Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600

1 June 2015

Dear Sir/Madam

The pathway to a better tax system

PwC welcomes the opportunity to be involved in the national conversation regarding a better tax system that delivers taxes that are lower, simpler and fairer. The Tax Discussion Paper, *Re:think Better tax system, Better Australia* is the first step in the reform process.

Our attached submission, *The pathway to a better tax system*, focuses on the critical factors that will enable a successful reform process.

We welcome the opportunity to discuss this submission with you further.

Yours sincerely

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Protecting our prosperity
The pathway to a better tax system

28 May 2015

PwC's response to the Commonwealth Government's Tax Discussion Paper

Let’s ensure a process that will support real reform

It is critical to Australia’s future prosperity that we pursue genuine tax reform. We cannot waste the opportunity offered by the *White Paper on Tax Reform* process recently initiated by the Commonwealth Government. This process, along with the associated *Reform of the Federation White Paper* process which is occurring concurrently, creates a unique moment for fundamental national reform.

Since 2013, PwC has been directly engaged in driving the conversation on tax reform. This role has included the establishment of an Advisory Panel comprising representatives from governments, the business sector, academia, unions and non-profit organisations. This Advisory Panel, along with our Tax Experts Group, a group of senior tax professionals, was brought together regularly to explore and debate the key elements of tax reform including the case for tax reform in Australia and how this message can be readily shared and understood by all Australians.

Both the Advisory Panel and the Tax Experts Group have played a key role in informing our work in this area, which has included the development of the *Protecting our prosperity* publication series (see http://www.pwc.com.au/tax/tax-reform).

Our tax reform activities have provided PwC with the unique opportunity to hear a breadth of views across different stakeholders in our community. It has also provided us with an understanding of the key issues and potential areas for which careful consideration and negotiation could secure a reform package that would support Australia’s ongoing prosperity.

Leveraging this knowledge we have developed this submission to the Commonwealth Government’s Tax Discussion Paper, *Re: Think, Better tax system, Better Australia* (the tax discussion paper). It focuses on the critical factors that will enable a successful reform process.

PwC is committed to a process that will lead to the achievement of real, comprehensive tax reform to drive economic growth and innovation, support governments, and maintain the living standards of all Australians. Minor reforms or tweaks to existing tax arrangements will not be enough to address the current challenges Australia faces. The Commonwealth Government, with the support of relevant community groups and our business sector, will need to take a stand, explain clearly to the Australian public why we need major tax reform and how they plan to do it, and then pursue an electoral mandate for reform. If done the right way, we believe proper reform can be achieved.

Luke Sayers

Chief Executive Officer, PwC Australia

Key points

Tax reform is about trust

- We face some pressing challenges. We have a sluggish economy, declining growth in our incomes, and governments which are struggling to balance their budgets.
- We need reform – including comprehensive tax reform – to address these economic and fiscal challenges. This encompasses measures to improve our competitiveness, our innovation, and to build our businesses through greater productivity and workforce participation.
- Reforms are rarely made simply because they are a good idea. Reform involves change, and change requires trust in our governments, our politicians, and our bureaucratic institutions to explain, design and implement reform.
- People must trust that comprehensive tax reform will support the needs of Australians – affordable housing, a secure job, a decent education for their children, a good health system and a comfortable retirement.
- The tax reform process will also need to be seen as fair and equitable. Excluding certain taxes or tax concessions from assessment will undermine trust and affect the acceptability of any final package of reforms.
- To build trust and achieve tax reform we need public understanding of the need for reform. We also need clear principles to guide the reform process, an effective plan which has community acceptance, and timeframes which allow for proper engagement and transition.

Setting the path to reform

- We must not rush to solutions until trust and understanding are established. We must not propose simplistic panaceas, nor exclude sacred cows from being assessed.
- But we must address our challenges:
  - We must look at our mix of taxes, including the balance between taxes on income, consumption and wealth, so that efficiency can drive productivity and participation.
  - We must resolve bracket creep and protect wage earners from its regressive impact.
  - We must build trust that large business and high income earners are paying their fair share.
  - We must review our taxes to eliminate concessions and exemptions, reduce thresholds and lower rates.
- We must also ensure that in addressing our challenges, we set the path for budget repair. While tax reform alone cannot solve this, it will be important for the success of this process.

Tax reform is about trust

Addressing Australia's economic challenges will require significant reform

Policy reform is critical if Australia is to address its economic challenges and ensure continued prosperity. This includes measures to improve international competitiveness, innovation and business growth along with greater job creation and workforce participation.

The stakes are high on this reform agenda, with the Australian economy facing significant challenges:

- The mining boom and the improvements in our terms of trade which underpinned Australia's most recent economic performance have passed.[1] The resources sector is now expected to contribute less significantly to economic growth.[2] If the non-mining sectors of our economy do not grow sufficiently to outweigh this impact, it may not be possible for Australia to return to trend growth over the medium term. To date, there has been limited evidence of greater capital spending in non-mining sectors.[3]

- Workforce participation rates need to rise, particularly for women and older workers. Working age ratios – that is the number of working age people supporting those over 65 years of age – have fallen from 7.3 in 1974-75, to 4.5 today.[4] This ratio, along with workforce participation rates, is expected to continue to fall and have a direct impact on economic growth if measures are not introduced to attract and retain more female and older individuals in the workplace.

- Falling terms of trade are undermining real national income growth and Australia's labour productivity levels are expected to remain at the long-term average growth rate. These two factors are likely to reduce growth in national incomes per person to 1 per cent per annum over the forward period to 2025.[5] This is less than half the rate to which Australians are accustomed and will directly affect living standards.

- An ageing population places increased pressure on key government services such as aged care, health services and the age pension. Expenditure on health in particular, and aged care services, is anticipated to grow at a faster rate than GDP, and will gradually take up a larger share of the economy.[6] Adding to these pressures is broader population growth which will also drive greater demand across a range of government services, including health, education, transport and infrastructure.

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1 Gruen, D, 'After the resources investment boom: seamless transition or dog days?', Speech to the Australian Conference of Economists, Hobart, 3 July 2014. Available at: http://www.treasury.gov.au/PublicationsAndMedia/Speeches/2014/20140703. [Accessed on 20 November 2014].

2 Ibid.

3 Stevens, G, 2014, 'Economic Possibilities', Address to the Committee for Economic Development of Australia (CEDA) Annual Dinner. Available at: http://www.rba.gov.au/speeches/2014/spgov-181114.html. [Accessed on 20 November 2014].

4 The Commonwealth of Australia, 2015, Intergenerational Report: Australia in 2055, Circulated by the Honourable J.B Hockey MP, Treasurer of the Commonwealth of Australia, March 2015.

5 Parkinson, M, 2014, 'Challenges and opportunities for Australia over the next decade'. Speech to the Association of Mining and Exploration Companies Convention. Perth, 2 July 2014. Available at: http://www.treasury.gov.au/PublicationsAndMedia/Speeches/2014/Challenges-andopportunities-for-Australia-over-the-next-decade. [Accessed on 22 May 2015].

6 Ibid.

- Australia's productive infrastructure deficit is undermining growth and the ability of the economy to adjust to the end of the mining boom.[7] Australia's growing population requires adequate infrastructure – both economic infrastructure, such as transport networks, communication and information technology infrastructure, and health and social infrastructure – to support a productive economy and workforce.

Combined, these factors are undermining our economic growth and placing our prosperity at risk of decline for the first time in almost 25 years.

At the same time, the Commonwealth Government, along with state and territory governments, are finding it increasingly difficult to balance budgets as growth in expenditure continues to outpace revenue growth.

Current Commonwealth budget projections are not dire because they assume a return to trend economic growth and employment levels. They are also based on growth in personal income tax receipts due to bracket creep and assume that reduced funding to states and territories for education and health, proposed in last year's budget, and totalling around $80 billion in savings over the period to 2025, will not have to be overturned. These are important assumptions.

The spending pressures of state and territory governments are growing, while their revenue base has been declining. Partly, this is due to falling GST revenues as people began to save more and spend an increasing share of their income on items not subject to GST, such as health care, education and internet purchases under $1,000.

With limited revenue sources of their own, states and territories are increasingly reliant on Commonwealth grants. This can place these states and territories in a challenging position, particularly as the Commonwealth Government seeks to balance its own budgets and has very few savings avenues that do not affect state and territory funding arrangements.

We will need to advance a broad reform agenda to support economic growth and protect our Australian way of life. This will include identifying those reforms which will address current impediments to innovation, productivity growth, employment, workforce participation and investment. A critical complement to this reform process must be comprehensive tax reform.

Comprehensive tax reform can also enable a better alignment of government revenues with the expenditures they are required to fund. Though governments will need to demonstrate that their expenditures are efficient and being directed appropriately.

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Comprehensive tax reform is a critical part of the reform agenda

Australia's tax system has become highly complex and fragmented as result of ongoing *ad hoc* and piecemeal changes. We do not have a system which is guided by a clear framework aligned to supporting growth, minimising distortions and supporting distributional outcomes (in tandem with the welfare system).

The specific shortcomings of our tax system include:

- Australia's tax revenues (most notably GST and company tax) are not growing in line with the expenditures they are required to fund, particularly since the GFC.
- Our tax mix is reliant on taxes which are highly distortive – such as stamp duties and insurance levies – which prevent otherwise beneficial transactions from taking place. Other taxes have been designed with exemptions and tax-free thresholds which can also undermine efficiency by distorting decisions to invest, spend, work, save or employ staff.

7 Hutchens, G, 2015, 'RBA boss Glenn Stevens says Australia needs new infrastructure to survive downturn', The Sydney Morning Herald. Available at: http://www.smh.com.au/federal-politics/political-news/rba-boss-glenn-stevens-says-australia-needs-new-infrastructure-to-survive-downturn-20150320-1m45d8.html. [Accessed on 19 May 2015].

- Australia has a high reliance on income taxes, including company income tax. The relatively high tax rate associated with company tax can hinder growth and the effects from this are largely borne by workers. There have been calls for the reduction of the company tax, though it is acknowledged that in part Australia's company income tax regime is acting as a tax on economic rent, in lieu of alternative tax arrangements.[8]

- Personal income tax bracket creep is increasing the average tax rate faced by all workers. From this year, average income earners will face a marginal tax rate of 37 per cent for any earning over $80,000 per annum (Table 1). Bracket creep is highly regressive as the increase in average tax rates is greater for those on lower incomes. It can also undermine work incentives for these workers and can create incentives for tax minimisation by high income earners.[9]

Table 1: Average and marginal tax rates due to bracket creep, average annual earnings

Year	Average annual earnings	Average tax rate	Marginal tax rate
2000[10]	$41,501	25.2%	43%
2001	$43,815	21.7%	30%
2010	$66,310	20.7%	30%
2015	$80,179	22.0%	37%
2020	$99,412	24.9%	37%
2030	$152,827	29.1%	37%

Source: PwC Analysis based on Average Weekly Ordinary Time Earnings (ABS Cat 6302.0).

- Australia is recognised as being highly redistributive due to the targeted nature of Australia's tax and welfare system.[11] It also levies a low level of direct taxation on lower income groups.[12] This is partly due to our progressive personal income tax arrangements. However, there are questions around the equity of certain exemptions and concessions (eg negative gearing, capital gains tax discount and superannuation concessions) which are seen to benefit those that need it the least, or result in taxpayers in the same circumstances facing a different tax burden.

- With increasingly open flows of trade and investment, along with technological developments, our tax system is unable to meet the requirements of this changing environment. There is a view that our current tax arrangements, along with those of other countries, have allowed for the increased incidence of non-taxation and tax avoidance behaviours. Actions by the Commonwealth Government to review these arrangements should continue with a view to ensure the integrity of Australia's tax system and build the community's trust in its operation.

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[8] Commonwealth Treasury, 2009, *Australia's future tax system: Report to the Treasurer (Part One: Overview).* Available at: http://taxreview.treasury.gov.au/content/downloads/final_report_part_1/00_AFTS_final_report_consolidated.pdf. [Accessed on 20 May 2015].

[9] Parkinson, M, 2014, 'Enhancing our living standards through tax reform', *Speech to the Business Council of Australia/PricewaterhouseCoopers Tax forum,* 11 September 2014. Available at: http://www.treasury.gov.au/PublicationsAndMedia/Speeches/2014/Martin-Parkinson-20140911. [Accessed on 20 April 2015].

[10] The fall in average and marginal tax rates between 2000 and 2001 are attributed to changes to personal income tax arrangements associated with the implementation of A New Tax System by the Howard Coalition Government.

[11] The distribution of benefits is so progressive, due to means testing, and the level of taxes paid by the poor so low, that Australia redistributes more to the poorest 20 per cent of the population than any other OECD country except Denmark (which spends about 80 per cent more on social expenditure than Australia). For further information see: Whiteford, P, 2013, Australia: Inequality and prosperity and their impacts in a radical welfare state. Crawford School of Public Policy.

[12] Whiteford, P, 2013, Australia: Inequality and prosperity and their impacts in a radical welfare state. Crawford School of Public Policy

- Our tax system imposes high compliance costs due to exemptions, tax free thresholds and the complexity of tax laws.

The trust deficit in tax reform

Progressing any economic reform is difficult and tax reform has proved to be particularly difficult. However, the Australian community has demonstrated in the past that it will accept significant economic reforms (Box 1).

Box 1: Tax reform in Australia

The Hawke Labor Government took a tax reform package to the 1987 election which, along with adjustments to income tax, saw the introduction of new taxes on fringe benefits and capital gains. They won that election. In 1998 the Howard Coalition Government went to an election advocating the introduction of the GST as part of a broader tax reform package that sought to replace more distorting indirect taxes and to allow for changes to personal income taxes. It was re-elected notwithstanding the highly contentious and polarising nature of the then GST debate.

Progressing any economic reform is difficult and tax reform has proved to be particularly difficult.

Tax is complex and proposals to change the tax system are generally viewed with suspicion. As such, tax reform is unpopular, and attempts at reform face significant opposition from sections of the community and non-government political parties. But a key feature underpinning previous successful reform efforts was the ability of governments to engage with the community and build trust around why the reform was necessary and what it would mean for the future prosperity of the country.

Past tax reforms have often included substantial compensation packages which largely addressed much of the 'pain' associated with any given reform measure. However, such compensation measures will not be possible in this current tax reform process due to Australia's current fiscal challenges. This further emphasises the need for effective community engagement and trust to enable reform.

In recent years, trust in proposals for tax reform – by either side of politics – has been undermined:

- The inherent complexity of tax makes it fertile ground for misrepresentations and scare campaigns. Tax is inherently 'political'. There has been limited bipartisan support or engagement on tax reforms in recent years. Both major political parties have, at different times, characterised tax policy in negative terms, or failed to agree on the key principles of reform, damaging community trust.

- In the 2014-15 Budget, the Commonwealth Government attempted to introduce measures to reduce the budget deficit. However these were seen as disproportionately affecting low-income households. In response to the significant concerns raised by the community in relation to the apparent unfairness of the 2014-15 Budget, the Government took a different approach in the 2015-16 Budget and reduced its emphasis on the need for 'budget repair'. This change in emphasis is likely to have created uncertainty around the Government's objectives and impacted on community trust. Australians need to be able to believe the Government's assurances that the reforms being proposed are in the nation's best interest and this relies on a consistent, clearly explained narrative.

- Australia's federation is characterised by a vertical fiscal imbalance (VFI) where our state and territory governments have expenditure functions that they cannot wholly finance, and are therefore reliant on funding from the Commonwealth Government. While VFI is not new to Australia, it can lead to blame shifting, given the apparent disconnect between revenue raising and spending responsibilities. Conflicting messages across different levels of government can add to confusion and the erosion of trust across the electorate.

- The perception that businesses and wealthy individuals are not paying their fair share of tax undermines trust. Recent media reports in relation to the taxation of businesses, including the *Senate Inquiry into Corporate Tax Avoidance*, have increased awareness around the base erosion and profit shifting (BEPS) activities of large multinationals and impacted upon trust in corporate tax systems. Tax concessions around superannuation and the taxation of certain income streams, while originally structured to increase the savings of middle income earners, are argued to provide higher earners with a disproportionate level of support.[13]

- With government expenditure growing, some question the necessity and efficiency of this expenditure. Limited trust in how governments choose to allocate their revenues can undermine attempts to reform tax measures, particularly any measures to increase revenues. Research shows that greater transparency in government activities, including their expenditure decisions, can help to achieve policy aims more effectively and build trust.[14]

There is also limited trust between the different stakeholder groups in the tax reform debate, as they attempt to redirect the 'pain' of reform to other groups. For instance, perceptions of tax avoidance by big businesses and wealthy individuals have led certain groups to suggest that these entities (or individuals) should simply be taxed more. While the merits of specific proposed changes need to be debated, such an approach is not consistent with a tax debate focused on addressing the current shortcomings in the tax system and ensuring a wide-ranging debate on how to build a better tax system for Australia.

Reforms are rarely made simply because they are a good idea. Reform requires that the community has the necessary trust in the political and bureaucratic institutions which explain, design and implement reforms. Tax reform will need this trust.

In the current tax reform debate, a clear, open conversation on the case for change is essential if the community is to have trust in the process. This includes explaining Australia's current fiscal situation and how comprehensive tax reform underpins the fundamental tenets that Australian's aspire to. It will also be important to build the confidence of the business sector, the union movement, the welfare sector, and all Australians that the reform process will lead to a better outcome, while maintaining equity and fairness.

Reform requires that the community has the necessary trust in the political and bureaucratic institutions which explain, design and implement reforms.

[13] Commonwealth Treasury, 2012, Distributional analysis of superannuation taxation. Available at: http://www.treasury.gov.au/Policy-Topics/SuperannuationAndRetirement/Distributional-analysis-of-superannuation-taxation-concessions. [Accessed on 15 March 2015]

[14] The Economist, 2010, The open society: Governments are letting in the light. Available at: http://www.economist.com/node/15557477/print. Accessed on 25 May 2015.

A clear, open conversation on the case for change is essential if the community is to have trust in the process.

Understanding will build trust

Tax is complex and multifaceted, and success with tax reform will depend on whether:

- the community is able to understand the case for reform
- there is a degree of consensus across relevant key groups in the community – such as non-profit and welfare groups, unions, business groups and other interest groups – in support for reform.

Understanding and trust are self-reinforcing, as the process of information sharing and debate allows the community to evaluate the motives of all governments and build confidence in the key messages.

It can be easier to maintain the status quo than have the difficult conversations about what is wrong with the system and how it can be addressed. For instance, there is significant opposition to any proposal to change the GST, due to its impact on equity. However, the bracket creep associated with Australia's fixed personal income tax brackets is able to continue with limited challenge, despite its regressive nature and that fact that lower- and middle-income earners are gradually paying more tax over time. This is an outcome which is similarly inequitable and can have broader consequences for workforce participation and tax minimisation.

Enabling greater understanding of the case for tax reform is a significant task for governments as it requires turning potentially complex concepts into simple objectives that resonate with all Australians. It is a task that needs constant reinforcement through both the words and actions of governments. The Commonwealth Government also needs to be responsive to the concerns being raised by the community and demonstrate how their concerns have been taken into consideration.

Throughout PwC's tax reform engagement activities, representatives from unions and the non-profit sector have continued to highlight that the things that really matter to Australians are access to affordable housing, a secure job, a decent education for their children, a good health system and a comfortable retirement. The pursuit of these goals should be articulated within the tax reform debate and linked to the case for change.

This does not mean these are to be public goods, delivered by government. Rather, each of these factors relies on a vibrant economy, which will be supported by tax reform to enable all Australian's to realise these fundamental tenets.

Beyond community engagement, there is a need for greater consensus across all key stakeholder groups in the objectives of reform and what it will mean. Indeed, many of these stakeholders can play a significant role in reinforcing and verifying the key messages presented by the government to build understanding and trust in reform (Box 2).

Box 2: Tax reform in New Zealand, 2010

The success of the New Zealand Government's 2010 tax reform process is often linked to how it effectively engaged with the broader community and built community understanding in the need for tax reform. This was achieved via the establishment of a partnership between the Government and the Victoria University of Wellington. A Tax Working Group led by the University was formed which comprised experts across public policy, economics and private sector tax practitioners. This process convened public workshops and the establishment of a dedicated website which published relevant papers and the outcomes of all Tax Working Group meetings; enabling information to readily shared, while at the same time building trust.

So will ensuring equity and fairness

Australia will accept a new tax system that is fair and equitable. Achieving this will require fairness in the tax reform process, and fairness in the final package of tax reforms proposed, including how any adverse distribution outcomes are addressed.

Having all reform options on the table for consideration will be critical to a fair tax reform process. If reforms which have adverse effects on certain groups – such as higher income earners or the business sector – are excluded from consideration, this could be interpreted as unfair and will undermine the broader reform agenda.

It will also be necessary to demonstrate that the final package of reforms is fair. There are number of tax measures which have been proposed for reform – each with differing distributional effects. While some individual taxes may have adverse distributional outcomes, assessments of equity and fairness should be considered within the context of a package of reforms. For example, while it may not be possible to ensure that no household is adversely affected by any individual tax change, as a package of reforms, along with Australia's progressive personal income tax arrangements and welfare system, any adverse effects could be managed or mitigated.

Compensation arrangements and the welfare system will play an important role in maintaining equity and building public acceptance for reform. This is not to suggest that compensation arrangements should ensure no individual should be worse off from tax changes; rather that changes should seek to uphold the principles of vertical and horizontal equity[15] and ensure that the burden of any tax change does not fall excessively on low income or vulnerable households.

While targeted compensation will support public acceptance of reform, compensation arrangements accompanying past reforms have sometimes been seen as insufficient, or have eventually eroded over time following a change in political or economic circumstances. This can reduce trust that agreed compensation arrangements will be maintained over the longer term.

PwC's tax reform activities have found the above factors have impeded consideration of proposals to broaden the base of the GST, and/or increase its rate above 10 per cent.

GST is undeniably a regressive tax as low income households spend a higher proportion of their income on consumption. However, the regressive nature of GST should not remove it from consideration altogether. A broad-based consumption tax can be highly efficient as it has relatively minor distortionary impacts on the behaviour of individuals and business, and has a lesser impact on economic growth than other taxes such as stamp duties, insurance levies or corporate income taxes. Consumption taxes are also widely used across the member states of the European Union (and the rates of these taxes are much higher). New Zealand has one of the purest broad-based GST regimes, with limited exemptions.

However, the tendency by certain interest groups to focus solely on GST reform fails to acknowledge the broader shortcomings of Australia's tax system and has been viewed as unfair by non-profit and welfare groups. There are a number of other tax measures which also have the potential to support broader efficiency and revenue adequacy principles, while at the same time improving distributional outcomes. A fair process would also allow for the consideration of these measures.

At the same time, while it is widely accepted that any reform of GST would be accompanied by targeted compensation, there is limited trust these arrangements will be sufficient or will remain in place over the longer term. There are also challenges in effectively targeting low income earners, who fall below the tax free threshold, but do not qualify for welfare payments. The Commonwealth Government will need to demonstrate a willingness to establish compensation in a transparent, fair and critically, a sustainable way.

No panaceas, no sacred cows and no shortcuts

Throughout PwC's activities around tax reform, we have sought to highlight the need to clearly articulate the reasons for reform and patiently ensure that these reasons are understood by the broader public. All options should remain open for consideration in a broad, wide-ranging debate.

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[15] Horizontal equity requires that individuals in the same economic circumstances pay the same tax, and vertical equity requires that those with greater capacity pay more tax than those with less capacity.

However, to date, Australia's tax reform debate has proceeded too quickly to solutions without sufficient explanation of the problems faced. Worse still, many solutions proposed are narrowly-defined and fail to take into consideration the broader objective of building a tax system for Australia that can support our future prosperity.

Some interest groups have immediately turned to proposals which they believe will singlehandedly address the current fiscal and economic challenges of Australia. These proposals have also tended to be measures that would not directly impact the constituency group which they represent. For example, many groups continue to propose GST reform as a panacea solution, without considering a package of other reforms which are also necessary to ensure an efficient and fair tax system for Australia. Other interest groups have developed their own panacea solutions for raising tax revenues via the abolition of concessions on negative gearing and superannuation, or through the collection of more company tax.

Yet these narrowly-defined solutions fail to consider the broader impact of a tax mix on the economic performance of the country, and arguably will not address the range of shortcomings currently present in Australia's tax system. Comprehensive tax reform will not be based on changes to one or two taxes, but rather a package of tax measures will be required to address current distortions and support economic growth.

At the same time, there have been continued attempts to propose 'sacred cows' and exclude these options from further consideration.

Australian governments need to provide leadership by resisting the temptation to rule out reform measures.

The Government's tax reform white paper process provides an important opportunity to building a better tax system. However, even in the tax discussion paper a number of taxes were overlooked, such as minerals and environmental taxes. Moreover, since the process has begun, the Government has ruled out reforms to superannuation arrangements and negative gearing, and indicated that GST reform would only be pursued if bi-partisan support could be garnered. If this debate is to provide a 'once-in-a-generation' opportunity to examine the whole tax system, this is what the process should allow. Australian governments need to provide leadership by resisting the temptation to rule out reform measures. Rejecting certain reform measures or seeking to rely on narrowly-defined solutions will undermine this process and the trust of the broader community.

Special interest groups have similarly sought to remove certain tax reform measures from consideration, leaving very few options left to consider in the development of a tax reform package. Compromise by all stakeholders will be necessary in order to develop a sustainable package of reforms. This means allowing for the assessment of all potential tax and tax concession measures and being ready to present a considered argument to reinforce stated positions.

It is recognised that many taxes and tax concessions were introduced to achieve a certain outcome. This tax reform process therefore provides an important opportunity to assess whether these conditions are still valid, whether certain measures have given rise to unintended adverse outcomes (in terms of both efficiency and equity), and whether new circumstances have emerged which reinforce (or weaken) arguments for their continuation. Such a process can then be used to build trust and understanding across the broader community regarding the basis for the final tax reform package and why certain measures where included (or excluded).

Principles that are operative and meaningful

Australia's tax reform process needs to be guided by clear, practical principles. While notions of equity, efficiency, simplicity and sustainability are often mentioned when considering tax reform (and rightly so), there needs to be greater definition of what they really mean when applied.

This is important for a range of reasons. Principles may be easier for the broader community to understand and agree. Hence, once there is broader agreement regarding the overarching principles of reform, this can be leveraged to build the case for specific reforms.

Clearly defined principles can also be used to guide the direction of reform. If true reform of our tax system is to occur, it will take time and exceed a single term of government. It will be necessary to have measures in place to ensure that changes in political leaders or parties do not derail the reform process. Principles can play an important role in setting a clear path toward reform and building bipartisan support.

This is not to suggest that differing sides of politics need to agree on specific policies. Such an outcome would be impractical (or even undesirable). Rather, while opposing political parties may differ in what they will do in reform, if they can agree the guiding framework, it should ensure that they continue to move toward the same end goal.

The key reform principles could be defined in the following way.

Principles	*Description*
Equity	• Principles of vertical equity – such that the burden of tax only falls on those most able to pay – are best managed through the interaction of the personal income tax regime together with the welfare system. Together these two systems enable assistance to be targeted at those most in need. Tax exemptions or concessions introduced on the basis of addressing vertical equity outcomes should be avoided on the basis that these can lead to increased complexity in the system and undermine efficiency. • Tax reforms should seek to uphold the principles of horizontal equity – such that those in the same circumstances are subject to the same tax burden. Inconsistent taxation of incomes earned from savings, employment or investment should be addressed. • Measures to address equity should focus on the final or economic incidence of tax, rather than the statutory or immediate incidence. While there is general agreement on the final incidence of some taxes, such as the GST on higher household prices, there is an on-going debate for other taxes, such as how much of a lower corporate income tax benefits labour as higher wages versus shareholders.
Efficiency and simplicity	• Australia's tax system should move toward a regime in which tax bases are defined broadly (that is, with low thresholds and minimal exemptions) to enable lower tax rates. Such a regime minimises economic distortions which can impede growth and affect workforce participation levels. A broad-base, low rate approach to taxes is consistent with the objectives of administrative simplicity and reduced opportunities for tax avoidance and arbitrage. • While all taxes distort choices, those taxes (and tax concessions) which have the greatest distortionary effect on economic behaviour should be abolished, in favour of less distortive taxes. Tax arrangements under which the design, including the inclusion of exemptions or tax free thresholds, or high tax rates, creates distortions should also be subject to review.
Sustainability	• The tax system should raise sufficient revenue to allow governments to provide effective government services without compromising the economic stability of low levels of government debt, or burdening future generations of taxpayers. • The tax system should be reviewed to address highly volatile revenue streams which may undermine the fiscal positions of governments. • There should be consistency in the design and administration of state and territory taxes. While tax competition between states and territories is often encouraged to drive efficiencies and innovation, it has contributed to the decline in state and territory government revenues with the abolition of certain efficient taxes (such as estate taxes) or the introduction of distortions like exemptions or tax free thresholds (for example, payroll tax). • Australia's tax regime was not designed to deal with the global nature of many businesses or the digital economy in which they now operate. Australia should continue to implement measures which seek to reinforce the integrity of the tax system. This includes the use of appropriate unilateral and multilateral tax arrangements to address tax avoidance and build trust, and therefore greater compliance in Australia's tax arrangements.

Set the way for budget repair

We believe that Australia's tax reform agenda should be guided by a process which focuses on addressing the current features in our tax system which impede growth, workforce participation and employment, innovation and investment. This should be the primary element of any reform agenda and will help to ensure that Australia's tax system is able to support our economy well into the future.

However, tax reform has a critical role to play in terms of budget repair.

Should existing budget deficits extend over long timeframes or show no signs of returning to a sustainable balanced budget over the economic cycle they can have broader consequences. This is particularly the case when budget deficits are driven by structural rather than cyclical factors. Large deficits which are focused on funding the requirements of citizens today, rather than investment for the future, may also mean future generations will face a higher tax burden. These circumstances create the impetus for governments to implement an appropriate policy response.

Any reform of Australia's tax system should therefore align with broader changes aimed at addressing the fiscal challenges of Australian governments. Accordingly, with the design of a more efficient tax regime, it may also be appropriate to review tax rates, how taxes align with expenditure growth, and whether there are appropriate counter-cyclical features in place.

While tax reform alone cannot be expected to address the current fiscal conditions of Australian governments, the community may question the validity and success of a process that does not, at least, demonstrate how it will support broader budget repair. Indeed, this is also likely to contribute to public acceptance around reform.

Tax reform requires a broad and collective understanding of the problems and consensus on the way forward. This will only be achieved if governments have a genuine conversation with the Australian public on tax reform and help them understand the case for change.

Have a clear plan

Tax reform is a critical ingredient to supporting Australia's continued growth and prosperity. The outcome from the tax reform process will be a white paper that will form the Coalition's tax reform agenda for the next election. The Australian Labor Party is also presenting a range of tax reforms it will seek to pursue if elected to government.

But tax reform will not be implemented quickly, and it will certainly not be achieved in a single term of government. The pace of reform will depend on both economic and political circumstances. As such, the reform process is subject to significant risk, associated with changes to political leaders or governments.

A clear plan is needed to support tax reform which should include the following:

- **Engagement with the Australian public** – Tax reform needs more than just the right conceptual solution. It requires a broad and collective understanding of the problems and consensus on the way forward. This will only be achieved if governments have a genuine conversation with the Australian public on tax reform and help them understand the case for change.
- **Clearly articulated and agreed principles to benchmark the reform process** – such principles could form the framework against which reform proposals could be assessed and evaluated.
- **Engagement with state and territory governments** – The pathway to reform will require effective engagement with state and territory governments. Many of the taxes which particularly significant distortive effects are levied by these jurisdictions, and hence to ensure these measures can be addressed and that the reform process achieves its desired outcome, the buy-in of state and territory governments will be critical. In practice, this engagement process will also be informed by the concurrent *Reform of the Federation White Paper* process.
- **Solutions for bracket creep** – The immediate effects of bracket creep on the labour force highlight the need to review and address this, in line with the overarching principles of reform.
- **Assessment of the design of taxes that include exemptions and tax free thresholds** – Tax exemptions and thresholds are included in the design of a range of taxes including GST, personal income taxes, company income taxes, payroll tax

and land tax. These arrangements should be subject to review in line with the principle of a broad based, low rate system.

- **Assessment of tax concessions** – Tax expenditures may be an appropriate measure for delivering a particular policy outcome. However, periodic review can help to ensure they are continuing to deliver the outcomes they were intended to support. In light of the questions in relation to equity of measures such as superannuation and negative gearing, a review of these arrangements should be part of the tax reform process.

- **Identification of opportunities to simplify existing tax measures** – There are some reform measures which the Commonwealth could pursue unilaterally to improve compliance with tax arrangements.

Implementation of the reform agenda should consider opportunities to stagger of reforms. This may help to gain momentum for reform based on successful cooperation across different stakeholder groups and governments. If reforms were staged, it could allow governments to build on measures where some agreement already exists.

As an example, Australian governments could start with reforms to property tax arrangements. The Australian Capital Territory (ACT) announced it would gradually phase out stamp duties and replace this revenue with a broader land tax arrangement administered through their existing general rates system.[16] Other states are also considering similar proposals, including South Australia.[17] Given momentum for this type of reform already exists, it could provide an appropriate first step for reform, though this would be subject to the outcomes from Government's broader tax reform process.

Once momentum around reform has begun, it may be possible to pursue more contentious proposals. Measures which have been raised and debated extensively include GST and personal income tax, company income tax and business tax exemptions, superannuation concessions and other arrangements such as negative gearing and the capital gains tax discount. However, with sufficient momentum, there may be an opportunity to pursue reform in some of these areas if the tax reform process determines this is appropriate.

And a realistic timeframe

Any plan should also allow sufficient time for the assessment of the reform measures and the design of tax changes. A range of factors will need to be assessed and implemented including processes for amending current tax arrangements, transitional arrangements, and mechanisms for balancing undesirable equity outcomes.

The recent decision of the ACT Government to swap stamp duties for land tax is being implemented with a 20 year transition phase. Caution should be exercised when determining the implementation timeframe and any transitional arrangement to ensure that the time period is not so long that it jeopardises or undermines the reform, or makes it appear that progress (and any associated benefit of reform) is minimal. Hence, while such a long transition phase may not be desirable for this process, it is acknowledged that such a process could take as long as a decade.

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[16] ACT Treasury, 2014, *Tax Reform*. Available at: http://apps.treasury.act.gov.au/taxreform. [Accessed on 11 October 2014].

[17] ABC Online, 2015, 'Annual homeowner tax of $1,200 an option in SA Government's overhaul of state's tax system', *ABC Online*, 11 February 2015. Available at: http://www.abc.net.au/news/2015-02-11/sa-government-releases-discussion-paper-on-tax-system/6085352. [Accessed on 18 May 2015].

But lastly it is important to acknowledge that the process of tax reform is ongoing. While it is hoped that the current tax reform process will ensure the step towards a better tax system for Australia, it will unlikely end with this process. Over time changes in both political and economic circumstances, along with international developments, are likely to create impetus for further reviews (and reforms). This further highlights the importance of a clear and contemporary framework of principles to guide the development of our tax system and ensure it is conducive to sustaining growth, minimising distortions and supporting distributional outcomes.