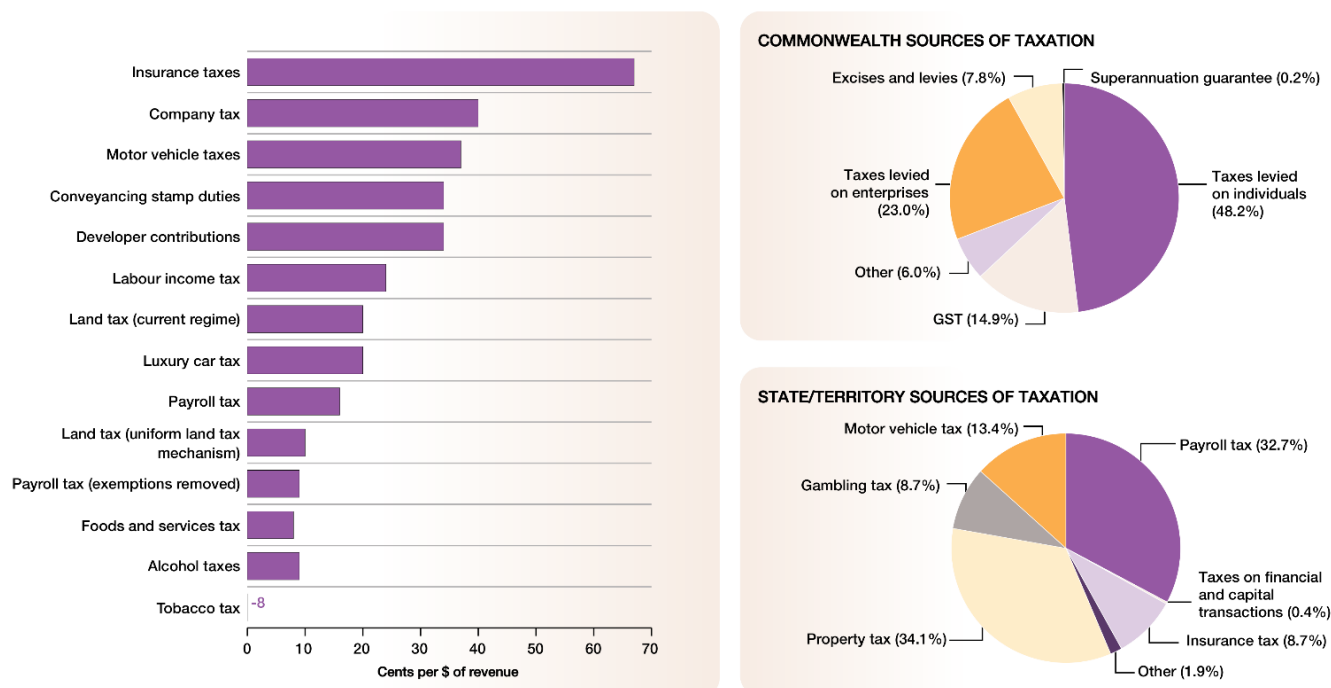
Australia's tax system is needlessly complex and relies on a large number of taxes which raise less than 10 per cent of total taxation revenues. Figure 2 highlights the level of revenues earned by different types of taxes. It shows that 10 taxes currently raise around 90 per cent of total tax revenues collected.

Figure 2 Revenue raised by Australian taxes, 2012-13



Source: ABS, 5506.0.

Figure 3 compares the marginal loss in economic well-being from a small increase in taxes by type of tax (otherwise referred to as the marginal excess burden of taxes). It also shows the source of the Commonwealth and state/territory taxes by type of tax.

Figure 3: Australian taxes by type and cost of increase in tax (marginal excess burden), 2012-13

Source: ACIL Allen Consulting estimates of MEB based upon Henry Review base estimates and ABS, 5506.0.

Figure 3 highlights that many of the taxes that the states rely upon are at the top end of the list of the economic cost of different taxes (the excess burden). Due to limited opportunities, state and territory governments currently rely on a number of taxes that are the more economically inefficient taxes available. These taxes are complex, inefficient and volatile.

In addition, the reporting, assessment and compliance requirements of many taxes impose high costs on business. Australian firms have indicated that large resources are required to meet and comply with the multitude of state/territory taxes. These costs are magnified for those firms operating in more than one jurisdiction.

Complicated Commonwealth-State fiscal arrangements further detract from government accountability by blurring expenditure and taxation responsibilities.

Many of the worst taxes that the states and territories rely upon lack transparency. By taxing intermediaries, both the extent of state/territory taxation and its incidence is masked from the community. This reduces the accountability of governments to the community for their decisions where governments shift blame for taxes and responsibility for costs onto other levels of government.

1.2.7 Strategic tax choices

The inability of Australia's existing tax base to raise sufficient revenues to fund essential government highlight the need to make a choice. It can either:

- cut government services and welfare; or
- raise tax revenue by increasing taxes or pursuing targeted tax reform; or
- achieve targeted expenditure cuts and pursue targeted tax reform.

The Commonwealth Treasurer indicated in 2012 that pursuing tax reform is an important policy option to be pursued over the coming years:

"You cannot go forward with a complicated and unresolved taxation system if you want to give business and consumers the best hope that what they work hard to achieve will be achieved."

Hockey, Treasurer, 6 November 2012. Accessed from www.news.smh.com.au on 6 November 2012.

The tax system can be made more efficient through broadening tax bases and using additional revenues to fund lower tax rates and abolish inefficient taxes.

Improving the structure of the tax system by replacing inefficient taxes with a suite of efficient taxes will assist with streamlining administration, has the potential to increase government accountability, reduce the tax system's complexity and business compliance costs and drive economic growth.

The upcoming tax review provides an opportunity to reinvigorate the debate in light of pressing needs and the government's recent announcement of their intention to deal with the inefficient legacy issues of Australia's tax system.

The next sections outline possible tax reform packages which provide targeted tax changes that would ensure a more sustainable tax system. That is, a tax system which will meet key challenges while ensuring a more efficient, competitive and simple system which will distortions, remove the existing barriers to investment and productivity and most importantly drive economic growth.

1.3 Structure of report

The remainder of this report is structured as follows.

- **Chapter 2** provides an overview of the Commonwealth and state/territory taxes.
- **Chapter 3** analyses taxation of the property sector.
- **Chapter 4** outlines the tax modernisation principles used to assess taxes in this report.
- **Chapter 5** assesses the major Commonwealth taxes against the tax reform principles.
- **Chapter 6** assesses the state/territory taxes, as well as local government developer charges, against the tax reform principles.
- **Chapter 7** establishes the case for tax reform, discusses three potential taxation reform scenarios and reports on their direct economic impacts.
- **Chapter 8** outlines the preferred tax reform package – Tax modernisation reform package – and measures the performance of this scenario using an economy-wide model.
- **Chapter 9** outlines a pathway to reform which is necessary to transition a 'good' taxation idea into 'good' taxation practice.

2 Setting the scene: taxes in context

This chapter provides an overview of the Commonwealth and state/territory taxes, their magnitude and relative importance as a source of revenue. It also provides a brief overview of historical government revenue and expenditure for the Commonwealth Government and combined state/territory governments.

KEY POINTS

- The Commonwealth's taxation revenue was \$338.4 billion in 2012-13. The main sources of revenue are personal income tax, company income tax and the GST. Together, these taxes account for around 85 per cent of the Commonwealth's taxation revenues.
- State and territory taxation revenue collected in 2012-13 totalled \$63.5 billion.
- Unlike the Commonwealth where the majority of revenues are raised from only a handful of bases, state/territory governments raise their taxes from a variety of sources.
- There are a myriad of state/territory taxes. The main categories of state/territory taxation include: payroll, property, financial and capital transactions, insurance, the provision of goods and services (excise and levies, gambling), use of goods and performance of activities (e.g. motor vehicle registration) and franchises.
- Each state/territory tax is unique in terms of its coverage (i.e. tax base), marginal tax rate/s and amount of revenue it generates. These different design characteristics make the tax system complex for those businesses operating in different jurisdictions.
- The absolute and relative magnitude of revenue generated from key taxes provide a basis for approaching tax reform, as it provides a sense of the impact of reforming a tax, whether through reducing or increasing reliance on a tax, or abolishing it altogether, on overall government revenue.

2.1 Commonwealth taxes

A distinctive feature of the Australian federation system is that the Commonwealth Government levies and collects all income tax, from individuals as well as from businesses.

The Commonwealth Government also collects taxes on the provision of goods and services, including the Goods and Services Tax (GST) and taxes on the use of goods and performance of activities.

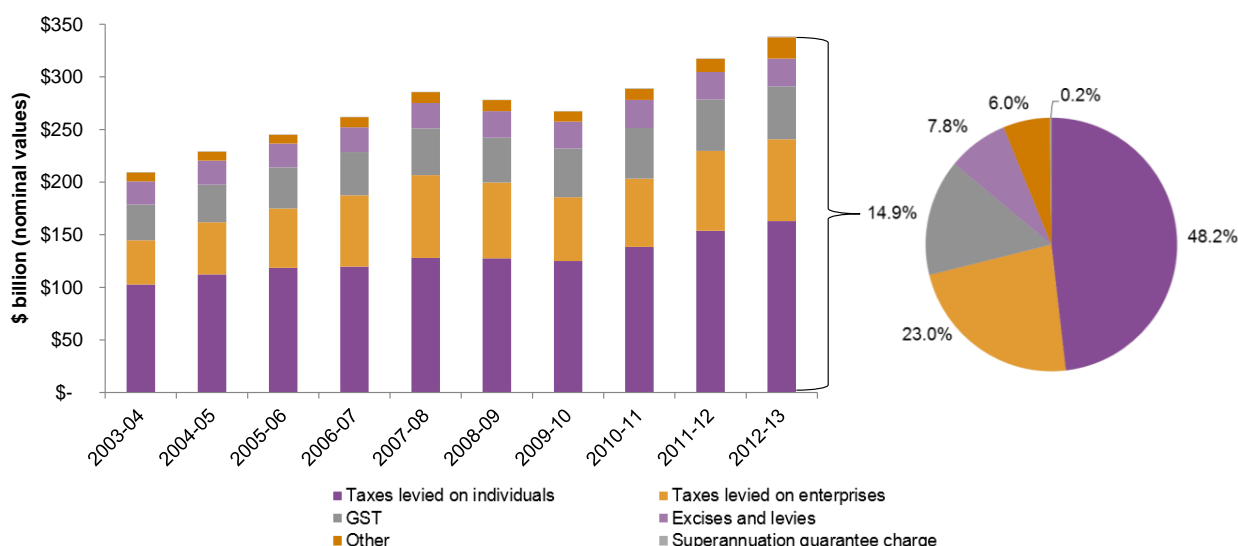
The main sources of tax revenue for the Commonwealth Government are personal income tax, company income tax and the GST— see Figure 3. Taken together, these taxes raise approximately 85 per cent of total Commonwealth Government revenue, with taxes levied on individuals⁴ representing the largest share (at 48 per cent of total), followed by taxes levied on enterprises⁵ and GST (23 per cent and 15 per cent of total in 2012-13, respectively).

⁴ Taxes levied on individuals include personal income tax, fringe benefits tax, prescribed payments by individuals and other income tax levied on individuals.

⁵ Taxes levied on enterprises include company income tax, income tax paid by superannuation funds and prescribed payments by enterprises.

Commonwealth Government taxation revenue in 2012-13 was \$338.4 billion, an increase of 6.6 per cent compared with 2011-12. Taxes levied on individuals increased by \$9.2 billion (6.0 per cent) to \$163.0 billion, while taxes levied on enterprises increased by \$1.8 billion (2.4 per cent) to \$77.7 billion and taxes on provision of GST increased by \$1.5 billion (3.0 per cent) to \$50.3 billion.

Figure 3 Commonwealth Government tax revenue by type, 2012-13



Note: Nominal values. Taxes levied on individuals include personal income tax, fringe benefits tax, prescribed payments by individuals and other income tax levied on individuals. Taxes levied on enterprises include company income tax, income tax paid by superannuation funds and prescribed payments by enterprises.

Source: ABS 2014a.

2.1.1 Tax offsets and exemptions

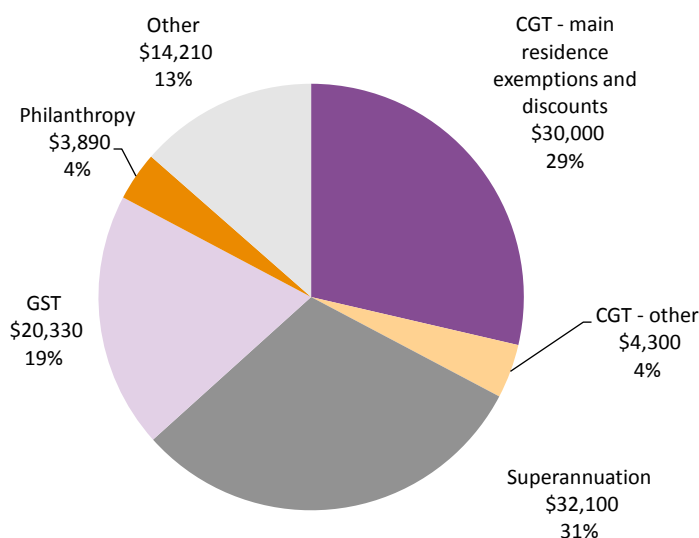
Australia's tax system has large and increasing tax expenditures (i.e. often referred to as tax concessions).⁶ Tax expenditures include tax exemptions, deductions or offsets, concessional tax rates and deferrals of tax liability.

In 2013-14, 355 tax expenditures were provided under the Australian taxation regime, with a total value estimated to be around \$104.8 billion, equating to 7 per cent of GDP (Treasury 2014). In comparison, direct government spending for the same year was about 23.5 per cent of GDP.

The largest tax expenditures in 2013-14 were those related to capital gains tax (CGT), accounting for around 33 per cent of the total tax expenditures at \$34 billion (see Figure 4). A break-down of CGT tax expenditures in 2013-14 is provided in Figure 4, with the CGT exemptions for the main residence accounting for around \$30 billion in 2013-14.

As shown in Figure 4, the next largest tax expenditures in 2013-14 were related to the concessional taxation of superannuation fund earnings and employer contributions, which are estimated to account for 31 per cent of the tax expenditures and provide a benefit of around \$32.1 billion for 2013-14.

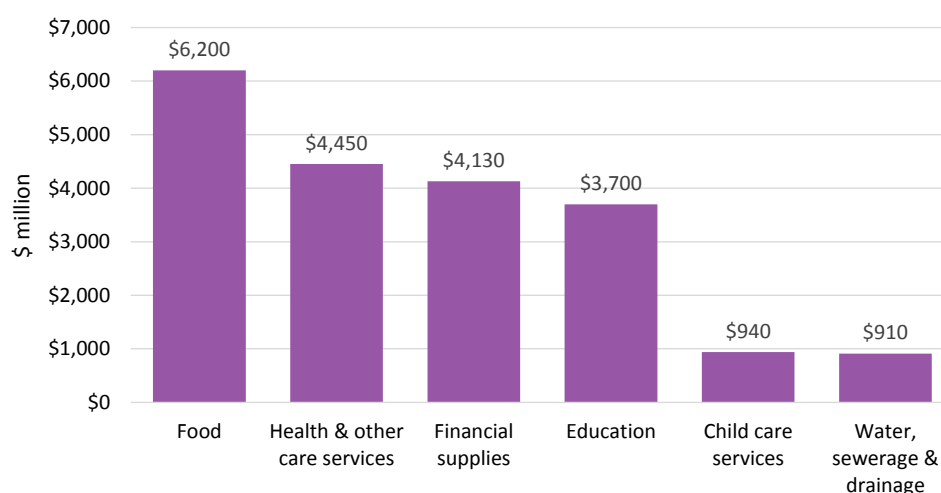
⁶ Tax concessions are regarded to be 'tax expenditures' because they are cost to the Government budget in so far that if the tax concession did not exist, the 'usual' tax treatment would apply which would mean that increased taxation is collected.

Figure 4 **Total tax expenditures, 2013-14**

Note: Australian Government tax offsets and exemptions grouped by ACIL Allen Consulting. A table detailing individual tax expenditures is provided in Appendix A.

Source: ACIL Allen Consulting based on Treasury (2014).

The third largest portion of forgone tax revenue in Australia are a result of exemptions from the GST. Exemptions from the GST are estimated to account for 19 per cent of the tax expenditures in 2013-14. GST exemptions cost more than \$20 billion in foregone GST revenue, compared with GST revenues of around \$50 billion a year. As shown in Figure 5 the GST-free status of most basic food results in a \$6.2 billion expenditure. Health and education expenditures also make up a large proportion of GST expenditures at \$4.5 billion⁷ and \$3.7 billion respectively.

Figure 5 **GST tax expenditures, 2013-14**

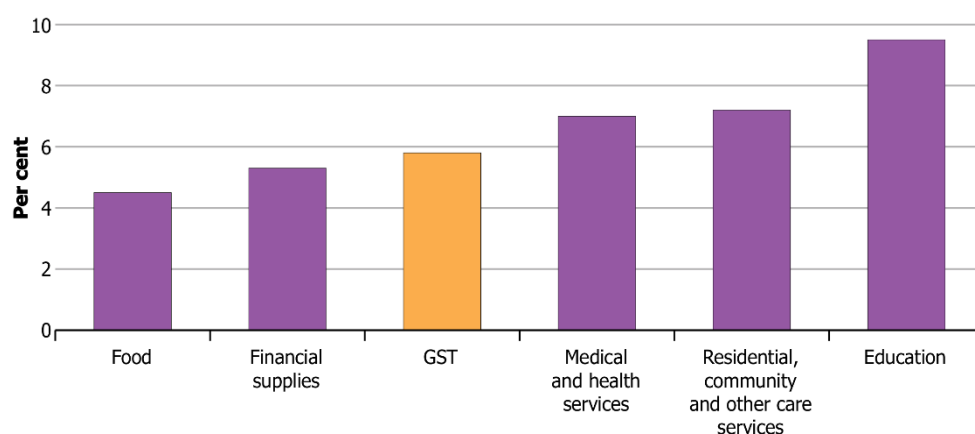
Note: The health and other care services do not include the GST exemption for residential care, and other care services.

Source: Treasury 2014.

⁷ This estimate does not include the GST exemption for residential care, community care and other care services.

The foregone revenue from GST-exempt items is expected to continue to erode the GST base as expenditure on these items is expected to continue to increase into the future (see Figure 6).

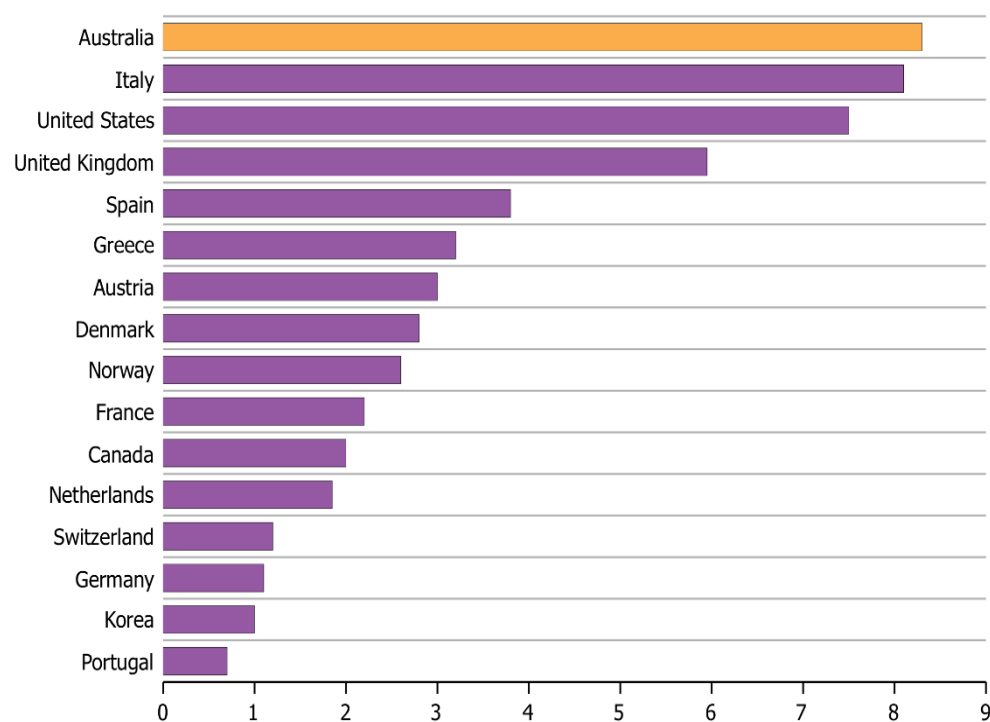
Figure 6 Average annual growth in GST revenue vs largest GST– exempt items, 2013–14 to 2017–18



Source: BCA 2014.

Interestingly, according to the International Monetary Fund (IMF) Australia relinquishes more tax revenue as a proportion of GDP than any other OECD country (see Figure 7).

Figure 7 Tax expenditures in selected advanced economies, per cent of GDP, 2010



Note: Higher values may arise from more comprehensive reporting (recent estimates for Italy are higher due to change in benchmark).

Source: IMF 2014.

2.1.2 Commonwealth budget balance

Overall, the Australian Government's medium-term fiscal strategy outlined in its 2014-15 Budget is to achieve budget surpluses building to at least 1 per cent of GDP by 2023-24. This strategy is the result of the assessment of the Commonwealth's financial position in the 2013 Pre-Election Economic and Fiscal Outlook (PEFO), the 2013-14 Mid-Year Economic and Fiscal Outlook (MYEFO) and the National Commission of Audit (NCOA) report⁸ which suggested that the Australian Government is approaching an unsustainable fiscal position.

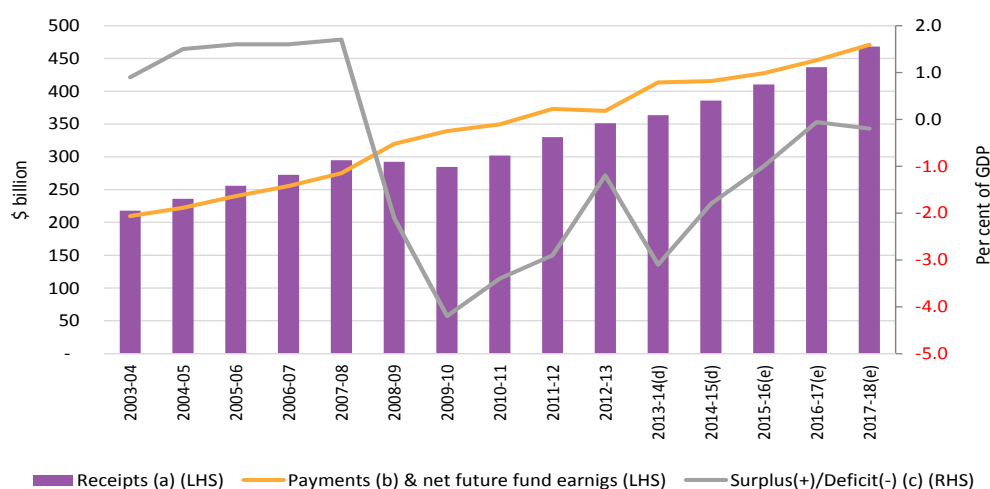
The Budget projects an underlying cash deficit of \$29.8 billion in 2014-15 (1.8 per cent of GDP), compared to a deficit of \$33.9 billion projected in MYEFO. The deficit is expected to fall to \$2.8 billion (0.2 per cent of GDP) in 2017-18 with the underlying cash balance expected to reach surplus around the end of the decade (see Figure 8).

Net debt for the general Australian Government⁹ is estimated to be \$226 billion (13.9 per cent of GDP) in 2014-15, compared with the 2013-14 MYEFO estimate of \$231 billion (14.2 per cent of GDP). By the end of the forward estimates, net debt as a percentage of GDP is expected to reach 14.0 per cent.

The 2014-15 Budget also includes cuts to overall spending, with total expenses expected to decline from 25.3 per cent of GDP in 2014-15 to 24.8 per cent of GDP in 2017-18.

Given this substantial budgetary challenge, reforms to the Australian tax system can improve its structure by replacing inefficient taxes with a rationalised suite of taxes, reduce system complexity and compliance costs and delivering a more sustainable long-term budget position by making the economy more productive and driving economic growth.

Figure 8 Commonwealth cash balance



Notes: (a) Receipts are equal to cash receipts from operating activities and sales of non-financial assets. (b) Payments are equal to cash payments for operating activities, purchases of non-financial assets and net acquisition of assets under finance leases. (c) Underlying cash balance is equal to receipts less payments, less net Future Fund earnings. For the purposes of consistent comparison with years prior to 2005-06, net Future Fund earnings should be added back to the underlying cash balance. (d) Estimates. (e) Projections.

Source: Treasury 2013.

⁸ The NCOA was established in October 2013 as an independent body to review and report on the performance, functions and roles of the Australian Government. In its Phase One Report, the NCOA suggests that 'There is a substantial budgetary challenge. Australia's budget situation is weaker than it should be and the outlook is ominous.' (NCOA 2014, p.2)

⁹ General government, as defined by the Australian Bureau of Statistics (ABS) comprises all government units (of local, state and national governments) and non-profit institutions controlled and mainly financed by the government.

2.2 State and territory taxes

Unlike Commonwealth taxes where the majority of revenue raised is from only a handful of bases (i.e. income tax, company tax and GST), state/territory governments raise their taxes from a variety of sources. Broadly speaking, the main categories of activities subject to state government taxation are:

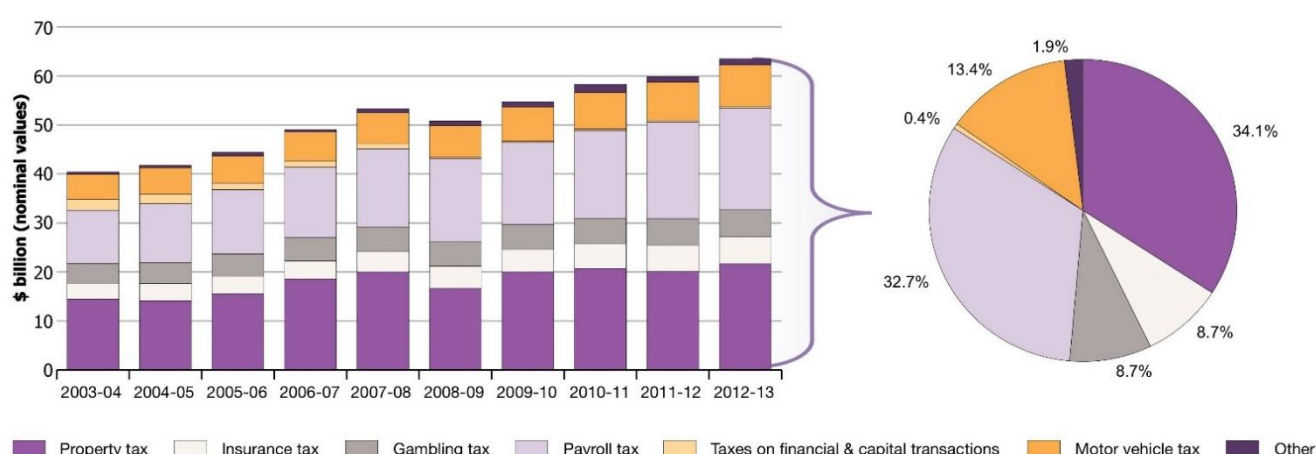
- property (e.g. stamp duties on conveyances, land tax)
- payroll
- use of goods and performance of activities (e.g. motor vehicle registration)
- financial and capital transactions
- insurance
- the provision of goods and services (excise and levies, gambling)
- franchises.

State and territory taxation revenue collected in 2012-13 totalled \$63.5 billion. This is an increase of 6 per cent when compared with 2011-12 (see Figure 9). As shown in Figure 9, there is greater distribution in terms of tax revenue across various types of taxes at the state/territory level compared with taxes collected at the national level.

Property-related taxes have historically been overly relied upon by state/territory governments (accounting for approximately 34.1 per cent of total revenue raised in 2012-13), closely followed by taxes on payroll (32.7 per cent). If developer charges and levies were also included, then this figure increases to 46 per cent. Taxes levied on motor vehicles, gambling and insurance are also important revenue sources, collectively accounting for 30.8 per cent of state/territory taxes in 2012-13.

Notably, the revenue base of state and territory governments is supplemented by the distribution of grants from the Commonwealth Government, which includes the allocation of GST revenue.

Figure 9 State/Territory government tax revenue, 2012-13

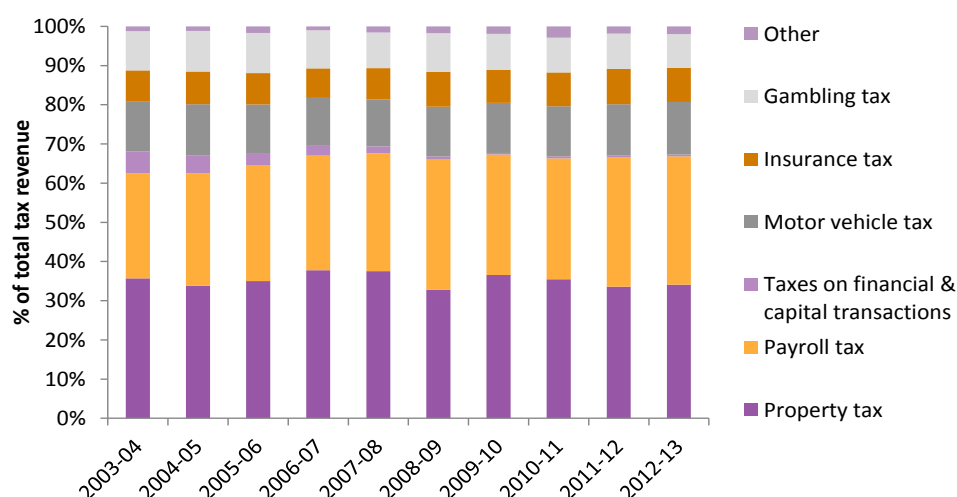


Notes: Nominal values. Taxes on property include revenue from land tax, stamp duties on conveyances, government borrowing guarantee levies and other taxes on immovable property (metropolitan improvement rates, property owner's contributions to fire brigades and taxes on immovable property n.e.c). Property taxes do not include local government municipal rates. Taxes on financial and capital transactions include financial institutions transactions taxes and other stamp duties (stamp duty on shares and marketable securities and other stamp duties on financial and capital transactions).

Source: ABS 2014a.

Figure 10 shows the 2012-13 tax revenue mix by state and territory. As can be seen, payroll tax and taxes on property generate the lion share of state/territory revenues – an average of 67 per cent across the jurisdictions in 2012-13. That said, the size of revenue for each tax type differs across the jurisdictions, due to differences in the design of payroll taxes by the respective state and territory governments.

Figure 10 Tax mix by state and territory, 2012-13



Note: Nominal values.

Source: ABS 2014a.

Importantly, taxes are dynamic and will continue to evolve in the future as it always has in the past. Land taxes provide an example of a tax which has continually experienced change via rate changes, changes to land value thresholds and new land tax exemptions. Another classic example of changing taxes is payroll tax – interstate competition has led to ongoing revisions of thresholds, tax rates applied to taxable payrolls, and exemptions and concession rules in each state/territory. The ongoing revisions and lack of uniformity in land taxes, payroll taxes (and other taxes) across jurisdictions has made it burdensome from a compliance perspective for businesses which operate across state/territory boundaries.

Generally, the implication of taxes selectively applied to different segments of the economy (i.e. inter-market) and within a sector (i.e. intra-market) is the creation of distortions through changes to relative prices of goods and services; and greater instability in tax revenue, since individual sectors tend to be more volatile than the aggregate economy as a whole. For example, revenue from stamp duty is volatile because it is dependent on the state of the housing market, which can vary considerably from year to year.

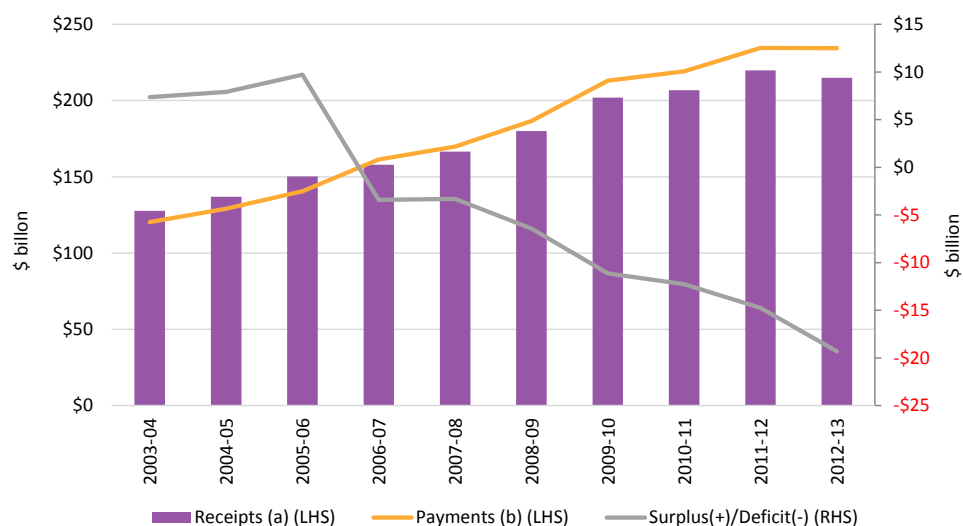
Specific issues relevant to individual taxes are discussed in detail in Chapter 5.

2.2.1 States and territory budget balance

Similarly to the Commonwealth Government, the states and territories also face an increasing budgetary challenge. As shown in Figure 11, over time, state/territory payments have increasingly surpassed their receipts, resulting in deficits of around \$19.3 billion in 2012-13. Notably, while the magnitude differs by state/territory, all have experienced a budget deficit in 2012-13. The state/territory budgets have deteriorated significantly over time, from a surplus of \$7.4 billion in 2003-04, to the current deficit of \$19.3 billion.

Reforming key state/territory taxes can help deliver a less volatile and more reliable revenue base and make a significant positive contribution to the challenging fiscal outlooks of all levels of government.

Figure 11 **State/Territory cash balance**



Notes: (a) Receipts are equal to cash receipts from operating activities and sales of non-financial assets. (b) Payments are equal to cash payments for operating activities, purchases of non-financial assets and net acquisition of assets under finance leases.

Source: ABS 2014b.

3 Taxation of the property sector

This chapter analyses the taxation of the property sector. In particular, it assesses governments' reliance on property related taxes and the significant burden of tax falling on the property sector compared to other sectors of the Australian economy.

KEY POINTS

- There are a myriad of taxes that currently apply to the property sector. Currently the Australian property sector contributes nearly \$35.6 billion in taxation revenue to state and local governments in Australia each year - 46.1 per cent of total taxation revenue collected by the state/territory and local levels of government.
- In addition, the property sector contributes to Commonwealth taxation revenues through company taxation, the GST and other taxes.
- The property sector is one of the most heavily taxed sectors of the Australian economy. The non-residential building construction is the most heavily taxed sector among Australia's largest sectors (those with value added higher than \$10 billion), with an average rate of 39.7 per cent and the residential building construction sector being the third most heavily taxed sector, with an average tax burden of 33.1 per cent of the value of its output. This compares with an economy-wide average of 21.0 per cent.
- Many of the taxes applying to property are needlessly inefficient and complex due to a high incidence of exemptions and different design characteristics depending upon the state/territory government levying the tax on property.
- In addition there is a range of hidden taxes that add to the cost of property in Australia and impose deadweight losses on the economy (e.g. zoning restrictions and development controls).
- Taxes on new homes dampen economic activity and reduce housing affordability, and with many of the taxes on new housing being highly inefficient, there are significant economic gains to be made from their removal.

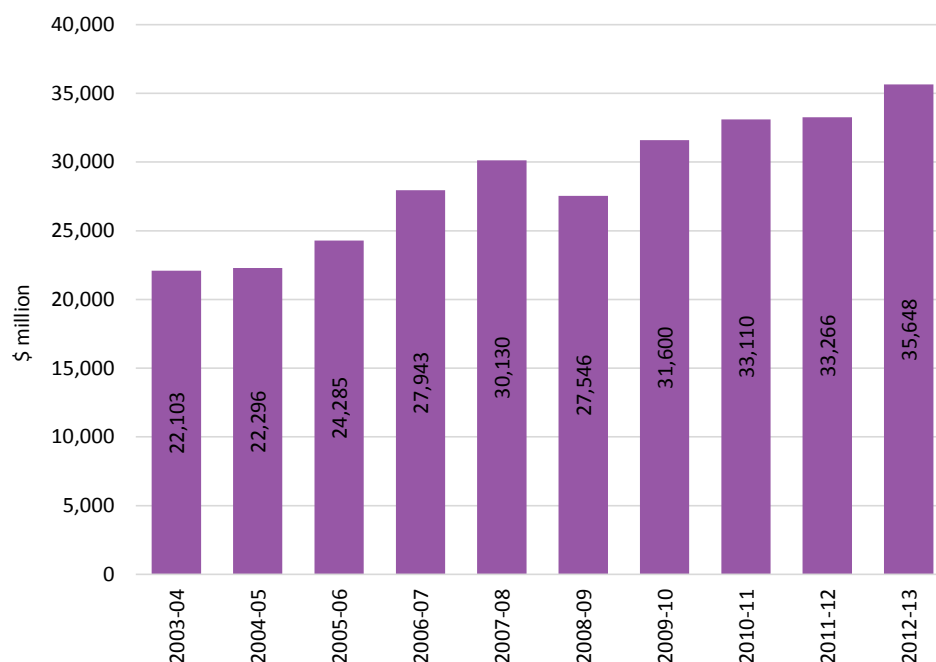
The property sector is a vital part of the Australian economy. While it is difficult to accurately measure the size and economic contribution of this sector as it includes a wide range of industries (from construction services to product manufacturing, property management services and professional services), it has been estimated that it accounts for around 12 per cent of Australia's total production and for approximately 10 to 13 per cent of total employment (ACG 2010). To put this contribution in perspective, in 2010-11, the construction industry alone was the second largest contributor to Australia's gross domestic product (GDP) at 7.8 per cent of total GDP (ABS, 2012). This compares with the mining industry which contributed 7.3 per cent of total GDP in the same year.

In addition to its direct economic contribution, the property sector also significantly impacts on the efficiency and productivity of other sectors of the economy through its role as a supplier and consumer of goods and services to/from other sectors.

As a result of its economic contribution, the property sector also makes a significant contribution to the level of taxation collected across all governments. Figure 12 shows the total value of property-related taxes collected by state/territory and local governments. As shown in this figure, in 2012-13 state/territory and local governments collected \$35.6 billion in property related taxes. In comparison, \$20.8 billion was collected from payroll and labour force taxes, and \$11.1 billion from taxes on the consumption of good and services in the same year.

Taxation collected from property has also grown rapidly. Since 2011-12, property related tax revenues have increased by 7.2 per cent. In contrast, revenue from taxes on employer's payroll and labour force rose by 5.1 per cent and revenue from the provision of goods and services rose 2.4 per cent. On average, property related taxes have grown by 5.7 per cent per annum over the last 10 years.

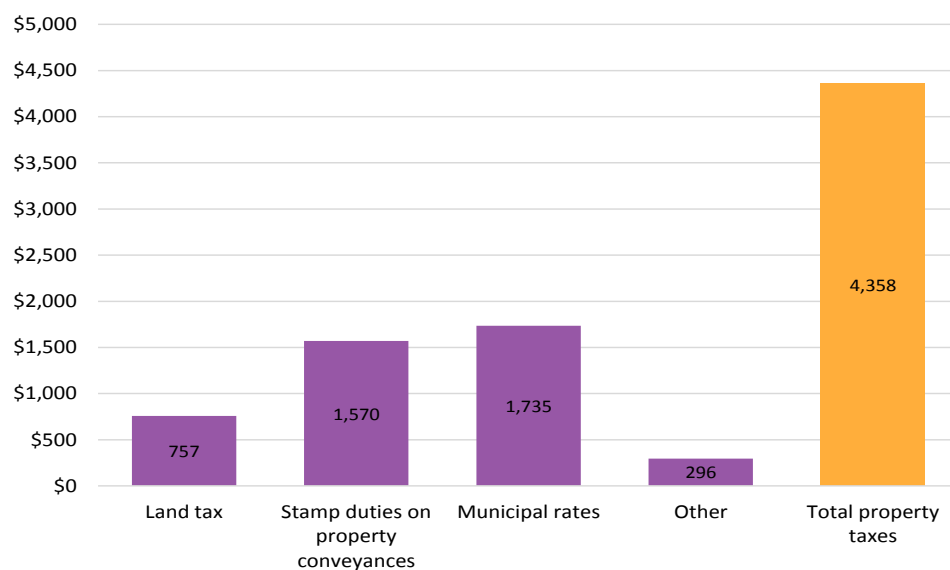
Figure 12 Total value of property tax revenue for state/territory and local governments



Note: Includes revenue from land tax, stamp duties on conveyances, municipal rates, government borrowing guarantee levies and other taxes on immovable property (metropolitan improvement rates, property owner's contributions to fire brigades and taxes on immovable property n.e.c).

Source: ABS 2014a.

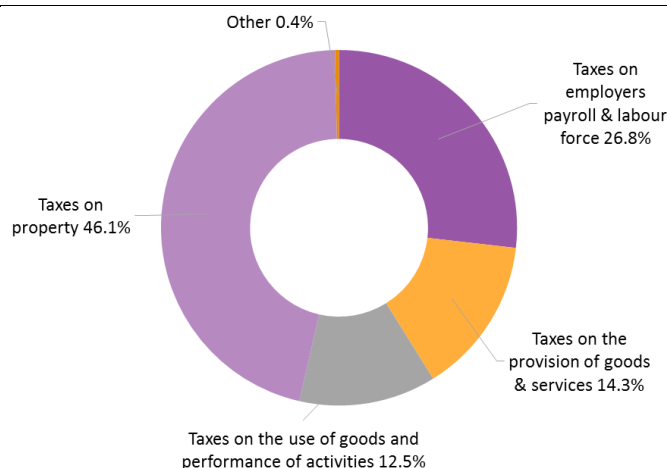
Figure 13 shows the average property taxes paid by households in 2012-13 by type of property tax. As shown in this figure, across Australia's 8.18 million households, the level of property taxes collected are equivalent to each Australian household paying an average of \$4,358 in property related taxes in 2012-13.

Figure 13 Average property taxes paid by households, 2012-13

Note: Includes taxes paid to states and local governments. Other includes government borrowing guarantee levies, metropolitan improvement rates, property owner's contributions to fire brigades and taxes on immovable property n.e.c.

Source: ACIL Allen Consulting and ABS 2014a.

Figure 14 shows the categories of state/territory and local government taxes as a proportion of total taxes. It shows that Australian governments rely heavily on property related taxes, with taxes on property accounting for the largest source of taxation revenue for the state/territory and local governments in 2012-13, contributing around 46 per cent of total revenue in that year.

Figure 14 State and local government taxes, 2012-13

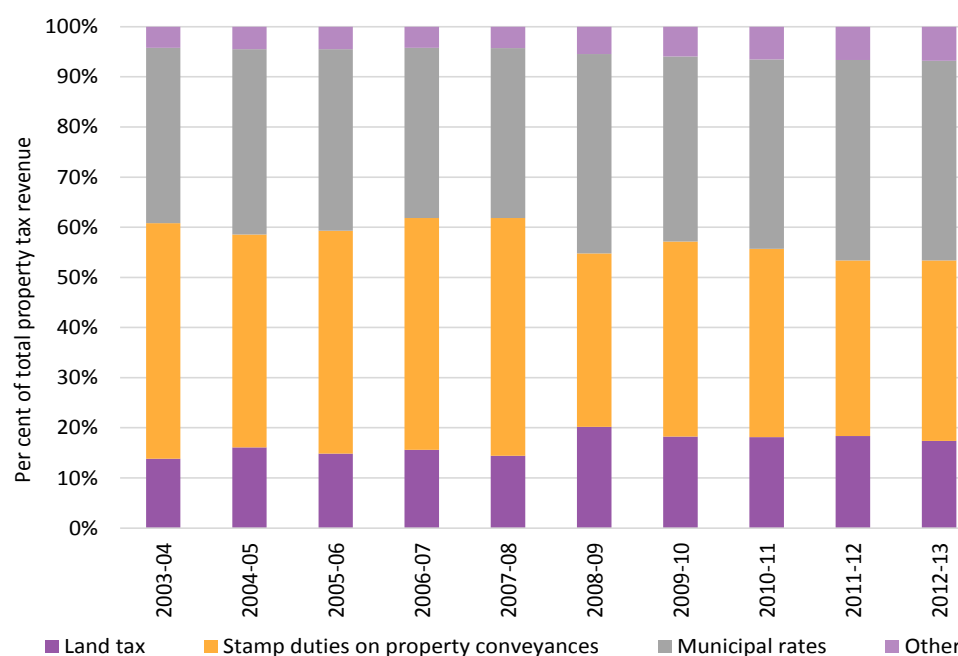
Note: Taxes on property include revenue from land tax, stamp duties on conveyances, municipal rates, government borrowing guarantee levies and other (metropolitan improvement rates, property owner's contributions to fire brigades and taxes on immovable property n.e.c). Other includes financial institutions transactions taxes & other stamp duties (stamp duty on shares and marketable securities and other stamp duties on financial and capital transactions).

Source: ABS 2014a.

Figure 15 shows the proportion of property related state and local government tax revenue by category. As shown in this chart, the largest proportion of property taxes in 2012-13 came from municipal rates (around 40 per cent or \$14.2 billion), closely followed by stamp duties on conveyances which collected \$12.8 billion, representing 36 per cent of the total revenue collected from property related taxes. The next most sizeable contributor to property tax revenue was land tax, accounting for 17 per cent (or \$6.2 billion) of collections in 2012-13.

While municipal rates provided the largest share of property tax revenue in 2012-13, historically stamp duties on conveyances have been the main contributor, providing around 41 per cent of total property tax revenue over the last 10 years. This compares with an average contribution of 37 per cent and 17 per cent of total property taxes over the last 10 years by municipal rates and land tax, respectively.

Figure 15 Proportion of property related state and local government tax revenue by category



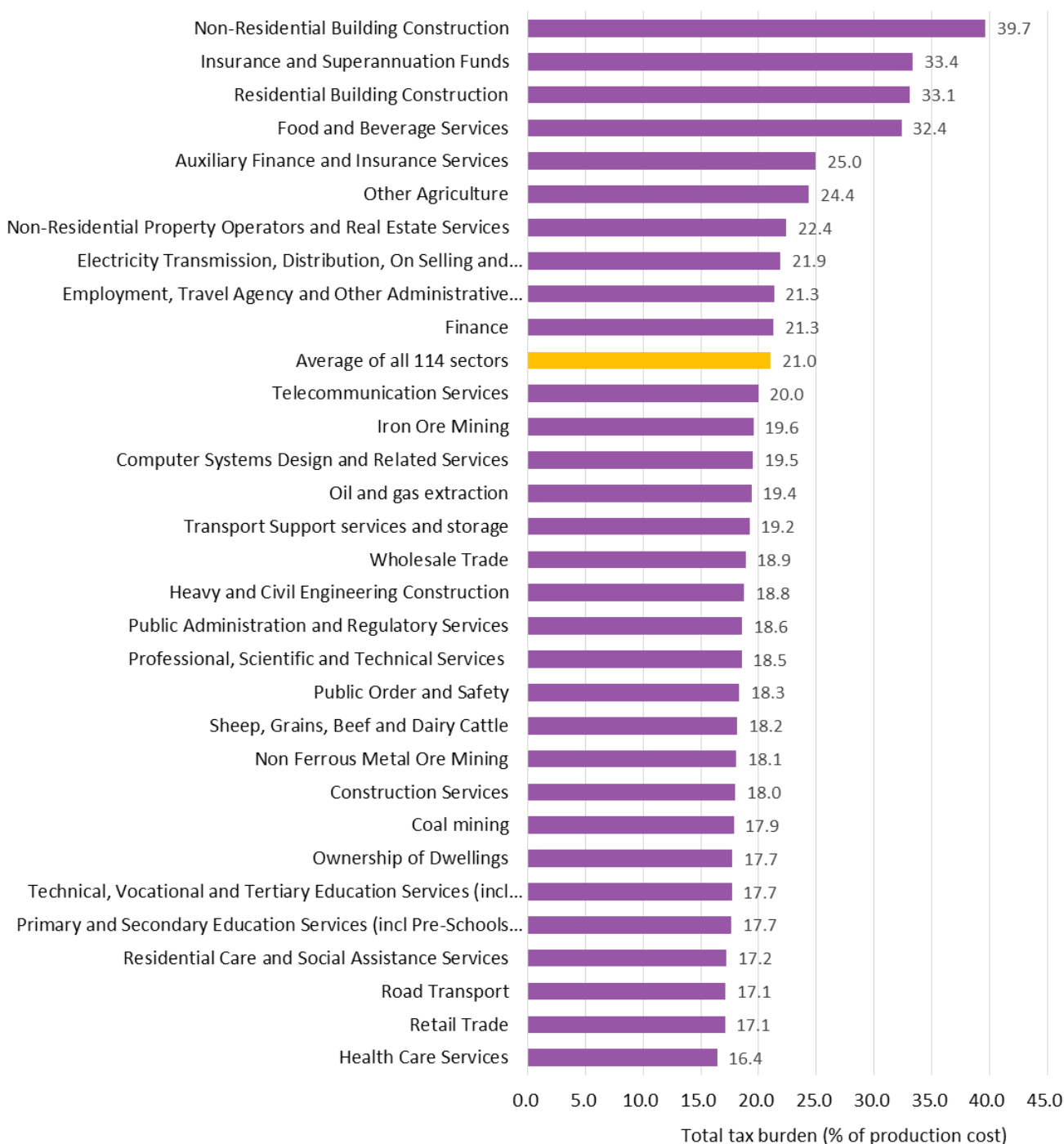
Note: Other includes government borrowing guarantee levies, metropolitan improvement rates, property owner's contributions to fire brigades and taxes on immovable property n.e.c.

Source: ABS 2014a.

3.1 How taxes on property compare with taxes on other sectors

The property sector is one of the most heavily taxed sectors of the Australian economy. Figure 16 provides estimates of the total tax burden on an industry's good or service as a percentage of production cost by sector.

Figure 16 Tax burden as a percentage of production cost of selected sectors, 2009-10



Note: Sectors were selected with value added higher than \$10 billion from 113 sectors in the ABS input-output tables. Total tax burden includes direct and indirect taxes and net taxes on use.

Source: ACIL Allen Consulting.

The total tax burden by industry was estimated using ABS input-output tables and include estimates of:

- the direct tax burden in producing a commodity or service, which includes:
 - net taxes on products¹⁰
 - other net taxes on production¹¹
 - income taxes on labour
 - income taxes on capital
- the indirect tax burden in producing a commodity or service, which reflects the taxes embedded in intermediate inputs used by the sector
- taxes charged on the industry and final use of the product (e.g. in the case of residential construction, these taxes include stamp duty and GST).

Figure 16 shows that the housing sector alone (i.e. not the property sector in its entirety) pays significantly higher taxes than other sectors. In particular, analysis by ACIL Allen and CIE (2011) found that:

- new housing is particularly inequitably taxed. It accounts for about 1.2 per cent of total value added in the economy, yet contributes 2.8 per cent of government taxation revenues¹² (CIE, 2011, p.7)
- existing housing accounts for about 7 per cent of total value added, while contributing about 8.4 per cent of taxation revenue (CIE, 2011, p.8)
- residential building construction is the third most heavily taxed sector among Australia's largest sectors (those with value added higher than \$10 billion), with an average tax burden of 33.1 per cent of the value of output (see Figure 16, which shows the tax burden as a percentage of production cost of selected sectors). This compares with an economy-wide average of 21 per cent.

In addition, as shown in Figure 16, the non-residential building construction sector is the most heavily taxed sector among Australia's largest sectors, with an average tax burden of 39.7 per cent of the value of output.

¹⁰ CIE 2011 (P. 63) defines a tax on a product as 'a tax that is payable per unit of some good or service. The tax may be a specific amount of money per unit of quantity of a good or service (quantity being measured either in terms of discrete units or continuous physical variables such as volume, weight, strength, distance, time, etc.), or it may be calculated ad valorem as a specified percentage of the price per unit or value of the goods or services transacted. A tax on a product usually becomes payable when it is produced, sold or imported, but it may also become payable in other circumstances, such as when a good is exported, leased, transferred, delivered, or used for own consumption or own capital formation.'

¹¹ CIE 2011 (P. 63) defines other net taxes on production as 'taxes related to the payroll or workforce numbers excluding compulsory social security contributions paid by employers and any taxes paid by the employees themselves out of their wages or salaries; recurrent taxes on land, buildings or other structures; some business and professional licences where no service is provided by the Government in return; taxes on the use of fixed assets or other activities; stamp duties; taxes on pollution; and taxes on international transactions.'

¹² Gross value added measures the value of an industry's production. It is used to measure the contribution of individual industries to the gross product of a state or territory.

3.2 Taxes paid on new property

Property is subject to a range of taxes both during construction and throughout a building's asset lifecycle. To illustrate the magnitude of these taxes during the development phase of new properties, Figure 17 to Figure 19 show the main cost components of an illustrative new house, apartment and office building in Sydney (additional information about taxes and charges paid by different asset classes in different states is provided in Appendix B).¹³ As shown in these charts, it is estimated that taxes and charges in Sydney represent:

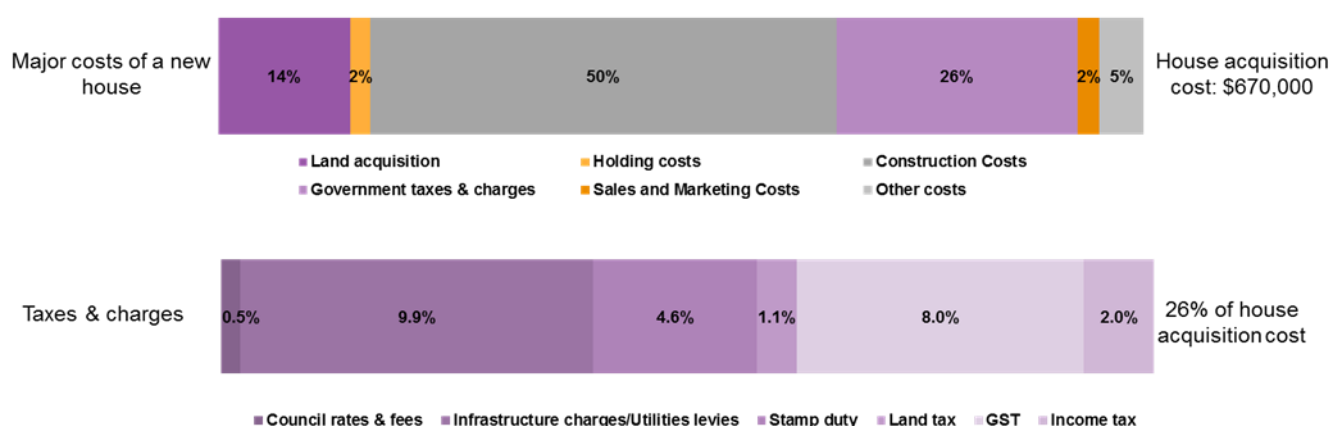
- around 26 per cent of the cost of acquiring a new house (around \$175,000 of a \$670,000 house)
- around 20 per cent of the cost of acquiring new apartment (around \$108,000 of a \$546,000 apartment)
- around 12 per cent of the cost of acquiring a new office building (around \$720 per square metre of net lettable area of a \$6,100 per square metre of lettable area office space).

To provide a comparison about the amount of taxes and charges paid during the development phase of new properties across Australia, Figure 20 provides a comparison of the main cost component for an illustrative new house, apartment and office building in the capital cities.

Notably, these taxes and charges include the stamp duty on conveyances that would be paid by the new owners when acquiring these properties, which add to the total tax burden.

In addition to these readily identifiable taxes, there is a range of hidden taxes that add to the cost of property in Australia and impose deadweight losses on the economy (e.g. zoning restrictions and development controls).

Figure 17 Breakdown of costs and taxes of a new house in Sydney

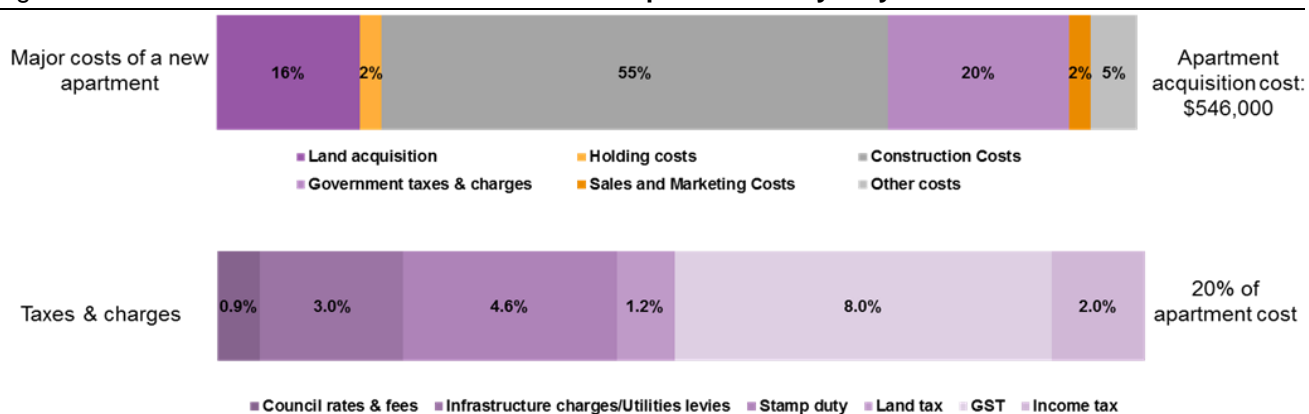


Note: Other costs include legal fees and developer margins. Acquisition costs include stamp duty paid for the property purchase.

Source: ACIL Allen Consulting.

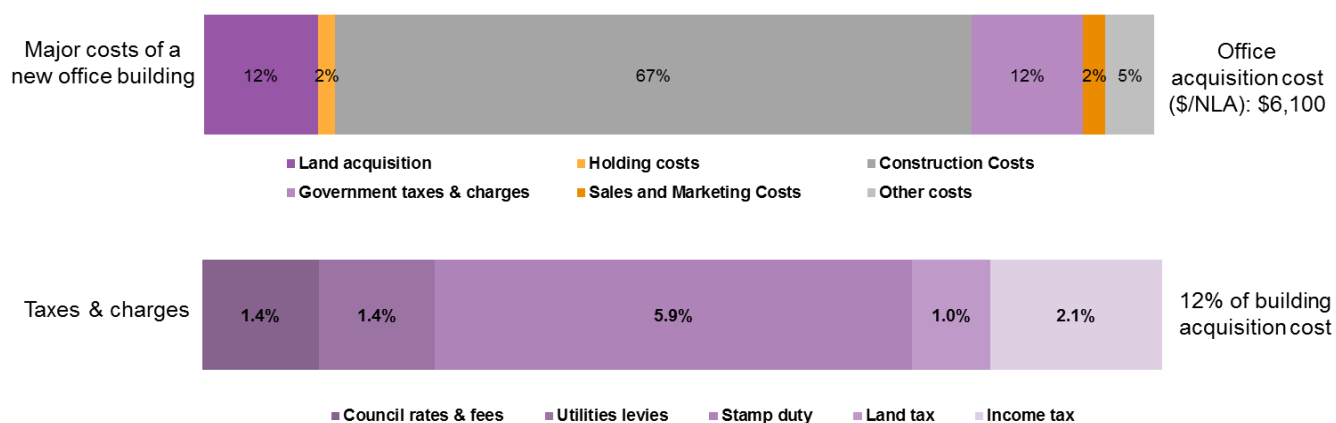
¹³ This information was sourced from the Property Council of Australia's Property Taxes Dashboard created by ACIL Allen. This dashboard provides a range of metrics that illustrate: the magnitude of taxes paid by different property types at different stages of their lifecycle; what are the main factors influencing property prices; how competitive are different states and territories with regards to property development and investment; and how reliant are different states and territories on property related taxes. Additional information about the Property Taxes Dashboard is provided in Attachment C.

Figure 18 Breakdown of costs and taxes of a new apartment in Sydney



Note: Other costs include legal fees and developer margins. Acquisition costs include stamp duty paid for the property purchase.
Source: Rider Levett Bucknall and ACIL Allen Consulting.

Figure 19 Breakdown of costs and taxes of a new office building in Sydney



Note: NLA stands for net lettable area. Other costs include legal fees and developer margins. Acquisition costs include stamp duty paid for the property purchase.

Source: Rider Levett Bucknall and ACIL Allen Consulting.

Figure 20 Comparison of development costs for houses, apartments and offices across Australia's capital cities, share of final building acquisition cost (per cent, 2014)



Note: Other costs include legal fees and developer margins.

Source: Rider Levett Bucknall and ACIL Allen Consulting, 2014.

4 Reform principles

This chapter details key tax modernisation principles for reforming Australia's taxation system. Reforming the taxation system requires a prudent, transparent and principles-based approach with a coherent and consistent basis for amending specific taxes and designing whole of tax system reform, for the benefit of Australia.

KEY POINTS

- Taxes are traditionally assessed against a set of principles to determine 'good' taxes and 'bad' taxes.
- Different overarching objectives and goals of tax reform result in different proposed tax changes and ultimately different taxation outcomes. This is highlighted by the previous different reviews and reports on Australia's tax system which have identified different overarching objectives and goals for Australia's taxation system.
- In order to identify what changes to Australia's tax system are necessary, it is necessary to define the need for change and then the design principles which are necessary for achieving the overarching goals of reform.
- The tax modernisation principles identified provide a consistent and transparent platform for reform. Principles considered to underpin 'good' taxation include: stability, efficiency, equity, simplicity, competitiveness and revenue adequacy.
- Previous tax policy studies have used broadly similar principles. Specifically these principles recognise that:
 - ♦ A stable and predictable tax base is important for better planning by governments and for ensuring governments' financial commitments can be met both now and into the future
 - ♦ The imposition of taxes are economically inefficient however taxes are particularly inefficient and distort economic activity when levied on a narrow base at a higher rate
 - ♦ Equity of taxation should be measured in terms of horizontal equity and vertical equity impacts, with a trade-off between them existing
 - ♦ Taxes reduce the competitiveness of businesses, particularly when levied on mobile capital in small open economies such as Australia
 - ♦ Complex tax systems place compliance and administrative costs on government and the private sector; a simple tax system is desirable
 - ♦ Revenue adequacy must be considered from a 'whole-of-system' perspective
- Assessing taxes individually against these principles say little about what should be reformed to improve Australia's tax system. However, the individual assessment of these taxes against these principles provide an indication about what taxes should be reformed and priorities for achieving an overall tax reform package.

4.1 What do we need from our taxation system?

There is a consensus that Australia's tax system needs reform to meet the existing and future challenges (see chapter 1 for more detail on the need for reform). Different overarching objectives and goals of tax reform however will result in different proposed tax changes and ultimately different taxation outcomes.

As highlighted in the following box (Box 1), different reviews and reports have identified different overarching objectives and goals for Australia's taxation system. Notwithstanding these different goals, it is notable that efficiency, equity and simplicity have been commonly identified principles for taxation reform.

Box 1 Tax design principles used in previous studies

Tax design principles adopted in previous studies in this policy space are shown in the following table. Although the specific terms used for a given principle may differ across studies, four 'core' principles appear consistently in these publications. These are: efficiency, equity, simplicity (or cost effectiveness) and stability (or sustainability).

This study has adopted these four 'core' principles to assess key taxes, and has also added concepts of 'competitiveness' and 'revenue adequacy' to its tax modernisation principles.

Summary of tax design principles

Quinlan Review	Henry Tax Review	Treasury Business Tax Working Group	ACG PCA/BCTR tax reform report	CIE State business tax reform study
2012	2010	2012	2011	2009
Efficiency	Efficiency	Efficiency	Efficiency	Efficiency
Equity	Equity	Equity	Equity	Equity
Simplicity	Simplicity	Simplicity	Simplicity	Neutrality
Stability	Sustainability	Competitiveness	Sustainability	Buoyance & robustness
	Policy consistency	Revenue adequacy		Cost effectiveness
		New investment focus		

Source: ACIL Allen Consulting, 2014.

The first step to achieving successful taxation reform involves identifying what we need from our taxation system. As outlined in chapter 1, there are several key problems with Australia's existing taxation system. It is:

- *Out of date* – incremental and *ad-hoc* changes have been made however these changes have failed to address challenges facing Australia as the economy transforms.
- *Ineffective in raising sufficient revenues to sustainably meet the community's needs* – since the Global Financial Crisis (GFC), Australia's ability to raise revenue has become structurally impaired, evident by the continual budget deficits.
- *Inefficient, inconsistent and incoherent* – Australia's tax system is needlessly inefficient and inconsistent due to the high dependence on a range of narrow based taxes. This is exacerbated by the base of the relatively efficient taxes being continually eroding due to large and growing tax expenditures.
- *A barrier to exports and investment* – Australia has a less competitive tax base with a relative high company tax rate and a heavy dependence on company taxation and a lower reliance on consumption taxation.
- *Unfair* – Many state/territory are applied unequally to different goods, transactions, household types and business practices. This is exacerbated by the different tax treatments between states/territories.

Raising revenue should be done so as to do least harm to economic efficiency, provide equity (horizontal, vertical and intergovernmental), and minimise complexity for tax payers and the community.

*Henry Tax Review 2009
(Terms of Reference)*

In light of these issues, the following six tax modernisation principles for assessing Australia's existing taxes and prioritising reforms have been identified:¹⁴

- **Stability** – The central purpose of taxation is to fund Government expenditure on public services. In order to fulfil this purpose a tax must be sustainable, in that it grows in line with economic growth, and reliable, in that revenues are not subject to wide fluctuations
- **Efficiency** – an efficient taxation system minimises the distortionary effects and unnecessary influences of taxes on the behaviour of consumers and producers.
- **Equity** – in-principle, taxes should be both horizontally and vertically equitable. Horizontally equitable taxes tax people in similar financial circumstances in the same way. Vertically equitable taxes are progressive, imposing higher taxes on individuals with greater capacity to pay.
- **Simplicity** – taxes should be simple, transparent, practical and enforceable, with minimal administration and compliance costs.
- **Competitiveness** – taxes should be aimed at improving competitiveness of Australian businesses both domestically and internationally.
- **Revenue adequacy** – reform measures should aim to minimise significant impacts to the economy by avoiding sudden large-scale expenditure cuts.

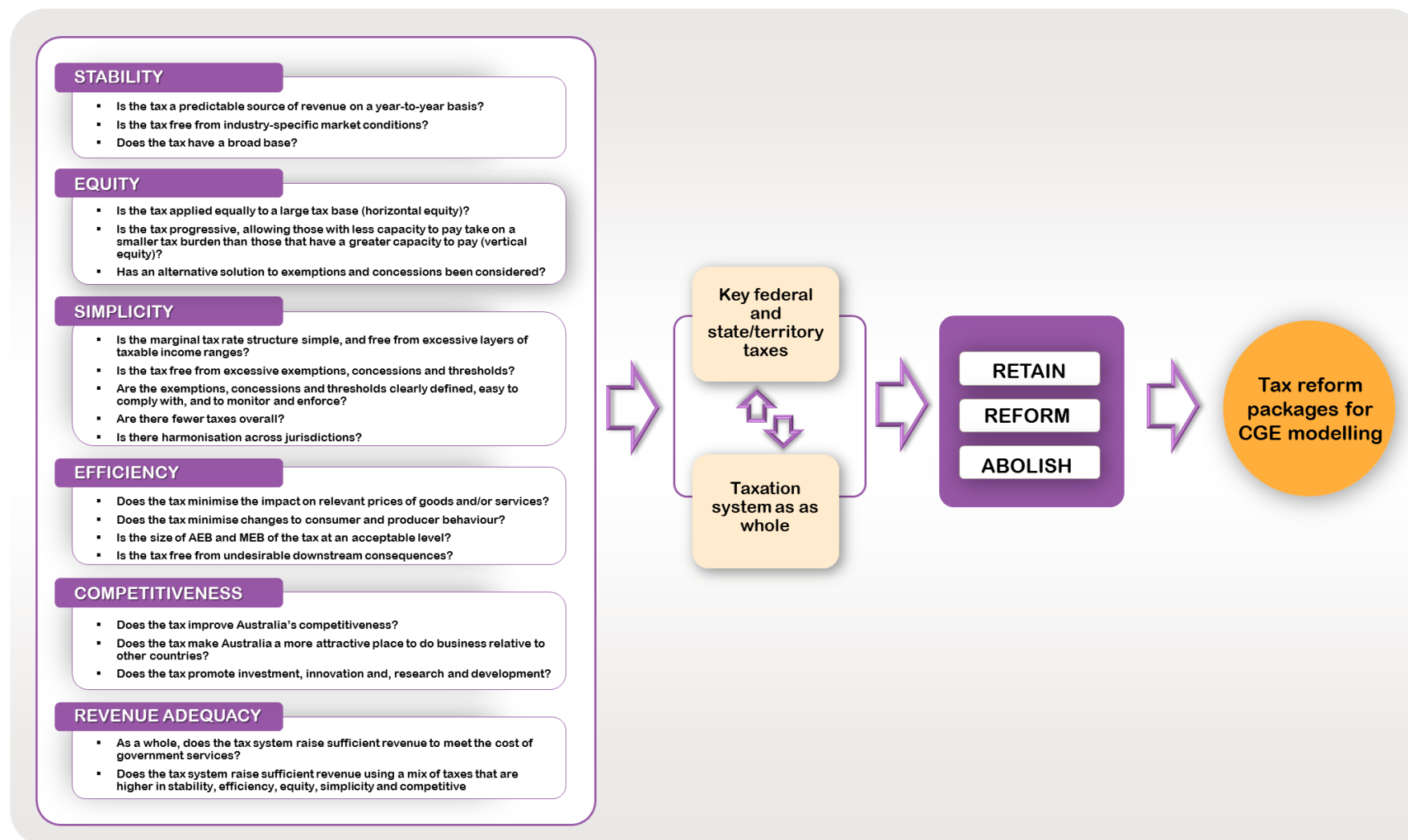
Importantly, these principles have been selected for the purpose of assessing taxes to improve Australia's *taxation system*, and are *not* intended for evaluating:

- the adequacy of the existing social security system
- the efficacy of Australia's superannuation/retirement funds
- whether Australia should/shouldn't adopt a 'user-charging' system to fund public infrastructure investments.

This discussion of the tax modernisation principles for assessing individual taxes has been amalgamated into a framework – see Figure 21. The principles are discussed in more details in section 4.2 to section 4.7.

¹⁴ Descriptions for stability, efficiency, equity and simplicity have been sourced from Quinlan 2012, p.17.

Figure 21 Tax modernisation framework for assessing taxes



Source: ACIL Allen Consulting, 2014.

4.2 Revenue stability

A consistent and predictable source of revenue is paramount for governments to be able to plan policies and deliver public services effectively and sustainably into the future. Governments at both the national and state/territory levels make difficult budgetary decisions on competing priorities every year.

The ability of governments to provide services is inextricably linked to the amount of tax revenue collected in a given year. A stable tax base will provide government with both a sizable and reliable tax base to fund government programs. Unreliable tax revenue collections from one year to another adversely impacts on budget positions. Where projections of tax revenue are overestimated they may not sufficiently cover the cost of providing government programs, with difficult decisions concerning continuation of these programs needing to be made.

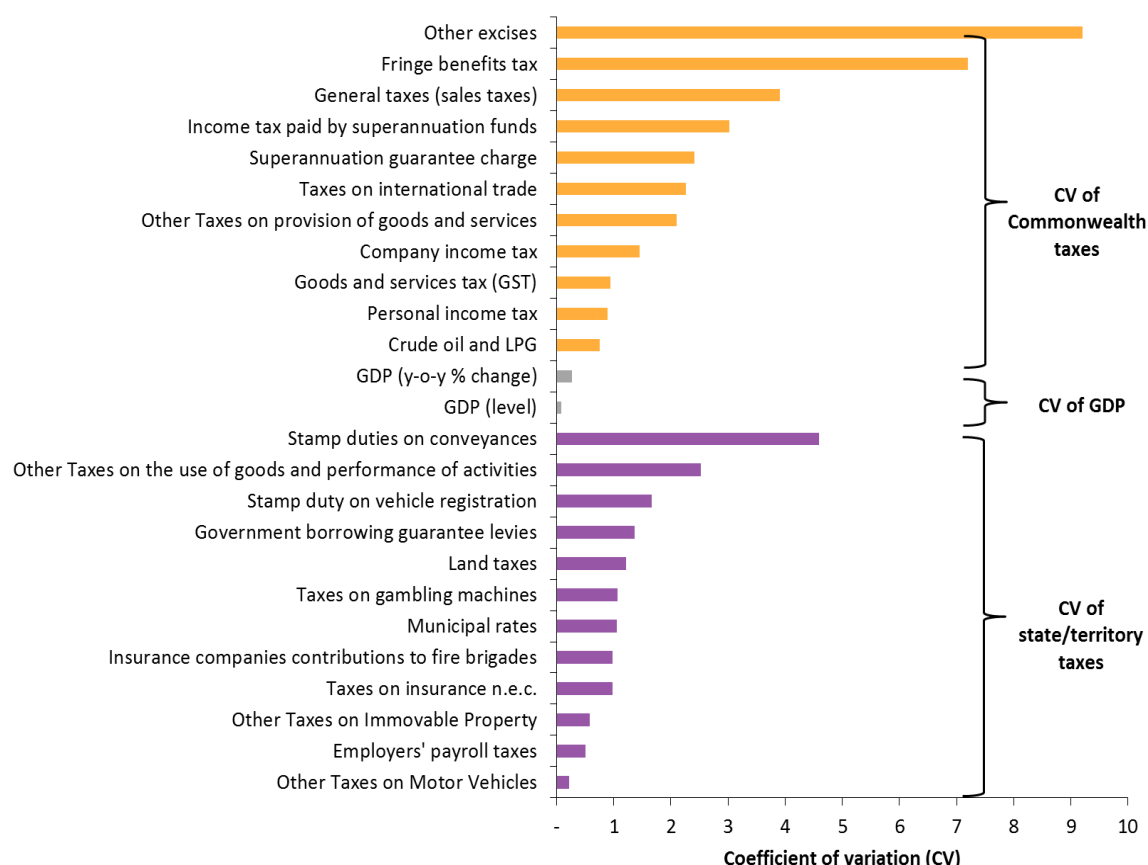
Different taxes have varying degrees of revenue stability. For example, taxes with broader bases such as the goods and services tax (GST) on the consumption of goods and services are more reliable than taxes with narrower bases such as stamp duties on conveyances.

The stability of a tax can be measured by looking at its variability; the less variable a tax is the more stable its revenue stream on an annual basis, which assists governments with being able to fund their programs on a reliable basis.

Figure 22 shows measures of the variability of Commonwealth and state/territory taxes between 2003-04 and 2012-13 using the coefficient of variation (CV) of annual tax revenue growth.¹⁵

¹⁵ The CV is a normalised measure of the variance of a probability distribution – in this case, the variability of revenue growth for each of the taxes from one year to another. The CV of gross domestic product (GDP) have also been shown as a benchmark.

Figure 22 Variance in growth of tax revenue collection by type of tax, 2003-04 to 2012-13



Source: ACIL Allen calculations based on ABS 2014, Catalogue 5506.0 Taxation Revenue, Australia, 2012-13.

At the Commonwealth Government level, the most stable taxes are personal income tax, GST and company income tax (these were three of the four taxes put forward in the Henry Tax Review to be used as the main sources of government revenue).

At the state/territory government level, payroll tax and other motor vehicle taxes (which includes road and transport maintenance tax and heavy vehicle registration fees) are more stable. In contrast, stamp duties on conveyances has the greatest degree of variance and is the least stable of all state/territory tax bases. Its variance is explained largely by the fluctuations of the property market which directly impacts the number of property transactions and the amount of tax collected that is tied to property values in a given year.

The stability of the broader tax bases is evident from the low CVs of the GST and payroll tax.

Analysis of the variability in the tax revenues collected by tax base reveals one of the growing problems associated with the current tax system – namely, the increasing reliance of state/territory governments on unstable revenue sources.

The detrimental impact for the states/territories from relying on a range of unstable taxes is exacerbated by the volatility in the Commonwealth Government's transfers to them too (see Box 2).

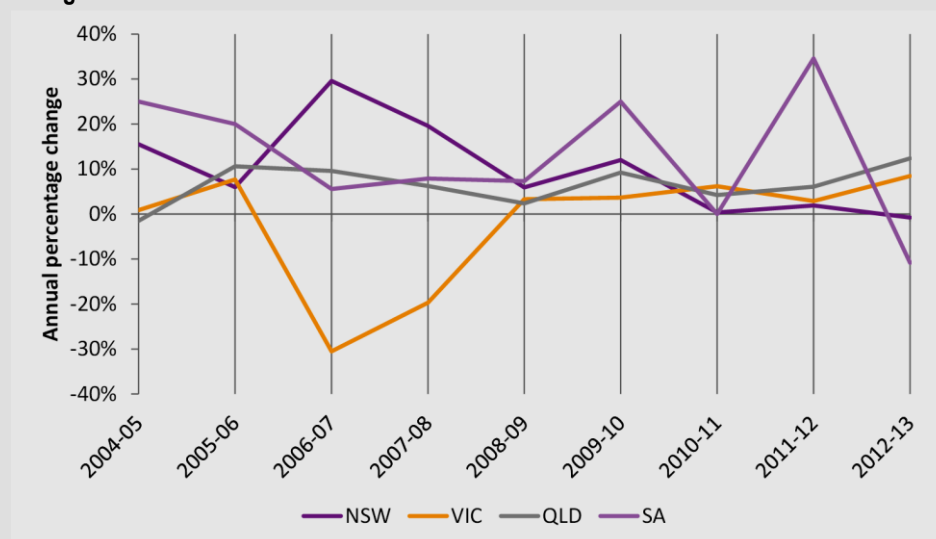
Box 2 Volatility of Commonwealth Government transfers

In addition to the instability of revenues from the taxes directly collected under their own administration, state/territory governments are also subject to the fluctuations of Commonwealth Government transfers each year.

As discussed in Section 2.2.1, state/territory governments heavily rely on Commonwealth Government transfers (revenue predominantly raised from GST) to meet service requirements. The distribution of GST revenue is based on recommendations made by the Commonwealth Grants Commission (CGC) – fundamentally, the CGC determines the allocation of transfers using principles of Horizontal Fiscal Equalisation (HFE); that is, how to distribute revenue in a way that would achieve as much equity across states and territories as possible, recognising that differing economic and social conditions exist.

The figure below shows the annual percentage change in the total transfers from the Commonwealth Government to state/territory governments. It is clear that there are significant fluctuations in the year-on-year change in transfers.

Commonwealth Government transfers to selected state governments, annual percentage change



Note: Annual percentage change of 'taxes received from other levels of government'
Source: ABS 2014a

Source: ACIL Allen Consulting, 2014.

4.3 Economic efficiency

The economic efficiency of a tax refers to the degree to which a tax distorts the economy by changing the behaviour of consumers and producers. The greater the change in behaviour of economic agents as a result of a tax, the larger the distortions created in the market.

4.3.1 Market distortions created by taxes

Taxes can affect market efficiency in several different ways.

First, taxes can alter people's behaviour and adversely affect economic wellbeing in some way. For example, the existing state/territory land tax systems which aggregate taxpayers' land holdings to estimate land tax liabilities results in taxpayers making decisions on land purchases to minimise their tax; including unbundling land holdings to minimise tax or investing in land across different jurisdictions in order to minimise land tax.

Stamp duties on conveyances are another tax which alter business behaviour. Stamp duties on commercial property are a tax on business inputs which impede the restructuring of businesses because they add to the costs of doing so. This reduces business flexibility and inefficiency, and as a result undermines business competitiveness.

Alternatively, taxes on personal income change an individual's incentive to work; a highly progressive personal income tax structure that redistributes wealth from high income earners to low income earners will reduce the incentive of certain individuals to attain a job, since welfare payments reduce the gap in living standards between those that are unemployed and those that are working in low-paying jobs. At the margin, the returns to labour (i.e. compensation through wages) are diminished, reducing the relative benefit of working compared to the benefit of receiving government assistance. High-income earners that are heavily taxed will also have less incentive to work extra hours due to the significant portion of their payment being allocated to the government via the taxation system.

Second, taxes can alter consumer behaviour by changing the relative price of goods and services when applied selectively within an economy. Changes to consumer behaviour consequently act as a signal to suppliers to adjust their behaviour in order to meet the new demand created from the taxes imposed on commodities. The effects of changes to the relative price of goods and services are particularly significant for commodities that have high substitutability. One example of this is the tariffs applied to certain fresh produce imported from overseas. By placing a tariff on imported goods that may otherwise be cheaper than the same good produced domestically, inefficiencies are created in the economy since consumers experience a reduction in welfare as they no longer have the option to purchase the imported commodity at a lower price than is available. Furthermore, the behaviour of domestic producers is also altered, since the need to innovate and increase productivity (thereby producing a good at a lower cost) is diminished.

Since impacts from altered relative prices arise when taxes are applied to specific commodities over another, taxes with broader bases (such as GST) are generally more efficient than those goods and services taxed via a narrower-base.

Third, taxes that lead to an increase in the price of a good may have adverse downstream consequences. Insurance taxes is one example where the imposition of duties leads to an increase in the price of insurance products, resulting in the reduction in the amount (i.e. number) of insurance products consumed. This leads to socially undesirable outcomes since a greater number of people are exposed to risks that they could otherwise be insured against, had insurance prices been lower without the tax.

How a tax impacts the efficiency of the economy depends on its type, taxable base, amount of exemptions and concessions as well as the structure of the tax rates. All of these can vary significantly.

4.3.2 Cost to economic well-being of taxes (excess burden)

A measure of the loss in economic efficiency as a result of a tax is the *excess burden of tax* or the *cost to economic well-being of the tax*. Excess burden is defined as the ratio of change in economic well-being to the change in tax revenue, and represents society's aggregate economic wellbeing loss (or gain) induced by taxes.

Excess burden of taxes can be measured in marginal terms or in average terms, where:

- **Marginal excess burden (MEB)** represents the loss of economic well-being to the economy from incremental changes to taxes, expressed in cents per dollar of additional tax revenue. Alternatively it measures the efficiency gains from reducing tax by \$1; and

— **Average excess burden (AEB)** represents the loss of economic well-being from introducing a new tax, expressed in cents per dollar of additional tax revenue.

Consequently also represents the efficiency gain from abolishing particular taxes.

Taxes inducing greater distortionary effects on the economy, usually as a result of altered consumer and/or producer behaviour in response to changes in relative prices of goods and services, will have higher 'excess burdens'.

Further discussion on the concept of the excess burden of tax is outlined in Appendix C.

ACIL Allen's estimation of the excess burden (loss of economic well-being) of key Commonwealth and state/territory taxes is shown in Table 1.

Table 1 Estimated marginal excess burden of taxes

Efficiency Rating	Tax	Marginal Excess Burden
Relatively efficient	Tobacco tax	-8
Relatively efficient	Alcohol & WET	9
Relatively efficient	GST (10% & broader base)	6
Relatively efficient	GST (10%)	8
Relatively efficient	Payroll tax (exemptions removed)	9
Relatively efficient	Land tax (broad based low rate)	10
Inefficient	Payroll tax (current regime)	16
Inefficient	Luxury car tax	20
Inefficient	Land tax (current regime)	20
Inefficient	Personal income tax	24
Highly inefficient	Developer contributions	34
Highly inefficient	Stamp duties on conveyances	34
Highly inefficient	Motor vehicle tax	37
Highly inefficient	Company tax	40
Highly inefficient	Insurance tax	67

Note: The estimate has been applied to both residential and commercial conveyancing duties. However, it is generally acknowledged that stamp duties on commercial conveyances are more inefficient with a more adverse effect on economic well-being per dollar of revenues raised. MEB based upon Henry Review estimates with ACIL Allen Consulting analysis to estimate additional MEBs.

Source: ACIL Allen Consulting, 2014.

Taxes have been ordered from the more efficient taxes to the least efficient taxes at the bottom. Taxes that have a broad base and more limited distortionary effects on the behaviour of consumers and producers are typically more efficient (e.g. GST, broad-based low rate land tax, and broad based payroll tax) whilst those that significantly impact behaviours through changes to relative prices or other means, are inefficient (e.g. stamp duties on conveyances, company tax and insurance tax).

4.4 Equity

The equity principle implies that a tax system should aim to achieve both horizontal and vertical equity. Horizontal equity is achieved by applying taxes to people in similar financial circumstances in the same way, while vertical equity is achieved through a progressive tax system that levies individuals with greater wealth and/or income at higher marginal tax rates (Quinlan, 2012).

The existing land tax systems provides another example of the inevitable trade-offs involved with achieving vertical and horizontal equity. The existing land tax systems across the various states and territories apply aggregation whereby the land holdings of each land owner is taxed as a single amount. Where a progressive rate scale applies, this obviously means that the average rate of land tax on a portfolio of land can be much higher than if each property were taxed separately. Aggregation assists with pursuit of vertical equity however it does not achieve the principle of horizontal inequity in that two parcels of land with the same value and characteristics will end up being taxed differently as a result of the application of aggregation.

Payroll tax provides an example of the trade-off between the pursuit of vertical and horizontal equity. Payroll tax exemptions through the setting of thresholds are aimed at reducing the tax burden on companies with limited resources, so that they have a better chance of competing against well established businesses. However, whilst a threshold that exempts a large group of enterprises from payroll tax may lead to vertical equity outcomes, it also leads to horizontal inequity, since taxes are applied differently to an otherwise similar activity, placing a greater cost of doing business on larger enterprises.

The fact that the tension between vertical equity and horizontal equity cannot be avoided for a specific tax lends support to the argument that tax reform needs to be approached strategically. The balance between equity and creation of market distortions resulting from significant exemptions and thresholds that effectively narrow the tax base, needs to be assessed carefully. This means that some taxes (such as personal income tax) are better suited for achieving equity than other taxes (such as land tax) that create significant market distortions.

Moreover, the equity issue should not be solved through the taxation system alone. Supplementary policy tools such as transfer payments should be considered in parallel, to achieve meaningful reform to the tax system.

4.5 Simplicity (administration and compliance)

Taxes impose a cost to the economy as they require individuals and businesses to understand and comply with relevant tax legislations. Widely recognised as the administrative and compliance cost of taxation, a modern tax system should have simple rules that are easy to adhere to and administer, in order to minimise unnecessary cost on the economy.

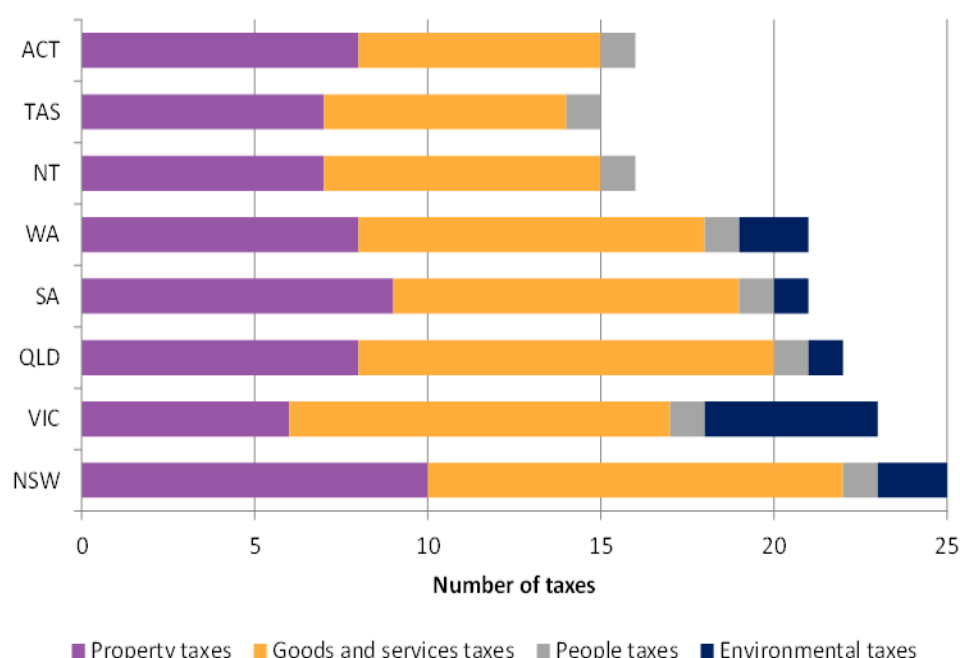
From the private sector's perspective, a complex tax system may be burdensome due to the real costs that arise through, for example, having to hire an accountant or tax agent to ensure tax obligations are being met, or from the opportunity cost of having to allocate resources to comply with tax laws. Furthermore, the complexity of a tax may deter individuals from engaging in certain economic activities that involve relatively large amounts of paperwork.

On the other hand, taxes impose a cost on the economy through the administrative requirements of the public sector in legislating and enforcing the taxation system. Tax revenue is collected by the Australian Taxation Office (ATO) and various government offices. They incur intrinsic operational costs associated with implementing new taxes (for example, setting up systems for revenue collection or means-testing of exemptions and concessions) and with monitoring collection. In this regard, taxes that differ by state and territory lead to unnecessary costs for firms operating in more than one jurisdiction as a result of duplicated systems, practices and activities that often marginally differ which could otherwise be rationalised under a single system/rule.

Australia has a relatively large number of taxes under the existing tax system. This is a major concern for the business sector since companies that operate across different state/territory jurisdictions are burdened with high compliance costs associated with having an inadvertently large number of taxes.

Figure 23 shows the number of taxes by category for each state and territory.

Figure 23 Australia's business tax landscape



Source: BCA and CTA 2007.

As shown, four out of the seven jurisdictions have more than 20 different taxes, while the remaining states/territories have at least 15. Whilst many of these taxes are similar in nature (i.e. payroll tax, stamp duty on conveyances, land tax, and so on), the specifics of the taxes such as marginal tax rates, thresholds and exemptions varies across jurisdictions, making Australia's state taxes unduly complex.

The Business Council of Australia (BCA) and Corporate Tax Association (CTA) study which surveyed 92 Australian businesses and 78 businesses from the United Kingdom (UK) revealed that Australia had significantly more taxes borne and collected, at an average 56 different taxes for the survey participants, compared with the UK average 26 taxes. This demonstrates the complexity of Australia's tax system compared against UK standards.

It is recognised that the existing large number of taxes that exist under current arrangements are unnecessarily complex and inefficient. Designing a simple tax system that has fewer taxes to comply with is critical for delivering productivity gains to an economy, as it allows scarce resources to be allocated to the provision of goods and services instead of compliance and administration.

In general, simple taxes are associated with the following characteristics:

- *Simple flat tax rate structure* – theoretically, a flat tax rate would be the most simple tax structure since the need to differentiate the tax base based on their activity (for example, total land values aggregated in terms of taxpayers' land holdings for annual land tax calculations, salary paid in the case of payroll tax, and personal income in the case of personal income tax) can be avoided. Conversely, the greater the number of differentiation (e.g. taxable income brackets), the more complex and therefore more costly it is to ensure compliance.
- *Minimal exemptions and concessions* – a simple tax should not be plagued by multiple exemptions and concessions rules that require an individual or business entity to constantly monitor their own activity to comply with a tax. The greater the complexity in how exemptions and concessions apply, the greater the compliance and administrative cost, as taxpayers would need to document and demonstrate they qualify for them, whilst the public sector assesses each claim.
- *Clearly defined exemptions and concessions* – taxation rules that are not clearly defined necessitate the opinion of 'experts' (i.e. tax agents or accounts), which add to the cost of doing business. Furthermore, loosely defined exemptions and concessions may lead to distortions in the market, as economic agents look for ways to maximise their wellbeing by qualifying for as many exemptions and concessions as possible. When individuals and businesses focus their energy on benefiting from 'loopholes' in tax rules, it reduces the welfare of the economy.
- *Harmonisation across jurisdictions* – the complexity of a tax increases when the rules are different across jurisdictions. Different rules in different states/territories is particularly costly for businesses that operate in multiple jurisdictions. Simple taxes should have the same rule regardless of the geography in which a taxable entity operates.
- *Use of technology to reduce compliance and administrative costs* – a simple tax system should reduce the amount of time taxable entities have to spend meeting their tax obligations.

4.6 Competitiveness

Taxes impact on the competitiveness of domestic businesses, and the attractiveness of Australia as an investment destination, particularly as global integration of markets continue to progress further and further.

In order for Australia to continue to prosper in the future, taxes need to be designed in order to:

- attract vital foreign capital through direct foreign investment
- improve the international competitiveness of domestic businesses.

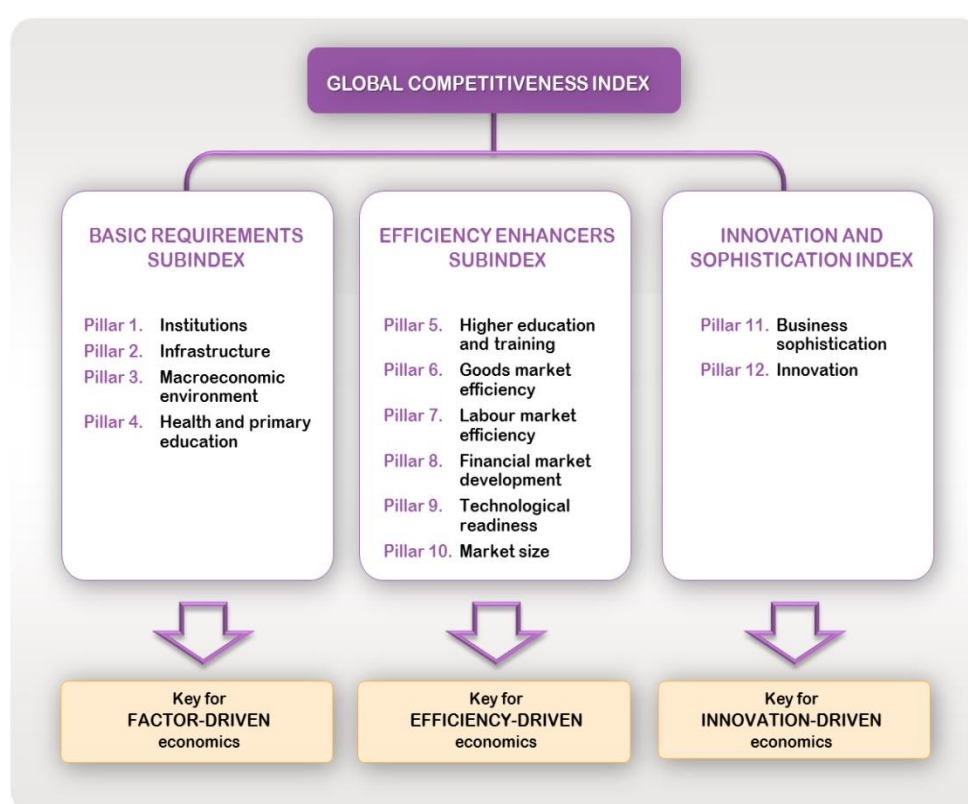
To achieve this, it is important to first establish a common understanding of what is meant by 'competitiveness' in the context of this report.

4.6.1 Competitiveness, productivity and economic growth

Although the word ‘competitiveness’ is used frequently in public policy debate, it is typically the case that a concrete definition of the concept is not provided, making it difficult to compare policy options due to the lack of a consistent benchmark. In this regard, the World Economic Forum (WEF) provides a strong foundation for the concept: “the set of institutions, policies, and factors that determine the level of productivity of a country” (WEF 2013).

Recognising the multiple determinants that drive productivity and competitiveness, the WEF adopts a 12-pillar approach for comparing the competitiveness of countries in its global competitive index (GCI). These are shown in Figure 24.

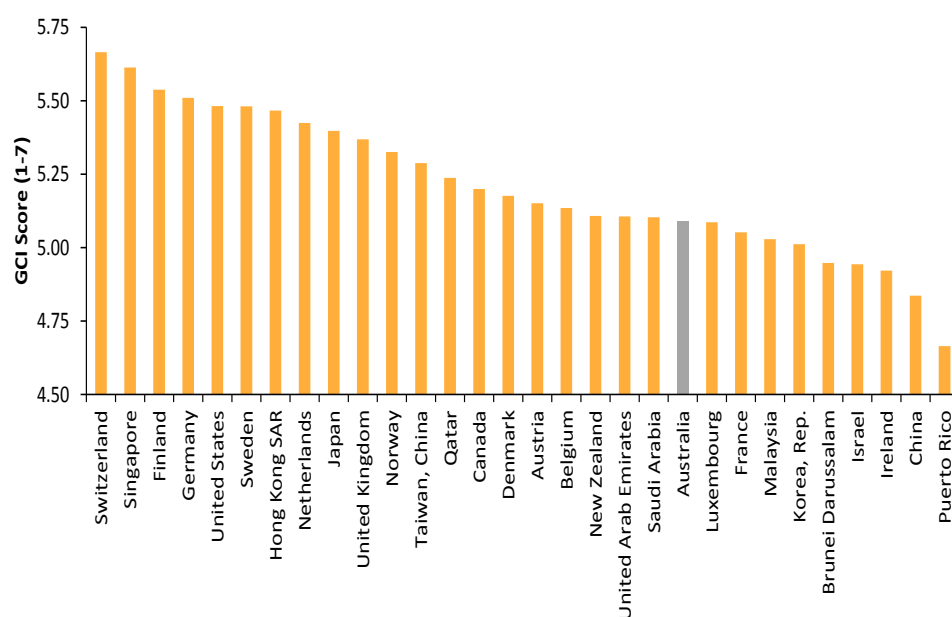
Figure 24 **Twelve pillars of competitiveness identified by the World Economic Forum**



Source: WEF 2013.

Figure 25 shows the rankings of the top 30 countries according to the Global Competitiveness Index (GCI).

Figure 25 Top 30 countries by Global Competitive Index, 2013-14



Note: The range for the Global Competitive Index (GCI) is 1 (lowest) to 7 (highest).
Source: WEF 2013.

In 2013-14, Australia came in 21st from the top in the GCI ranking (Figure 25). This is the first time Australia did not make the top 20, and was overtaken by New Zealand, which jumped five places to 18th. According to the WEF, Australia performed well on Pillar 8 – financial market development and was improving on Pillar 3 – macroeconomic environment.

The area in which Australia performed poorly was Pillar 7 – labour market efficiency, ranking at 54th as a result of rigid labour markets and inflexibility in wage setting for businesses. Moreover, Australia's government institutions were found to be one of the best performing in the world, except for a high degree of regulation and red tape.

Tax policy can impact Australia's performance on many of the twelve pillars, whether by making Australia a more attractive place for direct foreign investments, reducing inefficiencies in markets, encouraging innovation, and by improving Australia's budget position.

4.6.2 Impact of tax on business competitiveness

High marginal rates on source-based taxes for business activity act as a disincentive for multinational businesses to invest in the highly taxed country. This is because high taxation of investment reduces returns received by the business. High tax rates will also encourage multinational enterprises operating in Australia to transfer profits to low-tax foreign jurisdictions, placing a greater burden of tax on Australian residents. In this regard, company income taxes are relatively distorting, since company taxation directly influences business decisions (e.g. where, what and how much to invest).

The combined effects of increased capital mobility, ongoing progress in digital technology and the rapid growth of low-wage emerging economies in recent decades has meant that, for small open economies such as Australia, the level at which the company tax rate is set at, has more relevance than ever in determining its attractiveness as a business investment destination. As recognised by Johansson et al (2008):

- Duties on non-residential conveyancing are a barrier to transactions, thereby reducing the number of business transactions than would otherwise occur. The impact of this barrier is that it prevents land from being put to its most valuable source.
- Land tax aggregation mechanism underlying state/territory land tax bases means that businesses may seek to unbundle their land holdings to minimise tax
- Company taxes can distort relative factor prices (that is, between the corporate and non-corporate sector) resulting in a reallocation of resources from one sector to less productive sectors, consequently lowering total factor productivity
- High corporate income taxes may reduce the incentive to invest in research and development (R&D) by reducing after-tax returns on investments
- Complex tax systems reduce productivity by absorbing resources to compliance and administration, instead of producing goods and services
- Foreign direct investment (FDI) in Australia may be discouraged by average statutory taxes that are high compared to other countries. This may result in the reduction in technology transfers required to increase domestic competitiveness
- Company income tax can distort corporate financing decisions, particularly if interest can be deducted from taxable profits under debt financing arrangements, unlike equity.

Importantly, there is a large body of literature highlighting that increase taxation reduces the total factor productivity of businesses, of all sizes and maturity (*ibid.*).¹⁶

The evidence for such decision making by businesses is reported by the OECD (2007), which cites summary statistics of empirical studies concerning the sensitivity of foreign direct investment (FDI) to marginal tax rates. It was found that, on average, a 1 per cent increase in marginal tax rates led to a 3.72 per cent decrease in FDI. Whilst this number should be interpreted with caution, the overall conclusion is that reducing statutory corporate tax rates relative to other countries can make Australia more competitive as a destination for business investments.

Australia's international competitiveness can be enhanced through increased efficient investment channelled by the appropriate signals and incentives of a well-designed tax system. Whether taxes are conducive to fostering a competitive economy is an important tax modernisation principle by which key Commonwealth and state/territory taxes should be assessed.

¹⁶ The exception to this finding is for small and young companies, which is likely explained by the fact that start-up firms typically do not generate significant profits for a number of years after commencing operation, and because many countries provide tax exemptions and concessions to this business group.

4.7 Revenue adequacy

The primary function of any tax system is to raise revenue to fund the provision of goods and services by the government

Treasury 2012a, p. 15

For governments to be able to serve their function without compromising equity between current and future generations, revenue raised from taxes needs to be sufficiently large to meet government funding requirements while in principle, regularly achieving a budget balance.

The process of modernising Australia's taxation system must pay close attention to how the proposed reforms – which inevitably requires altering and/or abolishing some taxes – might impact overall government revenue at both Commonwealth and state/territory levels. This entails endeavouring to minimise the reduction in aggregate tax revenue by making provisions for 'backfilling' revenue fall associated with altering or abolishing taxes, whether through increases in marginal tax rates and/or expansion of tax base of those that are less distorting.

Importantly, given the federal system, meeting the revenue adequacy principle is virtually impossible if each of the Commonwealth and state/territory governments is considered in isolation. As such, inter-governmental collaboration and cooperation will be a prerequisite for agreeing on a sustainable new tax system that raises sufficient revenue to meet the needs of Australian society.

5 Assessing Commonwealth taxes

Key Commonwealth taxes are assessed in this chapter using the tax modernisation framework and principles developed in Chapter 4.

KEY POINTS

- The assessment of taxes highlight that taxes which are complex, unstable with a high efficiency and competitiveness cost are generally characterised by:
 - ◆ a narrow base
 - ◆ high tax rate
 - ◆ complicated and differentiated rate schedules.
- The performance of Commonwealth taxes vary across the different tax modernisation principles. Generally, broad-based taxes such as GST that minimise market distortions perform well on the efficiency front compared to those with distortionary effects such as company income tax.
- Poorly designed taxes stifle business innovation, investment and competitiveness, thereby reducing Australia's overall productivity compared against other countries.
- Commonwealth taxes generally perform well on stability and simplicity since they do not apply on a sector-specific basis, and since many burdensome rules have been consolidated in recent years.
- The Commonwealth's company taxation, however, poses particular challenges to the competitiveness of Australia. There is much scope to improve corporate income tax which currently adversely impacts Australia's competitiveness as a place of doing business.
- Greater leverage of efficient taxes should be made a strategic reform goal by reducing dependence on 'bad' taxes and increasing revenue from 'good' taxes. Increasing utilisation of taxes that are broad and simple will lead to better economic outcomes for Australia as a whole.

All taxes discussed are assessed using each of the tax modernisation principles *except* for 'revenue adequacy', which is an overarching measure of whether the Australian tax system as a whole raises sufficient revenue to meet future requirements of government services.

Whilst the assessment of taxes follows a similar approach to that used by Henry (2010) where taxes were assessed based on *what they would ideally look like*, one-by-one, it is also important to consider their relative performances against other taxes. Doing so, assists with prioritising taxation reform areas.

Given that there is no such thing as a 'perfect' tax or taxes that Australia could rely on to raise future revenue, tax reform inevitably involves selecting a 'portfolio' of changes to key taxes, which may benefit some stakeholders but not others. In this regard, tax reform packages need to be developed based on a selection of taxes that perform well against the reform principles and reducing reliance on those that measure poorly against the principles, whilst satisfying the principle of revenue adequacy from a whole-of-package perspective.

The Henry review outlined and analysed individual taxes and, in some cases, made recommendations with respect to each tax and/or areas for further analysis. This report provides practical reform packages involving a portfolio of taxes for moving Australia's tax system forward. The selection of reform packages and the results from the economic modelling of the proposed package is detailed in Chapter 7 and Chapter 8.

5.1 Commonwealth taxes

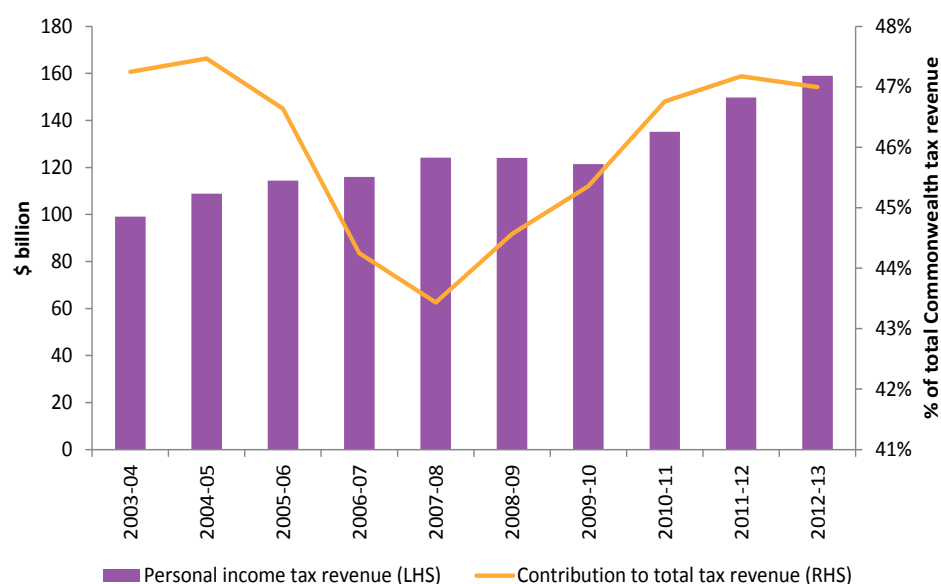
5.1.1 Personal income tax

Tax overview

Figure 26 shows historical revenue from personal income tax, and its percentage contribution to total Commonwealth tax revenue. As can be seen, personal income tax is a large source of tax revenue for the Commonwealth Government, raising approximately \$159 billion in 2012-13.

The annual contribution of personal income tax to total Commonwealth Government revenue has been moderately stable over the past decade at around 47 per cent, except for during the Global Financial Crisis (GFC) period where it decreased to between 43-45 per cent. The 10-year average annual contribution of personal income tax to total government revenue (from 2003-04 to 2012-13) is approximately 46 per cent.

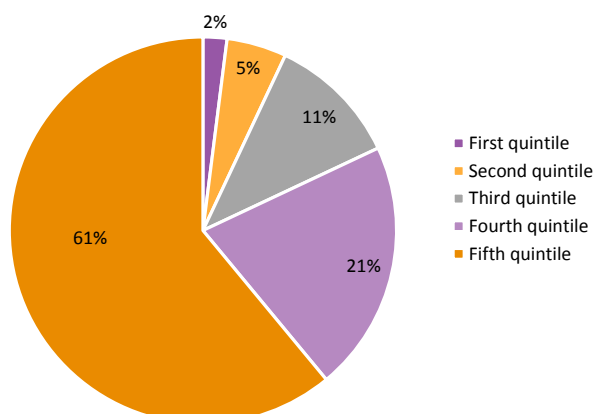
Figure 26 **Personal income tax revenue**



Source: ABS 2014a.

According to the Australian Taxation Office (ATO), almost 10 million Australians pay personal income tax (ATO 2014), with the top 20 per cent of taxpayers paying over 60 per cent of the personal tax collected – this is shown in Figure 27.

Figure 27 Personal income tax by income quintile



Source: ATO 2014.

While the Australian personal income tax system has a broad base that covers all working individuals with a taxable income, as suggested by Henry (2010), it has become “inordinately complex” over the years as a result of a variety of tax exemptions and concessions as well as poorly defined taxes that often require professional judgement of its applicability to an individual:

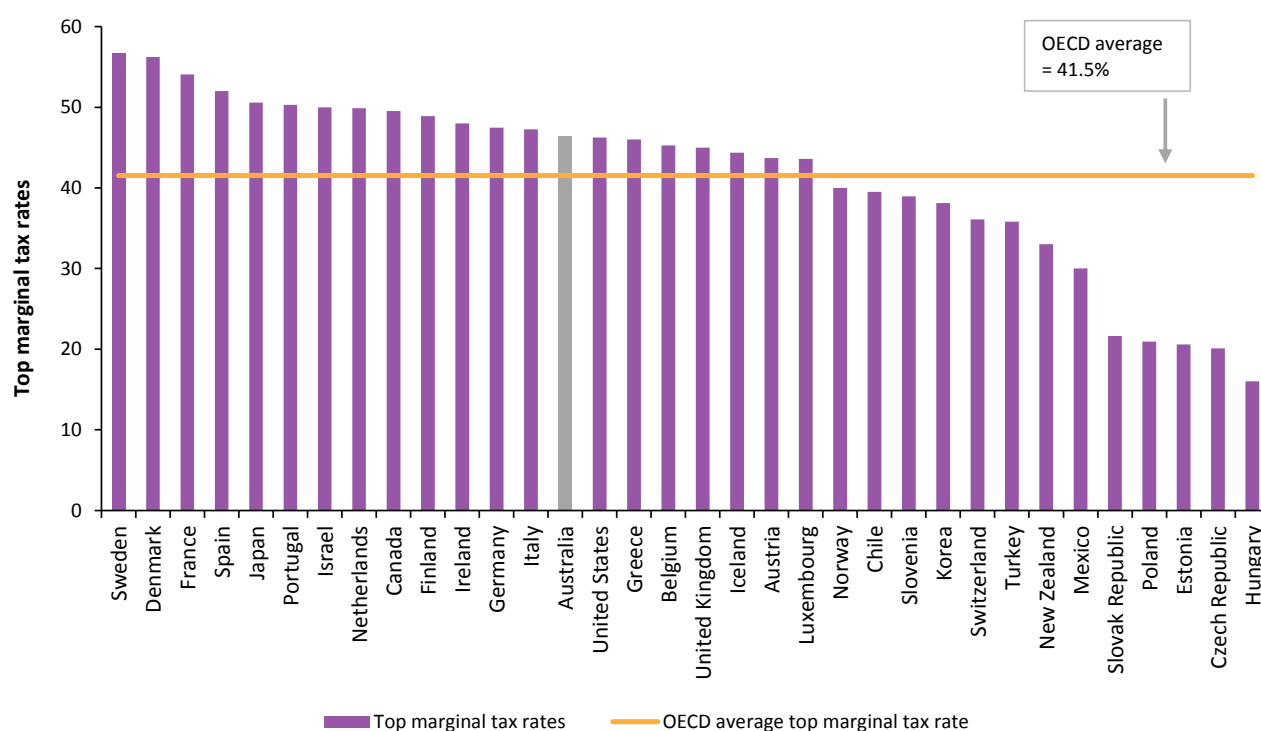
“For many people, the personal tax system is complex not only because of the rates scale and the lack of coherent definition of taxable income, but also because they must deal with a large suite of complex deduction rules, numerous tax offsets and a variety of exempt forms of income.”

Henry Tax Review: part one 2010, p.30

In addition to creating complexity, offsets and other concessions can erode personal tax revenues and create adverse incentives.

In the international context, Australia has one the highest personal income tax rates. Australia’s 45 per cent personal income tax rate is higher than the Organisation for Economic Co-Operation and Development (OECD) average of 41.5 per cent for individuals (see Figure 28).

Figure 28 Statutory top personal income tax rates, OECD countries, 2014



Note: This is the combined central government and sub-central government marginal personal income tax rate at the earnings threshold where the top statutory personal income tax rate first applies. It is calculated as the additional central and sub-central government personal income tax resulting from a unit increase in gross wage earnings. The combined rate takes account of the effects of tax credits, the deductibility of sub-central taxes in central government taxes, etc.

Source: OECD 2014.

Stability

Personal income tax is a relatively broad based tax, since it applies to all Australian workers earning above the threshold level. In addition, since the total amount of income earned by the population is strongly correlated with economic performance, revenue from income tax is relatively predictable compared to other taxes. This is evident from the low variability measure shown in Figure 22 (the only other Commonwealth tax which performs better against this measure is tax on crude oil and LPG).

Personal income tax performs well against the stability principle and is one of the more desirable sources of government revenue.

Efficiency

The current structure of Australia's income tax creates a moderate loss in economic wellbeing. ACIL Allen's estimates that personal income tax reduces Australia's economic well-being by 24 cents for every dollar of revenue raised.

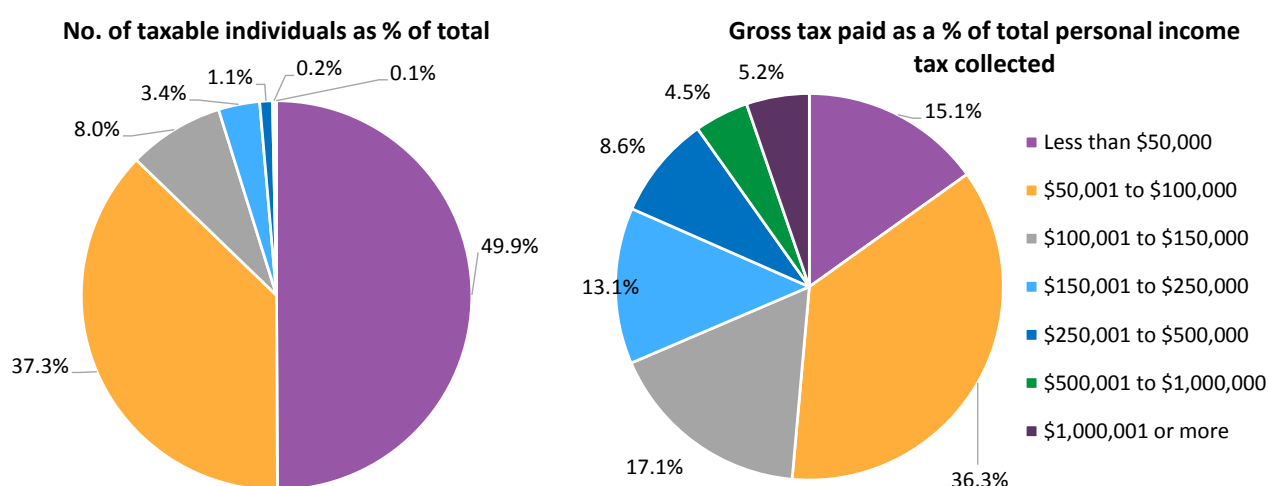
Although there are strong reasons for making personal income tax progressive from an equity perspective, the threshold level which narrows the base, and the differing marginal tax rates that apply to individuals depending on their income level, creates inefficiencies in the market. Taxing labour reduces the incentive to work, since the returns to labour falls. For those at the margins of either entering or exiting the workforce, the marginal tax rate levied on their income may be the deciding factor between value-adding to the economy or not.

Equity

One way to assess the progressivity of personal income tax, and therefore its performance in terms of vertical equity, is to look at the distribution of tax revenue by taxable income group.

Figure 29 shows the number of taxable individuals as a percentage of total taxable persons, and the percentage of gross taxes paid as a proportion of total personal income tax collected, in 2011-12. As shown, approximately 87.2 per cent of all taxable individuals in Australia had a taxable income of less than \$100,000. The total tax raised from this group was approximately \$73.3 billion, which was equivalent to 51.4 per cent of the \$146.5 billion personal income tax collected by the Commonwealth Government in the same year. The remaining 48.6 per cent of personal income tax revenue was raised from only 12.8 per cent of the total number of taxable individuals.

Figure 29 **Number of taxable individuals and gross tax paid by taxable income range as share of total, 2011-12**



Note: ACIL Allen grouping of taxable income range

Source: Australian Taxation Office, Detailed Taxation Statistics 2011-12, Table 3.

Higher income earners clearly contribute a disproportionately larger amount of personal income tax in Australia, indicating a system that is highly progressive. This is demonstrated by the fact that, despite representing only 0.3 per cent of the total number of taxable individuals, gross taxes paid by those earning \$500,000 and above contributed to approximately 9.7 per cent of total personal income taxes collected in 2011-12.

Australia's personal income tax system performs well in terms of vertical equity. This finding is supported by the Henry Tax Review (2010) which concluded:

Overall, Australia has a progressive personal income tax system. The personal income tax and transfer system taken together is among the most progressive in the OECD.

Henry Tax Review: part two 2010, p.17

Given its relatively broad base, personal income tax is well suited compared to many other taxes in fostering vertical equity in Australia, particularly when delivered in conjunction with a well-designed transfer system.

Competitiveness

When labour is taxed, individuals are discouraged from working or working 'more', since the returns to their labour (i.e. compensated through income) are reduced by the amount of tax they have to pay.

Taxing personal income too highly has the effect of reducing the size of the labour supply, which in turn, adversely impacts the overall productivity of the Australian economy.

Moreover, for individuals that are relatively mobile, a high marginal tax rate on income may encourage them to move abroad where income is not as heavily taxed.

Australia's top personal income marginal tax rate is currently 45 per cent; 3.5 per cent higher than the OECD average of 41.5 per cent. The implication of having a higher-than-average top marginal tax rate is difficult to quantify, though in theory, Australia's attractiveness as a place of working for high income earners arguably diminishes relative to other countries that have lower top marginal tax rates. This leads to an outflow of highly productive labour (using income as a proxy of labour productivity) and/or a reduction in the migration of highly productive foreign workers, who otherwise would have chosen to work in Australia.

Simplicity

One area of the personal income tax system that could be improved is its simplicity and transparency.

As shown in Table 2, currently, there are five taxable income brackets in Australia with corresponding tax rates. The current personal income tax scale makes it difficult for individuals to readily estimate their own after-tax income.

Table 2 **Tax rates 2014-15**

Taxable income bracket	Marginal tax rate
Less than \$18,200	Nil
\$18,201 to \$37,000	19 cents for each \$ over \$18,200
\$37,001 to \$80,000	\$3,572 plus 32.5 cents for each \$1 over \$37,000
\$80,001 to \$180,000	\$17,547 plus 37 cents for each \$1 over \$80,000
\$180,001 and over	\$54,547 plus 45 cents for each \$1 over \$180,000

Source: Australian Taxation Office 2014.

Moreover, the personal income tax system is excessively complex due to the numerous tax exemptions, deductions and offsets that exist. These provisions add cost to the Australian economy as they reduce transparency and simplicity. A simplified income tax scale could reduce distortions at the margin of each taxable income bracket, since a constant rate would be applied to the vast majority of taxable individuals. For example, if the main income bracket is set at \$25,001 to \$180,000 as suggested in the Henry Tax Review (2010), it would capture just over 85 per cent of all taxable individuals in 2011-12. Such a system has the added benefit of increasing disposable income for low income earners by widening the tax-exempt population, and pave way for making the transfer system more efficient as well.

Overall assessment

Australia's personal income tax system performs very well in terms of its fairness (i.e. vertical equity). This is demonstrated by the fact that just over half of personal income tax revenue in 2011-12 was raised from 12.8 per cent of the taxable population (those with a taxable income of over \$100,000). Personal income tax is also a relatively stable and predictable source of revenue, as it has a broad base.

There is room for improvement on the simplicity principle, since the current system, when combined with the transfer system, is highly complex and distortionary.

5.1.2 Company income tax

Tax overview

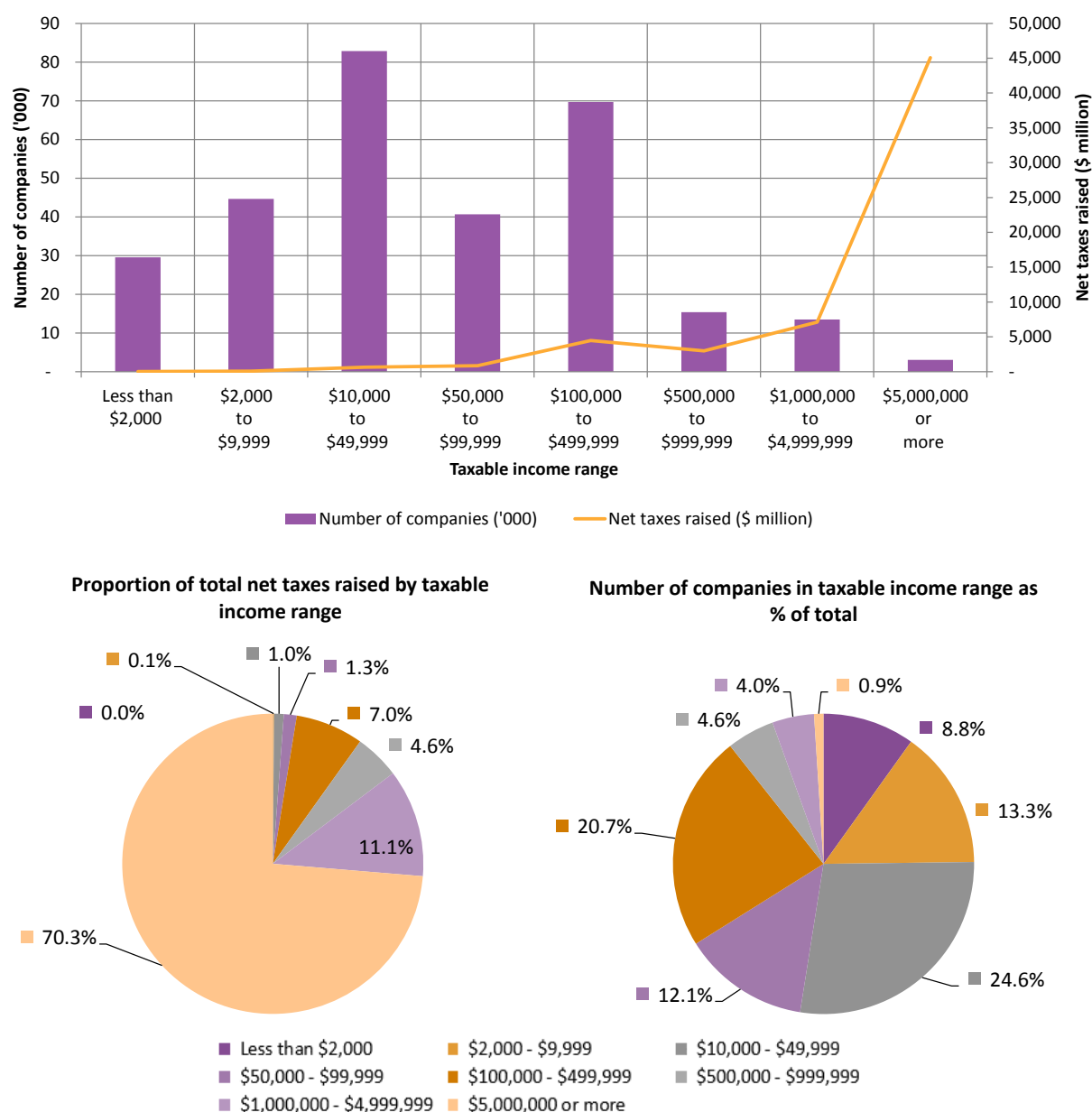
Company income tax applies to corporate enterprises and other relevant statutory bodies established in Australia engaging in commercial activity. Taxes are imposed on the annual revenue generated by a business, at a flat rate of 30 per cent for most statutory bodies, although some exceptions apply.¹⁷

In 2012-13 the Commonwealth Government raised approximately \$77.1 billion via company income tax. The annual contribution of company taxes to total Commonwealth Government revenue has been volatile over the past decade, ranging from 18 per cent of total taxes at its lowest in 2003-04 to a high of 23 percent in 2007-08. The 10-year average annual contribution of company taxes to total government revenue (from 2003-04 to 2012-13) is approximately 21 per cent.

A significant proportion of corporate income tax revenue is raised from a relatively small number of companies. As shown in Figure 30, 70.3 per cent of corporate income tax in 2011-12 was raised by companies with a taxable annual income of \$5 million or more. Collectively, there were 3,020 companies in these taxable income range, which was equivalent to around one per cent of the 337,000 taxable companies that were operating in Australia that year.

¹⁷ The current company tax rates can be found on the Australia Taxation Office (ATO) website: <https://www.ato.gov.au/rates/company-tax/> accessed 25th June 2014.

Figure 30 Net taxes raised by taxable income groups (private and public enterprises), 2011-12



Source: ATO 2013.

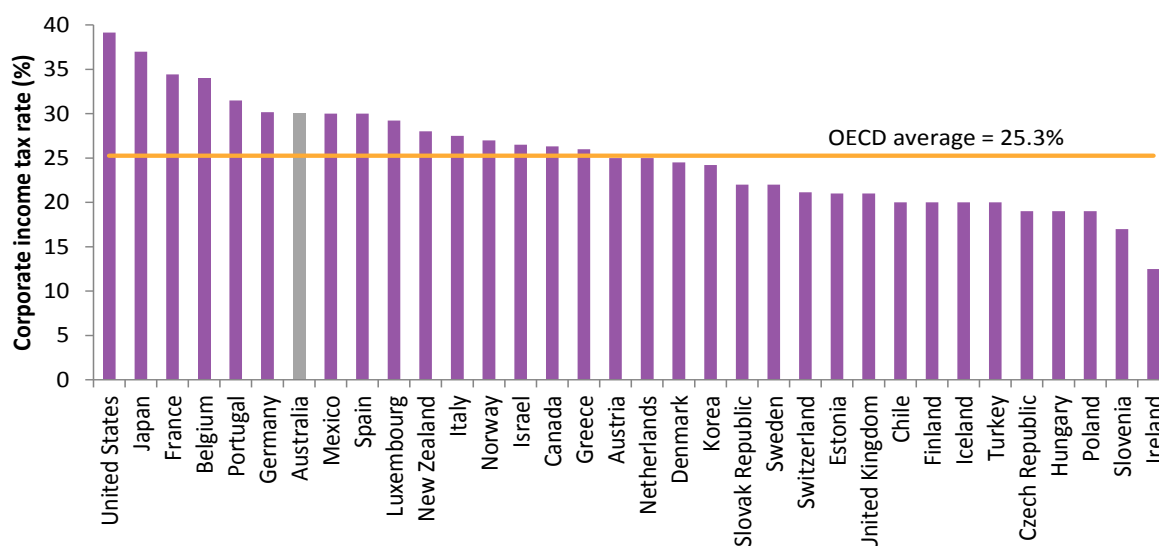
In the international context it is worth noting that Australia's statutory corporate income tax rate is relatively high when compared against other OECD countries.

As shown in Figure 31, Australia's 30 per cent company tax rate ranks equal-sixth highest out of 34 OECD member countries. Countries with high marginal corporate tax rates include: United States (39.1 per cent), Japan (37.0 per cent) and Germany (30.2 per cent). Typically these countries have corporate income levied at both national and regional (i.e. state) levels.¹⁸

¹⁸ In 2014, Australia, Mexico, Portugal and Spain all had a company income tax rate of 30 per cent.

In contrast, countries with the lowest company tax rates include Ireland (12.5 per cent), Slovenia (17.0 per cent), and Poland, Hungary and the Czech Republic which each have a combined statutory marginal tax rate of 19 per cent. Interestingly, there are no obvious similarities across these countries in terms of population size, economic structure or geographical location.

Figure 31 **Statutory corporate income tax rates, OECD countries, 2014**

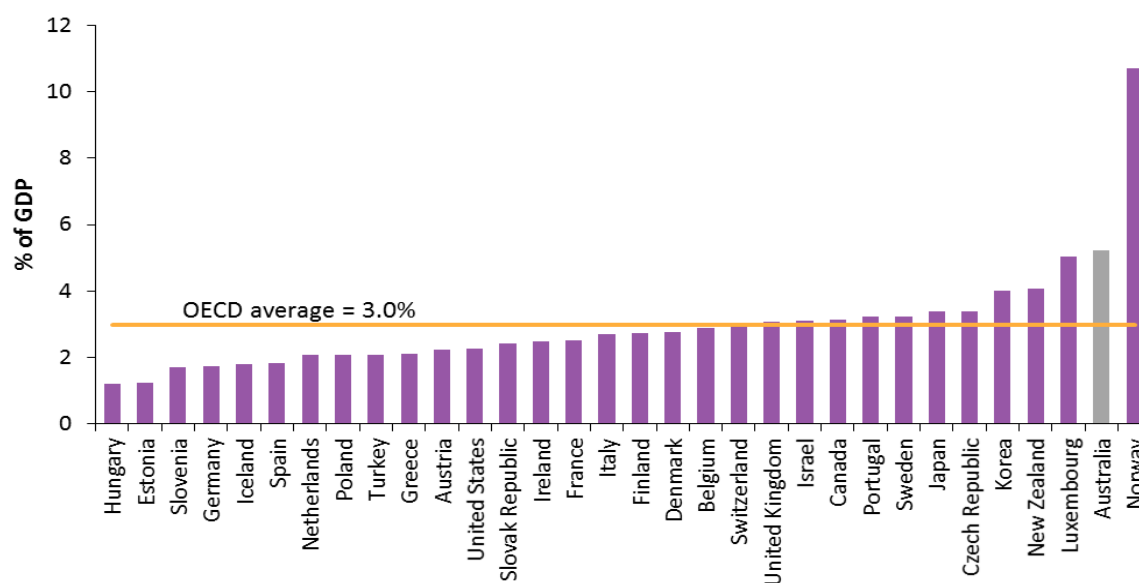


Note: Combined corporate income tax rate shown - shows the basic combined central and sub-central (statutory) corporate income tax rate given by the adjusted central government rate plus the sub-central rate.

Source: OECD 2014.

Australia's reliance on company income tax revenue is disproportionately high by international standards. As shown in Figure 34, at 5.2 per cent, revenue from taxes levied on enterprise income as a percentage of GDP was second only to Norway in 2011 amongst the 27 OECD members.

Figure 32 **Company income tax revenue as percentage of GDP, 2011**



Source: OECD 2014.

Stability

Company income tax has a moderate level of stability with a measure of variability indicating it is:

- more volatile than the other major Commonwealth taxation sources (personal income tax and the GST) but
- less volatile (more stable as a revenue source) than other Commonwealth taxes including such as fringe benefits taxes and superannuation guarantee charges (see Figure 22).

Efficiency

Company income tax has large distortionary effects on the economy. As discussed in Section 4.6, when companies are levied with an income tax, the pre-tax rate of return that an investor is willing to accept in exchange for investing in Australia increases. Since international investors are able to divert capital investments away from countries with relatively high marginal tax rates – such as Australia – corporate income tax is relatively inefficient and results in a relatively high loss to Australia's economic well-being from every dollar raised from company taxation.

Equity

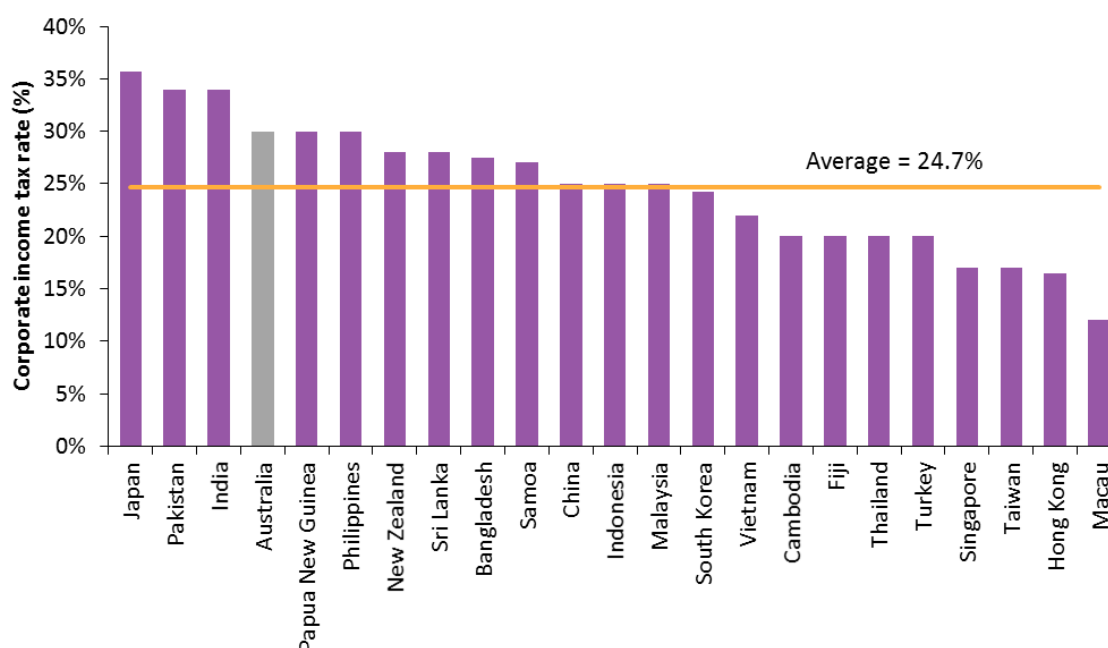
Company income tax is horizontally equitable since all companies regardless of their size and revenue are levied at a single marginal tax rate. Concessions exist for small businesses on the accounting treatment of certain types of assets, providing some amount of vertical equity.

The franking credit system in Australia for company taxation allows domestic companies to pass through taxes that have already been paid on corporate profits. The investor receiving stock dividends receives a quantity of franking credits in proportion to the overall tax rate of the company per dollar in profits which ensure that investors are taxed at their own marginal tax rate. This part of the company tax system enhances the equity of company taxation as a tax.

Competitiveness

Australia's high marginal corporate income tax rate compared to OECD countries was highlighted in Figure 31. Figure 33 demonstrates that Australia's marginal corporate income tax rate is substantially higher when compared against countries in the Asia-Pacific region as well. Tax rates in some of these countries such as Singapore, Taiwan and Hong Kong, are more than 10 percentage points lower than in Australia, making them a highly attractive investment destination for multinational enterprises.

Figure 33 Corporate income tax rate, selected Asia-Pacific countries, 2014



Note: Selected countries in Asia-Pacific region

Source: KPMG 2014.

Implications on competitiveness

The importance of competitiveness as a tax reform principle is recognised by both the private and public sector. For example, the Commonwealth Treasury's *Business Tax Working Group Final Report* suggests that a lower company tax rate has often been regarded as central to Australia's international competitiveness (Treasury 2012a).

This is consistent with the views of Australian business leaders:

If Australia's tax rate is uncompetitive and it's increasingly uncompetitive, then capital will flow to other markets and we won't get the investment in productive assets that will improve economic growth and the creation of jobs and wealth creation in Australia.

Richard Goyder, CEO of Westfarmers, 2014

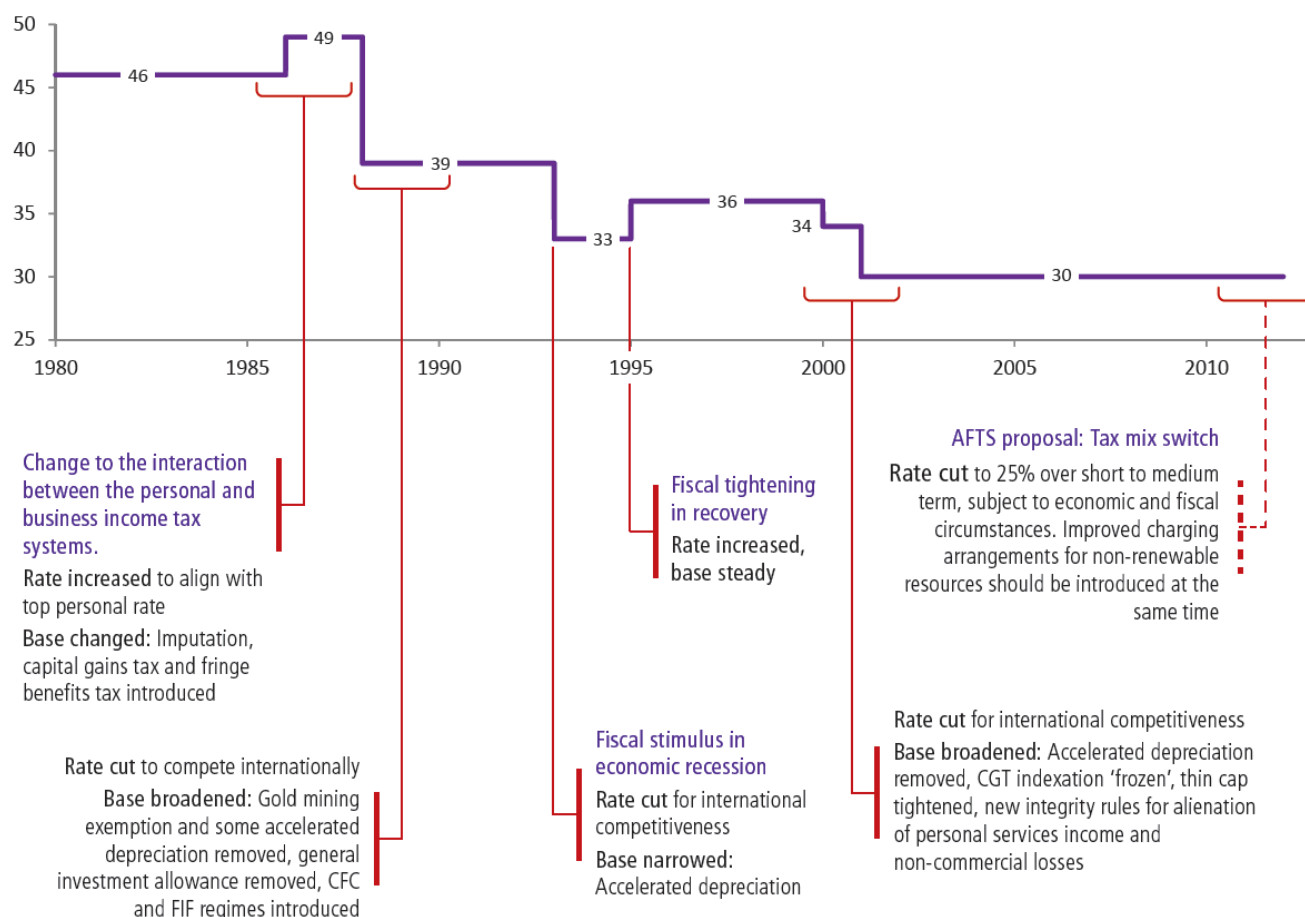
Moreover, insofar as designing a tax system that, as a minimum, maintains Australia's competitiveness by global standards is concerned, a reduction in the marginal company income tax rate will assist with making Australia a more attractive country to do business in. This is because the *relative* marginal tax rate on company income between Australia and other countries affect investment decisions made by multinational companies. Keeping rates unchanged while other countries reduce their statutory tax rates is effectively decreasing Australia's competitiveness as a place of doing business, since the relative return on investment is lower here than elsewhere.

Progress has been made but continued reform is necessary

Since the end of the 1980s, Australia's corporate income tax rate has been on a declining trend, falling by as much as 19 per cent since its peak of 49 per cent (Figure 34). Changing rates reflect various economic conditions as well as policy goals of the time. Since 2001, however, company income tax rate has remained steady at 30 per cent, during which time, many OECD countries have continued to reduce their marginal tax rate.

The Henry Tax Review (2010) recommended that the company income tax rate should be reduced to 25 per cent over time, with the timetable for the reduction being guided by both economic and fiscal conditions.

Figure 34 Historical change in Australia's company income tax rate (1980-2013)



Source: Treasury 2012b.

Simplicity

The Henry Tax Review (2010) notes that complexities continue to exist in the current Australian company tax system, primarily through the numerous capital allowance arrangements that apply to certain assets. Businesses must determine the appropriate treatment of assets based on its value and effective lives, and calculate its depreciation in order to deduct them from income. There are separate capital allowance arrangements for small businesses as well. These capital arrangements creates compliance burden for businesses, and also distorts the market by encouraging investment in less productive assets.

Overall assessment

Given the potentially far-reaching effects of company income taxes on the overall performance of the economy, a reduction in the marginal tax rate should be made one of key priorities of tax reform. A high corporate income tax rate relative to other countries reduces the attractiveness of Australia as a place for investing and doing business, which in turn, reduces productivity.

By aligning the marginal tax rate with the average level of small and medium economies particularly in our region, Australia is likely to benefit significantly from increased investments, and higher income from a larger and more productive capital stock.

5.1.3 Consumption tax (goods and services tax)

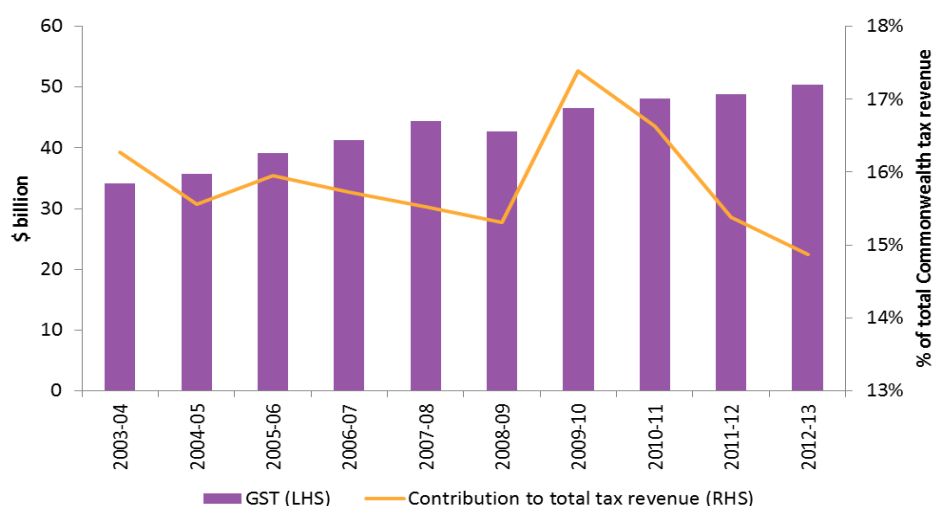
Tax overview

The goods and services tax (GST) commenced in 1 July 2000. It is a broad-based tax imposed at 10 per cent of the value of most goods and services supplied and consumed in Australia.

A number of goods and services have been exempt from the GST since its introduction. Exempt goods and services include fresh food, some education courses and some medical, health and care products and services.¹⁹

In 2012-13, the total amount of taxation raised through GST was \$50.3 billion (see Figure 35). Between 2003-04 and 2012-13, on average, GST accounted for approximately 16 per cent of the Commonwealth Government's annual tax revenue.

Figure 35 Goods and services taxation revenue

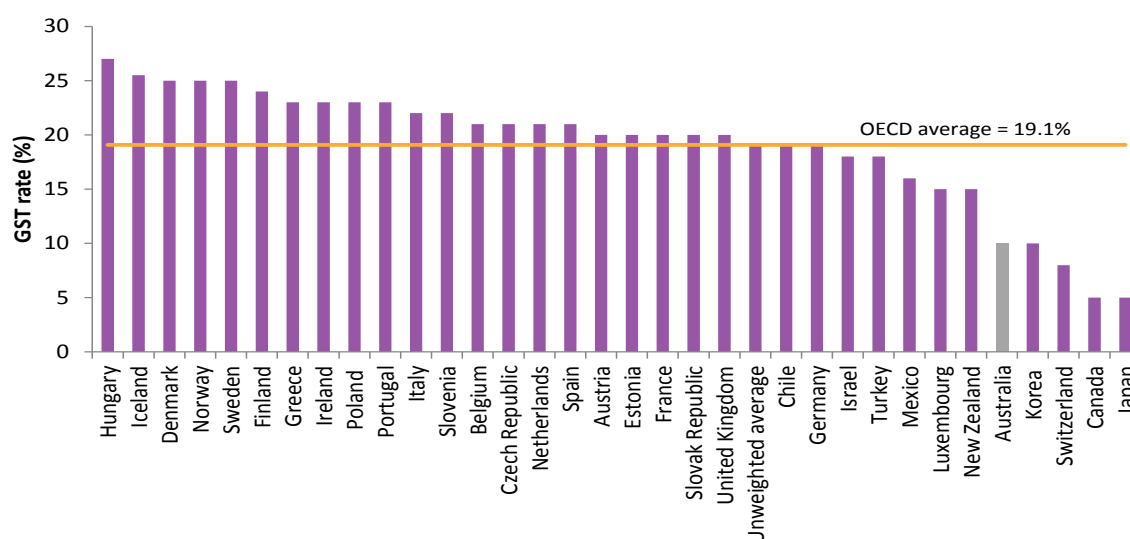


Source: ABS 2014a.

As shown in Figure 36, Australia's marginal GST rate is low compared against other OECD countries. Out of the 34 OECD countries, Australia's 10 per cent GST rate ranks as the fifth lowest, and its rate is approximately half the OECD average GST rate of 19.1 per cent.

¹⁹ A list of GST free items can be found at: [https://www.ato.gov.au/Business/GST/When-to-charge-GST-\(and-when-not-to\)/GST-free-sales/Main-GST-free-products-and-services/](https://www.ato.gov.au/Business/GST/When-to-charge-GST-(and-when-not-to)/GST-free-sales/Main-GST-free-products-and-services/).

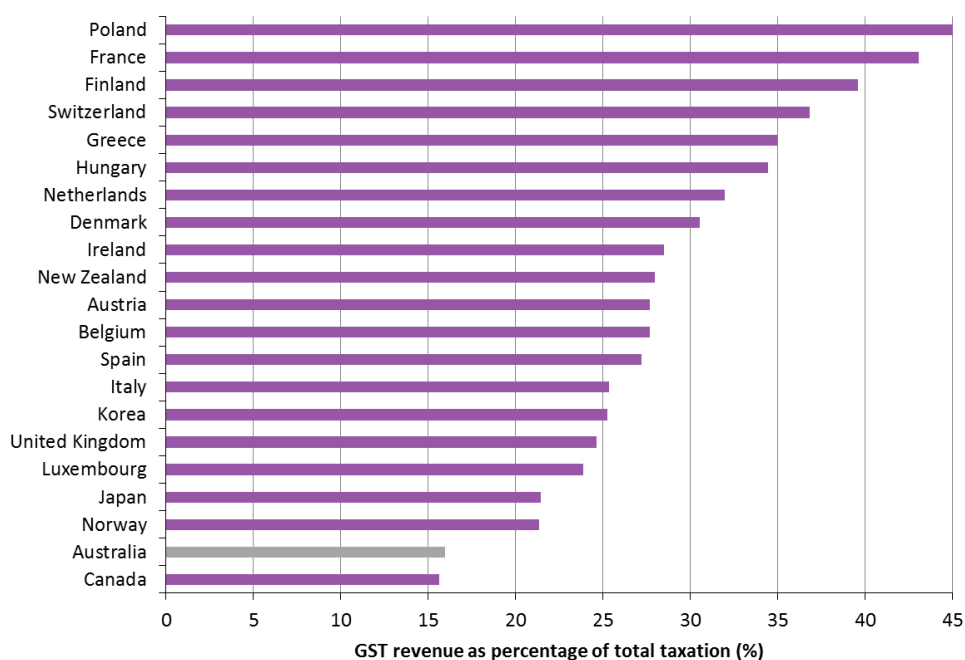
Figure 36 Goods and services tax rates, OECD countries, 2014



Source: OECD 2014.

Part of the reason why Australia's GST rate is relatively low compared against other OECD countries is that Australia has a higher reliance on other forms of taxation (both levied on consumption and income). This is supported by Figure 37, which shows that Australia's average GST revenue as percentage of total taxes for the period 2002 to 2011 is low (15.4 per cent) when compared to most other selected OECD countries (an average of 29.0 per cent).

Figure 37 Central government GST revenue as percentage of total taxation, selected OECD countries (2002 to 2011 average)

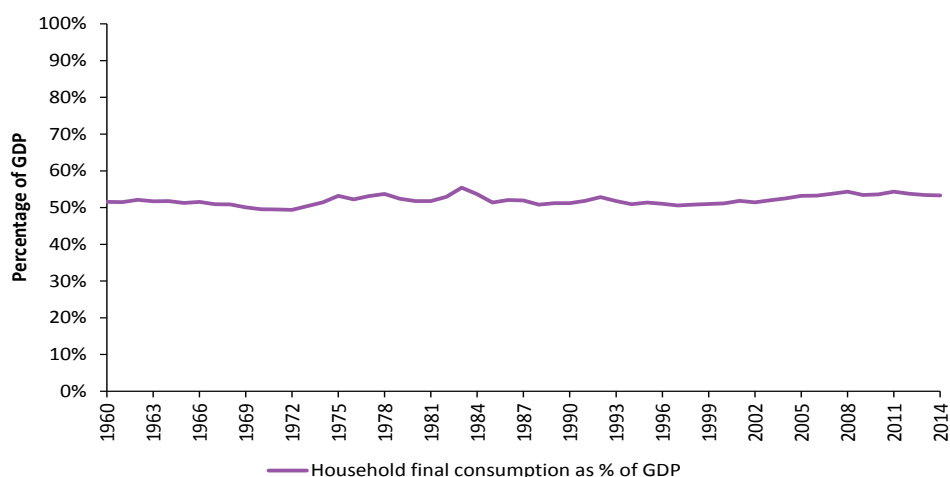


Source: OECD 2014.

Stability

Australia's goods and services tax (GST) is a relatively stable source of revenue for Government since household final expenditure as a percentage of GDP does not vary significantly on a yearly basis as shown in Figure 38. The average household expenditure to GDP ratio between 1960 and 2014 was 52 per cent. The highest ratio during this period was recorded in 1983 at 55.4 per cent, while the lowest ratio was in 1972 at 49.4 per cent. To the extent that household expenditure remains relatively stable over time, GST revenue are also be expected to be stable and predictable in the future.

Figure 38 Household expenditure as a percentage of GDP, 1960 to 2014



Note: 2011-12 Chain Volume Measures

Source: ABS 5206.0 System of National Accounts

Since its introduction 2000, however, the Commonwealth Government has experienced the erosion of the GST base, as households spend a greater proportion of their income on healthcare services and products, as the population ages.

Efficiency

A broad-based, single rate consumption tax minimises market distortions, making it one of the most efficient taxes available to government.

Taxes on consumption do not directly tax normal returns to capital, thereby ensuring that investment and saving is not discouraged. Moreover, since these taxes are neutral from a consumer's consumption timing preference perspective, it induces minimum distortions to consumer behaviour, since the same tax is paid whether an individual chooses to consume now or in the future.

Importantly, provided that the tax base is broad, consumption taxes minimise market distortions that would arise if certain goods and services are excluded from the tax. If consumption tax is levied on certain goods and services but not on others, relative prices of goods and services within the economy changes. This may lead to an increase in consumption of untaxed goods and services that are now relatively cheaper, the extent depending on the substitutability and price elasticity of demand for the good (or service).

Exclusions could be reduced to improve efficiency and simplicity

As shown in Table 3, the Commonwealth Government currently makes GST exemptions to a range of goods and services - the total amount of GST revenue foregone as a result of exemptions is estimated at around \$21.9 billion for 2013-14.

Table 3 Exemptions to goods and services tax, 2013-14

Good / Service	Revenue foregone (\$ million)
GST — Food; uncooked, not prepared, not for consumption on premises of sale and some beverages	6,200
GST — Education	3,700
GST — Health; medical and health services	3,400
GST — Financial Supplies; input taxed treatment	3,300
GST — Health; drugs and medicinal preparations	420
GST — Health; medical aids and appliances	110
GST — Health; private health insurance	280
GST — Health; residential care, community care and other care services	1,050
GST — Child Care Services	940
GST — Water, sewerage and drainage	910
GST — GST free status of diplomats	7
GST — Importation threshold	470
GST — Imported services	170
GST — Sale of boats for export within 12 months of supply	10
GST — Tourism; travel agents	95
GST — Religious services	30
GST — Simplified accounting methods	10
GST — Cross-border transport supplies	2
GST — Financial supplies; input taxed treatment	830
Total	21,934

Source: Treasury 2014, Tax Expenditure Statement.

Generally speaking, the goods and services exempt from GST are those that are typically associated as having 'social value', such as education, healthcare and childcare services. In this regard, the items on the GST exemption list is a reflection of the attempt made by governments to make consumption tax progressive (i.e. redistributive), in order to achieve vertical equity.

However, a narrower GST base does not necessarily mean it is fairer, as stated in the Henry Tax Review (2010), and can result in increased complexity of the consumption tax system. For instance, the current exemptions on unprepared food items largely benefit higher income households since, the absolute amount of income spent by the highest income group on fresh foods is reportedly more than five times the amount spent by the lowest income group (ibid.).

Equity

Since the same marginal rate of GST applies to everyone in Australia who consumes goods and services regardless of their income level, it is typically labelled as a regressive tax (i.e. vertically inequitable). Conversely, insofar as a single marginal tax rate is applied to all consumers, GST can also be viewed as being a horizontally equitable tax.

The exemption of certain goods and services such as health care and child care contributes to achievement of vertical equity as it assists with ensuring that certain goods and services can be more cheaply accessed by all individuals relative to other goods and services.

Competitiveness

A reduction in GST compliance burden increases the competitiveness of Australian companies – particularly those that are small, since compliance costs are typically higher for smaller businesses that have limited resources. Streamlining differential treatments of various goods and services alleviates much of the compliance costs associated with record-keeping of different types of supplies that are GST exempt.

Simplicity

A broad-based single rate consumption tax system minimises compliance costs for business, particularly those that are small. The Board of Taxation (2007) found that GST-specific compliance requirements add to the cost of doing business, since:

- working out exemptions and concessions can be confusing and time-consuming
- classifying supplies into taxable, GST-free and input-taxed items may not be straightforward
- distinguishing between capital and non-capital items for business activity statement is arduous.

Given these factors, a reduction in GST-exempt goods and services would reduce the compliance burden on businesses and individuals, allowing them to focus on value-add activities for the benefit of the economy.

Overall assessment

In contrast to the relatively high reliance on corporate income tax compared to other OECD countries, Australia's reliance on a GST is low at 10 per cent of GDP as opposed to the 19.1 per cent OECD average (see Figure 36).

Given that consumption tax is generally more efficient than corporate income tax, a strong case can be made for Government to increase the share of tax revenue from GST as a justification for reducing the corporate income tax rate. In so doing, Australia could increase its global competitiveness as a place of doing business, whilst maintaining a budget neutral position using a less distorting tax.

5.1.4 Alcohol taxes and wine equalisation tax

Alcohol is currently taxed through a number of different regimes. Beer and spirits are subject to as many as 8 different excise rates while wine is taxed under the Wine Equalisation Tax (WET), where a tax is applied to the value of the wine.

Stability

Figure 39 shows Commonwealth Government revenue from excises on beer, and WET, between 2006-07 and 2012-13. Each year, taxes on beer raises approximately \$2 billion, whilst WET contributes approximately \$700 million to Government revenue.

Annual growth in revenue for both taxes between 2006-07 and 2010-11 was very similar, at a CAGR of 3.1 per cent respectively.

Figure 39 Revenue from beer and wine equalisation tax



Source: Compiled using Commonwealth Government Budget Papers 2006-07 to 2012-13.

Taxation revenue from alcohol tax is proportional to demand for alcoholic beverages. Demand for alcohol does vary to a degree due to industry specific conditions including the relative price of imported alcohol beverages and climate which impacts yields on vineyards and other inputs to production.

Efficiency

The myriad of differing excise rates applied to different types of alcohol leads to large market distortions since it changes the relative prices of alcoholic beverages. In their study, the Allen Consulting Group (2011) explained that the distorting effects of inconsistent alcohol taxes encourages individuals to consume:

- more cheap wine and less premium wine (since WET is applied to the wholesale value of wine and not alcohol content itself, cheaper wines are made more affordable compared to more expensive wine, than otherwise would be)
- more wine from small producers than larger producers since WET makes provisions for small-scale producers
- more draught beer than packaged beer (since draught beer, typically served in pubs, is taxed at a concessional rate compared to packaged beer)
- more brandy than spirits.

The range of taxes and concession rates are essentially reflected in the prices of various types of alcoholic beverages available. To meet the distorted demand, producers are provided with the incentive to increase production of beverages that are taxed at lower rates, resulting in an overall misallocation of resources and reduction in output.

Equity

Alcohol tax is not equitable since it lacks a consistent framework for levying alcoholic beverages. Currently, exemptions and concessional excise rates apply to different alcoholic beverages, advantaging some types over others. There is limited horizontal equity since taxes are applied to different products that are consumed in different context (e.g. draught beer taxed at a concessional rate than packaged beer).

To the extent that WET is calculated based on the value of wine, it could be seen as being vertically horizontal (i.e. progressive) since those that can afford to consume more expensive wines pays more. However, given the social cost of consuming alcohol, and that the WET leads to increased consumption of cheap cask wine (Allen Consulting Group, 2011) and increased alcohol misuse, the benefit of achieving vertical equity from a value-added tax on wine is highly debatable.

Competitiveness

Significant distortions created by alcohol taxes has implications to the broader economy in the form of misallocation of productive capital and labour. Furthermore, the inordinately complicated alcohol tax regime can act as barriers to entry for foreign alcoholic beverages company.

Simplicity

As highlighted in the Henry Tax Review (2010), alcohol tax is highly complex and inconsistent. There is an unnecessarily large number of concessional rates available to different types of alcoholic beverages, which generates a significant amount of inefficiency in the sector. There is a strong case to be made for reducing the number of marginal tax rates through consolidation of concessions and simplifying the overall tax structure.

Overall assessment

Alcohol tax is highly complex and inconsistent, creating unnecessary inefficiencies within the sector. The number of concessions should be reduced and reformed so that they better align with overall social policy objectives of reducing abusive alcohol consumption.

5.2 Assessment summary

Based on the qualitative assessment of Commonwealth taxes detailed above, each of the key taxes have been given a score out of five, as shown in Table 4. The maximum score of five indicates that the tax meets the reform principle very well, whilst a minimum score of zero means that it does not meet the principle at all.

The tax by tax assessment highlights which taxes are better or worse. In doing so, this analysis points to which taxes could be expanded and which should be reduced or abolished. Such an approach where taxes are compared against one another, has been used in previous tax policy studies to identify reform priority areas.²⁰

²⁰ See, for example, IPART (2008).

Table 4 Assessment of Commonwealth taxes

Tax/Modernisation principle	Stability	Efficiency	Equity	Competitiveness	Simplicity
Personal income tax	4.0	3.0	4.0	3.0	3.0
Company income tax	2.5	1.0	2.5	1.0	3.0
Consumption tax (GST)	4.0	4.5	2.0	3.5	4.0
Alcohol taxes and wine equalisation tax	3.0	4.5	3.0	2.0	3.0

^a The principle of competitiveness has limited relevance for gambling tax.

Note: Each tax has been assigned a value between zero and five based on the qualitative assessment of taxes. A score of five indicates that the tax performs very well against the principle, whilst a score of zero indicates that it performs very poorly. In interpreting the results, emphasis should be placed on the relativity of scores between taxes.

Source: ACIL Allen Consulting, 2014.

- The performance of Commonwealth taxes vary across the different tax modernisation principles. Generally, broad-based taxes such as GST that minimise market distortions perform well on the efficiency front compared to those with distortionary effects such as company income tax.
- Poorly designed taxes stifle business innovation, investment and competitiveness, thereby reducing Australia's overall productivity compared against other countries.
- Commonwealth taxes generally perform well on stability and simplicity since they do not apply on a sector-specific basis, and since many burdensome rules have been consolidated in recent years.
- Increasing dependence on taxes that are broad and simple will lead to better economic outcomes for Australia as a whole.

6 Assessing state, territory and local government taxes

Key state and territory taxes, along with infrastructure charges imposed by local government, are assessed in this chapter using the tax modernisation framework and principles developed in Chapter 4.

KEY POINTS

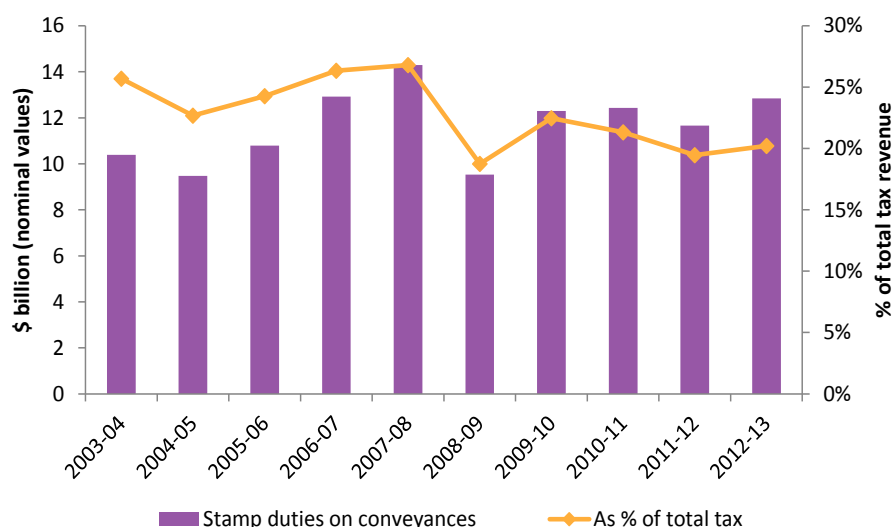
- The assessment of taxes highlight that taxes which are complex, unstable with a high efficiency and competitiveness cost are generally characterised by:
 - ♦ a narrow base
 - ♦ high tax rate
 - ♦ complicated and differentiated rate schedules.
- These characteristics are predominant in state/territory taxes. The most inefficient taxes levied by states/territories include: stamp duty on conveyances, insurance tax and taxes contributing to fire and emergency services.
- Many state/territory taxes are origin taxes levied at point along the production chain, as opposed to being levied at points along the production chain. These taxes increase the cost of production in Australia and disadvantage Australian based firms in competition with overseas markets.
- State/territory taxes and the Commonwealth's company taxation pose particular challenges to the competitiveness of Australia.
- The various forms of state/territory taxes also provide barriers and impediments to competition. A business operating in just one state or territory in Australia can be required to navigate 15 businesses taxes. If that business spreads its operations to cover Australia the total number of individual state taxes increases up to 161. This is in addition to the 21 business taxes levied at the national level. This complexity is a hindrance and cost to conducting business in Australia.
- Reducing reliance on poorly performing state/territory taxes such as stamp duties on conveyances, payroll taxes and insurance taxes will reduce economic inefficiency, and will contribute to increased consumer welfare across Australia.
- Greater reliance on a single rate broad-based land tax and reducing complexity of payroll tax would generate improved outcomes.
- Reducing dependence on 'bad' state/territory taxes highlights the need for cooperation and collaboration between the Commonwealth and state/territory governments in order to achieve meaningful reform. This is because abolishing the 'bad' state/territory taxes necessitates a need for a commensurate increase in transfer from the Commonwealth Government to the state/territories to ensure adequate revenues.

6.1.1 Stamp duties on conveyances

Tax overview

Stamp duties on conveyances is an important source of state/territory government revenue. Despite a sharp fall in collection recorded in 2008-09 as a result of the GFC, collection levels have been recovering since, with revenue totalling \$12.8 billion for all state/territory governments combined in 2012-13, equivalent to approximately 20.2 per cent of total state/territory tax revenue in the same year (Figure 40).

Figure 40 Historical revenue from stamp duties on conveyances, all states and territories combined

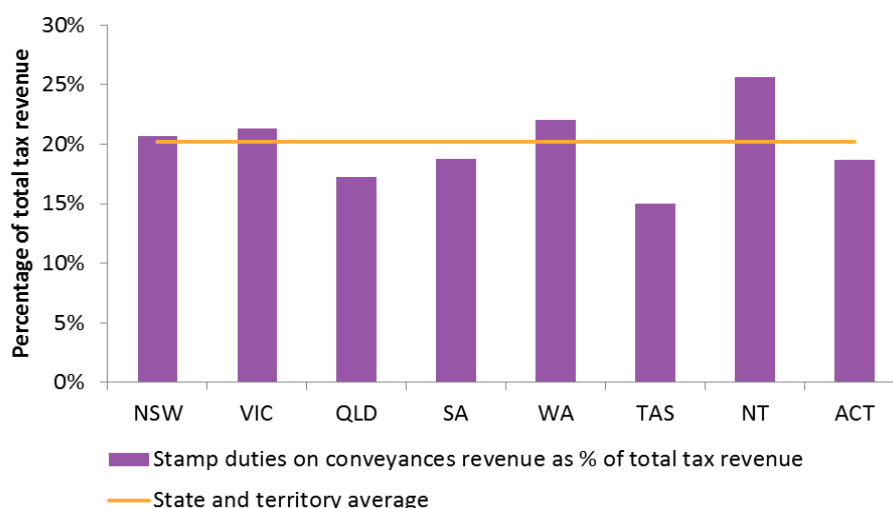


Note: Nominal values.

Source: ABS 2014a.

Government reliance on revenue from stamp duties on conveyances by jurisdiction is shown in Figure 41. As can be seen, the level of reliance varies for each jurisdiction though it is clear that for all state/territory governments, stamp duties on conveyances is a fundamental source of revenue, ranging from 11.1 per cent of total revenue in Tasmania to 21.5 per cent in the Northern Territory.

Figure 41 Stamp duties on conveyances revenue as percentage of total tax revenue by state and territory, 2012-13



Note: Nominal values.

Source: ABS 2014a.

The major factor that determines the amount of stamp duty an individual has to pay is the value of the property, driven largely by the prevailing property market conditions. From a government revenue perspective, the turnover of property (i.e. number of transactions), also influenced by property market conditions, impacts upon the amount of tax revenue raised from stamp duties. These two factors make annual revenue from stamp duties on conveyances relatively volatile, since the number of property transactions and housing prices can change dramatically from year-to-year.

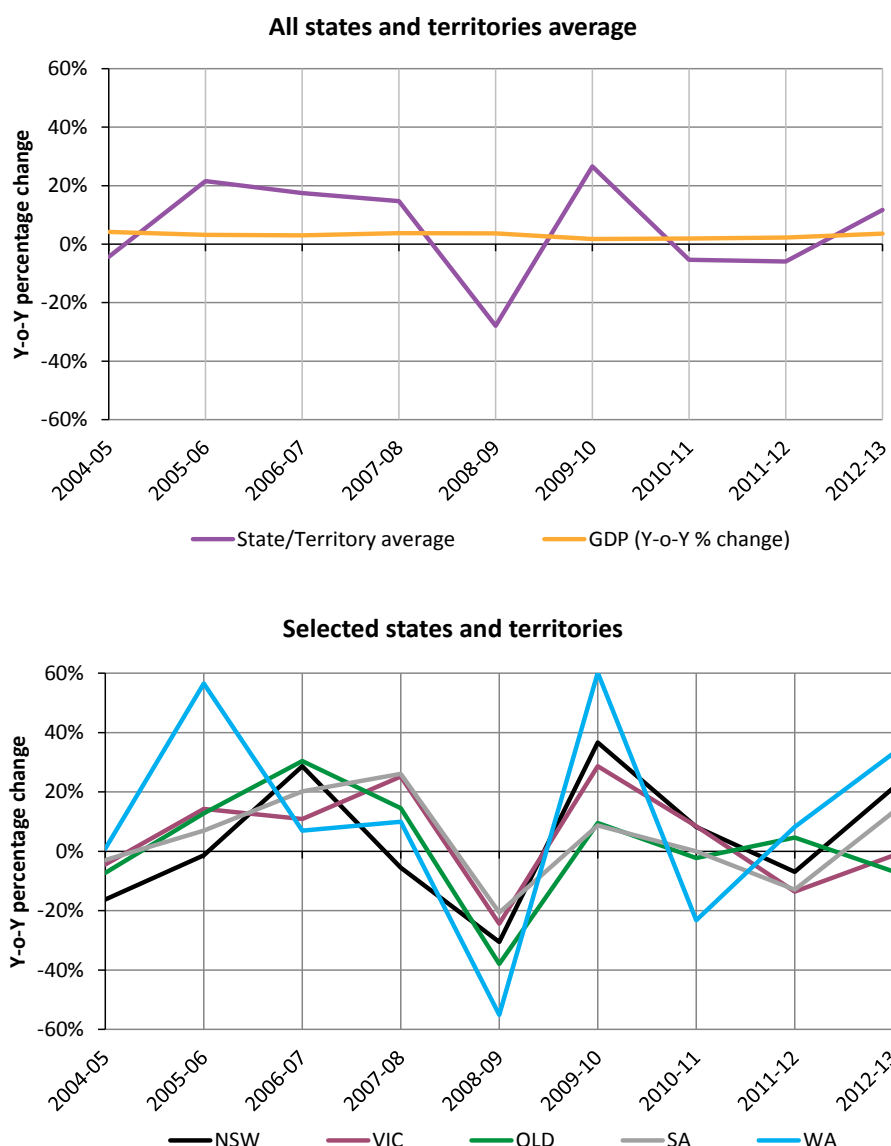
Stability

Despite being one of the most heavily relied on tax bases for state and territory governments, year-to-year revenue from stamp duties on conveyances is highly volatile, providing limited ability for governments to predict their future revenue streams.

As shown in Figure 42, historical year-on-year percentage change to government revenue from duties demonstrates very little consistency. Year-on-year percentage change in revenue fluctuates as much as 27 per cent when taking the state/territory average. Fluctuations are even more pronounced when we consider jurisdictions separately – Western Australia's revenue from stamp duties on conveyances has fluctuated by as much as 60 per cent (both positive and negative) on a year-to-year basis, whilst year-on-year percentage change in states such as New South Wales and Queensland have both been in excess of 35 per cent at least once over the past decade.

The significance of these fluctuations in revenue is particularly clear when compared against year-on-year percentage change of GDP. Stamp duties on conveyances performs poorly against the principle of stability.

Figure 42 Revenue from stamp duties on conveyances, annual percentage change (2004-05 to 2012-13)



Source: ABS 2014a.

Efficiency

Due to its strong distortionary effects on the market, stamp duties on conveyances is a highly inefficient tax. There are many ways in which this tax adversely affects the efficiency of the economy. ACIL Allen estimates existing stamp duties on conveyances to be highly inefficient result in a loss of economic well-being of around 34 cents per one dollar of revenue raised.

It holds back investment and slows down the economy by inhibiting transactions and movement of people. A population of individuals and businesses which are reluctant to move will be inhibited from exploiting employment and business opportunities across Australia.

Stamp duties on conveyances discourages people from moving, because it adds to the cost of relocating on top of other non-tax cost of moving such as removalist fees, real estate agent fees and search cost. The consequence of a reduction in housing transactions due to the additional cost of moving can lead to a misallocation of housing stock. For example, people who are interested in living in a larger house may choose to renovate instead of moving, or purchase a house larger than they currently need in anticipation of a larger family, leading to an imbalance in the housing stock in favour of large houses.

Moreover, since it reduces the incentive for people to move, it can also lead to inefficiencies and rigidities in the labour market. Unemployed individuals may decide not to take up a job opportunity available elsewhere, or, those that already have jobs may choose not to accept a better paying job, since they are discouraged from moving – both of which reduces economy-wide productivity levels.

For those that are looking to enter the housing market, duties may act as a barrier to entry. This is particularly the case when real house prices grow faster than the growth in real wages. As housing prices grow, the deposit required on the purchase of a home also increases, delaying the ability for home-purchasers to own the property they desire.

Stamp duty on conveyances for non-residential property transactions typically have even more distortionary effects than duties on residential property. Further discussion on the inefficiency implications of taxing non-residential property transactions is provided in the competitiveness section below.

Equity

Stamp duty rates on conveyances are designed to be a higher burden of tax is placed on those who can afford to purchase more expensive properties. Stamp duties on conveyances therefore embodies the principle of vertical equity by taxing those that can afford to pay, more than those who cannot.

Most jurisdictions also make concessions for first home owners and low-income households to reduce the barrier to entry created by the added cost of home ownership stemming from this tax.

From a horizontal equity perspective, however, these duties are inequitable, since the burden falls heavily on those who have a preference for housing consumption, and on those who move more frequently. This means that taxpayers who purchase properties relatively frequently pay more than tax than those who don't, regardless of their income level and/or assets.

The disproportionately large burden of tax on frequent movers is illustrated in Box 3. It is evident that those that move more often over their lifetime pay significantly more tax than those who remain in their occupied dwelling for longer periods. The same outcome is true for businesses – the attractiveness of moving to a lower cost geography is reduced as a result of the stamp duties they must pay in the process. This in turn, has adverse repercussions on the overall productivity of the economy, since businesses are slower to adapt to an ever-changing market place.

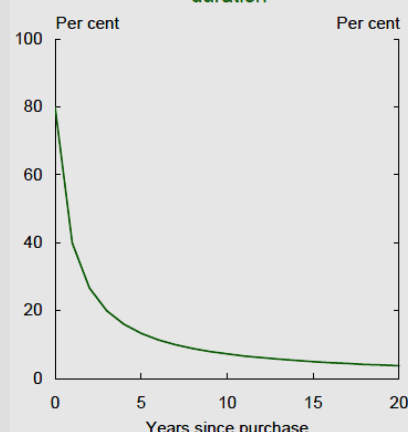
Box 3 Higher tax burden on frequent movers

The figure below shows an illustration of how frequent movers are unfairly burdened by stamp duties on conveyances. It is evident that those that move more often over their lifetime pay significantly more tax than those who remain in their occupied dwelling for longer periods.

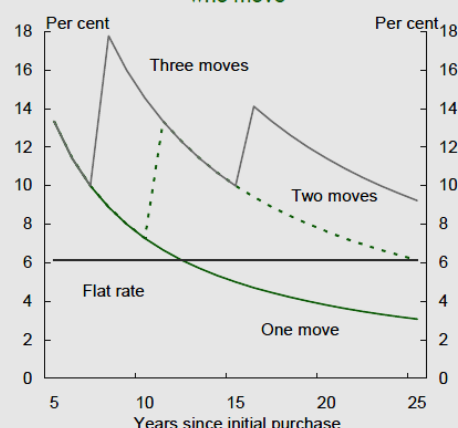
The same outcome is true for businesses – the attractiveness of moving to a lower cost geography is reduced as a result of the stamp duties they must pay in the process. This in turn, has adverse repercussions on the overall productivity of the economy, since businesses are slower to adapt to an ever-changing market place.

Effective tax rate of stamp duty on frequent movers

Panel A: Effective tax rate falls with occupancy duration



Panel B: Increased tax rate on people who move



Note: The effective tax rates are calculated as the ratio of stamp duty (assumed to be \$20,000) to the value of imputed rent over the period the property is owned (assumed to be \$25,000 per annum). In Panel B, the 'flat rate' reflects a constant tax on imputed rent, with the rate equal to the effective rate faced by a person making two moves in 25 years (which is not average but intended to be indicative).

Source: Henry Tax Review 2010, Chart C2-4

Source: ACIL Allen Consulting, 2014.

Competitiveness

Stamp duties on conveyances effectively tax capital used to improve existing property, since it is calculated based on the total value of the land and property itself. In this regard, stamp duty reduces incentives for capital owners to invest in their properties that could lead to better quality housing, since a proportion of the returns to their investment is absorbed by government.

This outcome is particularly undesirable where businesses are concerned. Since capital investments on property is taxed, businesses are encouraged not to undertake productivity-enhancing investments to their property as well as organisational restructuring (for example, through consolidation of offices or establishing regional offices). Similarly, given the added cost of moving, businesses may continue to operate out of a location that has high cost structures (e.g. poor access to freight routes) instead of relocating to a low cost location. Stamp duties on commercial property reduces the ability of enterprises to be flexible and adjust to the conditions of the market, thereby reducing overall competitiveness.

These inefficiencies are likely passed onto consumers in the form of higher costs from the inefficient use of capital to provide goods and services and/or through higher tax burden on goods and services that have a relatively high dependence on the use of property for their production.

Simplicity

Compliance and administrative costs of stamp duties on conveyances is relatively low since the amount of tax that needs to be collected is easily observable (i.e. property sale price) and difficult to avoid. This is in part because property rights are enforced on large transactions such as houses through contracts, which means administrative documents are prepared regardless of whether stamp duty is levied on the transaction.

That said, the introduction of various concessions and exemptions increases administrative and compliance costs since there is a need to assess and monitor means testing in income thresholds. Moreover, marginal rates of stamp duty on conveyances vary across jurisdictions, with different treatments of multiple home ownership through trusts and other entities. These complexities add to the administrative cost of stamp duties on conveyances – the consolidation and simplification of which would benefit society as a whole.

Overall assessment

Stamp duties are consistently rated poorly against efficiency criteria due to their distortionary effect on decisions to buy, rent, move or renovate (IPART, 2008). The Henry Review (2010) concluded that stamp duty is highly inefficient and can prevent land from being put to its most valuable use. Stamp duty has also been labelled as essentially an inequitable tax as its incidence is dependent on how often people move as opposed to actual wealth (IPART, 2008). As stamp duties are underpinned by property values revenues are also highly volatile and subject to short term fluctuations in the property market (Carling, 2006).

For these reasons, stamp duties on conveyances should be one of the high-priority tax reform agendas, with consideration to either reduce dependence on it (i.e. reduction in marginal rates), or to abolish it altogether, by replacing it with a more efficient tax.

6.1.2 Land Tax

Tax overview

Land tax is imposed on land in all states and territories except the Northern Territory. The legal liability of land tax resides with the landowner who is responsible for paying a levy on the unimproved value of all taxable land that exceeds a particular threshold.

Similar to stamp duties on conveyances, each state and territory has different land tax free thresholds as well as marginal tax rates. Marginal land tax rates are designed to be progressive, with higher tax rates applied to land of greater value.

In 2012-13, state and territory governments raised a total of \$6.2 billion through land taxes. As shown in Figure 43, the annual contribution of land tax to total state and government revenues has increased over the past decade from around 7.6 per cent in 2003-04 to 9.8 per cent in 2012-13.

Figure 43 Historical land tax revenue, all states and territories, 2003-04 to 2012-13

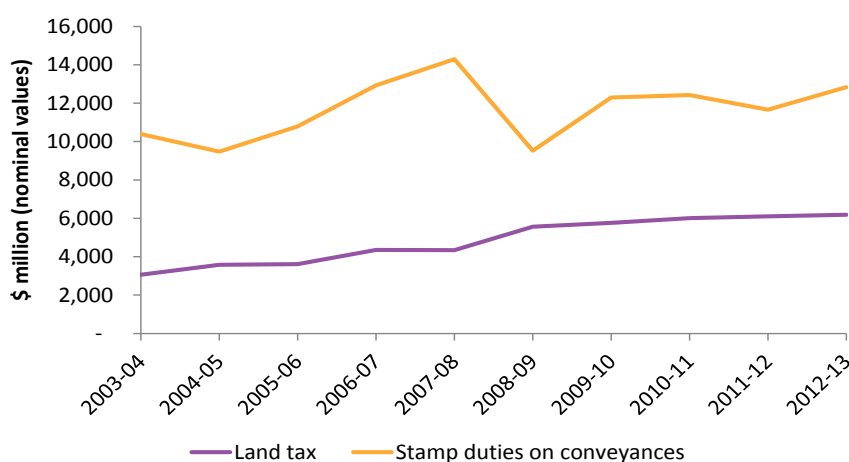


Note: Nominal values.

Source: ABS 2014a.

Figure 44 shows historical land tax and stamp duty on conveyances revenue raised by state/territory governments between 2003-04 and 2012-13.

Figure 44 Historical land tax and stamp duty revenue, all states and territories



Note: Nominal values.

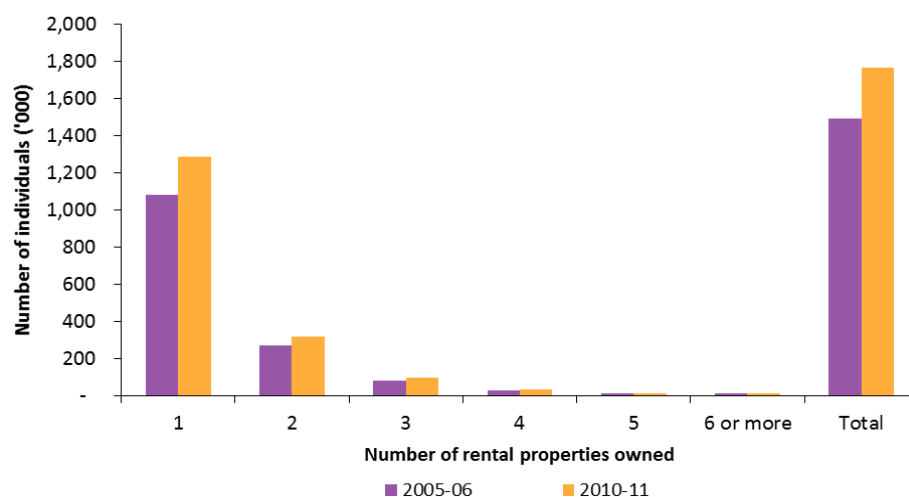
Source: ABS 2014a.

Revenue raised from land taxes however changes over the years due to changes in the value of land, which is reflected in the gradual increase in total land tax revenue between 2003-04 and 2012-13.

Another factor increasing the level of land taxation collected is the increasing number of individuals who own property for investment purposes. Given that every jurisdiction exempts land tax for individuals who use their land as a principal place of residence, an increase in ownership of rental properties represents an increase in the amount of taxable land.

As shown in Figure 45, the number of individuals owning rental property has grown by approximately 270,000 from just under 1.49 million individuals in 2005-06 to 1.76 million by 2010-11.²¹ During this period, the number of rental properties grew by approximately 390,000 from 2.13 million to 2.52 million.²² The quantity of taxable land has increased with the rise of increasing rental property ownership, as those exempt from land tax under the 'principal place of residence' declined.

Figure 45 Rental property ownership, 2005-06 and 2010-11



Source: ACIL Allen, based on ATO 2009 and ATO 2014.

In addition to 'principal place of residence' exemption from land tax, there are a significant list of exemptions and concessions from land taxation. These include, for example:

- land used by a charitable institution
- land used by not-for-profit organisations (such as sporting clubs and recreational associations)
- land used for primary production (i.e. farming land)
- retirement villages
- land vested in a public statutory authority (such as public hospitals and public schools).

Stability

Revenue from land tax has historically been relatively more stable compared to revenue raised from stamp duties on conveyances. This is because the quantity of taxable land is less variable each year compared to the number of property transactions.

Nevertheless, land tax has a moderate level of revenue volatility relative to other taxes (see Figure 22). Some of this is explained by the fact that state and territory governments do change the amount of taxable land each year by releasing new land for development and/or rezone existing land for different purposes. This in turn, changes the amount of tax collected in a given year, contributing to the variability of land tax revenue. Moreover, the existing land tax systems are based on the value of land, and *not* the characteristics of land. The value of land subsequently varies considerably due to changes in the economy, thereby adding volatility to land tax revenues.

²¹ These figures include properties that are either solely owned, jointly owned or part-year owned.

²² Calculated by assuming all individuals in the '6 or more' category owned 6 properties.

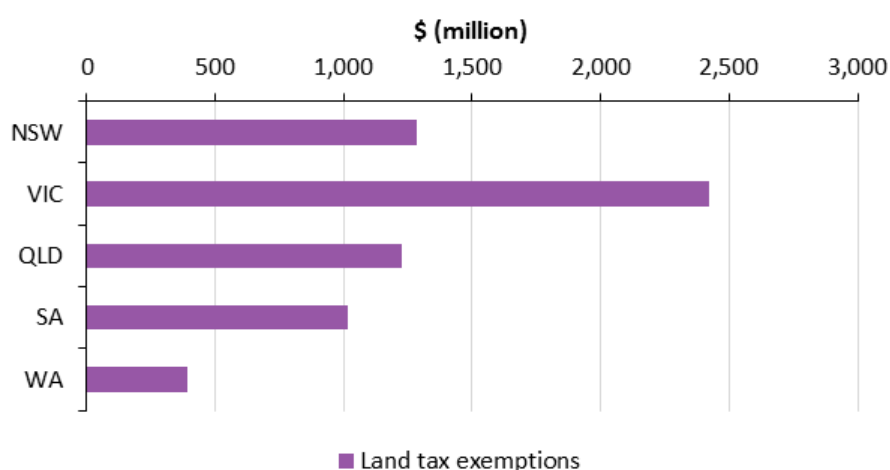
Efficiency

Land tax has the *potential* to be an efficient tax, if a low flat rate is applied to a broad base. In reality, however, many exemptions and concessions to land tax exist, consequently narrowing the tax base. In addition, the respective land tax systems of the states/territories are based upon the value of land and characterised by a land aggregation mechanism.

Equally, high flat land taxation of a broad base is also not efficient as the higher tax rate will have the effect of altering the portfolio of investment for a consumer, due to them favouring less highly taxed investments and reducing the value of land as an investment. In short, when land tax is taxed at a relatively high rate compared to other investments, it alters investor behaviour. This occurs with the existing land tax systems where the aggregation of land results in a relatively high tax rate being applied to the value of the taxable land.

As shown in Figure 46, land tax exemptions are significant in most jurisdictions, with exemptions in Victoria being particularly high at close to \$2.5 billion in 2012-13.

Figure 46 Land tax exemptions, 2012-13 – selected states and territories



Source: ACIL Allen Consulting estimates based on 2012-13 budget papers prepared by relevant state/territory governments.

Importantly, the amount of taxable land, which currently includes industrial, commercial and non-owner occupied housing, is not fixed. When governments change planning zones on the use of land (which may also include new land releases), it essentially changes the mix of taxable and non-taxable land. Changes to the supply of land alter the relative cost of production across taxable and non-taxable sectors of the economy. Since land tax reduces the returns on industrial and commercial land use but not others – such as farming – the land use decisions may favour the latter economic activity as a consequence, thereby creating a market distortion.

Another source of significant inefficiency under the current land tax regime is the way in which land tax is applied to aggregate holdings of land. Currently, land tax is levied on the aggregate value of land held by a taxable person/entity, instead of the corresponding tax rate applicable to the value of each landholding within the portfolio. This means that the burden of land tax is higher for larger landholders, leading to a bias towards small-scale investors in the property market who are at a significant advantage compared to large-scale investors. This creates distortions in the market, since, large-scale long-term investors who may be more suited to providing dwellings for private tenants over a long period are discouraged from making such investments.

The consequence of broad exemptions to land tax – whether through owner-occupied residential property or certain types of commercial/industrial activity such as farming – is that the incidence of tax is also partly borne by tenants since investors/landowners adjust their rents, to a degree, to achieve an adequate return. The current land tax regime leads to many economic inefficiencies that lead to undesirable consequences.

ACIL Allen estimates land tax in the current form reduces the well-being of the economy by 20 cents for every dollar of revenue raised, making it an inefficient tax (see Table 1). However the reduction in economic well-being from the imposition of land taxation could be reduced substantially if a broader base was introduced and a lower rate applied.

Equity

Land tax may be viewed as being equitable if all of it was paid by all owners of land, since those who own higher value land would have to pay more tax. In reality, however, some land owners are exempt. The extent to which the cost of land tax can be passed on depends on the market conditions.

From a horizontal equity perspective, the considerable amount of exemptions means that only a certain segment of society pays taxes for the benefit of others. The principal place of residence is a significant exemption common across all jurisdictions, along with allowances made for charitable institutions, not-for-profits and land used for primary production (i.e. farming). In this regard, land tax is arguably horizontally inequitable.

As the Henry Tax Review (2010) notes, land tax is not an ideal tool for achieving vertical equity objectives since its effectiveness as a tax depends largely on having a broad base and minimising exemptions and concessions. The focus of land tax reform should therefore be to expand its base, whilst using other policy tools to ensure equity is not significantly diminished as a result.

Competitiveness

Whilst capital, and labour (to a lesser extent), is mobile, land is not mobile. This means that although capital and labour as factors of production can move to places with higher returns to production (signalled by demand), changes in the demand for land only results in the change in the price of land itself, commensurate to its value.

Given this, one of the merits of a broad based low rate land tax instead of raising government revenue through stamp duties on conveyances, is that it is less likely to discourage investment and innovation on the use of land, since it is only applied to the value of the land, and not the value of buildings and factories built on top of it (as in the case of stamp duties on conveyances). If improvements on the structures above the land were also taxed – as it is currently the case through stamp duties on conveyances, investment on the efficient use of land would reduce, which will adversely impact the overall productivity of the economy.

In this regard, a broad based land tax with a lower marginal tax rate than current levels is likely to provide a better allocation of capital resources across Australia for the benefit of society. Implementation of a broad based land tax with a single low marginal tax rate is only suitable if it is used to replace highly distortionary state and territory property taxes such as stamp duty on conveyances which are highly inefficient due to their being cascading in nature (that is, a tax on a tax). Otherwise, keeping conveyancing duties and implementing a low flat land tax on a broader base would result in an increasing burden on property and governments being even more over-reliant on property taxes. Abolishing stamp duties and replacing with a low flat tax rate on a broad base would allow governments to raise the

same or more revenues with smaller inefficiency consequences for the economy. Without a single low rate, the land tax would remain complex and inequitable and its positive impact on the economy would be limited.

Simplicity

The compliance cost of existing land tax arrangements is high due to the vast range of marginal rates and thresholds across jurisdictions, numerous exemptions (which also differs across jurisdictions), aggregation and the land value assessment mechanism in place. As noted above, single tax rate applied to a broad base by removing exemptions will substantially resolve the complexity of land tax.

Overall assessment

Land tax is currently, in practice, inefficient, complex and inequitable. This is a result of its design including the existing exemptions, the aggregation principle applied and also the existing prohibition on pass-through of the tax to tenants. However land tax has the potential to be an efficient tax if its base is broadened by abolishing existing exemptions and concessions and a lower rate of tax is applied across the board. Its reform can only be undertaken in conjunction with removing stamp duties on conveyances to resolve the Government overreliance on property taxes. The net effect of this reform of the two taxes will substantially improve the prosperity of Australian society.

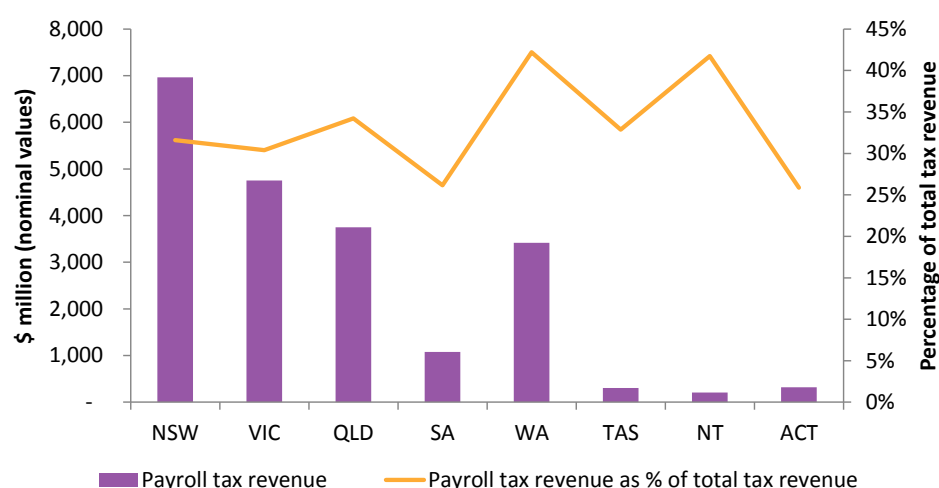
6.1.3 Payroll Tax

Tax overview

Payroll taxes are designed to tax the value-added from labour, and are typically levied on all components of employee remuneration. The legal liability to remit the tax falls on the businesses that are taxable in each state and territory.

In Australia, payroll tax structures differ across the states and territories as a result of inconsistent tax-free thresholds and marginal rates applying to taxable payrolls. However, as shown in Figure 47, for all states and territories, payroll taxes are an important source of revenue. In 2012-13, payroll taxes totalled \$20.8 billion and accounted for, on average, 33 per cent of total taxes collected by a state/territory government.

Figure 47 Payroll tax revenue by state and territory, 2012-13



Note: Nominal values.

Source: ABS 2014a.

Payroll tax is a levy on the value of certain types of income paid within a particular state or territory by employers to, or on behalf of, their employees. It is the largest source of state/territory own-source revenue, accounting for about a quarter of such revenue.

Stability

As shown in Figure 22, payroll tax has one of the lowest coefficient of variation amongst the state and territory taxes. Historically, volatility of revenue raised from payroll tax has been low, making it a relatively predictable tax base for state and territory governments.

Efficiency

Although payroll tax once used to have a broad base, making it a relatively efficient and stable revenue source for state and territory governments, the increasing number of exemptions and concessions in recent years has made it a more complex and inefficient tax base (CIE 2008).

Payroll tax has distortionary effects on business behaviour since it changes the relative returns to factors of production between capital and labour. Since payroll tax is levied as a percentage of total wages paid by a business, the returns to labour is reduced. This means that in the long term, businesses may choose to relocate interstate or overseas where payroll tax is lower and therefore returns to production is higher. Alternatively, insofar as the cost of labour increases from a business' perspective, a firm may decide to replace its labour with capital to maintain its profit margin, thereby increasing unemployment.

Moreover, in a system where payroll tax exemptions are offered to some businesses but not others, the burden of tax will nevertheless fall on all workers, and not just those in sectors that remit payroll tax. In the short term, labour can move from a sector where payroll tax is levied to one that is exempt from it, since the latter is able to offer relatively higher wages as a result of not having to pay tax. In the long term however, the increase in labour supply in the sector that is exempt from payroll taxes reduces the need for businesses to pay higher wages to attract labour, resulting in an overall fall in income for workers (Henry Tax Review, 2010). Workers who could be more productive in a payroll taxable sector may be pushed into a non-taxable sector (since wages may be higher in the latter), resulting in a misallocation of labour.

ACIL Allen estimates existing payroll taxes to be moderately inefficient resulting in a loss of economic well-being in the order of 16 cents per one dollar of revenue raised (see Table 1). However it is estimated that this loss of economic well-being could be significantly reduced to around 9-10 cents per dollars of revenue raised by broadening the base and introducing a lower flat payroll tax rate across all states/territories.

Exemptions are growing

As a result of generous and elaborate exemptions, a significant proportion of worker wages is not subject to payroll tax. In 2009, an estimated 43 per cent of total employee compensation was exempt from payroll tax (Henry Tax Review, 2010). The fact that nearly half of the theoretical tax base is exempt, makes payroll tax a more highly narrow and inefficient tax than it needs to be.

In some jurisdictions, reductions in the basic flat rate and/or increases in the threshold level has likely further deteriorated their tax base since 2008-09. New South Wales, Victoria, South Australia and the Northern Territory have all reduced their basic flat rate applied to payroll tax over the past five years. New South Wales, for example, have dropped rates by 0.3 per cent from 5.75 per cent in 2008-09 to the current 5.45 per cent, whilst Victoria and

South Australia have both lowered the basic rate by 0.05 per cent. The Northern Territory has reduced its rate by the biggest margin – at 0.4 per cent – from 5.90 per cent in 2008-09.

This downward trend in payroll tax rates is explained by both:

- interstate competition in an attempt to attract businesses from other jurisdictions
- a general recognition by state and territory governments to protect and promote the growth of small and medium enterprises by providing them relative advantage through tax exemptions compared to large enterprises.

Whether this results in a narrowing of the tax base depends on whether the reduction in rates and increases in thresholds has been made at a faster or slower pace than at which real wages have grown during the same period.²³ Notwithstanding, the fact remains that payroll tax has a significantly narrow base compared to many other state/territory taxes.

Equity

Payroll tax is arguably relatively inequitable since a greater burden of tax falls on companies that are labour intensive, and also since many firms are exempt from it due to the thresholds and concessions that exist.

Quinlan (2012) notes the inequity created by payroll tax between private sector firms and the tax exempt public sector in the Australian Capital Territory, particularly where there is competition between the two sectors to attract certain labour skills.²⁴ The private sector is disadvantaged compared to the public sector when it comes to attracting the right labour, since payroll tax reduces the ability for companies to pay their employees higher wages, whilst the public sector is not affected by payroll tax.

Similarly, inequity is created between payroll taxable and non-taxable industries, which may also lead to misallocation of labour resources in the economy.

Competitiveness

Payroll tax is levied on all components of employee remuneration, and is therefore similar to personal income tax in that it reduces the real return from working. The misallocation of labour resulting from the changes to relative returns to labour between industries in which payroll is taxable and non-taxable, arguably reduces overall national productivity (Henry Tax Review, 2010).

Furthermore, businesses that find it difficult to either pass on the additional cost of payroll tax to employees (through a reduced wage) or attract the necessary labour at the suppressed wage rate, may look for alternative investment destinations outside of Australia, where the returns to production is relatively higher. Payroll tax reduces Australia's competitiveness as a place of doing business in this regard as well.

Simplicity

Payroll tax rules differs considerably across each of the states and territories, making it a complex tax for businesses to adhere to, particularly for those that operate in multiple jurisdictions.

²³ The exemption thresholds have also increased during this time in nominal terms, however, it is difficult to conclude whether there has been a *real* increase in thresholds, in comparison to real wage rate growth.

²⁴ This impact is likely more prevalent in the ACT where a large proportion of the population is employed by the public sector. Nevertheless, the same principles apply in other jurisdictions where there are shortages in skills.

As shown in Table 5, businesses must consider the following elements of payroll tax rules in each jurisdiction they operate in, when calculating their tax obligations:

- The tax rate
- Method of calculation
- Threshold
- Various concessions available within each jurisdiction.

Table 5 Interstate comparison of payroll tax, 2013-14

State	Basic flat rate (%)	Method of calculation	Tax scale and thresholds
NSW	5.45	Single marginal rate	First \$750,000 exempt
VIC	4.90	Single marginal rate	First \$550,000 exempt
QLD	4.75	Deduction system	First \$1,100,000 exempt For payrolls \$1,100,000 up to \$5,500,000, deduction of \$1,100,000 reducing by \$1.00 for every \$4.00 payroll exceeds \$1,100,000. No deduction for payrolls of \$5,500,000 or more.
WA	5.50	Single marginal rate	First \$750,000 exempt (Threshold scheduled to increase to \$800,000 from 1 July 2014 and \$850,000 from 1 July 2016)
SA	4.95	Single marginal rate	First \$600,000 exempt
TAS	6.10	Single marginal rate	From 1 July 2013, first \$1,250,000 exempt
NT	5.50	Deduction system	Deduction of \$1,500,000 For payrolls \$1,500,000 up to \$7,500,000, deduction of \$1,500,000 reducing by \$1.00 for every \$4.00 payroll exceeds \$1,500,000. No deduction for taxable wages of \$7,500,000 or more.
ACT	6.85	Single marginal rate	First \$1,750,000 exempt

Note: Each jurisdiction has additional concessions. See source for details.

Source: NSW Treasury, 2013 – *Interstate Comparison of Taxes 2013-14*.

Most jurisdictions provide exemptions based on the activity of an organisation (e.g. charities, not-for-profits, hospitals and non-government bodies), as well as for certain types of employees within a firm (such as payments made to workers on maternity leave).

The requirement to adhere to as many as eight different payroll tax rules places unnecessarily high compliance cost on businesses. These requirements also increase the barrier for overseas enterprises to enter the Australian market, reducing competition which could have otherwise benefited consumers.

Payroll tax also impose a high cost on society from a government monitoring and administration perspective. Under current arrangements, each jurisdiction must facilitate a revenue authority of their own that effectively duplicate many activities that could otherwise be consolidated to reduce costs.

Overall assessment

Payroll tax generally ranks well against most of the principles of good tax design. It is relatively simple to administer and comply with (IPART, 2008) and is a sustainable source of revenue that moves in line with the economy (PC, 1998). However the equity of payroll tax is questionable. The economic incidence of the tax falls on employees without reference to their ability to pay and the concessions and thresholds mean that some firms pay the tax while others do not, although often there is little difference between the firms (IPART, 2008). Moreover, the efficiency of payroll tax has eroded over time and its incidence is characterised by a large amount of thresholds, concessions and exemptions (IPART, 2008), making it a moderately inefficient tax.

There is strong potential to improve Australia's tax system by reforming payroll tax – primarily by abolishing exemptions which would also allow governments to reduce the basic tax rate.

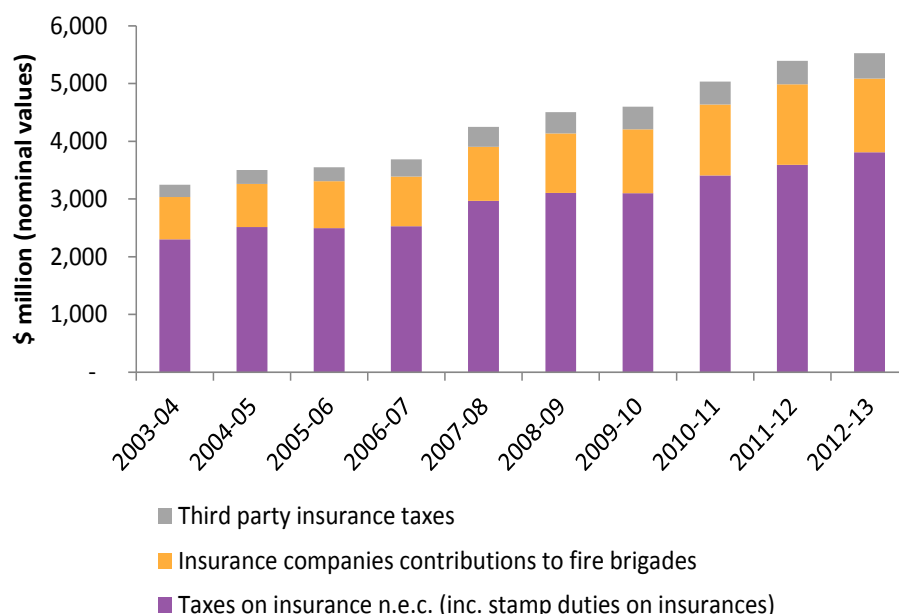
6.1.4 Insurance Taxes

Tax overview

As shown in Figure 48, state/territory government revenue raised through taxes on insurances has grown steadily over time, from approximately \$3.2 billion in 2003-04 to \$5.5 billion in 2012-13. On average, insurance taxes account for 8.7 per cent of total taxes raised by state/territory governments in 2012-13.

As can be seen from Figure 48, a significant proportion of insurance taxes raised each year is from the 'taxes of insurance not elsewhere classified', which includes such payments as stamp duties on insurance (other than third party insurance) and contributions of insurance companies to Workers Compensation Board Funds and Casual Firefighters Compensation Funds.²⁵

Figure 48 **Historical insurance tax revenue, all states and territories**



Note: Nominal values. 'n.e.c.' refers to 'not elsewhere classified'.

Source: ABS 2014a.

Taxes applied to insurances differ by jurisdiction and across insurance schemes. The NSW Treasury (2013) report varying tax rates for each of the following insurance schemes:

- general insurance
- term/riders/disability insurance
- general insurance
- health insurance
- fire and emergency services
- surcharge/levy on motor vehicle third party vehicle insurance.

²⁵ ABS (2005) – *Australian System of Government Finance Statistics: concepts, sources and methods*.

Even in the absence of taxes levied on insurance products, the insurance market is generally more susceptible to market failure than other goods and services markets. Failure in the insurance market can arise from:

- ‘Adverse selection’, whereby, as a result of information asymmetry, high risk individuals who are aware that they are likely to require insurance coverage will consume more insurance products than those that need it less; and
- ‘Moral hazard’, whereby, individuals who are now covered by insurance schemes engage in higher risk behaviour than they otherwise would in the absence of it.

Despite this, insurance products serve an important role in markets by allowing individuals and businesses to spread the risk of potential debilitating financial loss amongst a pool of people. Many business decisions and transactions are only made because of the availability of appropriate insurance schemes that allow them to manage their risks.

Stability

Revenue raised from insurance taxes has relatively low variability year-on-year. As shown in the coefficient of variation in Figure 22, taxes on insurance have a moderate to low variability compared to other state and territory taxes.

Efficiency

Although insurance taxes are an importance source of government revenue for state and territory governments (i.e. 8.7 per cent of total revenue in 2012-13), levying insurance products exacerbates distortions in a market that is already prone to failures.

Insurance tax leads to higher prices of insurance products. This entails a reduction in demand since the return on purchasing insurance is lowered by the additional tax burden consumers must bear. Consequently, less people will be insured and are worse-off when a financially debilitating event occurs (for example, an illness for which they are not covered for).

Under-insurance and non-insurance created by insurance tax potentially places more costs on society, since less people would be prepared for natural disasters and other events (i.e. injuries and illness) for which they require financial assistance, thereby increasing the burden on government welfare.

Insurance taxes are highly inefficient as they are highly distortionary. Insurance taxes are estimated to result in a loss of economic well-being of 67 cents per every dollar of revenue raised. Table 1 indicates that it is the most inefficient tax amongst the taxes listed.

Equity

Insurance tax is arguably inequitable since it has a small base – those that do not pay insurance tax benefit from government services funded (in part) by those that consume insurance products. Moreover, the reduced size of the insurance market places additional burden on those that remain in the market, since the risk must now be shared by a smaller pool of people, typically resulting in higher insurance premiums.

Competitiveness

It is difficult to assess the impact insurance tax has on Australia's competitiveness. Under-insurance and non-insurance in health care, for example, may result in additional welfare burden placed on the Commonwealth Government due to more individuals coming through the public healthcare system than would otherwise if they could afford private health care insurance. A flow-on impact of this may be ill or injured individuals taking longer to return to the workforce, which would represent a reduction in labour productivity in Australia.

Simplicity

Administration and compliance cost of insurance tax is generally relatively low since taxes are levied on and collected from a small number of registered insurers and brokers (IPART 2008).

Overall assessment

From a tax reform perspective, state/territory governments should consider alternative revenue raising options that could replace collections from insurance tax, as this would improve efficiency of the insurance market.

6.1.5 Taxes contributing to fire and emergency services

Stability

Taxes on insurances (i.e. insurance companies contributions to fire brigades and taxes on insurance not elsewhere classified) has a moderate level of variability in annual revenue growth compared to other state/territory taxes (see Figure 22).

Efficiency

Each state/territory jurisdiction has a different method of raising revenue for the purpose of funding fire and emergency services. Arguably, some methods of raising revenue for fire and emergency services are more inefficient than others.

For instance, the distortionary effects of a fixed fire and emergency services levy imposed on residential property owners is likely to be limited, given that the amount is very small compared to the total cost of purchasing a home, and compared to the size of other property taxes such as stamp duties on conveyances. It is unlikely that the prospect of having to pay this fee would alter people's behaviour to have a material impact on the economy as a whole.

In contrast, statutory requirements for certain groups to contribute to these services is a highly inefficient way to raise tax. This is the case in New South Wales where the insurance industry contributes over 70 per cent of total funding for fire and emergency services while the remainder is paid by local governments and the State. The requirement for the insurance industry to make these contribution exacerbates the issue of under-insurance and non-insurance, assuming that this cost is passed onto consumers as higher prices of products offered.

Equity

Jurisdictions in which a fixed fire and emergency services levy is charged is horizontally equitable.

To the extent that fixed fees are very small, the vertical inequity created from all households having to pay the same amount regardless of income levels, is arguably negligible.

In the case of New South Wales, consumers of insurance products likely bear the burden of the insurance industry's contributions to fire and emergency services funding in the form of higher prices on insurance products. In this regard, those that purchase insurance schemes in New South Wales bear the burden of taxes on insurances as well as the additional cost imposed from the statutory requirement for the insurance industry to contribute to fire and emergency services funding – making it a highly inequitable tax base.

Competitiveness

It is difficult to assess the impact of taxes contributing to funding fire and emergency services. Given that its contribution to total revenue is relatively small compared to other taxes, its impact on Australia's competitiveness is likely to be small as well.

Simplicity

Henry Tax Review (2010) notes that for the fire services levy, insurance companies are required to provide their contribution to the levy in advance based on forecasts of the movement of the market when applying taxes to premiums. This poses costs for insurance companies as well as having to bear the collection risk in the event that the actual premiums collected is lower than their forecast.

Similarly to payroll tax collection, each jurisdiction has their own revenue collecting authority reflecting their revenue raising method – consequently adding more compliance cost to the economy than necessary.

6.1.6 Gambling Taxes

Tax overview

Taxes levied on gambling are an important source of revenue for state and territory governments. In 2012-13, total state/territory government revenue from gambling taxes amounted to approximately \$5.5 billion, which was equivalent to 8.7 per cent of total taxes raised in the same year.

Figure 49 shows the gambling revenue across different gambling categories. As shown in this figure, the six sub-categories of gambling taxes include:

- taxes on gambling machines
- taxes on government lotteries
- taxes on private lotteries
- casino taxes
- race betting taxes
- taxes on gambling not elsewhere defined (for example, revenue raised from the issue of bingo permits).

Each of these taxes are levied differently on gambling activities, but in most instances, taxes are applied to a percentage of player loss.

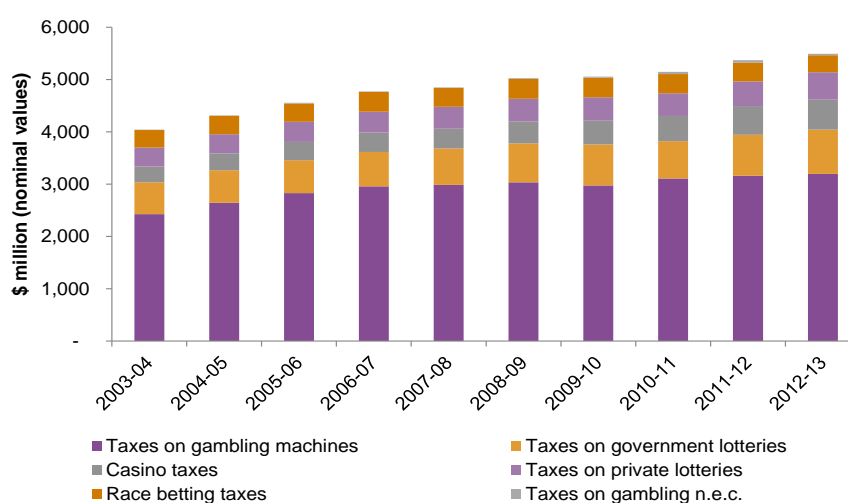
Race betting taxes, for example, are levied on the gambling business pooling the bets (through a totalisator wagering through a TAB) and deducting a percentage (i.e. the player loss) before distributing the remainder as prizes. Different jurisdictions have different deduction rates, with rate of deduction also varying depending on the type of bet.

Taxes on gaming machines are typically levied as a proportion of total player losses, and are paid by the owner of the machine. For most jurisdictions, marginal rate of taxes payable on a gambling machine depends on the magnitude of the loss incurred by the player along an increasing scale (i.e. larger the loss, the greater the marginal tax rate). Tax rates also vary depending on the type of establishment that owns the gaming machine. For example, hotels are typically subject to higher rates than clubs.

Businesses providing casino gambling also incur taxes on player losses (usually through levies on their annual profits) but in addition, generally pay a licence fee providing gambling services.

As shown in the figure, revenue from gambling taxes has gradually increased over the past decade. The 10-year compound annual growth rate (CAGR) of total gambling tax revenues is 3.1 per cent. Revenue from casino tax has grown relatively faster in comparison, at a CAGR of 6.7 per cent, whilst revenue growth from gambling machines has been more modest at a CAGR of 2.8 per cent.

Figure 49 **Historical gambling tax revenue, all states and territories**



Note: Nominal values. 'n.e.c.' refers to 'not elsewhere classified'.

Source: ABS 2014a.

Stability

As discussed in Chapter 2, government revenue from gambling taxes have grown steadily over the past decade, at a compound annual growth rate (CAGR) of approximately 3.1 per cent. Although only by a marginal amount, revenue grew during the global economic downturn period as well, demonstrating that gambling tax is generally a relatively stable base. This is consistent with its coefficient of variation (see Figure 22) where taxes on gambling machines is ranked in the middle in terms of its stability amongst other state/territory taxes.

Efficiency

It is widely recognised that gambling tax is an efficient tax since a change in the marginal rate of gambling taxes have a limited impact on the behaviours of consumers (i.e. gamblers due to inelastic demand for gambling).

Quinlan (2012) explains that taxes on gambling does not translate into explicit price signals for gamblers, since taxes are levied on the venue as a whole and not on specific gaming machines. As a result, increases in the marginal rate of gambling tax typically have very little impact on the price signals for players, which would otherwise alter their behaviour (for example, by reducing the amount of money spent on gambling). Furthermore, for problem gamblers, which only constitutes one per cent of the gambling population (Henry Tax Review, 2010), a decrease in player returns as a result of a material increase in gambling taxes that is then passed onto players, may encourage 'loss chasing' behaviour (ibid), thereby exacerbating the social cost of gambling.

Insofar as gambling taxes only have a limited impact on the behaviour of players, it is considered to be a relatively efficient tax from a societal perspective.

Equity

Given that gambling tax is paid by players who make discretionary spending decisions to 'consume' gambling activities, it could be argued that it is an equitable tax similar to taxes on consumption. A counter-argument on gambling taxes is that it unfairly penalises individuals who have a consumption preference for gambling over other products. However, the general consensus in the Australian community seems to be that gambling tax should continue to exist and to fund government services from its revenue.

Competitiveness

The impact of gambling taxes on the competitiveness of the Australian economy is difficult to assess. It is likely that it impacts, to a degree, the demand for gambling by foreigners who travel to Australia for the purpose of gambling. However the degree to which it adversely affects Australia's competitiveness is unknown but likely to be small.

Simplicity

Gambling taxes have relatively high compliance and administration costs, due to the various taxes and systems that exist across jurisdictions with differing methods of calculating tax on winnings.

6.1.7 Taxes on motor vehicles

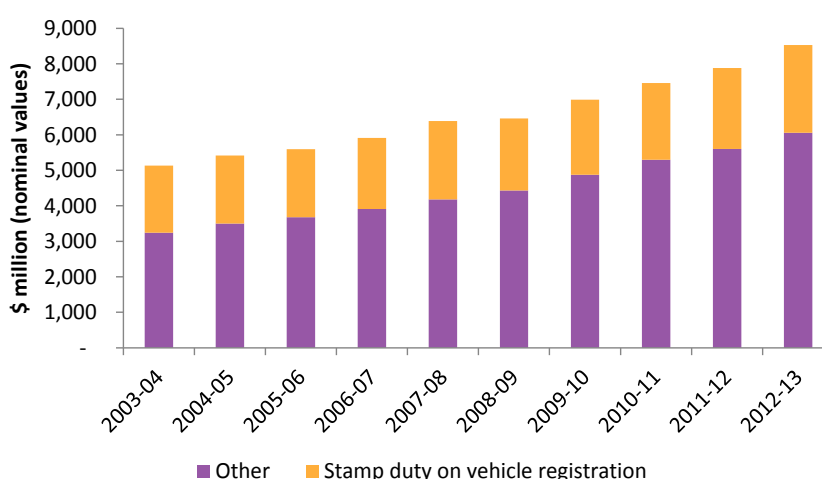
Tax overview

Motor vehicle taxes are levied on the operation of motor vehicles whether paid by households or corporations.²⁶ As shown in Figure 50, the Australian Bureau of Statistics (ABS) categorises motor vehicle taxes into two broad groups. These are:

- stamp duty on vehicle registration
- ‘other’, which includes, road transport and maintenance taxes, heavy vehicle registration fees and taxes as well as vehicle registration fees not elsewhere classified.

Annual revenue from motor vehicle taxes has increased steadily over the years, from approximately \$5.1 billion in 2003-04 to \$8.5 billion in 2012-13. Moreover, revenue from this tax is relatively less volatile compared to some of the other state/territory taxes such as stamp duties on conveyances. Motor vehicle taxes are an important source of government revenue, accounting for, on average, 13.4 per cent of total state/territory government revenue in 2012-13.

Figure 50 **Historical motor vehicle tax revenue, all states and territories**



Note: Nominal values.

Source: ABS 2014a.

Stability

Revenue from stamp duty on the registration of vehicles is highly variable (see Figure 22). This may be explained by the fact that vehicles can be substituted by other modes of transport. During economic downturns, the number of vehicle registrations fall as individuals defer having to incur the cost of registration until the economy improves. Following the downturn, registration rates may surge compared to historical levels reflecting the relatively low number of the previous period.

That said, the historical number of registered vehicles in an economy is closely correlated with the size of the population, allowing governments to forecast revenue from vehicle registration with some degree of confidence.

²⁶ ABS (2005) – *Australian System of Government Finance Statistics: concepts, sources and methods*.

Efficiency

Taxes on registration of vehicles creates market distortions much in the same way stamp duties on conveyances lead to inefficiencies in the market. Although only a relatively small cost compared to the amount of taxes paid on the purchase of property, stamp duty on vehicle registration result in:

- reduced demand for cars since vehicles are more costly than they otherwise would be without the tax
- reduce the turn-over of vehicles as a result of the ‘lock-in effect’ of paying taxes from each time a new vehicle is purchased
- inefficient allocation of cars in the market (for example, parents who no longer need a family car may continue to drive an old and large car long after their children have left home).

ACIL Allen estimates that motor vehicle taxes results in a loss of economic well-being in the order of 37 cents for every dollar of revenue raised (see Table 1), making it one of the most inefficient state/territory tax that exists today.

Equity

Stamp duty on vehicle registration is horizontally equitable since the amount payable is determined based on the type and weight of the vehicle for everyone who owns a car. Conversely, since the fee is not adjusted for level of income of the vehicle owner, it is not vertically equitable.

Competitiveness

From a business perspective, motor vehicle taxes change the relative price of factors of production. Businesses that are ‘vehicle-intensive’ in their production of goods and services are disadvantaged compared to those that are not, which can result in a misallocation of productive resources within the economy. Since their capital stock used in the production of goods and services are taxed through vehicle taxes, firms are discouraged from (or delay) investing in new capital (such as vehicles with better fuel efficiency or safety rating) that could benefit society as a whole.

Simplicity

The compliance costs associated with motor vehicle taxes is relatively low since it is an annual charge to all vehicles with unambiguous payment structures. The different systems between states/territories makes the existing motor vehicle taxes more complicated for those businesses operating in different jurisdictions.

Revenue adequacy

Wear and tear of roads, particularly created by heavy vehicles, is a significant cost of road use. The road transport and maintenance tax as well as heavy vehicle registrations fees (which are part of the ‘other’ motor vehicle taxes) are aimed at recovering this cost from the users who effectively generate this cost.

However, existing charges are imperfect as they do not fully recover the wear and tear caused by trucks on individual roads. Since the amount of taxes levied on heavy vehicles is based primarily on the weight of the vehicle but not the specific durability (and subsequently the overall cost profile of maintaining a specific road), there is little incentive for vehicle owners/operators to select routes that are socially cost reflective. Consequently, local government and road owners are required to cross-subsidise the maintenance of roads from alternative sources of vehicle and/or non-vehicle taxes.

Overall assessment

Motor vehicle taxes – particularly stamp duty on the registration of vehicles – are inefficient and unequitable taxes, much in the same way stamp duties on conveyances are market-distorting taxes. Whilst it is a relatively simple tax that has low administrative and compliance cost, it is undesirable from a competitiveness principle perspective, as it acts as a tax on factors of production for businesses that use vehicles to operate.

6.2 Local government charges

Infrastructure charges (developer charges)

Overview

The use of infrastructure charges, with the intention of recovering infrastructure costs from developers, has become increasingly prevalent in Australia since the 1980's (Henry Review 2010).

These charges are applied by both state and local governments and are known by a variety of names, including developer charges, 'levies' or 'contributions.' Infrastructure charges can be set at a flat rate, negotiated between the state/local government and the developer or take the form of a transfer of land or work in kind. Whatever the name or form, an infrastructure charge is a contribution paid by the developer to a state/local government towards the cost of providing the infrastructure necessary to support the development.

There are generally three different layers of infrastructure charges with distinct characteristics to consider:

- *Direct infrastructure provision by developers* – in Australia developers are generally responsible for providing new houses with basic utilities such as electricity, water and gas. These kinds of infrastructure charges are reasonably well accepted and consistent across Australia.
- *Local government charges* – are generally specified in local government plans to fund infrastructure such as footpaths, streetlights and district utilities. These vary from council to council and may take the form of compulsory conditions in local planning permits or be negotiated between developers and local government. There is often a nexus between payment of the charge and provision of the infrastructure in that if the specified infrastructure is not provided developers are entitled to a refund of their payments.
- *State charges* – are levied for offsite infrastructure such as schools, hospitals and public transport. These charges are generally not specific or linked to actually providing the infrastructure and tend to resemble a tax.

Table 6 overviews the multitude of mechanisms and determinants of infrastructure charges by each state and territory.

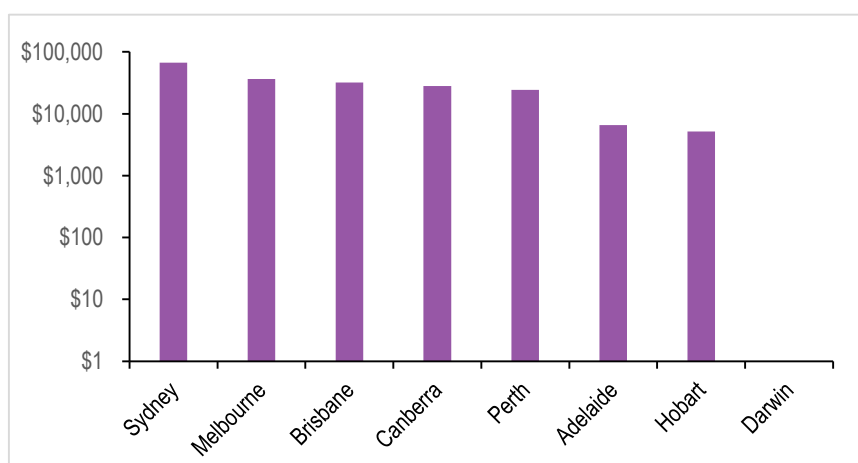
Table 6 Overview of mechanisms used for infrastructure charges and restrictions

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Mechanisms for charges								
State government charges for specific regions	✓	✓					✓ ^(a)	
Contributions plans & other mechanisms within local area planning schemes	✓	✓	✓ ^(b)	✓	✓ ^(c)	✓		✓
Conditions in local councils' development permits	✓	✓		✓	✓ ^(c)	✓	✓ ^(d)	✓
Voluntary agreements between developers & planning bodies	✓	✓		✓	✓	✓	✓ ^(e)	
Informal arrangements					✓			
Restrictions & influences on charges								
State legislation or policy specifies/mandates the infrastructure that can be charged by local councils.				✓	✓	✓		✓
State legislation or policy guides local council policies and charges		✓	✓	✓	✓			
State legislation or policy caps the charges and levies set by local councils	✓	✓	✓					

Note: (a) Change of use/lease variation charges are levied by the ACT Planning Authority. Some regions are subject to predetermined charges, other regions to a valuation regime. (b) Despite the limited mechanisms for charges, local government Priority Infrastructure Plans provide significant flexibility in the type and value of contributions charged. (c) Local councils can levy fixed charges and proportionate contributions, but it is unclear which mechanisms are used. (d) Conditions are placed in leases granted by the ACT government. (e) For rural leases only, entered into by the ACT Planning and Land Authority.

The array of different names and forms that infrastructure charges take and the government agencies that levy them means that they are not transparent, can be difficult to calculate and difficult to clearly identify what they will be (have been) used for. For this reason, ACIL Allen Consulting found it difficult to obtain the latest data on the amount of infrastructure charges collected by state and territory. Drawing upon a previous study and data, ACIL Allen estimated how much infrastructure charges were estimated as payable per broad acre housing lot in each capital city in 2011 – see Figure 51

Figure 51 Infrastructure charges per housing lot, capital cities (\$2011)



Note: Infrastructure charges include council fees, utilities levies, section 94 contribution and state infrastructure contributions and infrastructure bonds.

Source: ACIL Allen Consulting, 2014.

This figure highlights that there is considerable variance in the level of infrastructure charges payable across capital cities, with amounts spanning from \$67,300 in Sydney to \$816 in Canberra and nil in Darwin.

It is widely accepted that infrastructure charges have a role in funding and encouraging efficient infrastructure provision. However, in practice their design and implementation is plagued by issues that have significant implications for the equity, economic growth and overall living standards.

Simplicity

Infrastructure charges are complex. This is supported by Table 6 and Figure 51 which shows the disparity in mechanisms and the level of charges by state/territory.

The complexity of the existing infrastructure regimes is best highlighted by New South Wales (NSW). In NSW, five separate mechanisms – each subject to different requirements – can apply to the one development project. This issue is compounded by differing arrangements across jurisdictions. Regimes across Australia are complex and vary considerably. The end result is a segregated market characterised by high levels of complexity and compliance costs.

Efficiency

Distorting taxes change behaviour. Infrastructure charges are a tax on development, and target capital and labour. It is not a tax on land so is heavily influenced by developer behaviour. Equally however, they are charges designed for developing infrastructure to an area and will have inefficiency consequences where the charges are not used to fund infrastructure which the development relates (or any infrastructure at all).

The efficiency or inefficiency of infrastructure charges is determined in part on the debate about how developers respond to them. When a developer is faced with an infrastructure charge they can:

- pass the tax back to land owners if they can reduce prices paid for raw land;
- absorb the tax and face lower profits; or
- pass the tax forward to consumers, that is, homebuyers.

Infrastructure charges are an additional cost to developing a property and will increase for that property. As such, infrastructure charges are amongst the most inefficient taxes levied by any form of government (BCTR 2011). The inefficiency of this tax indicated that for every \$1 reduction in infrastructure charges that GDP would grow by \$0.90.

Infrastructure charges apply to a narrow section of the community. The eventual core users of the new infrastructure (if the charges are applied to that infrastructure) effectively fully pay for it in order to access the wider infrastructure 'grid.' This seems to satisfy the efficient 'user pays' principle. However, it imposes a significant burden on new additions to the grid. 'Simply funding infrastructure through general revenue, could be a more efficient way to fund infrastructure without imposing excessive burdens on later additions to the grid.

Stability

Infrastructure charges are levied on a narrow section of the community and will therefore be unlikely to be stable as a source of revenues relative to other tax and charges sources. The instability of revenues collected by these charges are exacerbated as they are dependent upon the level of construction activity, which fluctuates depending upon how the economy is performing. Due to the limited data available, it was not possible to test for the variability of infrastructure charges as a source of revenue.

Equity

Infrastructure charges:

- are not uniformly applied across states
- incur costs on a narrow section of the community
- are inconsistently applied to infrastructure projects (if at all) related to the development.

Having different developer contributions regimes across different states (and within states) is a source of considerable inequity. This is effectively a tax on home buyers in one region that is not matched in another. To make matters worse, the inequity is compounded by the fact the “contributions” tend not to be as reflective of the cost of building infrastructure as they could be.

The Henry review (2010) noted that applying different taxation treatments to labour income across states drives high compliance costs and inefficiency (while Henry was discussing this in the context of payroll tax, the principle equally applies to infrastructure charges as they are also a form of tax on labour).

Competitiveness

Infrastructure charges cause changes in more markets than just the market for new homes. New homes have substitutes - existing homes. Increases in the price of new homes as a consequence of infrastructure charges, should shift demand towards existing homes – pushing up the price in that market with the main impact being to increase the cost of housing throughout the economy. A shortage of affordable housing has adverse implications for the competitiveness of Australia’s economy.

Overall assessment

In recent times, there has been significant opposition to infrastructure charges both on tax principles and because they are often not used as intended in practice.

The Henry review flagged significant problems with how infrastructure charges are currently levied and recommended a review by COAG, which has yet to occur.

The opposition to infrastructure charges has largely arisen because they are:

- not uniform across jurisdictions
- misused and applied to costs unrelated to infrastructure
- inefficient
- inequitable
- inconsistently and non-transparently applied within jurisdictions.

6.3 Assessment summary

Based on the qualitative assessment of taxes detailed above, each of the key taxes have once again, been given a score out of five, as shown in Table 7. Other tax comparison studies used an equivalent methodology to identify tax reform priorities (IPART, 2008). A maximum score of five indicates that the tax meets the reform principle very well, whilst a minimum score of zero means that it does not meet the principle at all.

Table 7 Summary of qualitative assessment of taxes

Tax/Modernisation principle	Stability	Efficiency	Equity	Competitiveness	Simplicity
Stamp duties on conveyances	0.5	1.0	1.0	1.0	3.5
Land tax	2.0	3.0	2.0	2.0	1.5
Payroll tax	4.0	3.5	2.5	2.0	1.5
Insurance taxes	3.0	0.5	1.0	2.0	3.5
Taxes contributing to fire and emergency services	3.0	1.5	2.0	2.0	1.0
Gambling tax	3.0	5.0	4.0	n/a ^a	3.5
Taxes on motor vehicles	1.5	1.0	3.0	2.0	4.5
Developer charges	1.5	2.0	2.0	2.0	1.5

^a The principle of competitiveness has limited relevance for gambling tax.

Note: Each tax has been assigned a value between zero and five based on the qualitative assessment of taxes. A score of five indicates that the tax performs very well against the principle, whilst a score of zero indicates that it performs very poorly. In interpreting the results, emphasis should be placed on the relativity of scores between taxes.

Source: ACIL Allen Consulting, 2014.

- State/territory taxes generally perform worse compared to Commonwealth taxes (discussed in Chapter 5) due to their having a narrow base.
- Taxes that have narrow bases, high marginal tax rates and are complicated to administer as a result of complex rules and differences across states and territories are typically the worst taxes measured against reform principles. An example of such a tax is stamp duty on conveyances, which has the worse overall score in the table above.
- Taxes levied on specific industries such as stamp duties on conveyances and land tax in the property sector are subject to higher volatility, inefficient and unequitable, leading to a reduction in Australia's competitiveness.
- Poorly designed tax stifle business innovation, investment and competitiveness, thereby reducing Australia's overall productivity compared against other countries.
- Reducing reliance on poorly performing state/territory taxes such as stamp duties on conveyances, payroll taxes and insurance taxes will reduce economic inefficiencies, and is likely to contribute to increased consumer welfare across Australia.
- Greater reliance on a single rate broad-based land tax and reducing complexity of payroll tax would generate improved outcomes.

7 Gains from tax modernisation

Strategic tax reform requires the evaluation of portfolios of taxes rather than an assessment of each tax in isolation. This chapter outlines three portfolios of tax changes proposed by the Property Council for the benefit of the Australian economy and community.

KEY FINDING

- The potential gains of different portfolios of investment in tax reform are illustrated using three basic tax mix scenarios.
- To illustrate the large gains from tax reform, three tax reform packages were constructed. Changes in specific taxes in each reform package are less important than the overall point of the reform scenarios.
- The proposed tax reform packages alter the mix of taxes with the intent of:
 - ♦ Abolishing the 'worst' taxes – Tax reform package 1
 - ♦ Driving investment – Tax reform package 2
 - ♦ Driving economic growth – Tax reform package 3
- The three scenarios highlight that tax reform can be advanced via a number of ways:
 - ♦ Tax reform package 1 focuses upon abolishing the more inefficient state/territory taxes and replacing the revenue source with an increase in the GST rate to 12.5 per cent and abolishing the fresh food, education and health GST exemptions
 - ♦ Tax reform package 2 focuses upon driving business investment by abolishing the more inefficient state/territory taxes and reducing the corporate tax rate to 25 per cent and replacing the revenues source with an increase in the GST rate to 15 per cent and abolishing the fresh food, education and health GST exemptions
 - ♦ Tax reform package 3 focuses upon driving economic growth by increasing the efficiency of the existing tax system by abolishing the worst state/territory taxes, reducing the corporate tax rate to 27 per cent and re-designing existing taxes (payroll, land tax) to make them more efficient. The sources of revenues abolished are replaced by a proposed increase in the GST rate to 12.5 per cent and abolishing the fresh food, education and health GST exemptions.
- The underlying objectives of tax reform ultimately determine the tax changes and the outcomes achieved from tax reform.
- The analysis of the three tax reform packages clearly highlight the benefits from pursuing strategic and targeted tax reform:
 - ♦ increased tax revenues across the Commonwealth/state/territory governments can be collected in the order of \$6 billion to \$7 billion
 - ♦ while also simultaneously increasing the efficiency of the tax system which will reduce distortions and boost economic activity .
- The three scenarios show that change is worthwhile and all three packages show that there is a capacity to pay for such change to provide offsets to those adversely impacted by any tax changes due to the increased revenues collected from the proposed tax changes.

7.1 Moving forward: a tax reform plan

There is community agreement that tax reform is necessary. The Commonwealth Government's upcoming tax review provides an invaluable opportunity to reform the tax system to resolve the challenges and take advantage of the opportunities facing Australia.

It is accepted that tax reform should foster the public policy objectives outlined in Chapter 4, including economic efficiency, equity, simplicity, competitiveness, revenue stability and revenue adequacy.

Determining how well the individual taxes perform against these criteria quantitatively, however is difficult, and is the area that remains open to considerable debate.

7.1.1 Priorities of tax reform

Application of the tax principles to the existing Australian tax system however highlights the following reform priorities:

- State taxes can be improved considerably by abolishing the worst ‘inefficient’ taxes and replacing with more efficient taxes (a change in tax mix)
- Broadening the existing tax bases and lowering tax rates will improve the overall efficiency of the existing tax system
- The proposed tax system needs to raise sufficient revenues to meet the future expectations and needs of the community

Individually these priorities do not say very much about what can be done to improve Australia’s tax systems in their entirety. A more strategic approach which takes into account these priorities however highlights the following elements required for successful tax reform:

- Little can be achieved via changes in a tax-by-tax basis. A more strategic approach requires changes to the entire tax portfolio in order to achieve the overarching priorities
- Reflecting the current budget environment, tax reform has to be at least revenue neutral. That is, the tax changes cannot raise fewer revenues in the year of change compared to the level of revenues that would be collected without any tax reform
- Reform of significant scale is needed – the proposed packages involve tax reforms in the magnitude of \$43 billion to \$73 billion.
- Commonwealth-State cooperation is essential. The Commonwealth Government has access to better tax bases to replace the state and territory governments’ poor taxes. However, the Commonwealth Government also requires the cooperation of the state and territory governments in order to implement tax reform. Changing the GST is a clear example of where unanimous agreement of the state and territory governments is needed for it to occur.

7.1.2 Proposed tax reform packages

Three tax reform packages have been constructed during the development of this report. These scenarios show the effects of different tax reform portfolio changes and are designed to assess what can be achieved through strategic tax reform. The change scenarios alter the mix of taxes with the intent of:

- **Abolishing the worst taxes (Tax reform package 1)** – Abolish more inefficient narrow-based (‘bad’) taxes and offset with an increase in the goods and services (GST) tax (via both base broadening and a higher tax rate);
- **Driving investment (Tax reform package 2)** – Tax reform package 1 plus reduce the company tax rate to 25 per cent in order to drive investment and increase GST to 15 per cent in order to pay for additional company tax cut;
- **Driving economic growth (Tax reform package 3)** – Tax reform package 1 plus changes to payroll tax, land tax, company tax, alcohol taxes.

Each tax reform package is designed to reflect slightly different overarching tax reform objectives. Changes in specific taxes in each tax reform package are less important than the overall objective of each tax reform package. The tax reform packages were guided by a benchmarking exercise that highlighted how reform could generate the greatest impact on economic growth and investment respectively. Effectively this involved 'bad' state and territory taxes being replaced with 'better' Commonwealth taxes.

Table 8 outlines in more detail the three proposed tax reform packages.

Table 8 **Proposed tax reform packages**

Tax reform package	Objective	Taxes	Proposed change
1.	Abolish the worst State taxes	Stamp duties on conveyances	Abolish
		Car parking levy	Abolish
		Insurance taxes	Abolish
		Fire services & emergency levies	Abolish
		Motor vehicle taxes	Abolish
		Payroll tax	Unchanged
		Land tax	Unchanged
		Company income tax	Unchanged
		GST - broaden base	Abolish exemptions (fresh food, education & health)
		GST - rate	Increase rate to 12.5%
		Alcohol taxes	Unchanged
2.	Drive investment	Stamp duties on conveyances	Abolish
		Car parking levy	Abolish
		Insurance taxes	Abolish
		Fire services & emergency levies	Abolish
		Motor vehicle taxes	Abolish
		Payroll tax	Unchanged
		Land tax	Unchanged
		Company income tax	Reduce rate to 25%
		GST - broaden base	Abolish exemptions (fresh food, education & health)
		GST - rate	Increase rate to 15.0%
		Alcohol taxes	Unchanged
3.	Drive economic growth	Stamp duties on conveyances	Abolish
		Car parking levy	Abolish
		Insurance taxes	Abolish
		Fire services & emergency levies	Abolish
		Motor vehicle taxes	Retain
		Payroll tax	Abolish exemptions & apply flat rate (the rate will be reduced until revenue neutral)
		Land tax	Abolish exemptions, no tax-free threshold & apply flat land tax rate of 0.25%
		Company income tax	Reduce rate to 27%
		GST - broaden base	Abolish exemptions (fresh food, education & health)
		GST - rate	Increase rate to 12.5%
		Alcohol taxes	Reform WET

Note: Bold indicates tax change from previous tax reform scenario

Source: ACIL Allen Consulting, 2014.

7.1.3 Direct revenue and efficiency implications of tax reform packages

Using a first-round partial analysis of the tax reform packages, the proposed tax scenarios increase:

- the level of taxation collected by the Commonwealth/State/Territory governments in the order of \$6.2 billion to \$7.8 billion
 - Tax reform package 1 increases revenues in the order of \$6.6 billion per annum
 - Tax reform package 2 increases revenues by just over \$7.8 billion
 - Tax reform package 3 increases revenues by just over \$6.2 billion
- the economic well-being of the Australian economy in the order of \$4.7 billion to \$10.1 billion
 - Tax reform package 1 increases economic well-being by \$4.7 billion per annum
 - Tax reform package 2 increases economic well-being by just over \$7.2 billion per annum
 - Tax reform package 3 increases economic well-being by just over \$10 billion per annum.

Indicative estimates of the national fiscal implications of the reform vision by tax types are detailed in Figure 52. The estimates reflect the potential tax revenue impacts of the recommendations when introduced in their entirety in the first year. The estimates do not take into account any:

- transitional arrangements or transitional revenue effects
- subsequent indirect impacts on the revenue base as a result of the tax reform package resulting in additional tax revenues being collected as a result of the increase in economic output from implementing efficient targeted tax reforms (otherwise referred to as an efficiency dividend).

In each case, the estimates has been costed using 2012-13 as a reference year.

The tax reform packages are intended to improve the structure of Australia's existing tax system, not simply to raise additional taxation revenues for Commonwealth, state and territory governments. However the three tax reform packages are estimated to increase net tax revenues collected across all governments by at least \$6.2 billion. These estimates do not take into account any subsequent second round revenue impacts as a result of changes in investment and economic growth as a result of the tax changes.

The indicative direct revenue impacts of the tax reform packages also highlights that the packages rely on the Commonwealth accessing its better tax base to replace the worst state and territory taxes. Commonwealth Government has access to better tax bases to replace the state and territory governments' poor taxes.

Figure 52 Indicative 'direct' revenue impacts (\$ million)



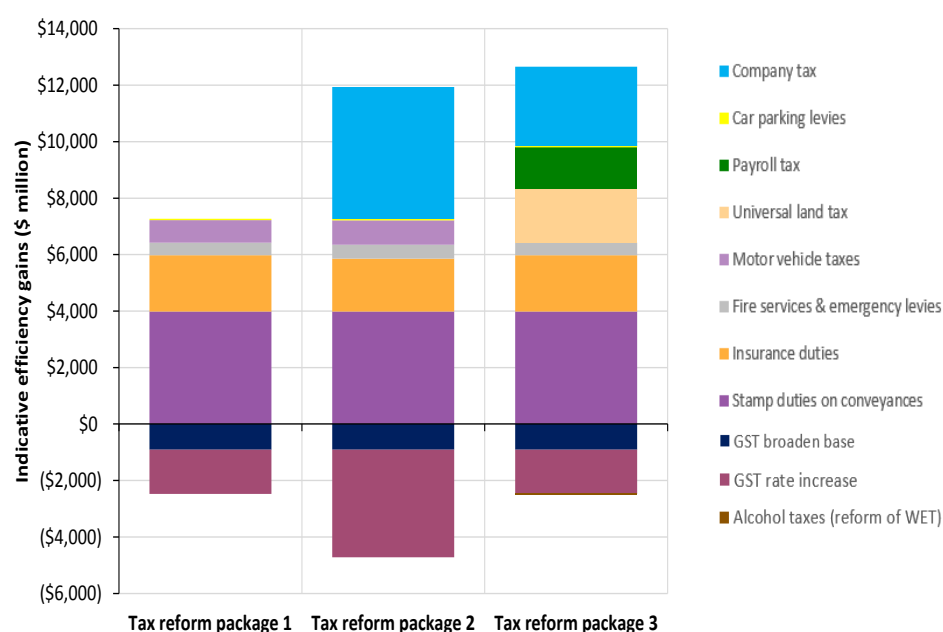
Source: ACIL Allen Consulting estimates from ABS, 5506.0.

Using a partial analysis of the efficiency of each tax and the quantum of revenue changes, ACIL Allen has calculated the indicative efficiency implications of the tax reform packages. Indicative estimates of the direct efficiency impacts of the tax reform packages are shown in Figure 53.

A measure of the efficiency of each tax estimates the cost to the well-being of the economy from raising taxation – this is referred to by economists as the marginal excess burden (MEB) of taxation. Applying the MEB to the change in the level of tax revenues provides an indication of the scale of the benefit/cost to the economy from the tax changes.

All three tax reform packages will increase the efficiency of the tax system as indicated from partial efficiency analysis of the impacts. For example, the analysis indicates that there will be a reduction in the costs of raising taxation revenues as a result of the three tax reform packages.²⁷

Figure 53 Indicative 'direct' efficiency impacts (\$ million)



Source: ACIL Allen Consulting, 2014.

These results highlight the importance of pursuing strategic and targeted tax reform because each proposed tax reform packages increases tax revenues collected by the Australian governments while simultaneously improving the overall efficiency of the tax system.

Due to the magnitude of the indicative gains to the economy from the partial efficiency analysis of the tax reform packages, the preferred tax reform approach identified is Tax reform package 3 which was designed to drive economic growth.

²⁷ These estimates however do not take into account any subsequent second round revenue impacts as a result of changes in investment and economic growth as a result of the tax changes.

8 Tax modernisation – driving economic growth

This chapter outlines the modelled tax reform package. It reports on the expected economic impacts of adopting the modelled package using a model of the Australian economy.

KEY FINDINGS

- The modelled tax reform package was selected because it simplifies the existing tax system, results in a more reliable tax base while most importantly increasing the growth of the economy. The results show that the Australian economy could be better with better taxes.
- This modelled tax modernisation package involves:
 - ◆ Abolishing the 'bad' state/territory taxes (i.e. stamp duties on conveyances, insurance tax, fire services and emergency levies)
 - ◆ Improving the design of existing state/territory taxes by broadening the base of these taxes (i.e. land tax and payroll tax)
 - ◆ Broadening the base of the more efficient taxes (i.e. GST and alcohol taxes)
 - ◆ Lowering the tax rates of existing taxes (i.e. reducing the rate of company taxation).
- By substituting state/territory tax revenues, the Commonwealth shoulders increased revenue burden of the proposed tax reforms. However, increasing the GST revenue base allows the different levels of government to balance obligations/opportunity for reform more effectively.
- The analysis evaluates the difference that the proposed Tax modernisation reform package would make to economic outcomes using a detailed economy-wide model. It shows:
 - ◆ Shifting the composition of taxes from inefficient state/territory taxes to more efficient Commonwealth taxes is forecast to improve many key economic outcomes.
 - ◆ Adopting a portfolio of tax changes that remove and reduce those state/territory taxes and introduce increased GST will lift economic activity. The analysis indicates that GDP is higher by 0.5 per cent per annum for the 10 years after the tax reforms are introduced.
 - ◆ Much of the boost to GDP stems from the increased investment from abolishing the inefficient taxes which are largely imposed on business. Abolishing these taxes reduces impediments to investment in land, buildings and other assets. This allows businesses to pass reductions in the cost of doing business to consumers. 10 years after the proposed change, investment is estimated to be 2.6 per cent higher.
 - ◆ Government consumption, investment and transfer payments, increases by 1 per cent. On an annual basis this is equivalent to increasing government spending by \$8 billion in 2014.
 - ◆ Real incomes, which measure the ability of individuals to purchase goods and services, increases as a result the Tax modernisation reform package. This indicator matters as a rise in real income indicates a rise in the capacity for current consumption, but also reflects an increased ability to accumulate wealth in the form of financial and other assets. On an annual basis, the increase is equivalent to increasing the real incomes of Australians by \$6.0 billion in 2014. Real incomes increase because the tax changes increase the efficiency of the economy's portfolios of taxes which boosts investment and increases overall output. The value of the impact is equivalent to increasing the average income of all Australia's residents by around \$260 per person per annum.
- The analysis shows that the business and community can become better off even where the overall size of the tax burden increases marginally. This is because the tax reform changes reduce the inefficiencies of the tax system. As a result, business profitability improves which leads to greater economic activity, and more investment.
- Importantly, the analysis has deliberately assessed the Tax modernisation reform package in isolation from transitional and compensation arrangements necessary to transition the package from a 'good' idea into 'practice'. However this analysis is necessary to be able to outline to the benefits from implementing tax reform, the parties who benefit, the parties who don't benefit and finally, to determine the funds available to transition in reform.

8.1 The modelled tax modernisation package

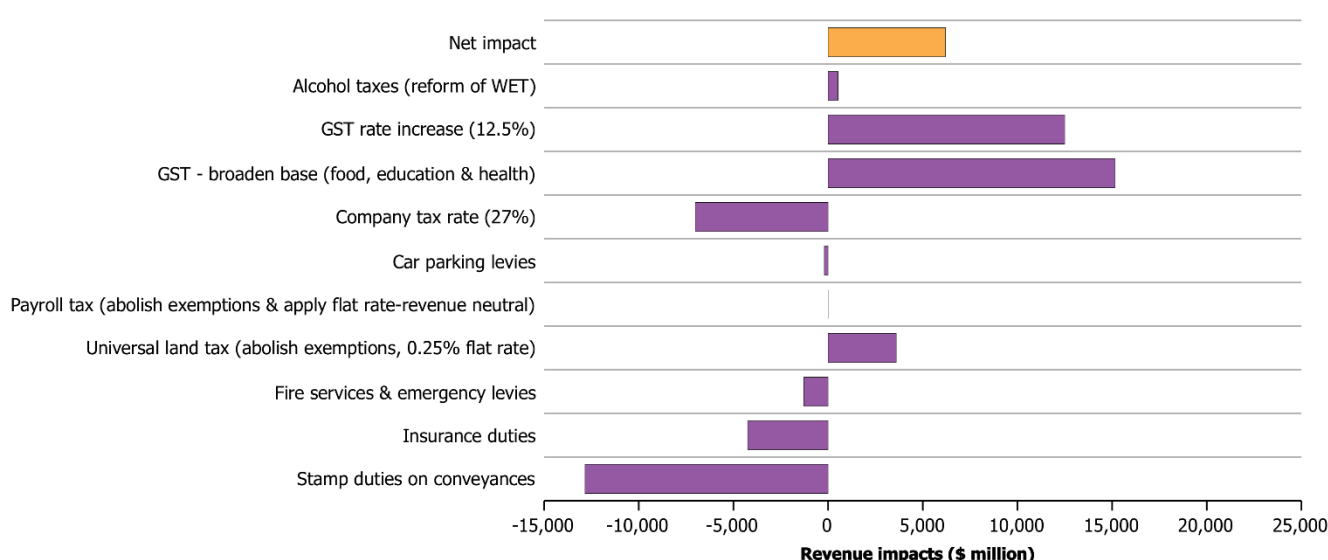
The modelled tax modernisation package – Tax reform package 3 – was selected as it provides governments with an increased and more stable tax base while importantly reducing distortions from taxation and driving growth in the economy by the most. There are five aspects underlying the scope of its reform:

- *Abolition of the bad state/territory taxes* – The modelled tax reform package abolishes the worst state/territory taxes in order to simplify the existing tax base and increase their efficiency
- *Maintenance of state/territory taxes* – The modelled tax reform package transforms existing inefficient non transaction taxes to efficient taxes (including, payroll taxes and land tax in coordination with abolition of stamp duty) in order to simplify the existing tax base and increase its efficiency
- *Broadening of the base of the more efficient existing taxes* – The modelled tax reform package reforms the Wine Equalisation Tax on alcohol and broadens the GST base to include fresh food, education and health in order to simplify the existing tax base and increase its efficiency
- *Lowering the tax rates of existing taxes* – The modelled tax reform package reduces the company tax rate in order to improve competitiveness of the tax system
- *Increasing reliance on the more efficient taxes* – The modelled tax reform package increases the GST tax rate in order to compensate for the tax revenue losses from cutting the more inefficient taxes and reducing tax rate and foster revenue adequacy and simplicity in Australia's tax base

In order to be credible and practical, reform must be funded.

Figure 54 summarises the indicative level of the tax funding changes by tax type.

Figure 54 **Cost and funding sources of tax changes under modelled tax modernisation reform package**



Source: ACIL Allen Consulting, 2014.

The strength of the modelled tax modernisation reform package is that it significantly simplifies the existing tax system and improves its efficiency while also realigning government revenue with the needs of the community, both now and into the future and most importantly drives growth of the Australian economy. The Henry Review (2010) recommended that revenue for the provision of public goods is best raised through the taxation of income, consumption and land. If levied consistently upon a broad base, such taxes are efficient and if properly structured allow the burden of taxation to be distributed as widely as possible.

As highlighted by Figure 54, the changes to the GST fund the change and abolition of the more inefficient taxes.

Although it is recognised that consumption taxes can be regressive in incidence due to the tendency of lower income earners to spend a higher proportion of their income on consumption, this can be addressed via the transfer system (Henry Review, 2010).

While the GST is an efficient tax relative to many of the other taxes levied in Australia, its complex design currently detracts from its efficiency potential. Exemptions from the GST tax base also mean that it is not as sustainable as other consumption taxes. The fact that GST exemptions are estimated to be worth around \$21.5 billion per annum whereas GST collections are around \$50.3 billion highlights that the GST is becoming increasingly inefficient and less robust.

While funding state tax reform through solely an increase in the rate of the existing GST is an option, it is clear that its design is not optimal and the Tax modernisation reform package highlights additional economic gains could be achieved through the use of a consumption tax applied to a broader base.

A broader-based GST levied consistently across goods and services is simple to calculate and, by being incorporated through the same remittance regime as the existing GST, would involve minimal compliance costs. Such a tax change has been applied to a broader base in the Tax modernisation reform packages, which would move it towards the New Zealand model. Alternatively it could be levied on a less broad base basis, with simple inclusions such as fresh food only.

8.1 Exploring the opportunity: approach to measuring the impacts of reform

The impact of the tax change is quantified using the dynamic CGE *Tasman Global* model of the Australian economy. This is used because it provides a broad representation of the key features of the Australian and State economies and allows assessment of outcomes with and without tax changes and therefore the difference that changes to the tax system on a portfolio basis make to the Australian economy – the following box outlines the benefits of this economic modelling framework.

Box 4 *Tasman Global* computable general equilibrium mode

An understanding of the impact of taxes and transfers on the allocation of resources in the economy is crucial to tax policy design. A general equilibrium economic model of the Australian economy is the only viable means of assessing the economic effects of a tax reform package, as opposed to analysis of tax changes on a tax by tax basis.

Such models represent the economy, the way it operates and the way people and businesses respond to changing price signals, using a consistent economic framework. They enable the economy-wide effects of a policy change to be observed, including so-called second-round effects in markets not directly affected by the policy under consideration.

While they provide a sophisticated means of assessing the impacts of policy change, these models have limitations. They are an approximation, or simplified version, of the real world. They are usually highly aggregated, reflecting both data limitations and the need to make the models tractable. Consequently, these models will not provide insight into all the possible effects of a policy change. For example, the actual impact of a policy change may vary between individual firms in a particular industry, due to differences in their business structure, but such effects will not be captured in an aggregated model.

Importantly, the results obtained from such a model are influenced by the structure of the model itself and its underlying assumptions about producer and consumer behaviour. There are also limitations to the precision with which individual taxes and transfers can be represented in such models.

The model used to analyse the economic effects of the recommendations in this Report is the *Tasman Global* computable general equilibrium model of the Australian economy. This model has a high level of tax detail, which has enabled a broad range of the existing Australian taxes and recommended policy changes to be modelled. It estimates the long-run impacts of a policy change over 10 years.

Key aspects of the model that are helpful for the analysis are that it:

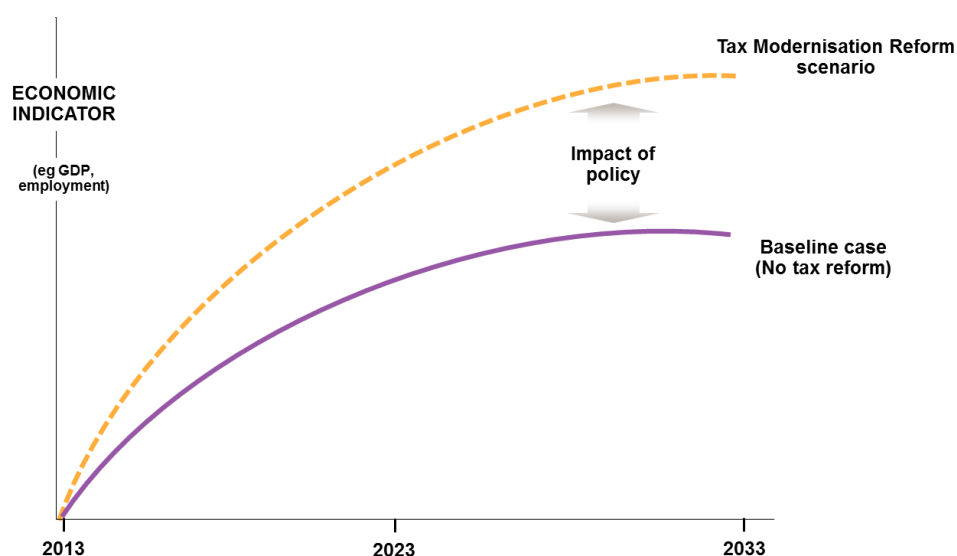
- is a multi-regional applied general equilibrium model
- accounts for the six States and two Territories as distinct regions including specific details about the budgetary revenues and expenditures of each of the eight State governments and the Australian Government
- specifically accounts for major taxes including land taxes, payroll taxes, stamp duties and others at the State level, as well as income taxes, tariffs, excise, the GST and other taxes at the Commonwealth level
- traces out the impact of transfers between governments
- provides a detailed account of industry activity, investment, imports, exports,
- changes in prices, employment, household spending and savings and many other factors.

An overview of the *Tasman Global* model is provided in the appendices.

Source: ACIL Allen Consulting, 2014.

When used for this benchmarking exercise, *Tasman Global* is operated in a long run closure. That is, the modelling results reflect the impacts of the tax cuts that are likely to occur after there has been full adjustment of capital and labour between jurisdictions and industries (say between 5 and 10 years). The *Tasman Global* model's results in this case provide a snapshot of the economy at a point in time after full adjustment to the policy change.

Figure 55 **Depiction of CGE modelling of proposed Tax modernisation reform plan**



Source: ACIL Allen Consulting, 2014.

For the Tax modernisation package, the analysis measures how a range of economic variables are expected to vary through time. The assessment is made relative to a base case (baseline). The baseline is a projection of economic outcomes without any of the proposed strategic tax reform changes.

The analysis then introduces the mix of tax changes undertaken in proposed tax reform package. The tax changes for each scenario start from 2012-13. The analysis captures both short term and long term impacts of tax changes. The main difference between the two is that capital and wage adjustments cannot occur.

Policy changes with long term economic gains may have short term economic costs as the economy adjusts to the new incentives captured in prices and rates of return and wages adjust to equilibrium.

The respective governments are treated as a group. Attempting to account for the different tax arrangements of each jurisdiction would weaken the analysis because:

- the results would be influenced by inter-jurisdictional competition (competition between the respective states and territories); and
- arbitrary decisions would be required about how each change scenario would be applied to each regime.

By treating the respective governments as a group the analysis is able to avoid both of these issues. Tax rates and thresholds are thus averaged such that they are applied in a common way across the economy. Additionally, this assumption captures the spirit of cooperation among the state and territory governments in the pursuit of improved taxation arrangements.

8.2 Tax modernisation reform package: economy wide benefits of change

The following sections outline the projected broader economic impacts of the Tax modernisation reform package.

When assessing the impacts of an industry or policy change on the Australian economy, there are a range of key macroeconomic variables that are commonly evaluated, these include:

- *Gross Domestic Product (GDP)* – GDP is a measure of Australia's economic activity. GDP is the sum of consumption, government spending, investment and net exports. Therefore, changes in GDP largely reflect changes in these economic variables, particularly those of investment and consumption.
- *Real income* – this is a measure of the ability to purchase goods and services, adjusted for inflation. An increase in real income indicates an increase in welfare of Australians.
- *Investment* – investment is another component of GDP that measures demand by private firms and individuals for capital, including factories, machinery, computer software, etc. This variable is an indicator of the future productive capacity of the Australian economy.
- *Government consumption* – this variable reflects government spending in goods and services to meet the needs of the Australian community.
- *Balance of trade* – the balance of trade provides insights about the relationship between imports and exports. A positive balance is known as a trade surplus if it consists of exporting more than is imported; a negative balance is referred to as a trade deficit.

The impacts of the Tax modernisation reform package on these key macroeconomic variables are summarised in the sections below. All the impacts are relative to the base case scenario where the Australian tax system remains unchanged and presented as changes 10 years after the reform has been implemented. Changes presented in monetary terms are in real terms in 2013-14 prices.

8.2.1 Economic activity (GDP)

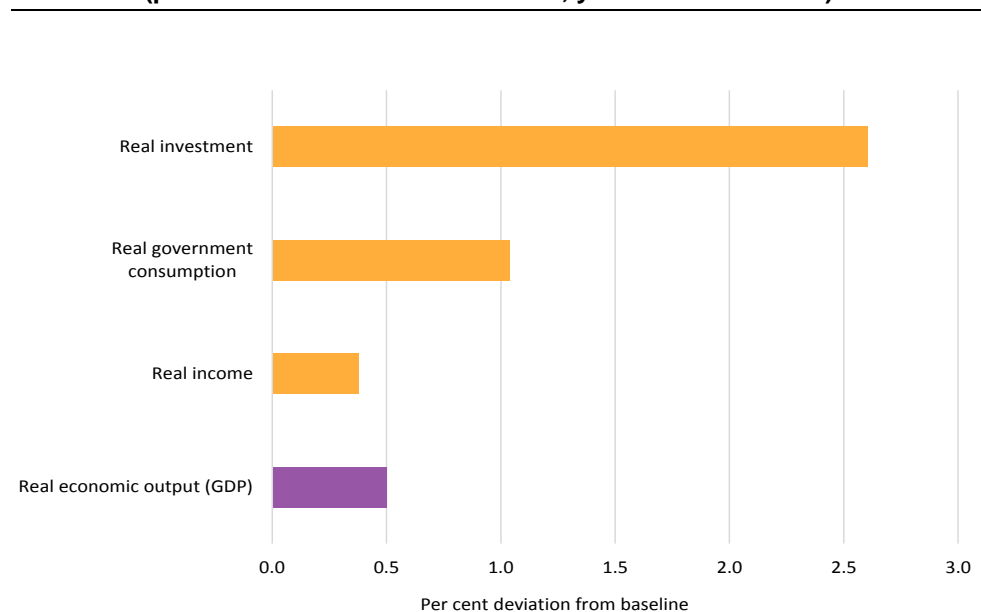
The projected macroeconomic impacts of the Tax modernisation reform package are presented in Figure 56. As shown in this figure, the Tax modernisation reform package improves the structure of Australia's tax system and by doing so generates economic growth through increased efficiency and reduced costs of raising taxation revenue.

It is estimated that the Tax modernisation reform package will generate higher GDP than would have been the case under the baseline. Specifically this scenario, which aims to drive economic growth, would increase GDP by 0.5 per cent per annum. While the impacts of the Tax modernisation reform package on economic output may look small in percentage terms, on an annual basis this benefit is equivalent to about **\$7.8 billion of real GDP in 2014**. In dollar terms over the 10 years from when the tax reform package is introduced, Australia's GDP would be expected to be \$39.87 billion higher over these 10 years relative to the base case where there are no tax changes.

The net impacts of the Tax modernisation reform package on GDP include a number of effects. A key effect comes from changes in the GST. When the GST rate is increased, prices for consumer goods and services increase, resulting in a reduction in real wages. Higher consumer prices and lower wages arising from changes in the GST translate into lower consumption and lower labour supply (lower wages discourage workers to supply labour) and ultimately, lower output. However, this impact is outweighed by the positive impact of reforming and abolishing inefficient taxes, which results in a more efficient allocation of resources and ultimately growth for the Australian economy.

Growth in GDP can also be measured against the 'size' of change. The proposed tax change reflects the deepest reforms of the three scenarios and has a commensurately larger impact on economic activity.

Figure 56 Economy-wide impacts of the Tax modernisation reform package (per cent deviation from baseline, year 10 after reform)



Source: ACIL Allen Consulting modelling.

8.2.2 Australian's welfare (real income)

As mentioned above, real income is a measure of the ability to purchase goods and services, adjusted for inflation. A rise in real income indicates a rise in the capacity for current consumption, but also an increased ability to accumulate wealth in the form of financial and other assets. The change in real income from a policy or reform is a measure of the change in welfare in the economy.

As shown in Figure 56, the Tax modernisation reform package is projected to increase the real income of Australia by 0.4 per cent per annum relative to the baseline. On an annual basis this is equivalent to increasing real income of Australians by about \$6.0 billion in 2014. This is because the proposed tax package boosts investment and increase Australia's overall output. This additional output is directed towards the domestic market and leads to higher incomes. The proposed tax package contributes to increased income because it undertakes the deepest reform of inefficient taxes.

To place these projected changes in income in perspective, the value today of this impact is equivalent to increasing the average income of all current residents of Australia by approximately \$260 per person per annum.

8.2.3 Competitiveness (Investment)

The projected impacts of the Tax modernisation reform package on investment are also shown in Figure 56. Much of the boost to GDP under the Tax modernisation reform package scenario would stem from higher investment. Indeed, 10 years after the proposed change, investment is estimated to increase by 2.6 per cent when compared to the baseline. This flows through to higher levels of economic activity, increasing GDP by 0.5 per cent as described above.

The Tax modernisation reform package abolishes inefficient narrow-based taxes and raises revenue from broad-based taxes on consumption and land. Most of the abolished taxes are imposed on business. Abolishing these taxes reduces impediments to investment in land, buildings and other assets and allow businesses to pass reductions in the cost of doing business to both domestic and overseas consumers. A lower rate of company tax also has a positive impact on the economy as it leads to a higher return from investing in Australia. This results in greater investment and higher capital intensity levels, which raises the productivity of the Australian workforce.

Importantly, higher investment leads to faster capital accumulation, which creates a larger capital stock in the economy. This implies that the economy would have greater production capacity, and thus boosts output.

8.2.4 Government consumption

Government consumption or spending includes all government consumption, investment, and transfer payments. As shown in Figure 56, the Tax modernisation reform package is expected to result in government consumption being 1.0 per cent higher than would otherwise be the case. On an annual basis this is equivalent to increasing government spending by about \$8.0 billion in 2014. This higher government expenditure is consistent with a bigger economy which is brought about by a more efficient tax system.

8.2.5 Trade impacts

The proposed tax reform would affect Australia's interactions with the rest of the world by affecting the cost of producing export goods and the exchange rate. There are a few factors driving the overall impact of the Tax modernisation reform package on Australia's trade and exchange rate.

- As mentioned before, the abolition of inefficient taxes reduces the cost of production for Australian business and improves the productivity of industries by removing distortions and allowing more efficient allocation of resources across the economy. This efficiency effect outweighs the price increases resulting from an increased GST rate. The overall effect is that prices for Australian goods and services (including the price of exports, which are not affected by the change in GST as all exports are GST-free) would be lower than would otherwise be the case, making Australian producers more competitive in the international market. The increase in demand for lower priced Australian exports puts upward pressure on the exchange rate and also raises the levels of imports.
- Price reductions passed from producers to consumers result in households effectively experiencing an increase in their real wages. This increase in real wages allows households to consume more locally made goods and services, save more and consume more imported goods, increasing the levels of imports.

- The reduction in the payroll tax rate allows business to operate more productively, resulting in a reduced need for foreign investment in capital. In the long run, a lower reliance on foreign capital leads to lower outflows of Australian currency to service these debt requirements and results in an appreciation of the exchange rate. The appreciation of the exchange rate offsets the tendency for higher exports and leads to a higher level of imports.

Overall, the impacts outlined above result in Australia having a trade deficit (the increase in imports is higher than the increase in exports, resulting in negative net exports) of \$4.3 billion 10 years after the introduction of the tax reform package and an appreciation of the exchange rate of 1.5 per cent when compared to the baseline. The appreciation of the dollar will benefit some parts of the economy (i.e. importers) while adversely affecting others (i.e. exporters).

8.2.6 Revenue impacts

The Tax modernisation reform package was designed so that it raised at least enough revenue to cover the shortfall from the abolishment of inefficient taxes. As such, Figure 57 shows that, overall, the budget position of the government is slightly higher than under the baseline. In particular, it is estimated that the proposed Tax modernisation reform package would result in total tax revenues being 1.2 per cent higher than would otherwise be the case. This is equivalent to \$34,834 million in additional taxes being collected over the 10 years from the tax reform package is introduced.

Figure 57 also shows that the Tax modernisation reform package results in a change in the tax mix. Abolishing stamp duties would lead to a loss in revenue on taxes on other factors of production of 23 per cent. In addition to the direct impacts on revenue from the abolishment of stamp duties and other inefficient narrow-based taxes, these changes would also have flow on impacts on revenues from other taxes, particularly company tax. As mentioned before, most of the abolished taxes are imposed on business and so their abolition leads to a lower cost of investment. A lower cost of investment affects company tax revenues in two opposite ways.

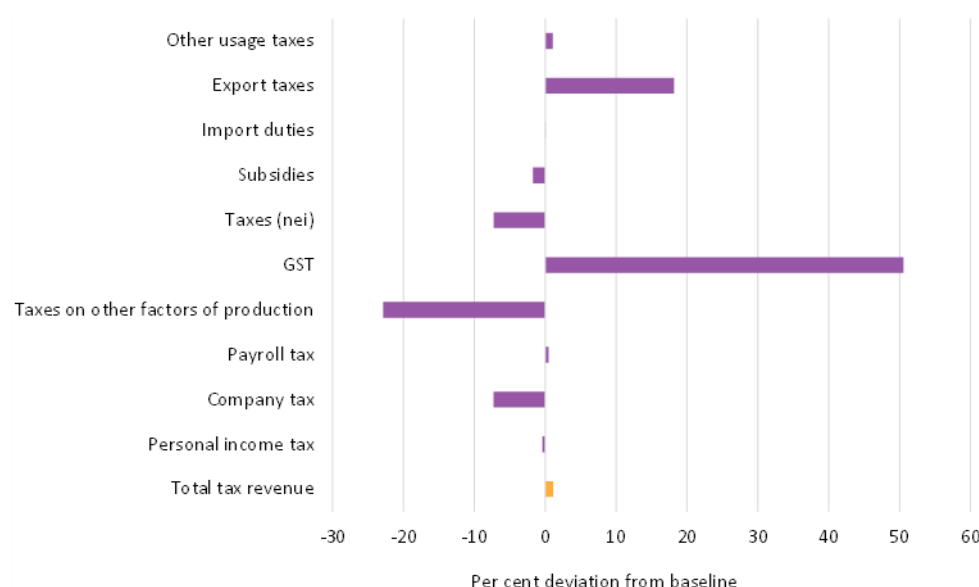
- As a small open economy, Australia is assumed to be a price taker in world capital markets, which means that capital is supplied to Australia at a fixed rate of return. When inefficient taxes are abolished and the cost of investment (capital) lowered, the dollar value of the return to that capital is lower too. This reduces the base for company tax and hence, company tax revenues.
- As mentioned before, abolishing inefficient taxes reduces impediments to investment, resulting in greater investment and a larger stock of capital, which increases the base for company tax and hence, company tax revenues.

Overall, the first of the above effects dominates, leading to lower company tax collections, however the overall effect is positive for the economy as we are a more attractive investment opportunity. The indirect effects and the direct effects from the reduction in company tax rate result in company tax collections being 7.3 per cent lower than under the baseline. This is equivalent to \$7,875 million less company tax revenues in 2024. Reducing Australia's reliance on corporate tax collections and increasing our reliance on GST collections would bring Australia in line with the reliance of other OECD countries in terms of corporate and consumption taxation.

Overall, a reduction in the company tax rate is a positive for the economy as it makes Australia more attractive as a destination for foreign capital which will result in increased investment and ultimately higher economic growth as the increase in capital investment will result in higher productivity for the economy.

GST revenues are projected to be around 50 per cent higher than under the baseline. This is a result of both the changes to the GST base and rate and the increase in overall economic activity resulting from the implementation of the Tax modernisation reform package.

Figure 57 Government revenue changes (per cent deviation from baseline, year 10 after reform)



Note: Taxes on other factors of production include stamp duties.

Source: ACIL Allen Consulting modelling.

8.3 Tax modernisation reform package: microeconomic analysis of universal land tax change

As indicated in the previous section, there are clear macro-economic benefits from implementing the Tax modernisation reform package. However, it is worth highlighting the impacts on different taxpayers from the 'tax maintenance' aspect of the Tax modernisation reform package, specifically:

- abolishing stamp duties on conveyances and replacing with a low uniform land tax regime across all state and territory governments
- reforming payroll tax across all state/territory governments

Economic theory is frequently used to justify taxes on land, with the argument being that land is inelastic (fixed in supply) so will be unresponsive to changes in taxation and therefore is an efficient tax. However this argument does not apply to the existing land taxes applied by the respective state and territories because the way in which they are currently applied result in market distortions (see following section for more detail on the inefficiency on the existing land tax system).

8.3.1 Inefficiency of existing land tax system

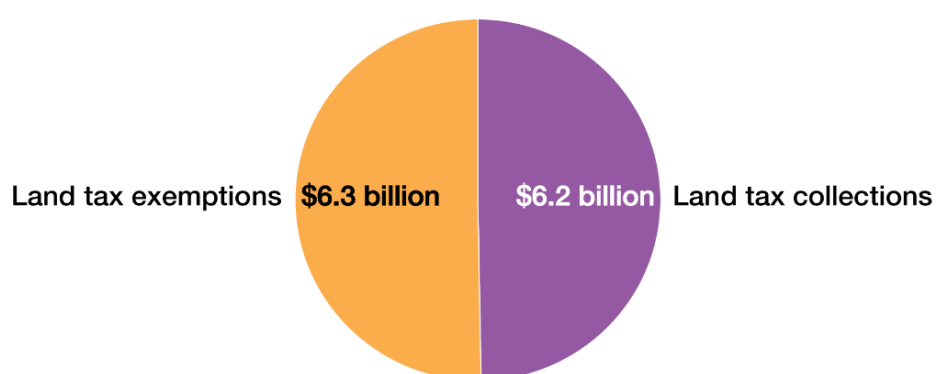
Currently all states and territories have multiple-rate land tax systems, except for the Northern Territory where there is no land tax. In some cases (e.g., Queensland) the relevant land tax rate scales have a large number of steps over which marginal tax rates increase above a tax-free threshold. These features highlight:

- The inefficiency of these multiple rate scale: the multiple rates with high tax free thresholds require higher marginal tax rates over a significant range of land values to raise the same level of revenues
- They are administratively more costly to administer and with which to comply. For example, they require attention to aggregation of ownership of land across owners to ensure that the appropriate tax rates are applied
- Land taxes cannot automatically be regarded to be efficient as a result of the fixed nature of land due to the fact that tax is applied to the value of the land, not some physical characteristics of the land. The value of land depends in the longer-term on the investment capital investors are prepared to allocate to property versus other investment assets. Therefore, given that investment capital is mobile, both between types of investments and geographically, the traditional argument that land taxes are extremely efficient due to the fixed nature of land does not hold. Importantly, land supply is not fixed in reality, as taxable land mix can change from rezoning existing land, and through new land releases.

As indicated in Chapter 3, the ACIL Allen estimates the states' and territories' existing land taxes result in a loss of economic well-being of around 20 cents per dollar per \$1 of raised revenue whereas a uniform low flat rate land tax with no tax threshold is estimated to result in a loss of economic well-being of 10 cents per dollar per raised \$1 of revenue.

Figure 58 summarises the level of land tax collections collected by the state/territory governments and the value of the current exemptions. The narrow-base of the existing land tax system is highlighted by more than half of the potential land tax base being exempt.

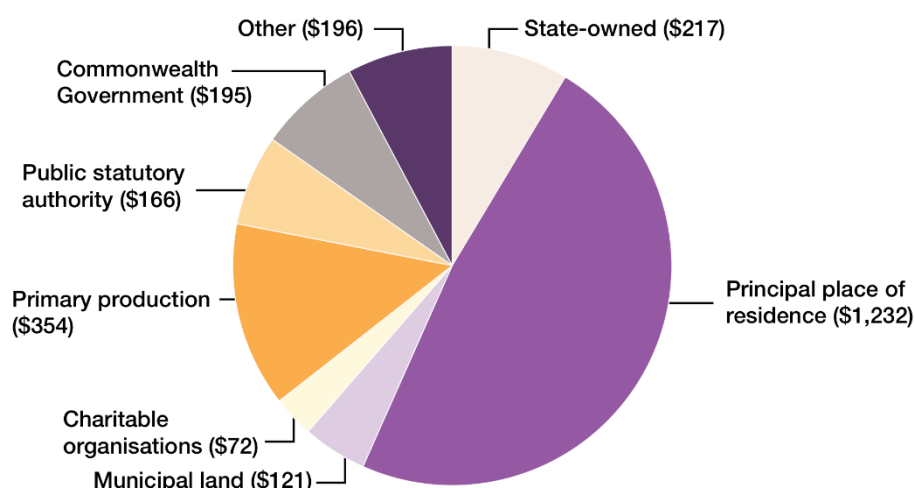
Figure 58 **Breadth of land tax base, 2012-13**



Source: ACIL Allen Consulting estimates based on 2012-13 budget papers prepared by relevant state/territory governments

Figure 59 highlights the sources of land tax exemptions in the existing Victorian land tax system. The exemption for principal place of residence accounts for the most significant land tax exemption. The principal place of residence exemption is not affected by the value of the land.

Figure 59 Distribution of land tax exemptions – Victoria, 2012-13 (\$ million)



Source: ACIL Allen Consulting estimates based on 2012-13 budget papers prepared by relevant state/territory governments

8.3.2 Universal broad-base low rate land tax

The Henry Review wrote in favour of continuing to use land as a base for taxation, citing the relative efficiency of this tax relative to other bases. However, in doing so, it recognised the failings of the existing land tax base by recommending that a uniform low rate and broad based land tax would serve the purpose of increasing the efficiency of this tax (Henry Review, 2010). The below box outlines the ideal land tax based upon the Henry Review's recommendations.

Box 5 What would a reformed land tax look like?

Based on the principles in the Henry Review (2010), a reformed land tax would have the following characteristics:

- consistency across states and territories
- a broad base with no (minimal) exemptions
- land values would not include building values or be triggered by transactions
- rates would not be varied to include vertical equity objectives
- should be levied at a flat rate so as to not discourage large aggregate land holdings
- recoverable from tenants in business property

Source: ACIL Allen Consulting, 2014

The Tax modernisation reform package abolishes stamp duties on conveyances and replaces the loss of tax revenues with the replacement of the existing land tax base with a uniform land tax of 0.25 per cent which applies to all land across Australia (no exemptions) and no tax free threshold (tax design change).

Any reform of the land tax system which increases the level of taxation revenues collected from land taxation should be tied to the abolition of stamp duties on conveyances. This is because there is already a relatively high tax burden on the property sector in Australia as highlighted in Chapter 3. Abolishing stamp duties on conveyancing while introducing a universal low rate land tax system with no tax free thresholds would ensure that the property sector does not bear an even greater tax burden.

In addition to the benefits of reforming the land tax system, there are benefits from abolishing stamp duties on conveyances. Abolishing stamp duties will:

- remove a significant barrier to transactions
- create a more flexible and mobile workforce
- increase the supply of established housing on the market as home owners will be able to upsize/downsize to meet their changing needs
- reduce the volatility of the state/territory tax base
- lower mortgage repayments as most purchasers roll the stamp duty cost into their mortgage.

The use of a low-rate, broad-based land tax, that is uniformly applied across states and territories would have another impact – the reduction in the compliance costs associated with the tax.

Compliance costs would reduce to a significant extent under such a system. The benefits to business and government would include:

- The potential for the number of government agencies responsible for administering land tax could reduce from seven²⁸ to one. Administration of land tax is costly and is primarily based on:
 - assessing land values and land uses is currently the function of seven Valuer-Generals, which creates a large cost
 - there is a large division of the ‘tax army’ comprised of bureaucrats involved in processing land tax returns and managing land tax policy
 - there are substantial exemptions to the land tax net. An example of this is the exemption for owner-occupied housing (Henry Review, 2010). Exemptions such as this increase the incentives for businesses and individuals to ‘game’ the system and thus require a substantial expenditure on audit to enforce compliance.
- There are considerable compliance costs for business from the existing model. These are a function of the current seven separate regimes and are driven by:
 - interaction with seven separate bureaucracies, the associated need to maintain seven separate inventories for land tax purposes and the associated forms;
 - the complexity from a calculation standpoint of the landholder model. This means that firms are not paying flat rates of land tax on a per property basis but against a detailed inventory – some of which, depending on its use – will be exempt; and
 - the landholder model creates perverse incentives – firms may seek to unbundle their land holdings to minimise their tax.

As such, moving to a broad-based, low-rate land tax that is nationally administered and does not involve the bundling from the landholder model would be a significant step to reduce a large volume of compliance costs.

²⁸ The Northern Territory does not have a Land Tax (Henry Review, 2010).

8.3.3 Analysis of implications of change to land tax and stamp duty on conveyances

This proposed tax change obviously has adverse implications for those taxpayers who currently do not pay land tax: principal residence owners, primary producers and government and not-for-profit owners. However these impacts need to be considered in light of the changes to the bundle of property related taxes, namely the abolition of stamp duties on conveyances.

The two reforms must be tied together in the interests of fairness and equitable burden on property taxpayers.

Given that residential housing accounts for a significant proportion of land across Australia and currently the principal place of residence exemption accounts for the largest proportion of the cost of existing land tax exemptions, the impact of the tax change on residential property owners has been analysed.²⁹

To test the impact of this change on principal residence owners, ACIL Allen undertook a net present value (NPV) comparison of the taxes that would be paid by principal residence owners under:

- the existing stamp duty on residential conveyances regime
- the proposed flat universal land tax regime.

Box 6 Assumptions underlying tax burden comparison of stamp duties on conveyances and flat universal land tax regime for residential property owners

To undertake the analysis, ACIL Allen Consulting made the following assumptions regarding the residential properties modelled:

- Assume a family purchases a 3-4 bedroom house in a capital city
- Located in city growth areas
- 25 lots per hectare
- 220 metre-squared house
- 400 metre-squared average lot area
- 7 year analysis period (single property transaction during period)
- 0.25 per cent land tax rate based on land value

Assumptions for land value, house sale price and corresponding stamp duties on conveyances are shown in the following table:

Assumption	Sydney	Melbourne	Brisbane	Perth	Canberra	Adelaide	Hobart	Darwin
Land value (\$ in 2013-14)	101,000	65,000	78,500	71,000	63,500	43,000	21,000	66,000
House sale price (\$ in 2013-14)	645,500	440,000	465,800	410,000	441,000	383,000	376,000	633,000
Stamp duties on house purchase (\$ in 2013-14)	24,500	18,000	15,000	13,500	14,500	15,500	13,000	31,000
Land tax (\$ p.a.)	253	163	197	178	159	108	53	165

Source: ACIL Allen Consulting, 2014.

Assumptions underlying the analysis are summarised in the above box (Box 7).

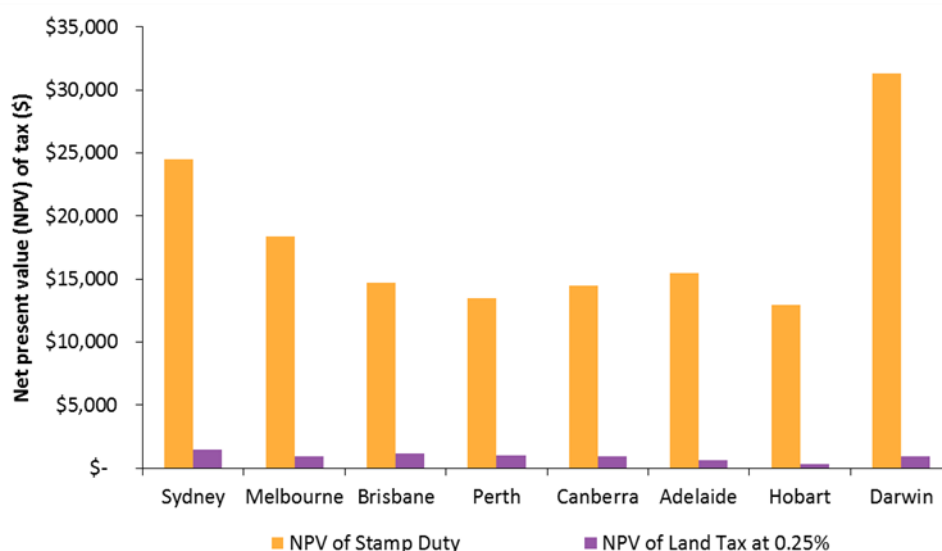
²⁹ In New South Wales (NSW), it is estimated that 90 per cent of stamp duty on conveyancing transactions are residential while also accounting for around 80 per cent of stamp duty on conveyance revenues collected.

Figure 60 shows the net present value of the amount of tax property owners would be expected to pay over a seven-year analysis period using 2013-14 land and house sale prices in each of Australia's capital cities. The analysis compares tax burden with respect to:

- conveyancing stamp duties paid upon the purchase of residential properties (i.e. a single payment in the first year); and
- land taxation where a broad-based low uniform rate of 0.25 per cent on the value of land is paid annually on residential properties for seven years.

The analysis indicates that the amount of tax paid under the existing stamp duty regime is significantly more than the amount that would be paid under a flat universal land tax regime, assuming a single marginal land tax rate of 0.25% applied to land value. Such a low flat land tax rate would result in a land tax liability equivalent to many property owners' council rates.

Figure 60 NPV analysis of impact of stamp duty/land tax change for residential property owners

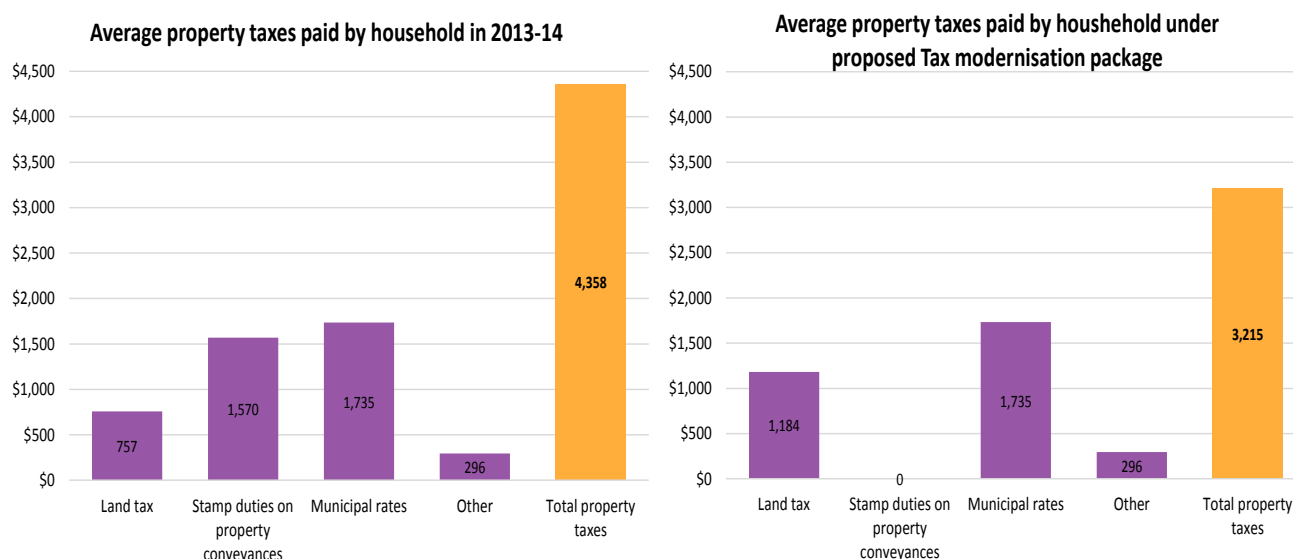


Source: ACIL Allen Consulting, 2014

Furthermore, it has been estimated that the proposed amendments to land tax and abolition of stamp duties would reduce the average burden of taxation on Australian households.

As shown in Figure 61, based on revenue estimates for 2012-13, the proposed changes in land tax and stamp duties would be equivalent to each Australian household paying an average of \$3,215 in property related taxes in 2012-13 instead of the current \$4,358, a reduction of \$1,143 per household.

Figure 61 Effect of stamp duty/land tax change on average property taxes paid by households, 2013-14



Source: ACIL Allen Consulting and ABS 2014a.

8.3.4 Transitional arrangements

The analysis to date has not mentioned possible transitional/compensation arrangements. Transitional arrangements should be used to mitigate any perceived unfairness from the tax changes. For instance, immediately imposing land tax on individuals who have recently purchased property and paid stamp duty will effectively result in these individuals bearing the burden of two taxes.

Importantly, the reform option provides around a \$6 billion uplift on existing revenues which can be used for transitional arrangements without impacting existing economic outcomes. There are a myriad of possible options which could include:

- owners occupiers not paying new land tax:
 - until the next house acquisition or period of time
 - for a given time period (e.g. 10 years)
 - until tax offset from previous stamp duty paid being used up.
- making the land tax regime elective – choice of paying stamp duty on next acquisition, or land tax (HECS-like approach but without any discount on upfront payment)
- other general compensation arrangements including:
 - an increase in welfare and pension payments to offset the additional land tax payable
 - lower marginal tax rates/higher tax thresholds
 - potential package for retirement villages and residents.

9 Tax modernisation recommendations

The previous analysis clearly highlights the large economic gains for the Australian economy from adopting the Tax modernisation reform package. Not only does the package increase direct tax revenues, but the package also ensures that the tax system is more efficient, translating into improved business productivity which leads to greater economic activity, higher wages and more investment.

Until now, this report has said nothing about how to transition the Tax modernisation reform package from a 'good' idea into 'practice'. Despite the clear benefits of previous policy reform, a number of barriers have ultimately hindered reform from occurring. In order to push reform forward it is necessary to be pragmatic about what realities will act as a barrier to reform and how these barriers can be overcome.

KEY FINDINGS

- There is an increasing recognition for the need for tax reform. Despite this recognition, there is a real risk that tax reform will not occur or will be stalled without a well-designed transition to reform.
- There are clear economic gains from well-designed and target tax reform. However reform is challenging.
- There are lessons to be learned from previous 'successful' and 'unsuccessful' attempts at reform. Experience has shown the need to obtain commitment from the states/territories to implement reform. Without this commitment, there is the danger of states/territories competing in a race to the bottom.
- To successfully implement a coordinated reform agenda with a broad tax reform package, the package should:
 - ◆ prioritise reforms – generally this will involve reforming taxes with the largest economic benefits
 - ◆ be fully funded
 - ◆ where possible, enhance the efficiency of the existing taxes
 - ◆ phase in the introduction of new or broadened taxes to ease transition to reform
 - ◆ be associated with a compensation package designed to neutralise the adverse consequences of tax reform
 - ◆ provide commitment to further longer term reforms.
- An overall package of tax reform must be backed up by a strong framework to implement and maintain the reforms. This is the difference between a good idea and turning a good idea into practice. The states/territories do not have sufficient fiscal incentive to implement tax reforms unilaterally – cooperation and agreement is vital for implementation.
- An agreement between governments to reform inefficient taxes is needed to ensure full implementation. This agreement needs to outline: clear timelines, measurable outcomes, financial incentives associated with both good performance, measures to guard against backsliding and an independent review and assessment.

9.1 Lessons from previous reforms

An examination of two of the more recent successful public policy reforms highlight factors necessary for successful reform.

9.1.1 A New Tax System

The last major tax reform was the A New Tax System (ANTS). The White Paper on ANTS was released in 1998. It recommended personal income tax and family benefits reform, the introduction of the goods and services tax (GST) to replace the wholesale sales tax, the removal of inefficient state and territory taxes and changes in Federal State financial relationships (Australian Government 1998).

Research commissioned by Senate Select Committee on ANTS showed that the impacts of ANTS on overall welfare were minimal. Specifically results indicated that the gain in overall welfare ranged from \$30 million to \$600 million per year (Australian Government, 1999).

In 1999, the GST legislation was passed and the Intergovernmental Agreement on The Reform of Commonwealth-State Financial Relations (IGA) was signed between the Commonwealth and State governments. The IGA stated that the state/territory governments were to abolish ten inefficient state/territory taxes in return for the GST revenue.

Another significant feature of the IGA was that the Australian Government guaranteed that the budgetary position of each state/territory would be no worse than it would have been had its reforms not been implemented. A guaranteed minimum amount (GMA) was the estimate of the revenue that each state/territory would have received under the previous system of financial assistance grants if their own inefficient state taxes had not been abolished as part of the reforms. The Commonwealth agreed to pay budget balancing assistance (BBA) to them during a transition period (which expired on 30 June 2009) if their share of GST revenues in a financial year was less than its GMA for that year.

In many ways, this revenue-sharing strategy was a political masterstroke. The prospects of accessing a growth tax ensured the support of the state/territory governments. Moreover, the IGA and the commitment therein that the proposed GST could only be altered with the unanimous support of both State/Territory/Commonwealth Governments reassured voters that the GST rate would not subsequently be increased (Costello 1998).

In terms of federalism, the most significant aspect of the ANTS package and the subsequent IGA was that it promised to put state/territory finances on a more secure footing. This point was made by the Treasurer, Peter Costello, when he confidently predicted that:

‘The GST will provide the States and Territories with a secure source of revenue that grows as the economy grows to secure funding for essential services, such as schools, hospitals and roads’.

Hamill, 2006

Despite the success of the GST, there are still a few lessons to be learned from the reform exercise that was not completely perfect in terms of its implementation:

- the agreed tax reform by the states/territories took longer than envisaged, with outstanding controversy remaining as to whether the states/territories met all of their commitments
- the comprehensive base of the GST was narrowed as a result of negotiations with the Democrats: the GST negotiations resulted in the exemption of food and other concessions (i.e. health, education, financial supplies). This negotiation also deferred the abolition of stamp duties on conveyances by the states and territories.

9.1.2 National competition policy - Hilmer reforms

On 4 October 1992, the Prime Minister announced an independent inquiry into a national competition policy (NCP) for Australia. Professor Fred Hilmer chaired the review which reported on 25 August 1993. On 11 April 1995, Australia's governments agreed to the National Competition Policy and Related Reforms. Governments also signed three agreements:

- *the Competition Principles Agreement* – set out the principles agreed for implementing the NCP, including on prices oversight, structural reform of public monopolies, review and reform of restrictive regulation, competitive neutrality and third party access to infrastructure services, and the application of these principles to local government
- *the Conduct Code Agreement* – set out the basis for extending the *Trade Practices Act*
- *the Agreement to Implement the National Competition Policy and Related Reforms* – set out the form commitment agreed to by government, covering the NCP reforms, national markets in electricity and gas, water reform and national road transport regulations, and provided for payments by the Australian Government to the states and territories where they achieve satisfactory progress with reform implementation.

NCP was Australia's landmark microeconomic reform program. The NCP reforms required cooperation between the Australian and State/Territory Governments which touched on so many areas of economic and social life. Spanning 1995-2005 the National Competition Policy is widely recognised as having contributed significantly to Australia's welfare: In 2005, the Productivity Commission reviewed the NCP reforms and found that NCP had delivered substantial benefits to the Australian community, which, overall greatly outweighed the costs (Productivity Commission 2005).

As recognised by the Centre for International Economics (CIE) it is clear that factors contributing to the success of the NCP include:

- the NCP had a clear mission – to enhance competition in Australia – and outlined definitive actions
- as part of the NCP, the Australian Government provided payments to the States for implementing NCP reforms. These payments were conditional on the States achieving satisfactory progress with the implementation of the reforms
- an independent body reviewed governments' progress in implementing the NCP reforms and advised the Australian Treasurer on whether the States have achieved satisfactory progress and so met the conditions for receipt of payment.

Centre for International Economics, 2008

9.1.3 Key lessons from recent successful major reforms

An examination of the lessons from ANTS and NCP reform show that the following factors which made these two major reforms a success include:

- clearly outlined objectives of reform, with subsequent clearly outlined definitive actions, milestones and timeframe. This was based upon recognising the need for reform in a transparent and engaging way. Subsequent to recognising the need for reform, it is necessary to identify principles underlying reform. These can be used to clearly outline the outcome based reform program and for assessing performance of reform during a later stage.
- the need to define a clear outcome based reform program.
- reasonable timetable and recognition for transition phase costs.

- recognised cooperation and collaboration needed across levels of government – to do this, new arrangements have to be conditional, rewarding performance and penalising poor performance. This was achieved via payments to the states/territories for implementing NCP reforms and in the case of the GST, the states/territories were assured receipt of the GST with a GMA clearly defined and a BBA which would be paid if the states'/territories' share of GST revenues in a financial year was less than its GMA for that year.
- recognise both winners and losers – both reforms identified losers, with the GST providing compensation for individuals and the states/territories and the NCP reforms providing payments to the states/territories upon satisfactory progress against their reform commitments. These payments were the way in which the gains of reform were distributed throughout the community.
- independent review of performance is important for success reform – reform should include processes for monitoring new arrangements to prevent bad policies from being introduced.
- political and market conditions matter – the success of the GST depended upon the negotiations between the Prime Minister and the leader of the Democrats. Without successful negotiation, the tax reform package would not have been passed by the Senate.

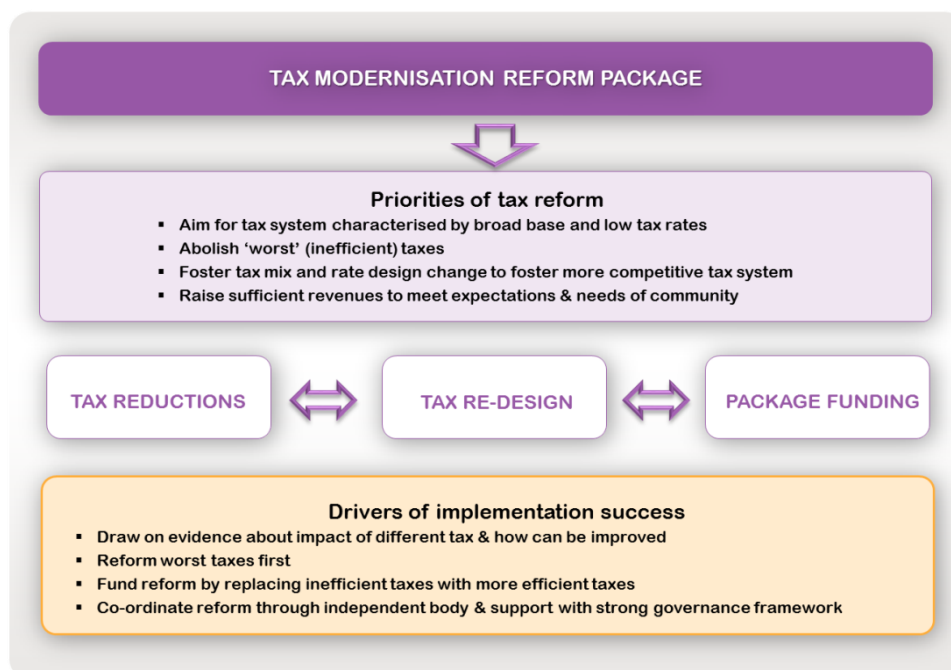
9.2 Pathway to reform

The factors and lessons identified in the previous section highlight the difficulty with achieving successful tax reform. To implement reform, it is recognised that a well-designed package of reforms (as outlined in the previous chapter), facilitated by agreement between the different levels of government are needed. This report will not set out the details of the precise reform package as this is for discussion and agreement between the relevant governments.

The next sections however do highlight the essential elements of a successful reform package and draws out key issues that need to be considered when designing a successful tax reform package.

Figure 62 summarises the pathway to reform (see next page).

Figure 62 Pathway to reform



Source: ACIL Allen Consulting, 2014

9.2.1 Outline tax reform priorities – prioritise taxes to be reformed

When outlining the key elements of the tax reform package, it is important to keep in mind the priorities for tax reform. They include: economic efficiency, equity, simplicity, competitiveness, stability and revenue adequacy. Application of these tax principles to the existing Australian tax system highlights the following reform priorities:

- State taxes can be improved considerably by abolishing the worst 'inefficient' taxes and replacing with more efficient taxes (a change in tax mix)
- Broadening the existing tax bases and lowering tax rates will improve the overall efficiency of the existing tax system
- The proposed tax system needs to raise sufficient revenues to meet the future expectations and needs of the community

In addition, it simultaneously needs to be recognised that:

- Little can be achieved via changes on a tax-by-tax basis. A more strategic approach requires changes to the entire tax portfolio in order to achieve the overarching priorities
- Reflecting the current budget environment, tax reform has to be at least revenue neutral. That is, the tax changes cannot raise fewer revenues in the year of change compared to the level of revenues that would be collected without any tax reform.

Tax reductions

Identifying which 'inefficient' taxes should be removed or reduced is the first step which should be undertaken. This step will be difficult to achieve as obviously the respective states/territories have their own self-interest. However, by making recommendations as to what taxes should be abolished based upon the public interest is the best way to proceed.

The economic modelling in Chapter 5 indicates that the greatest benefits to the economy would result from reducing:

- stamp duties on conveyances
- insurance taxes
- company taxation.

This is because these three taxes are more distortionary than other taxes and reduce the economic well-being of the economy by more per dollar of revenue raised.

Tax re-design

Major tax reform involves more than simply abolishing the inefficient taxes. Economic benefits can be achieved from tax mix and tax re-design (that is, re-designing existing taxes so that taxation is applied to a broader base and at a lower tax rate). As highlighted in Chapter 5, these economic gains can be achieved by:

- harmonising payroll tax which would involve reducing/abolishing exemptions and lowering the tax rate (this could be done in a revenue neutral manner)
- harmonising land tax across states/territories via the introduction of a universal land tax on a low rate, with no tax-free threshold and reduced exemptions. This specific recommendation should **only** be undertaken in conjunction with the abolition of stamp duties on conveyances
- broadening the base of the GST (for example, including fresh food, education, health etc.).

Both of the latter two changes also assist with funding the overall tax reform package due to the abolition of the inefficient state/territory taxes.

Tax reform package funding

It is recognised that given the existing budgetary position of government and the need to raise sufficient revenues to meet the future expectations and needs of the community, funding reform simply through a growth dividend is not ideal. A growth dividend is the additional tax revenues collected as a result of the increased economic activity from making the overall tax system more efficient.

It is recognised that given the existing budgetary challenges, funding for reform must come through the collection of new taxes, at either the Commonwealth or state/territory level. In the previous chapter, it is recognised under the Tax modernisation reform scenario that funding for reform will be derived from:

- an increase in the GST rate (up from 10 per cent to 12.5 per cent)
- broadening the GST base (including food, education and health)
- implementation of a universal land tax.

9.2.2 Transition to reform

There are equity issues that arise under the existing tax reform system and any subsequent changes to the system. This is because the existing state tax system has adverse impacts on vulnerable members and segments of the economy. For example:

- stamp duties on conveyances has a significant impact on housing affordability, and this impact is felt most strongly by those at the lower end of the income spectrum
- insurance taxes lead to underinsurance – and this is most likely to manifest itself in lower income earners being overexposed to uninsured risk (Henry Review, 2010).

During the transition to reform, it is important to recognise the equity impacts of any changes (i.e. winners and losers). This is because those adversely affected are likely to oppose reform, thereby imposing a barrier to reform. The proposed Tax modernisation reform package clearly has implications for different groups of individuals and businesses. For example, an increase in the rate of GST increases the price of goods and services consumed by individuals and business.

These equity implications can be addressed via the design of a compensation/transition package via: the use of direct assistance and/or phase in new or increased taxes.

A properly designed compensation package will enhance the efficiency of the proposed tax reforms as it would neutralise the adverse impacts of some taxpayer groups of the economy. This would alleviate the wider costs of reform.

Budgetary implications

It is important to identify the budgetary implications of tax reform because they impact upon the design of the transition and compensation arrangements underlying tax reform. Given the current budgetary realities, the proposed Tax modernisation package, if implemented in their entirety in year 1, would result in more revenues being collected by governments than if there was no tax reform. This additional revenue could be carried over to outlays in order to compensate specific groups disadvantaged by the change and to assist them to transition to the new tax system.

It is also noted that compensation is factored in as part of the package of reform. For example, it is essential that stamp duties on conveyances be abolished in conjunction with the introduction of a universal land tax system with a low rate and minimal exemptions and tax free threshold.

The economy wide analysis also indicates that there would be a fiscal dividend that will arise as a result of making the tax system more efficient. This arises where greater efficiency raises growth which is also subject to taxation. In the economy wide analysis this fiscal dividend is measured in terms of additional budget receipts which are assumed to be spent by government (in order to not also include into the analysis a contractionary change in fiscal policy). This fiscal dividend could be directed as transfers to assist groups disadvantaged by the change to adjust to the change.

The compensation and transition package should be carefully designed taking into account the overall impacts of the remainder of the tax reform package and the overall size of the fiscal dividend that would arise. This would be an important part of any negotiations related to implementation of the tax reform package.

Phase in and compensation arrangements

Consideration needs to be given to how arrangements should be phased in to mitigate any perceived unfairness and/or adverse consequences from changing taxes. For example, imposing a universal land tax on the principal residence of individuals who have recently purchased a property and paid stamp duty will result in these taxpayers paying the burden of two taxes.

The overall transition and compensation arrangements should take into account the impacts of tax changes and minimise the adverse consequences and/or perceived unfairness of tax changes where possible. The transition to reform could be eased using a number of methods, including:

- Phasing in new taxes at a specified rate each year;
- Grandfathering arrangements so that new taxes only apply to assets acquired after a given rate (i.e. introduction of capital gains tax in 1985 only applied to assets acquired after 20 September 1985);
- Introducing compensation arrangements targeted at adversely affected stakeholders – over the years, government has introduced a myriad of arrangements to compensate individuals and businesses for the introduction of new policies (see the following box for types of transitional arrangements which have been introduced in the past). The specifics of the compensation arrangements are at the direction of Government. Examples of recent phase in and compensation arrangements for major taxation policy reforms are summarised in the following box.

Box 7 Possible transition/compensation arrangements

Different transitional arrangements have been introduced to implement past microeconomic and taxation reforms.

National Competition Policy reforms

The key features of the arrangements included:

- The Australian Government provided payments to the states for implementing the NCP and related reforms. These payments were conditional on the states making satisfactory progress with the implementation of the reforms.
- The National Competition Council (NCC) reviewed progress and made recommendations to the Commonwealth Treasurer as to whether the states and Territories had met their commitments and should receive payments in full.
- The Commonwealth Treasurer was ultimately responsible for the final decision on the imposition of any penalty.
- States that proceeded with reform and applied principles received full payments. Those that failed to do so received penalties and deductions in payments.

A New Tax System

The Australian Government introduced a goods and services tax (GST) in July 2000 as part of a broader package of tax reform. The revenue of the GST was to be paid to the states/territories in exchange for the abolition of a number of inefficient state taxes. The package also included significant reductions in personal income taxes and large increases in Government payments to families, pensioners and low-income earners. Key elements of the package in its original inception:

- an increase in overall consumption taxes of around \$6 billion;
- personal income tax cuts costing \$13 billion and delivering an increase of \$86 per week in disposable income for high-income earners; and
- compensation, family assistance packages and cuts in diesel excise, costing \$8 billion

Carbon tax

When the Australian Government introduced the carbon tax, a number of arrangements were introduced to compensate individuals adversely impacted by the change:

- increase in the family tax payment benefits
- Clean Energy Advance was paid to eligible individuals
- the tax free threshold was increased

9.2.3 Implementation and governance arrangements

The implementation and governance arrangements are critical to the success of any tax reform package. This is because a good idea can only be turned in practice if implemented in a comprehensive and timely fashion. How the reforms are implemented is a crucial determinant in whether the potential benefits of reform become a reality. Therefore implementation and governance arrangements are important in ensuring:

- tax reforms are carried through with and result in real improvements in outcomes
- the co-operation and agreement of the different levels of government: in the case of ANTS, this was assured through an intergovernmental agreement (IGA) which clearly outlined deliverables, milestones and reward payments. The financial incentives were specifically designed to prevent any backsliding from the agreement.

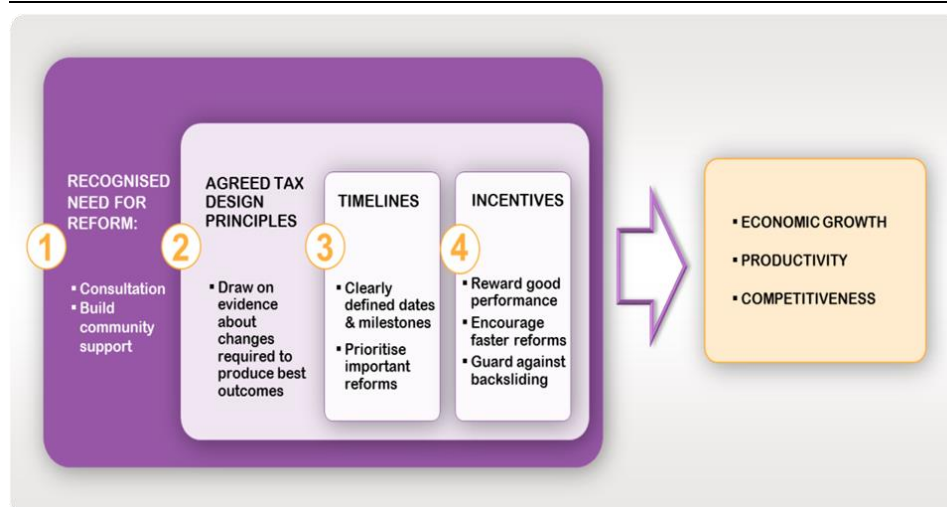
9.3 The plan

In summary, successful tax reform, designed to foster economic growth by improving productivity and Australia's competitiveness should be underpinned by:

- **Recognising the need for reform** – the upcoming tax review will be critical to consulting with stakeholders and building the case for tax reform
- **Agreeing upon principles underpinning tax reform** – to do this, evidence about the changes required to produce the best outcomes should be drawn upon. Again this will assist with building the case for reform and prioritising areas for reform
- **Clearly outlining the timeline for reform** – As highlighted by the lessons learned, this involves clearly defining dates, milestones, priorities for reform
- **Building cooperation and collaboration** – between the different levels of government by setting the correct incentives (e.g. rewarding and penalising performance). Both the NCP and ANTS case studies highlighted the need for new arrangements to be conditional in order to encourage reforms to proceed where requiring state/territory and Commonwealth implementation

Figure 63 outlines these 4 key steps to successfully implement a tax reform package.

Figure 63 **Steps for successful implementation of tax reform**



Source: ACIL Allen Consulting, 2014.

9.3.1 Vision and engagement

An important element to successful tax reform is the need to obtain agreement by the relevant parties that there is need for tax reform. This engagement and subsequent agreement provides a solid framework on which to build tax reform. The importance of a vision underpinning successful change is increasingly being recognised as necessary to ensuring that all stakeholders share an understanding about where we are headed and what it will be like when reform is achieved. This involves talking about the case for change. A shared understanding will foster buy-in by the relevant stakeholders.

The upcoming tax white paper will need to:

- obtain agreement on the desired reform outcomes
- raise awareness about the need for co-ordinated reform across all levels of Government
- educate the public about the benefits of reforms and building forward reform momentum.

The tax review is scheduled to occur with a tax white paper due towards the end of 2015.

9.3.2 Identify agreed tax design principles

Once agreement is reached in regard to the 'need for reform', it needs to be translated into agreed principles and outcomes. The principles and desired outcomes determined will guide the reform process.

To foster engagement and consensus, the principles should be based upon consultation and inclusive decision-making across all levels of Government. More importantly, priorities for reform should draw on evidence highlighting the economic gains to be achieved from tax reform. The analysis undertaken in the earlier chapters of this report provides evidence of the clear economic gains from properly designed tax reform.

The tax reform blueprint needs to move beyond the technical debate about what the ideal tax structure looks like.

While the precise taxes for removal and how these will be funded is a matter for the parties, there are several principles which should underpin the approach. These include:

- recognition from the relevant parties that better taxes can create better outcomes and a commitment to national taxation reform
- an evidence based framework on which to build reforms that will accord with the principles of good tax design: efficiency, simplicity, equity, revenue adequacy and revenue stability
- Clear roles and responsibilities for the relevant parties (i.e. Commonwealth, state/territories)
- a commitment to implementing permanent reforms and implementing review processes to block bad taxes from coming back
- reform is a priority and should be implemented as quickly as circumstances allow
- reforms will not disadvantage individual states – in the case of ANTS this was achieved via a guarantee that states/territories would not be worse off than if reforms were not implemented.

Timing – Complete by end 2015/beginning 2016

Outline clear tax principles to underpin tax blueprint

Timing – Complete by end 2016

Develop a tax reform blueprint which will outline clear economic gains from reform, tax priorities and ordering of reforms. Use as basis of negotiations with state/territory governments and other relevant stakeholders

Timing – Mid-2017

Timing – Beginning 2018

9.3.3 Set timelines and performance measures

Timelines for implementing tax reform needs to be linked to achievable, clearly agreed outputs and outcomes. An important aspect of setting the timeline involves prioritising the important reforms. In doing so, an effective timeline will:

- clearly define dates, with flexibility built in to provide for faster progress if circumstances permit
- practical ordering of reforms, in accordance to importance, difficult and potential benefits from each reform
- performance monitoring mechanisms.

9.3.4 Set incentives to achieve reform

As ANTS highlighted, the interaction of tax reform with intergovernmental fiscal relationships highlight the need for well-designed incentives to enable successful state tax reform implementation. In the case of ANTS and NCP reform, the Commonwealth made payments to the states/territories conditional on the satisfactory performance of their obligations. Making these payments conditional on reform progress provided substance to the reform timeline and ensured that strong forward reform momentum was maintained. In light of the lessons learned from ANTS and NCP reform, incentives underlying tax reform should be designed to:

- reward good performance and penalise poor performance
- encourage reform to happen faster than the agreed timeline by providing additional payments for reforms implemented ahead of time
- guard against backsliding once reforms have been completed through the imposition of penalties if bad policies resurface.

An important aspect to setting incentives involves ensuring effective accountability which requires assessment and review of performance of parties in meeting their tax reform implementation commitments. To set an effective assessment and review process:

- assessment and review processes should apply to all relevant parties to tax reform blueprint implementation
- an independent body/review should carry out the assessment and review function.

9.3.5 Intergovernmental agreement

The steps necessary to implement the Tax modernisation reform package will culminate in the development of an agreement between the state/territory and Commonwealth governments.

Key elements needing to be included in an intergovernmental agreement are summarised in Table 9.

Assessment and review of
Tax modernisation reform
package implementation
Timing – annual.

Complete first review 12
months after agreement to
implement Tax modernisation
reform package signed by
relevant parties – Beginning
2018

Table 9 Elements to an effective intergovernmental agreement

Preliminaries
Objectives
Agreed principles
Roles and responsibilities of each party
Taxes to be abolished or reformed
Implementation timeline – include specific dates for completion of deliverables and milestones
Funding arrangements
Transitional arrangements (to ensure no states/territories are worse off)
Administrative arrangements
Incentives and penalties
Establishment of independent review body
Review and assessment processes
Processes for ongoing legislation and regulation review

Source: ACIL Allen Consulting 2014.

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Appendix A Tax expenditures 2013-14

Table A1 Large measured tax expenditures for 2013-14

Category	Tax description	Revenue foregone (\$, million)
CGT	Capital gains tax main residence exemption — discount component	16,500
	Capital gains tax main residence exemption	13,500
	Capital gains tax discount for individuals and trusts	4,300
GST	GST — Food; uncooked, not prepared, not for consumption on premises of sale and some beverages	6,200
	GST — Education	3,700
	GST — Health; medical and health services	3,400
	GST — Financial Supplies; input taxed treatment	3,300
	GST — Health; residential care, community care and other care services	1,050
	GST — Child Care Services	940
	GST — Water, sewerage and drainage	910
	GST — Financial Supplies; reduced input tax credits	830
Other	CPM uncovered sectors — Agriculture	2,090
	Exemption of Family Tax Benefit, Parts A and B	2,080
	Exemption from interest withholding tax on certain securities	1,800
	Statutory effective life caps	1,720
	Exemption of the private health insurance rebate, including expense equivalent	1,450
	Exemption from the Medicare levy for residents with a taxable income below a threshold	1,320
	Small business — simplified depreciation rules	1,265
	CPM uncovered sectors — Deforestation	1,210
	Concessional rate of excise levied on aviation gasoline and aviation turbine fuel	1,010
	Research and development — non-refundable tax offset	1,000
	Deduction for capital works expenditure	890
	Application of statutory formula to value car benefits	810
	Higher rate of excise levied on cigarettes not exceeding 0.8 grams of tobacco	-1,885
	Customs duty	-3,000
	Philanthropy — Exemption for public and not-for-profit hospitals and public ambulance services	1,400
Philanthropy	Philanthropy — Exemption for public benevolent institutions (excluding public and not-for-profit hospitals)	1,340
	Philanthropy — Deduction for gifts to deductible gift recipients	1,150
Superannuation	Superannuation — concessional taxation of superannuation entity earnings	16,100
	Superannuation — concessional taxation of employer contributions	16,000
	Concessional taxation of non-superannuation termination benefits	2,450

Note: Australian Government tax offsets and exemptions grouped by ACIL Allen Consulting

Source: ACIL Allen Consulting based on Treasury (2014).

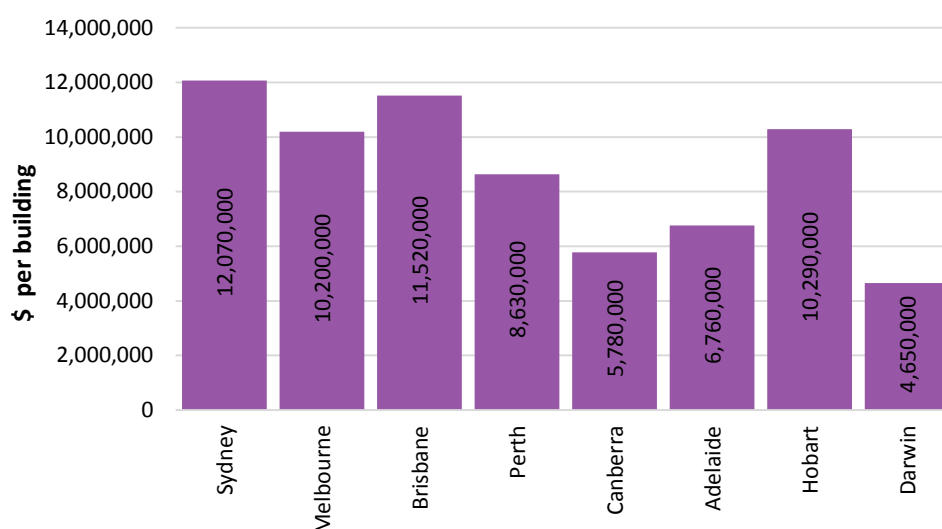
Appendix B Taxes and charges paid by different asset classes in different states

B.1 Taxes and charges paid during a property's development phase

The following charts show the total amount of taxes and charges paid during a property's development phase across different cities for different asset types (office, retail, hotel, etc.). These estimates have been sourced from the Property Council of Australia's Property Taxes Dashboard created by ACIL Allen Consulting.

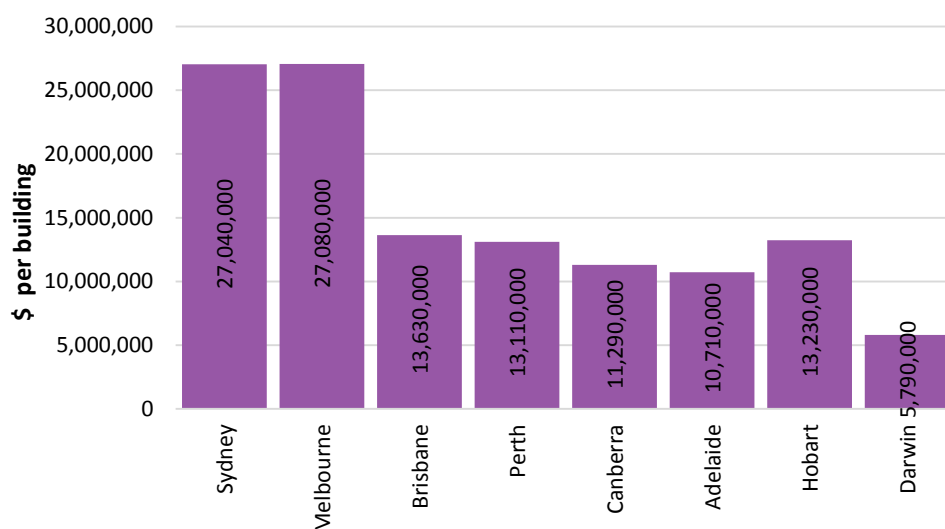
Notably, while the metrics presented in the Property Taxes Dashboard provide valuable evidence of the magnitude of the taxes and charges paid by different property types in different Australian states, different building types, qualities and locations will involve different development and operational costs and benefits. The metrics provided in the dashboard are for a series of illustrative buildings of certain characteristics and are not meant to reflect the 'average' property. Instead, to allow for a fair comparison of development and operational costs across different cities, an illustrative 'typical' development for each asset type was agreed with the Property Council of Australia and then 'built' and 'operated' in different cities. For more information about the dashboard, please refer to the Property Taxes Dashboard documentation in Appendix C.

Figure B1 **Total taxes and charges paid during an office building's development phase (for a similar physical building), \$ per building**



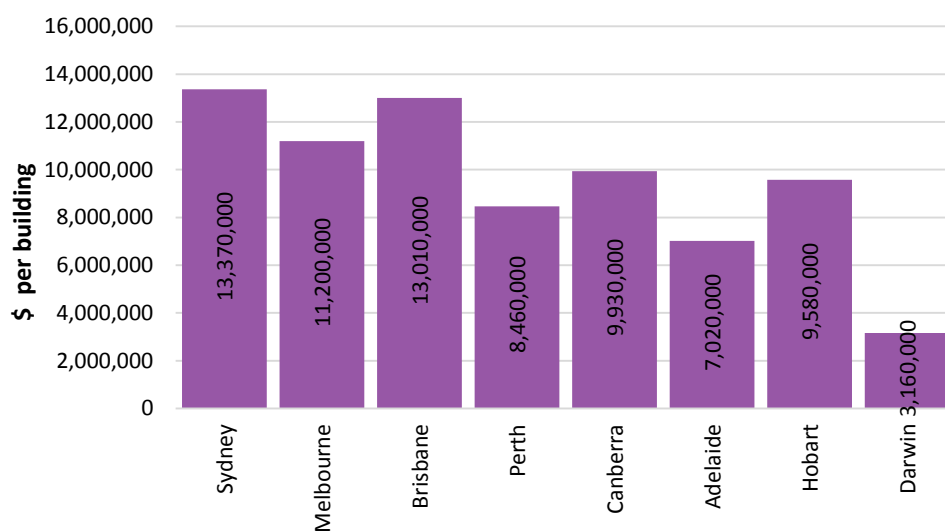
Note: Building characteristics are outlined in Appendix C. Total taxes and charges include council rates and fees, infrastructure charges/utilities levies, stamp duty on land, land tax and corporate income tax. Source: Rider Levett Bucknall and ACIL Allen Consulting.

Figure B2 Total taxes and charges paid during a retail building's development phase (for a similar physical building), \$ per building



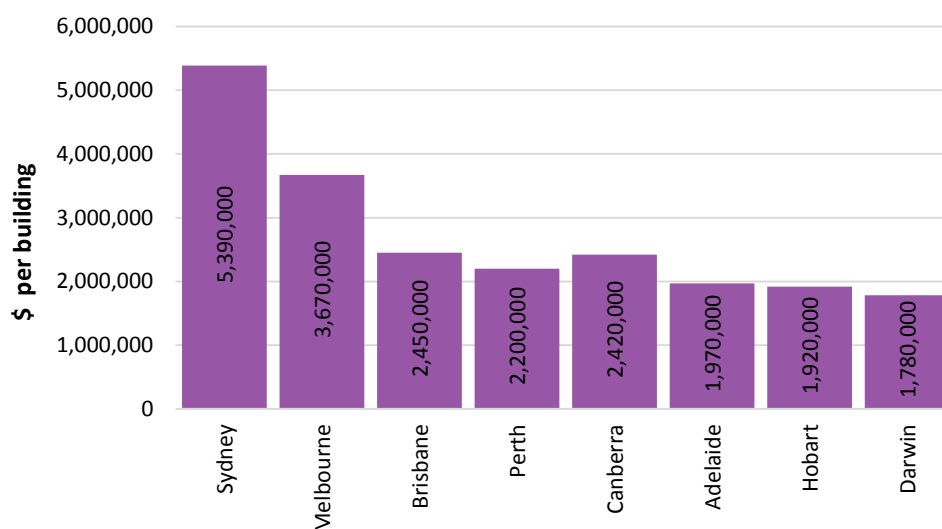
Note: Building characteristics are outlined in Appendix C. Total taxes and charges include council rates and fees, infrastructure charges/utilities levies, stamp duty on land, land tax and corporate income tax. Source: Rider Levett Bucknall and ACIL Allen Consulting.

Figure B3 Total taxes and charges paid during a hotel building's development phase (for a similar physical building), \$ per building



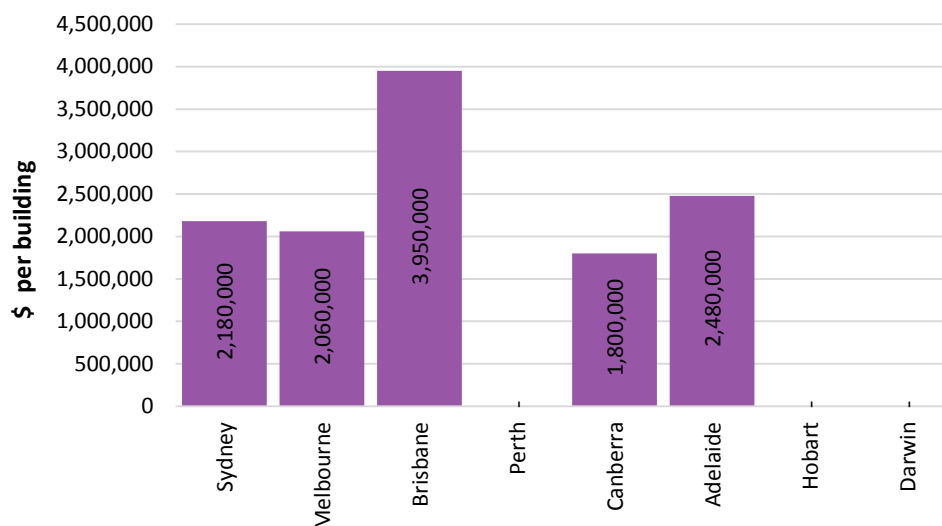
Note: Building characteristics are outlined in Appendix C. Total taxes and charges include council rates and fees, infrastructure charges/utilities levies, stamp duty on land, land tax and corporate income tax. Source: Rider Levett Bucknall and ACIL Allen Consulting.

Figure B4 Total taxes and charges paid during an industrial building's development phase (for a similar physical building), \$ per building



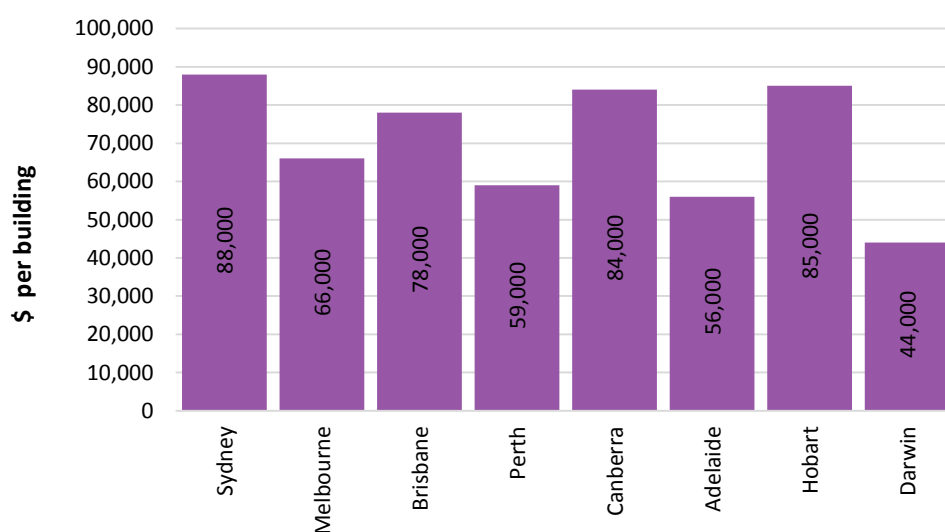
Note: Building characteristics are outlined in Appendix C. Total taxes and charges include council rates and fees, infrastructure charges/utilities levies, stamp duty on land, land tax and corporate income tax. Source: Rider Levett Bucknall and ACIL Allen Consulting.

Figure B5 Total taxes and charges paid during a retirement village development phase (for a similar physical building), \$ per building



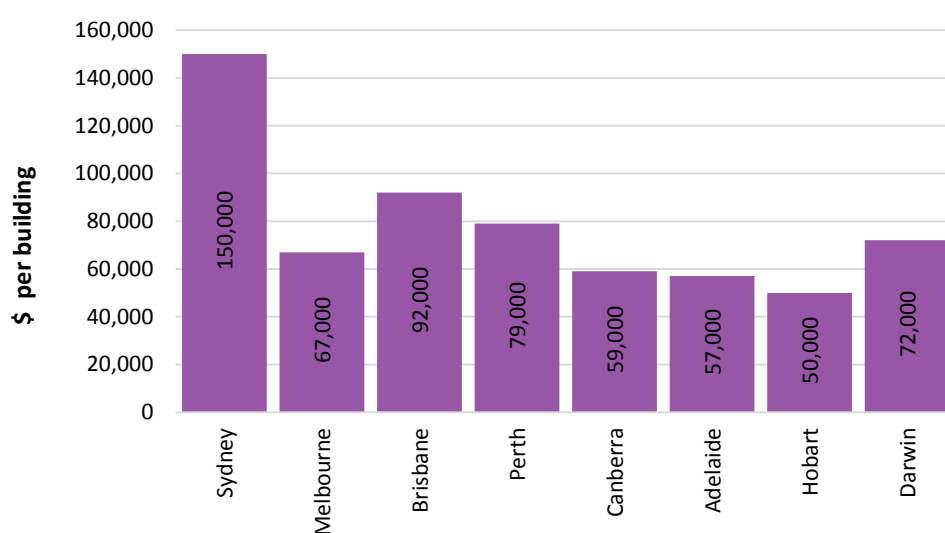
Note: Building characteristics are outlined in Appendix C. Data for Perth, Hobart and Darwin was not available. Total taxes and charges include council rates and fees, infrastructure charges/utilities levies, stamp duty on land, land tax and corporate income tax. Source: Property Council and ACIL Allen Consulting.

Figure B6 Total taxes and charges paid during an apartment's development phase (for a similar physical building), \$ per apartment



Note: Building characteristics are outlined in Appendix C. Total taxes and charges include council rates and fees, infrastructure charges/utilities levies, stamp duty on land, land tax and corporate income tax. Source: Rider Levett Bucknall and ACIL Allen Consulting.

Figure B7 Total taxes and charges paid during a house's development phase (for a similar physical building), \$ per house



Note: Building characteristics are outlined in Appendix C. Total taxes and charges include council rates and fees, infrastructure charges/utilities levies, stamp duty on land, land tax and corporate income tax. Source: ACIL Allen Consulting.

B.2 Competitiveness indicators

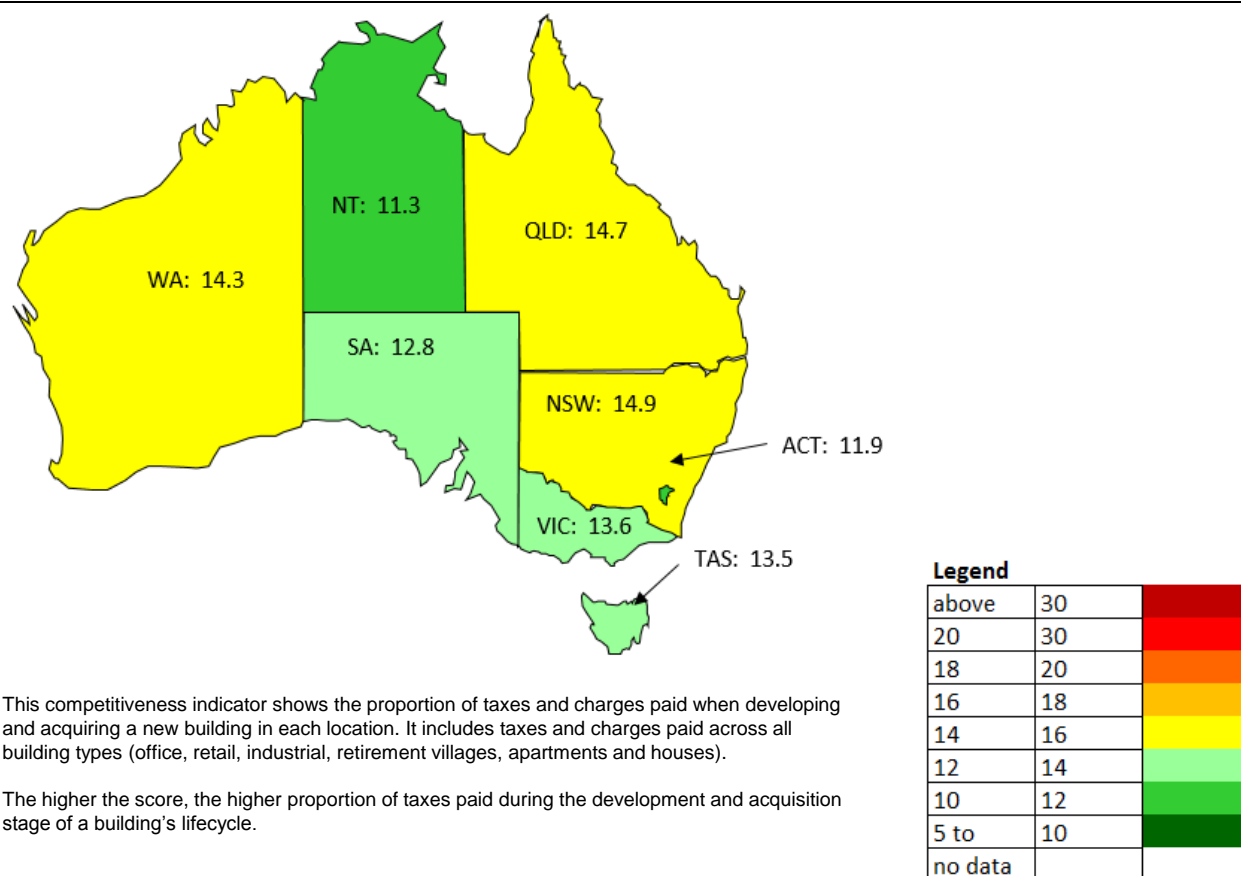
The following charts contain a series of competitiveness indicators for each state and territory. These indicators are based on the tax costs associated with developing and investing in different property asset types in those jurisdictions.

The competitiveness indicators show the proportion of taxes paid during a building's lifecycle phase. The higher the score, the higher proportion of taxes paid for a building over the studied phase. The three competitiveness indicators for each jurisdiction are defined as follows.

- *Competitiveness for development & acquisition of property* – this indicator is an average of the proportion of taxes paid when acquiring a new building (i.e. total taxes/total cost of acquiring a building, including stamp duty paid for the acquisition of the property) across property types for a selected location. It includes taxes and charges paid across all building types (office, retail, industrial, retirement village, apartments and houses) across all capital cities.
- *Competitiveness during property management* – this indicator refers to the taxes and charges paid during a building's 'typical' year and includes taxes and charges paid across the following building types/locations: Sydney (office, retail and retirement villages), Melbourne (office, retail and retirement villages), Brisbane (office, retail and retirement villages), Perth (office and retail), Canberra (office, retail and retirement villages), Adelaide (retail and retirement villages) and Hobart (retail). No operational data is available for any building type in Hobart.
- *Overall competitiveness during development, acquisition & management of property* – this indicator is an average of the two indicators above for a selected location and as such reflects the same inclusions/exclusions described above.

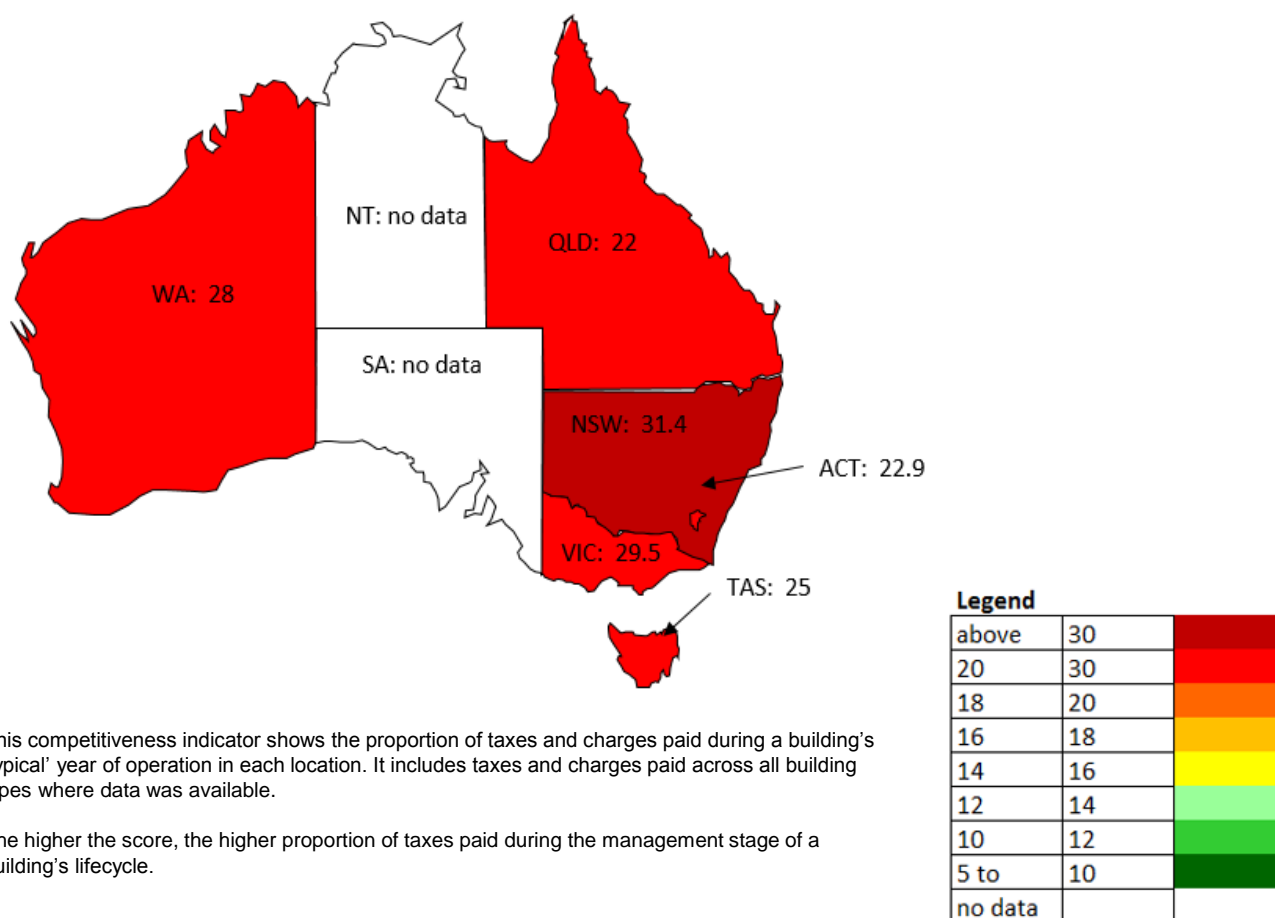
More details about these competitiveness indicators are provided in Appendix C.

Figure B8 **Competitiveness for development and acquisition of property, percentage of taxes and charges paid during the development and acquisition stage of a building's lifecycle**



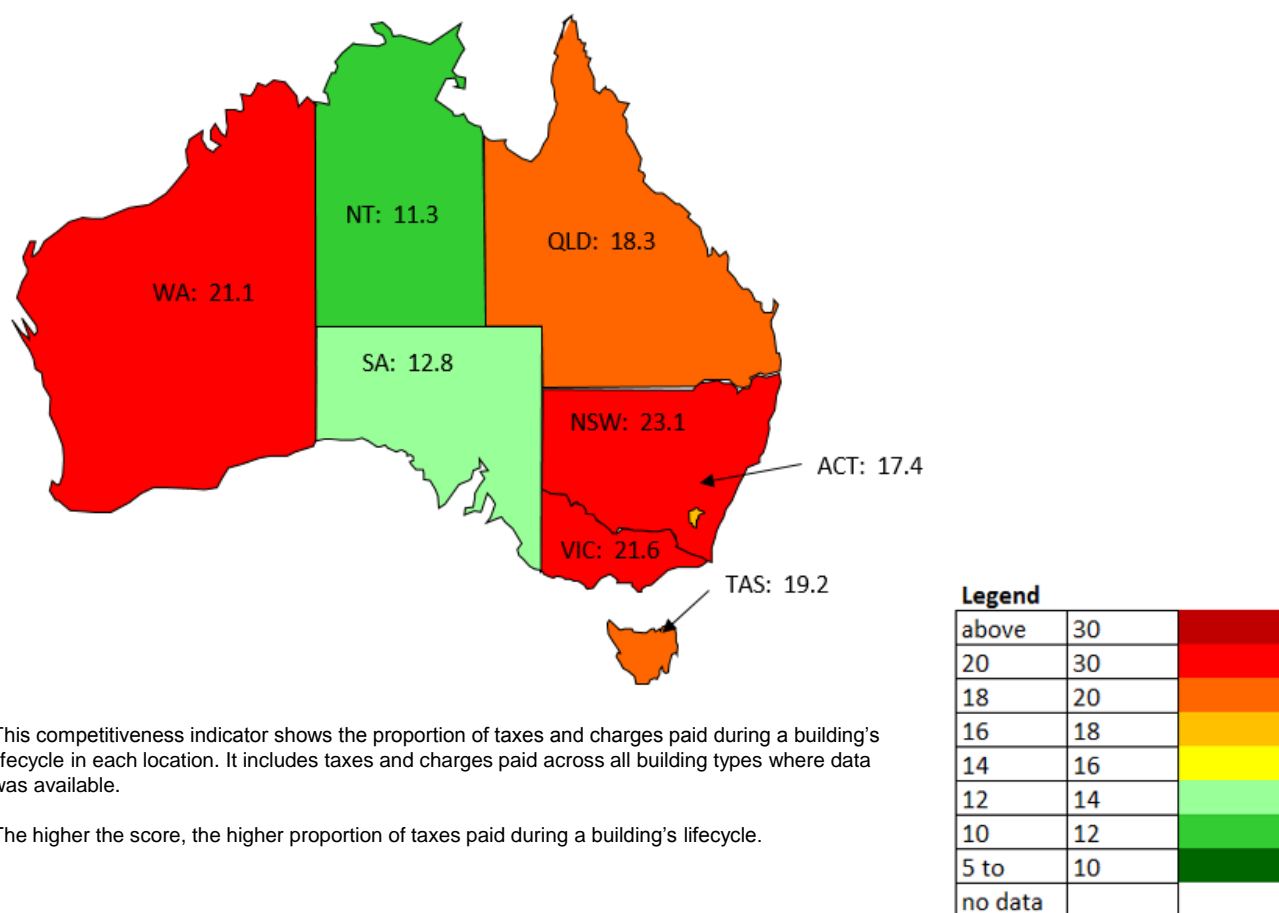
Source: ACIL Allen Consulting.

Figure B9 Competitiveness during property management, percentage of taxes and charges paid during the property management stage of a building's lifecycle



Source: ACIL Allen Consulting.

**Figure B10 Overall competitiveness during development, acquisition & management of property.
Percentage of taxes and charges paid during a building's lifecycle**



Source: ACIL Allen Consulting.

Appendix C Property Taxes Dashboard

C.1 Purpose

The purpose of the Property Taxes Dashboard is to provide a range of metrics that illustrate:

- the magnitude of taxes paid by different property types at different stages of their lifecycle
- what are the main factors influencing property prices
- how competitive are different states and territories with regards to property development and investment
- how reliant are different states and territories on property related taxes.

C.2 Data sources

The Property Taxes Dashboard was produced by ACIL Allen Consulting using data from a variety of sources. The main data sources are outlined below.

- Australian Bureau of Statistics (ABS) 2014, *Taxation Revenue*, Australia, 2012-13, Catalogue 5506.0
- Rider Levett Bucknall (RLB) – provided data relating to the acquisition/development costs of buildings (except retirement villages)
- Property Council of Australia (Property Council) – provided data relating to the operational phase of buildings and relating the acquisition/development costs and the operational phase of retirement villages.

C.3 Methodology

The Property Taxes Dashboard contains information for the following:

- two typical phases of the economic life of a building (acquisition/development and operation/management)
- seven asset types (where information available) – office, industrial, hotels, shopping centres (retail), retirement villages and two forms of residential development (greenfield detached house and infill apartment)
- eight capital cities (where information available) – Sydney, Melbourne, Brisbane, Perth, Adelaide, Canberra, Hobart and Darwin.

The production of the dashboard required the segmentation of acquisition, development and operational costs into relevant categories that can be compared across locations and asset types. To do so, a series of templates were created for each asset type, location and lifecycle. These templates were then filled by RLB for the acquisition/development phase (for all asset types except retirement villages), the Property Council for the operation/management phase (except for retirement villages) and the Property Council for retirement villages. The templates were then validated by a group of Property Council members through a workshop. ACIL Allen Consulting used the information contained in these templates and relevant ABS statistics to produce the metrics included in the dashboard.

The Property Taxes Dashboard contains a series of competitiveness indicators for each state and territory. These indicators are based on the tax costs associated with developing

and investing in different property asset types in those jurisdictions. The competitiveness indicators for each jurisdiction are defined as follows.

- *Competitiveness for development & acquisition of property* – this indicator is an average of the proportion of taxes paid when acquiring a new building (i.e. total taxes/total cost of acquiring a building, including stamp duty paid for the acquisition of the property) across property types for a selected location. It includes taxes and charges paid across all building types (office, retail, industrial, retirement village, apartments and houses) across all capital cities.
- *Competitiveness during property management* – this indicator is an average of the proportion of taxes paid on a typical year of managing a property as a proportion of the operating income of that property (i.e. total taxes/total operating income) across property types for a selected location. It includes taxes and charges paid across the following building types/locations: Sydney (office, retail and retirement villages), Melbourne (office, retail and retirement villages), Brisbane (office, retail and retirement villages), Perth (office and retail), Canberra (office, retail and retirement villages), Adelaide (retail and retirement villages) and Hobart (retail). No operational data is available for any building type in Hobart.
- *Overall competitiveness during development, acquisition & management of property* – this indicator is an average of the two indicators above for a selected location and as such reflects the same inclusions/exclusions described above.

C.4 Limitations

The metrics presented in the Property Taxes Dashboard provide valuable evidence of the magnitude of the taxes and charges paid by different property types in different Australian states in different lifecycles. Nonetheless, as with any modelling exercise, there are some limitations in this analysis. The key limitations of the dashboard are outlined below.

- Different building types, qualities and locations will involve different development and operational costs and benefits (i.e. rental income). The metrics provided in the dashboard are for a series of illustrative buildings of certain characteristics (outlined in the sections below) and are not meant to reflect the ‘average’ house or office. Instead, to allow for a fair comparison of development and operational costs across different cities, an illustrative ‘typical’ development for each asset type was agreed with the Property Council and then ‘built’ and ‘operated’ in different cities.
- The findings in the dashboard are subject to unavoidable statistical variation. While all care has been taken to ensure that the statistical variation is kept to a minimum, care should be taken whenever using this information. This report only takes into account information available to ACIL Allen Consulting up to the date of this report and the findings may be affected by new information.

C.5 Specifications and assumptions

The following sections outline the specifications and assumptions used to gather the data used to create the Property Taxes Dashboard.

Building characteristics

As mentioned above, the Property Taxes Dashboard is based on a series of illustrative buildings of certain characteristics. The characteristics of the illustrative ‘typical’ development for each asset type agreed with the Property Council are outlined in Table C1.

Table C1 Characteristics of buildings included in the Property Taxes Dashboard

	Office	Retail	Industrial	Hotel	Retirement	Infill	Greenfield
Location	CBD	Regional area	CDB fringe	CBD	10-15km of the CBD	CBD fringe	Growth areas in each capital city
Storeys	10-25	1	1	10-20	-	10	1
Site area (m2)	2,000	18,000	20,000	5,500	50,000	2,000	400 per house
Gross Floor Area (GFA) (m2)	40,000	15,000	25,000	20,000	-	30,000	220 per house
Net lettable area (NLA) (m2)	30,000	12,000	23,000	16,000	-	24,000 (on average 120 per apartment)	-
Building characteristics	Building classified as Property Council grade commercial office space with 4 passenger lifts.	Regional shopping centre comprising 2 major tenants, 50 specialty stores, provisions for food court, above ground car park, mid-level finishes to common areas and facilities.	Industrial warehouse comprising air-conditioned office and bathroom facilities, docking bay facilities, light frame construction with standard finishes and on ground car parking.	4 star hotel comprising approximately 200 rooms over 10-20 levels with a basement.	Horizontal retirement village on 5 hectares of land, with 100 ILUs.	Apartment block comprising a mix of 1, 2 and 3 bedroom apartments, basement car parking, 4 passenger lifts, entry lobby with mid-level finishes, provisions for internal laundry, tiled kitchen and bathroom, balconies to all rooms, split system air-conditioning to all rooms, plant, maintenance, storage and waste rooms, finishes, including sprinkler and security systems.	Four bedroom project home of medium quality.

Note: GFA = fully enclosed covered area plus unenclosed covered area

Source: ACIL Allen Consulting.

Key assumptions used in acquisition/development phase

The key assumptions for each cost component are outlined in the following table.

Table C2 **Acquisition/development phase assumptions**

Item	Key assumptions
Development timing	<ul style="list-style-type: none"> For all developments except retirement villages: <ul style="list-style-type: none"> ... Land bought in 2010 ... Construction starts 2012 ... Construction finishes 2014 For retirement villages: <ul style="list-style-type: none"> ... Land bought in 2009 ... Construction starts 2010 ... Construction finishes 2014 Assumes no undue time delay caused by planning approvals
Land	<ul style="list-style-type: none"> Land value for period 2009-2014 increases in line with land valuation data from Valuer Generals in each state. When land value data was unavailable, land values were assumed to increase 2.5 per cent per year during the development period Land value for period 2014 onwards assumed to increase by 2.5 per cent per annum Retirement villages pay land taxes during development period in all states except Victoria. Land tax only applies to the proportion of undeveloped land
Stamp duty	<ul style="list-style-type: none"> It is assumed that there are no stamp duty concessions available to the developer
Local council fees	<ul style="list-style-type: none"> Provided by RLB and based on development location local government charges
Consultant fees and development management costs	<ul style="list-style-type: none"> Provided by RLB for all asset types except greenfield and retirement villages and based on relevant project examples and models Provided by Property Council for retirement villages For greenfield development consultant fees are assumed to be 3 per cent of construction costs and development management costs are assumed to be 4 per cent of construction costs
Land preparation costs	<ul style="list-style-type: none"> Provided by RLB for all asset types except retirement villages and by Property Council for retirement villages Based on minimal constraints to development
Council rates	<ul style="list-style-type: none"> Provided by RLB for all asset types except retirement villages and by Property Council for retirement villages Based on the parent site throughout the development period
Land tax	<ul style="list-style-type: none"> Calculated on the parent site throughout the development period Based on the estimated land value each year during development and historical land tax rates
Marketing and sales costs	<ul style="list-style-type: none"> Calculated at 2.5 per cent of sales value
Holding costs	<ul style="list-style-type: none"> Retirement villages are assumed to be fully equity financed All other asset types assume that developer provides 40 per cent equity to purchase the land and gets a loan for 60 per cent of the land value. Interest on land is calculated for the whole of the development period based on the following loan assumptions: <ul style="list-style-type: none"> ... Interest only loan ... Interest rate of 6.25 per cent per annum
Developer margin	<ul style="list-style-type: none"> Assumed to be 8 per cent for all asset types except retirement villages and hotels Assumed to be 4 per cent for hotels For retirement villages: <ul style="list-style-type: none"> ... Assumed to be 10 per cent for developments in Sydney, Canberra and Melbourne ... Assumed to be 27 per cent for developments in Brisbane and 21 per cent for developments in Adelaide
GST liability	<ul style="list-style-type: none"> Calculated as 10 per cent of sale price for infill and greenfield developments Nil for other asset types as it is assumed that GST is fully creditable for all commercial property types
Ownership	<ul style="list-style-type: none"> It is assumed that land is acquired, developed and sold by a corporate

Source: ACIL Allen Consulting.

Key assumptions used in operations/management phase

The key assumptions for each component are outlined in the following table.

Table C3 Operations/management phase assumptions

Item	Key assumptions
Ownership	<ul style="list-style-type: none"> For all asset types except retirement villages, infill and greenfield, building is bought and managed by a corporate Retirement villages are assumed to be developed and managed by the same entity, a corporate Residential buildings (infill and greenfield) can be bought and managed by either an owner occupier or an investor
Financing costs	<ul style="list-style-type: none"> Retirement villages are assumed to be fully equity financed All other asset types assume that owner provides 40 per cent equity to purchase the building and gets a loan for 60 per cent of the building value. Interest on the building is calculated based on the following loan assumptions: <ul style="list-style-type: none"> ... Interest only loan ... Interest rate of 6.25 per cent per annum
Land value and land tax	<ul style="list-style-type: none"> Unimproved valued of land is assumed to increase by 2.5 per cent per annum Land tax rates are assumed to remain constant into the future
Local council fees	<ul style="list-style-type: none"> Assumed to remain constant into the future Local council fees for retirement villages are cost-recovered through service fees from residents
GST	<ul style="list-style-type: none"> Commercial buildings are assumed to be acquired as a GST going concern (i.e. development has pre-committed leases or agreements for lease) For operational costs and income it is assumed that the GST payable equals 10 per cent of rental income (and any other income received) and that the GST refundable equals 10 per cent of operating costs Any fees earned in retirement villages are input taxed
Capital improvements	<ul style="list-style-type: none"> Assumed no capital improvements during the period building is hold by investor
Rental income (for commercial buildings except retirement villages)	<ul style="list-style-type: none"> Assumed rental increase rate of 2.5 per cent per annum
Retirement village income	<ul style="list-style-type: none"> For retirement villages it is assumed that the annual income received from Deferred Management Fees (DMF) is that of a mature village (10 years +) For the calculation of received DMF it is assumed that: <ul style="list-style-type: none"> ... The market value of the village increases 2.5 per cent per annum ... The percentage of market value received per Independent Living Unit (ILU) per year from year 10 onwards is 3 per cent It is assumed that the annual increase in any other income is 2.5 per cent per annum
Operating costs	<ul style="list-style-type: none"> Assumed increase rate of 2.5 per cent per annum
Depreciation	<ul style="list-style-type: none"> Provided by Property Council for retirement villages Assumed to be 2.5 per cent of construction costs per annum for other commercial buildings.

Source: ACIL Allen Consulting.

Notably, given data limitations, the operational phase for the following building types and locations was excluded from the dashboard:

- offices in Hobart and Darwin
- shopping centres in Darwin
- retirement villages in Perth, Hobart and Darwin
- industrial in all locations
- hotels in all locations
- apartments (infill) in all locations
- houses (greenfield) in all locations.

Appendix D The Tasman Global model

ACIL Allen's computable general equilibrium model *Tasman Global* is a powerful tool for undertaking economic impact analysis at the regional, state, national and global level.

There are various types of economic models and modelling techniques. Many of these are based on partial equilibrium analysis that usually considers a single market. However, in economic analysis, linkages between markets and how these linkages develop and change over time can be critical. *Tasman Global* has been developed to meet this need.

Tasman Global is a large-scale computable general equilibrium model which is designed to account for all sectors within an economy and all economies across the world. ACIL Allen uses this modelling platform to undertake industry, project, scenario and policy analyses. The model is able to analyse issues at the industry, global, national, state and regional levels and to determine the impacts of various economic changes on production, consumption and trade at the macroeconomic and industry levels.

For this project, the modelling has been conducted at a national level. The state and regional level modelling capabilities of *Tasman Global* are therefore not included in the following description.

A dynamic model

Tasman Global is a model that estimates relationships between variables at different points in time. This is in contrast to comparative static models, which compare two equilibriums (one before a policy change and one following). A dynamic model such as *Tasman Global* is beneficial when analysing issues where both the timing of and the adjustment path that economies follow are relevant in the analysis.

The database

A key advantage of *Tasman Global* is the level of detail in the database underpinning the model. The database is derived from the latest Global Trade Analysis Project (GTAP) database (version 8.1). This database is a fully documented, publicly available global data base which contains complete bilateral trade information, transport and protection linkages among regions for all GTAP commodities.

The GTAP model was constructed at the Centre for Global Trade Analysis at Purdue University in the United States. It is the most up-to-date, detailed database of its type in the world.

Tasman Global builds on the GTAP model's equation structure and database by adding the following important features:

- dynamics (including detailed population and labour market dynamics),
- a detailed breakdown of the occupational structure of the Australian labour market,
- the ability to repatriate labour and capital income,
- a detailed emissions accounting abatement framework.

The *Tasman Global* database contains a wealth of sectoral detail currently identifying up to 70 industries (which, for this analysis, have been aggregated to the 57 industries presented in Table D1). The foundation of this information is the input-output tables that underpin the database. The input-output tables account for the distribution of industry production to satisfy industry and final demands. Industry demands, so-called intermediate usage, are the demands from each industry for inputs.

For example, electricity is an input into the production of communications. In other words, the communications industry uses electricity as an intermediate input. Final demands are those made by households, governments, investors and foreigners (export demand). These final demands, as the name suggests, represent the demand for finished goods and services. To continue the example, electricity is used by households – their consumption of electricity is a final demand.

Each sector in the economy is typically assumed to produce one commodity, although in *Tasman Global*, the electricity, transport and iron and steel sectors are modelled using a 'technology bundle' approach. With this approach, different known production methods are used to generate a homogeneous output for the 'technology bundle' industry. For example, electricity can be generated using brown coal, black coal, petroleum, base load gas, peak load gas, nuclear, hydro, geothermal, biomass, wind, solar or other renewable based technologies – each of which have their own cost structure.

Table D1 Sectors in the *Tasman Global* database for this analysis

Sector	Sector
1 Paddy rice	30 Wood products
2 Wheat	31 Paper products, publishing
3 Cereal grains nec	32 Petroleum, coal products
4 Vegetables, fruit, nuts	33 Chemical, rubber, plastic products
5 Oil seeds	34 Mineral products nec
6 Sugar cane, sugar beef	35 Ferrous metals
7 Plant- based fibres	36 Metals nec
8 Crops nec	37 Metal products
9 Bovine cattle, sheep, goats, horses	38 Motor vehicle and parts
10 Animal products nec	39 Transport equipment nec
11 Raw milk	40 Electronic equipment
12 Wool, silk worm cocoons	41 Machinery and equipment nec
13 Forestry	42 Manufactures nec
14 Fishing	43 Electricity
15 Coal	44 Gas manufacture, distribution
16 Oil	45 Water
17 Gas	46 Construction
18 Minerals nec	47 Trade
19 Bovine meat products	48 Transport nec
20 Meat products nec	49 Water transport
21 Vegetables oils and fats	50 Air transport
22 Dairy products	51 Communication
23 Processed rice	52 Financial services nec
24 Sugar	53 Insurance
25 Food products nec	54 Business services nec
26 Beverages and tobacco products	55 Recreational and other services
27 Textiles	56 Public Administration, Defence, Education, Health
28 Wearing apparel	57 Dwellings
29 Leather products	

Note: nec = not elsewhere classified.

The other key feature of the database is that the cost structure of each industry is also represented in detail. Each industry purchases intermediate inputs (from domestic and imported sources) primary factors (labour, capital, land and natural resources) as well as paying taxes or receiving subsidies.

Factors of production

Capital, land, labour and natural resources are the four primary factors of production. The capital stock in each region (country or group of countries) accumulates through investment (less depreciation) in each period. *Tasman Global* explicitly models natural resource inputs as a sector specific factor of production in resource based sectors (coal mining, oil and gas extraction, other mining, forestry and fishing).

Population growth and labour supply

Population growth is an important determinant of economic growth through the supply of labour and the demand for final goods and services. Population growth for the international and domestic regions represented in the *Tasman Global* database is projected using ACIL Allen's in-house demographic model. The demographic model projects how the population in each region grows and how age and gender composition changes over time and is an important tool for determining the changes in labour supply and total population over the projection period.

For each of the regions in *Tasman Global*, the model projects the changes in age-specific birth, mortality and net migration rates by gender for 101 age cohorts (0-99 and 100+). The demographic model also projects changes in participation rates by gender by age for each region, and, when combined with the age and gender composition of the population, endogenously projects the future supply of labour in each region. Changes in life expectancy are a function of income per person as well as assumed technical progress on lowering mortality rates for a given income (for example, reducing malaria-related mortality through better medicines, education, governance, etc.). Participation rates are a function of life expectancy as well as expected changes in higher education rates, fertility rates and changes in the workforce as a share of the total population.

Labour supply is derived from the combination of the projected regional population by age by gender and the projected regional participation rates by age by gender. Over the projection period labour supply in most developed economies is projected to grow slower than total population as a result of ageing population effects.

For Australia, the projected aggregate labour supply from ACIL Allen's demographics module is used as the base level potential workforce for the detailed Australian labour market module, which is described in the next section.

The Australian labour market

Tasman Global has a detailed representation of the Australian labour market which has been designed to capture:

- different occupations
- changes to participation rates (or average hours worked) due to changes in real wages
- changes to unemployment rates due to changes in labour demand
- limited substitution between occupations by the firms demanding labour and by the individuals supplying labour.

Tasman Global recognises 97 different occupations within Australia. The firms who hire labour are provided with some limited scope to change between these 97 labour types as the relative real wage between them changes. Similarly, the individuals supplying labour have a limited ability to change occupations in response to the changing relative real wage between occupations. The model produces results at the 97 3-digit ANZSCO (Australian

New Zealand Standard Classification of Occupations) level which are presented in Table D2.

Table D2 Occupations in the *Tasman Global* database, ANZSCO 3-digit level (Minor Groups)

ANZSCO code, Description	ANZSCO code, Description	ANZSCO code, Description
1. MANAGERS	3. TECHNICIANS & TRADES WORKERS	5. CLERICAL & ADMINISTRATIVE
111 Chief Executives, General Managers and Legislators	311 Agricultural, Medical and Science Technicians	511 Contract, Program and Project Administrators
121 Farmers and Farm Managers	312 Building and Engineering Technicians	512 Office and Practice Managers
131 Advertising and Sales Managers	313 ICT and Telecommunications Technicians	521 Personal Assistants and Secretaries
132 Business Administration Managers	321 Automotive Electricians and Mechanics	531 General Clerks
133 Construction, Distribution and Production Managers	322 Fabrication Engineering Trades Workers	532 Keyboard Operators
134 Education, Health and Welfare Services Managers	323 Mechanical Engineering Trades Workers	541 Call or Contact Centre Information Clerks
135 ICT Managers	324 Panel beaters, and Vehicle Body Builders, Trimmers and Painters	542 Receptionists
139 Miscellaneous Specialist Managers	331 Bricklayers, and Carpenters and Joiners	551 Accounting Clerks and Bookkeepers
141 Accommodation and Hospitality Managers	332 Floor Finishers and Painting Trades Workers	552 Financial and Insurance Clerks
142 Retail Managers	333 Glaziers, Plasterers and Tilers	561 Clerical and Office Support Workers
149 Miscellaneous Hospitality, Retail and Service Managers	334 Plumbers	591 Logistics Clerks
2. PROFESSIONALS	341 Electricians	599 Miscellaneous Clerical and Administrative Workers
211 Arts Professionals	342 Electronics and Telecommunications Trades Workers	6. SALES WORKERS
212 Media Professionals	351 Food Trades Workers	611 Insurance Agents and Sales Representatives
221 Accountants, Auditors and Company Secretaries	361 Animal Attendants and Trainers, and Shearers	612 Real Estate Sales Agents
222 Financial Brokers and Dealers, and Investment Advisers	362 Horticultural Trades Workers	621 Sales Assistants and Salespersons
223 Human Resource and Training Professionals	391 Hairdressers	631 Checkout Operators and Office Cashiers
224 Information and Organisation Professionals	392 Printing Trades Workers	639 Miscellaneous Sales Support Workers
225 Sales, Marketing and Public Relations Professionals	393 Textile, Clothing and Footwear Trades Workers	7. MACHINERY OPERATORS & DRIVERS
231 Air and Marine Transport Professionals	394 Wood Trades Workers	711 Machine Operators
232 Architects, Designers, Planners and Surveyors	399 Miscellaneous Technicians and Trades Workers	712 Stationary Plant Operators
233 Engineering Professionals	4. COMMUNITY & PERSONAL SERVICE	721 Mobile Plant Operators
234 Natural and Physical Science Professionals	411 Health and Welfare Support Workers	731 Automobile, Bus and Rail Drivers
241 School Teachers	421 Child Carers	732 Delivery Drivers
242 Tertiary Education Teachers	422 Education Aides	733 Truck Drivers
249 Miscellaneous Education Professionals	423 Personal Carers and Assistants	741 Store persons
251 Health Diagnostic and Promotion Professionals	431 Hospitality Workers	8. LABOURERS
252 Health Therapy Professionals	441 Defence Force Members, Fire Fighters and Police	811 Cleaners and Laundry Workers
253 Medical Practitioners	442 Prison and Security Officers	821 Construction and Mining Labourers
254 Midwifery and Nursing Professionals	451 Personal Service and Travel Workers	831 Food Process Workers
261 Business and Systems Analysts, and Programmers	452 Sports and Fitness Workers	832 Packers and Product Assemblers
262 Database and Systems Administrators, and ICT Security Specialists		839 Miscellaneous Factory Process Workers
263 ICT Network and Support Professionals		841 Farm, Forestry and Garden Workers
271 Legal Professionals		851 Food Preparation Assistants
272 Social and Welfare Professionals		891 Freight Handlers and Shelf Fillers
		899 Miscellaneous Labourers

Source: ABS (2009), ANZSCO – Australian and New Zealand Standard Classifications of Occupations, First Edition, Revision 1, ABS Catalogue no. 1220.0.

The labour market structure of *Tasman Global* is thus designed to capture the reality of labour markets in Australia, where supply and demand at the occupational level do adjust, but within limits.

Labour supply in *Tasman Global* is presented as a two stage process:

1. labour makes itself available to the workforce based on movements in the real wage and the unemployment rate,
2. labour chooses between occupations in a state based on relative real wages within the state.

By default, *Tasman Global*, like all CGE models, assumes that markets clear. Therefore, overall, supply and demand for different occupations will equate (as is the case in other markets in the model).

Modifications to *Tasman Global* for this research

To accommodate the needs of this research, *Tasman Global* has been modified in its database and in its equations to include greater taxation detail and modelling capability.

Database modifications

As stated earlier, *Tasman Global* uses the GTAP database (version 8.1). In this database Australia is one of the 129 countries/regions represented. Australia's representation in the database has been adjusted to better align the national economic structure in the database with the national input-output tables created by the ABS (ABS catalogue number 5209.0). As part of this process additional detail regarding commodity taxation and factor taxes has been incorporated into the model. In particular, the model now includes explicit commodity tax detail (taken from the national input-output tables) on:

- the goods and services tax (GST)
- other commodity taxes (such as excises)
- subsidies.

To improve the treatment of taxation on the factors of production compared to GTAP, the new *Tasman Global* database includes three categories of land: agricultural land, commercial land and residential land. Each industry in the model makes use of only one type of land. Agricultural industries make use of only agricultural land, the residential sector uses only residential land, with the remaining industries using only commercial land. This additional detail allows land taxes to be appropriately allocated in the database.

The taxes on factors of production consist of two types:

- A standard representation of taxes such as land tax, taxes on capital goods (such as motor vehicles) and payroll tax.
- An allocation of stamp duties to land and capital. By allocating stamp duties in this manner it is assumed that the industries that pay these taxes view stamp duties as a cost of the utilisation of land and (part of) capital. This cost would be annualised over the assets use, but in any given year is appropriately represented by the stamp duty collected from industry.

Model modifications

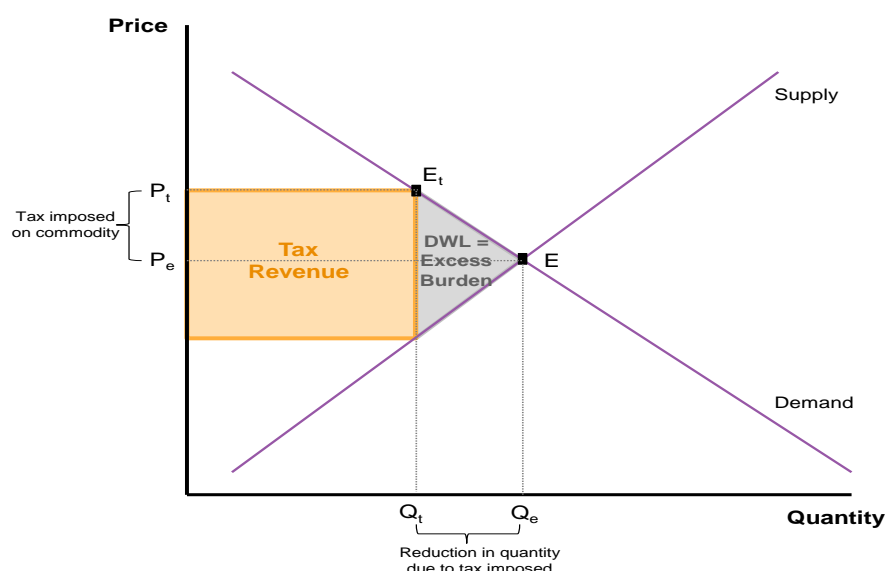
Within the *Tasman Global* model, the existing taxation module has been extended to allow the tax modelling for this analysis to occur. This module is linked to the behavioural equations in the model so that any adjustments made to tax rates send the appropriate signals to the agents in the model – consumers, government, industries, etc. – who then respond according to the microeconomic foundations that underpin the model.

With these modifications the new taxation data is fully integrated into the *Tasman Global* model.

Appendix E Excess burden of taxes

The concept of the excess burden of taxes can be explained using the following figure which represents the hypothetical market for commodity 'X'.

Figure E1 Excess burden of taxes – conceptual diagram



Source: ACIL Allen Consulting, 2014

In a perfectly competitive market, the price and quantity of a commodity produced and consumed is determined by the intersection of its supply and demand curves. In the above diagram, the equilibrium price and quantity of commodity 'X' is P_e and Q_e , determined by the intersection of its supply and demand curves at point E.

The market is in equilibrium at Point E, since the quantity of commodity 'X' producers are willing to supply the market with at P_e will be equal to the quantity demanded by consumers at that price. Therefore, at P_e and Q_e , there will be no excess or shortage of supply or demand of commodity 'X'.

When taxes are imposed by governments, the price of commodities are altered. In the above diagram, taxes on commodity 'X' leads to an increase in its price from P_e to P_t . Some consumers are no longer willing to purchase at this new price, leading to a fall in demand for (and consequently, supply of) commodity 'X' from Q_e to Q_t .

As a result, government raises tax revenue for every transaction made on commodity 'X' – the aggregate tax revenue is represented by the area of the orange square. Simultaneously, however, the market experiences a 'deadweight loss' (measured by the area of the grey triangle) which represents an overall reduction in welfare of the economy. This loss in welfare arises since those individuals who were prepared to consume commodity 'X' at prices between P_t and P_e are no longer able to do so. This deadweight loss in welfare as a result of taxes imposed on goods and services in an economy is equivalent to the excess burden of taxes.