

**Australia's future tax system
Consultation paper**

December 2008

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ISBN 978-0-642-74497-5

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Printed by CanPrint Communications Pty Ltd.

Foreword

The tax-transfer system is a fundamental part of Australia's social and economic infrastructure. It has been, and will continue to be, shaped by the choices that Australians make about the type of society in which they choose to live. It can have a profound influence on the opportunities available to Australians.

The terms of reference for the review into Australia's future tax system are broad and present a significant opportunity for the Review Panel, in consultation with the community, to design a tax-transfer system for Australia's future. Consistent with the 'root and branch' description of this review, the Panel wants to identify the appropriate form and structure for the tax-transfer system.

While the focus of the review is necessarily on the next 10 to 20 years, the choices made in the years ahead will influence the shape of the tax-transfer system well beyond this period. It is therefore important to consider the potential challenges, opportunities and choices facing Australians over the next few decades when considering the design of our tax-transfer system.

In August, the Review Panel invited submissions to the review, guided by four broad consultation questions. Submissions were received from people and organisations from across the entire community and cover a wide range of ideas, views and issues. The Panel wishes to thank everyone who participated in this stage of the consultation process.

In this paper, the Panel reports on the submissions we have received, provides some discussion of the main issues and outlines further questions, the answers to which are necessary in shaping the recommendations for our final report. In answering these questions the Panel will continue to draw upon the submissions already provided.

Over the next 12 months, the Panel will build on these initial steps, through supplementary submissions, further consultations, a series of technical papers to provide an informed basis for ongoing debate, and a high level conference to consider the major issues. The separate consultations being conducted on the issues of pensions and retirement incomes complement these processes. Taken as a whole, this program of work will be central in shaping the Panel's final report to the Treasurer in December 2009.



Ken Henry
Chair
Review Panel
Australia's Future Tax System

The Australia's Future Tax System Review Panel

Dr Ken Henry (Chair), Secretary to the Treasury

Dr Henry has made a significant contribution to developing Australia's tax policy over the past 25 years.

Early in his career he was a member of the team which developed the then government's draft White Paper on Tax Reform (June 1985) and tax reform package (Reform of the Australian Taxation System, September 1985). In August 1997 he was appointed Chairman of the then government's Taxation Task Force, responsible for providing advice to the government on tax reform options that led to a New Tax System.

Before being appointed in 2001 as Secretary to the Treasury, Dr Henry held a number of other senior positions within the Treasury including Minister (Economic and Financial Affairs) in the Australian Delegation to the OECD in Paris, head of the microeconomic modelling unit, head of the taxation policy division and Executive Director (Deputy Secretary) of Treasury's Macroeconomic Group.

Dr Henry is an ex-officio member of the Board of Taxation, member of the Board of the Reserve Bank of Australia, Alternate Governor (for Australia) of the International Monetary Fund, and Chairman of the Advisory Board of the Australian Office of Financial Management.

Dr Henry was awarded a Companion of the Order of Australia General Division (AC) in the 2007 Australia Day Honours.

Dr Jeff Harmer, Secretary, Department of Families, Housing, Community Services and Indigenous Affairs

Dr Harmer has a keen interest in social policy, management, leadership and organisational change and development.

He began his career in public service in 1978 following five years as a doctoral scholar and tutor at the University of NSW.

Dr Harmer has held various executive positions across a range of Australian government departments. He was appointed Secretary of the Department of Family and Community Services in 2004, and led the department through the changes associated with the addition of the Office of Indigenous Policy Coordination in 2006 and post-2007 election resulting in the department being renamed as Families, Housing, Community Services and Indigenous Affairs.

Professor John Piggott, Professor of Economics /Associate Dean, Research, Australian School of Business, University of New South Wales

Professor Piggott has a long-standing interest and has published extensively in the economics of taxation and the economic and financial aspects of retirement and pensions.

For the past several years he has worked on ageing issues with the Cabinet Office, Government of Japan, and has also advised on pension issues in the Asian region more generally. In 2007 he was appointed Visiting Professor, Zhejiang University, China, and is currently a Visiting Scholar at the Wharton School, University of Pennsylvania.

Professor Piggott is a member of the Australian Ministerial Superannuation Advisory Committee; Scientific Advisor to the Frisch Center for Economic Research, University of Oslo; and serves on the editorial board of the Cambridge journal – *Journal of Pension Economics and Finance*.

Ms Heather Ridout, Chief Executive, Australian Industry Group

Ms Ridout is a leading figure in public policy debate and is a member of a number of policy setting and consultative groups including Skills Australia, the Business Advisory Group on Workplace Relations, and Infrastructure Australia.

As Chief Executive of the Australian Industry Group, Ms Ridout is committed to helping Australian industry to meet the challenge of change.

Her focus is on building competitive industries through global integration, human capital development, productive and flexible workplace relations practices, infrastructure development and innovation.

She holds a Bachelor of Economics (Hons) degree from the University of Sydney.

Mr Greg Smith, Adjunct Professor, Economic and Social Policy, Australian Catholic University

Mr Smith consults and teaches in economic and social policy, public policy, advising and leadership.

Mr Smith worked as a tax adviser to the Treasurer in the mid 1980s. He has held senior positions in the Treasury, including Executive Director Budget Group and Revenue Group. He was also Secretary to the Financial System Inquiry, which reported to government in 1997.

He is currently a member of the Commonwealth Grants Commission, Governing Board of the Australian Tax Research Foundation, and the Ministerial Taskforce for an Economic Framework for an Efficient Transport Marketplace.

Notes

- (a) Figures in tables and generally in the text have been rounded.
- (b) The following notations are used:
- | | |
|----------|------------------|
| na | not available |
| - | zero |
| * | unquantifiable |
| \$m | \$ million |
| \$b | \$ billion |
| cat. no. | catalogue number |
- (c) References to 'the States' or 'each State' include the Australian Capital Territory and the Northern Territory. The following abbreviations are used for the names of the States, where appropriate:
- | | |
|-----|------------------------------|
| NSW | New South Wales |
| VIC | Victoria |
| QLD | Queensland |
| WA | Western Australia |
| SA | South Australia |
| TAS | Tasmania |
| ACT | Australian Capital Territory |
| NT | Northern Territory |
- (d) The term 'Australian Government' is used when referring to the current government and the decisions and activities made by the current Government on behalf of the Commonwealth of Australia.
- (e) The term 'Australian government' is used when referring to a past government or governments and the decisions and activities made by past governments on behalf of the Commonwealth of Australia.
- (f) The term 'Commonwealth' refers to the Commonwealth of Australia. The term is used when referring to the legal entity of the Commonwealth of Australia.

Contents

- FOREWORD III**
- THE AUSTRALIA’S FUTURE TAX SYSTEM REVIEW PANEL IV**
- ACRONYMS..... IX**
- EXECUTIVE SUMMARY 1**
 - Challenges and opportunities for reform 1
 - Key questions about the design of the tax-transfer system 2
- INTRODUCTION..... 13**
- 1 CHALLENGES AND OPPORTUNITIES FOR REFORM 17**
 - 1.1 Challenges and opportunities facing Australia and what they mean for the tax-transfer system 17
 - 1.2 Tax-transfer features to respond to these challenges and opportunities 31
- 2 THE STRUCTURE OF THE TAX-TRANSFER SYSTEM 39**
 - 2.1 The legal structure of the tax-transfer system 39
 - 2.2 The economic structure of the tax-transfer system 41
 - 2.3 The administrative structure of the tax-transfer system 47
- 3 THE REVENUE MIX 51**
 - 3.1 The mix of conventional taxes 53
 - 3.2 Taxing the returns to work and saving 60
 - 3.3 Taxing consumption 68
 - 3.4 User charges and beneficiary taxation 71
- 4 PERSONAL TAX AND TRANSFERS 77**
 - 4.1 Personal income tax 79
 - 4.2 Fringe benefits tax 87
 - 4.3 The transfer system 91
 - 4.4 The adequacy of support for people of working age 96
 - 4.5 Participation incentives and the tax-transfer system 101
 - 4.6 The tax-transfer system and skills acquisition 109
 - 4.7 Combined impacts of the tax and transfer systems 112
- 5 THE RETIREMENT INCOME SYSTEM 119**
- 6 TAXING BUSINESS AND INVESTMENT 123**
 - 6.1 International tax competitiveness and domestic investment 124
 - 6.2 Achieving international tax competitiveness 133
 - 6.3 Australia as a location for international businesses 138
 - 6.4 Investment and risk-taking biases 142
 - 6.5 Biases affecting commercial decisions 151
 - 6.6 The treatment of small business 154
 - 6.7 Biases in the personal investments of residents 156
- 7 NOT-FOR-PROFIT ORGANISATIONS 161**

8	COMPLEXITY — COST, RISK AND TRANSPARENCY	169
8.1	Complex policies and objectives.....	170
8.2	Simpler interaction with the system — who should bear the burden of complexity?	173
8.3	Certainty and transparency in the running of the system	178
9	STATE AND LOCAL TAXES AND TRANSFERS	183
9.1	Funding expenditure responsibilities in the federation	183
9.2	State and local taxes and other own-source revenue	190
9.3	Redistribution in the federation	195
9.4	Streamlining tax-transfer administration in the federation	197
9.5	Other issues.....	199
10	TAX AND TRANSFER IMPACTS ON HOUSING.....	201
10.1	Housing taxes and transfers	202
10.2	Impact on housing affordability	209
10.3	Impact of specific taxes and transfers on the efficient use of the housing stock and residential land.....	216
11	TAXES ON SPECIFIC GOODS AND SERVICES	219
11.1	Taxes on alcohol.....	220
11.2	Taxes on tobacco	225
11.3	Luxury car tax	228
11.4	Other issues.....	231
12	FUEL, ROADS AND TRANSPORT	233
12.1	Efficiency of motor vehicle-related taxes	233
12.2	Taxation of alternative fuels.....	239
12.3	Different modes of transport	241
12.4	Other issues.....	243
13	TAX-TRANSFER IMPACTS ON THE ENVIRONMENT.....	245
13.1	Using the tax-transfer system to manage environmental issues.....	246
13.2	Environmental impacts of the current tax-transfer system	249
14	NATURAL RESOURCE CHARGING.....	253
14.1	Non-renewable resources.....	255
14.2	Renewable resources	258
	APPENDIX A: TERMS OF REFERENCE.....	261
	APPENDIX B: LIST OF SUBMISSIONS	265
	APPENDIX C: ANALYSIS OF SUBMISSIONS.....	269
	APPENDIX D: RESEARCH COMMISSIONED BY THE REVIEW PANEL.....	273
	APPENDIX E: BUSINESS LEVEL EXPENDITURE TAX DESIGNS	277
	REFERENCES.....	283

Acronyms

AAT	Administrative Appeals Tribunal
ABS	Australian Bureau of Statistics
ACE	allowance for corporate equity
ATO	Australian Taxation Office
CBIT	comprehensive business income tax
CCB	Child Care Benefit
CEN	capital export neutrality
CGT	capital gains tax
CON	capital ownership neutrality
CRA	Canada Revenue Agency
DEEWR	Department of Education, Employment and Workplace Relations
DGR	deductible gift recipient
DHA	Department of Health and Ageing
DHS	Department of Human Services
DVA	Department of Veterans' Affairs
EATR	effective average tax rate
EITC	earned income tax credit
EMTR	effective marginal tax rate
FaHCSIA	Department of Families, Housing, Community Services and Indigenous Affairs
FBT	fringe benefits tax
FDI	foreign direct investment
FMW	federal minimum wage
FTB	Family Tax Benefit
GFS	Government Financial Statistics
GST	goods and services tax
GSTAS	GST Administration Sub-committee
HFE	horizontal fiscal equalisation
IGA	Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations
IGOT	Inspector-General of Taxation
IPART	NSW Independent Pricing and Regulatory Tribunal

Acronyms (continued)

IWT	interest withholding tax
LCT	luxury car tax
LITO	low income tax offset
LPG	liquefied petroleum gas
MAWTO	mature age worker tax offset
MTAWE	male total average weekly earnings
NFP	not-for-profit
NRAS	National Rental Affordability Scheme
NRS	National Relay Service
NTLG	National Tax Liaison Group
OECD	Organisation for Economic Co-operation and Development
PAYG	pay as you go
PBI	public benevolent institution
PPF	prescribed private funds
PRRT	petroleum resource rent tax
PTO	pensioner tax offset
PTR	participation tax rate
R&D	research and development
RWT	royalty withholding tax
SATO	senior Australians tax offset
SG	superannuation guarantee
SSAT	Social Security Appeals Tribunal
UK	United Kingdom
US	United States
VFI	vertical fiscal imbalance
WET	wine equalisation tax
WFTC	working family tax credit

Executive summary

Challenges and opportunities for reform

The terms of reference set an objective for the review of creating a tax-transfer structure that will position Australia to deal with its demographic, social, economic and environmental challenges, and enhance Australia's economic, social and environmental wellbeing.

The Panel's four consultation questions, issued in August, were intended to elicit community perspectives about the way in which Australia's tax-transfer system should be structured to better position Australia to respond to developments over the next few decades and address the perceived major short-comings in the system as it operates today.

Submissions have responded to these issues and identify several key challenges and opportunities of importance in considering Australia's future tax-transfer system:

- the type of society in which Australians might choose to live, including considerations about the role and size of government in Australia;
- increasing globalisation and the changing pattern of world economic activity;
- demographic change, including changing patterns of workforce participation;
- climate change, the environment and sustainable economic growth;
- intergovernmental relationships within the Australian federation;
- the process of policy formation and its administration; and
- the role of technological progress.

Consultation questions

Q1.1 In considering the community's aspirations for the type of society that Australia should become over the next two decades and beyond, which key features should inform or drive the future design of the Australian tax-transfer system?

Q1.2 Assuming that the absolute size of government will not fall, should (and can) Australia nonetheless aim to reduce the burden of taxation over time by promoting faster economic growth than public spending growth? Can it be demonstrated that alternative tax policies could help deliver that outcome?

Key questions about the design of the tax-transfer system

Design principles identified in submissions can be broadly categorised as equity, efficiency, simplicity, sustainability (including revenue adequacy) and policy consistency. Consistent themes emerging from submissions are that the tax-transfer system should be equitable, impose low costs on society in terms of economic efficiency and operating costs, provide sustainable revenue to fund government and be consistent with broader policy objectives, including environmental sustainability.

These broad principles may at times be in conflict. Inevitably, it will be necessary to make judgments about the balances to be made between the principles where this is the case. The Panel recognises that not everyone will make the same judgments when faced with these conflicts. The Panel will strive to be open and explicit where judgments are made.

The structure of the tax-transfer system

Australia's tax-transfer system spans three levels of government. In legal form it is comprised of the many different taxes and transfers designed and administered by government. It can be considered a single economic system that, through the complex interactions between its elements, impacts on a broad range of choices made by individuals and business. While the various elements affect economic decisions in similar ways, key differences exist between, and within, taxes and transfers in terms of their underpinning structural elements.

The revenue mix

The revenue mix can be considered at several levels: the balance between the underlying sources of government revenue; the balance between taxes faced by individuals; and the balance of approaches taken to raising revenue.

The short-term balance between government revenue from the three tax bases – labour, capital and consumption – is sensitive to economic conditions and government policy decisions. There has been a marked change in the balance of taxes from labour to capital since 2000-01. It is unclear how this balance will be influenced over the long-term by pressures such as the ageing of the population. However, it is possible there will be a continuation of existing pressures on capital and labour taxes as a revenue source, suggesting an increased reliance on consumption taxes.

The relative taxation of the return to work compared with the return to saving can affect individuals' choices about working, saving and consuming. These choices can have important implications for the efficiency and equity of the tax-transfer system. There are strong and conflicting views about the relative reliance on these bases.

Alternative arrangements, such as user charges, have the potential to play an important role in improving efficiency through the pricing of public resources and to provide an alternative source of revenue to more conventional taxes.

Consultation questions

- Q3.1 What problems, if any, are generated by the overall mix of taxes in Australia on business and labour income, consumption, transactions and assets, and what changes, if any, should be made?
- Q3.2 Does Australia's tax system penalise (or favour) the returns to savings relative to other activities and should this lead to changes in the structure of taxes and means tests?
- Q3.3 Does Australia's tax-transfer system appropriately deal with property and wealth, or should new approaches be introduced? What, if any, implications would any changes have for the taxation (or means testing) of capital income flowing from property and wealth?
- Q3.4 Assuming no increase in the rate or base of the GST, what principles should guide the future development of other consumption taxes in Australia, and is there a need to change the role and structure of such taxes?
- Q3.5 Could greater application of user charges, rather than general taxes, in the funding of government services or infrastructure bring social, environmental or economic benefits?

Personal tax and transfers

The personal income tax and transfer systems have far-reaching implications for the wellbeing of Australians and their choices to work, save and acquire skills.

Tax and transfer policies involve trade-offs between the adequacy of payment rates, incentives to work, and the complexity individuals and families face. Higher payment rates can lessen individuals' incentives to work and to invest in skills. The application of means tests for transfers leads to a more targeted but more complex system. Most critically, incremental reforms generally involve a trade-off between equity objectives on the one hand and efficiency and simplicity on the other.

With the ageing of the population and increasing global competitiveness, the structure and settings of the tax-transfer system and resulting incentives are key components in meeting these challenges.

Reforms which reduce complexity and deliver adequate incentives will improve resource allocation, productivity and participation. However, there are significant tensions between such objectives, and with targeting, equity and fiscal sustainability.

Consultation questions

- Q4.1 How might the personal tax system be changed to better achieve the goals of greater simplicity, transparency, equity and efficiency?
- Q4.2 What is the appropriate distribution of income tax across income levels and how should it differ from the current distribution? Should governments seek to maintain

- a similar distribution over time, or should they fix the value of current tax thresholds through indexation?
- Q4.3 Is the personal income tax base appropriately defined? Should reforms such as changes to the scope of deductions or other measures be considered?
- Q4.4 Should the tax treatment of transfer payments be reconsidered? Should transfer payments be taxed at the same rate or a lower rate than earned income?
- Q4.5 Should people in different circumstances be taxed differently (for example, by age, occupation, location), and what might be the implications of such arrangements? Are tax offsets the best way to achieve differential taxation?
- Q4.6 How can fringe benefits tax be simplified while maintaining tax integrity? Would it be better to adopt the general OECD practice of taxing fringe benefits in the hands of employees, rather than employers?
- Q4.7 Are the current categorical distinctions for income support, including rates of payment and income tests, still relevant? If not, would other categories be better? What goals or principles should guide categorical distinctions and associated payment rates?
- Q4.8 What priority should be given to the different objectives associated with family assistance, such as poverty alleviation, recognising the social value of child rearing, facilitating workforce participation of parents, and early childhood education? Would it be better to provide less family assistance to higher income earners?
- Q4.9 What are the key factors that should affect rates of transfer payments? What should be the relative importance of duration on income support, costs of work and job search, costs of children, value of home production and the level of the federal minimum wage?
- Q4.10 Should transfer payments have a common benchmark? If so, should it be a proportion of a wage measure, and if so, which one? Or is there a better benchmark? Should there be a common indexation arrangement?
- Q4.11 Should payments for retired people remain linked to payments for people of working age?
- Q4.12 In a targeted system there is a trade-off between the level of income support and workforce incentives. Given this, what priority should be given to reducing the disincentives to work?
- Q4.13 What structure of income tests and taxes would best support the increasing diversity of work and the need to increase workforce participation, and where should improved incentives be targeted?
- Q4.14 Does the tax-transfer system create disincentives for individuals seeking to acquire new skills or upgrade existing skills? If so, what sort of tax or transfer changes would provide better incentives?

- Q4.15 Given the competing demands of targeting assistance to people when they need it and minimising unnecessary transactions, what changes could be made to existing tax and transfer policies?
- Q4.16 Should the different bases of assessment for tax and transfers be reconsidered (including the unit of assessment, income definitions, period of assessment and assets treatment)?

The retirement income system

Australia has a three pillar retirement income system:

- a government provided Age Pension;
- compulsory savings enforced through the superannuation guarantee system (SG); and
- voluntary savings (both through superannuation and other sources).

The Age Pension provides a guaranteed income based on means, while the income generated from the second and third pillars depends on the amount invested and returns on these investments.

The retirement income system has developed over time. The SG pillar will not mature until 2037 when employees retire after a full working life (35 years) of compulsory superannuation contributions of 9 per cent.

Submissions to the Panel support the structure of the retirement income system. Common themes in the submissions concern the current rate of the SG and the level of concessions provided to encourage additional saving. Other themes relate to how the system should deal with individuals outliving their savings and the way the system treats individuals with different circumstances.

Key considerations about the retirement income system are whether it is broad and adequate, acceptable, robust, simple and approachable, and sustainable.

Another aspect to be considered is the role of the retirement income system in providing health and aged care services.

Consultation questions

- Q5.1 In considering the future of Australia's retirement income system, which objectives are relevant in setting retirement income policy? Does the current system of the Age Pension and compulsory and voluntary savings meet these objectives? If not, how should the system be changed to meet these objectives?
- Q5.2 As the SG system matures, it will become a greater part of an employee's retirement income. What are the implications for individuals partially or fully excluded from the mature SG system (the self-employed, individuals with broken work patterns such as carers, women and migrants), and how can the retirement income system best accommodate these groups?

- Q5.3 Noting that the adequacy of the Age Pension is being considered by the Pension Review, what is an appropriate concept of adequacy for the retirement income system? Should it be to ensure there is a minimum level of income in retirement, to replace a proportion of income earned prior to retirement, or some other alternative?
- Q5.4 What should the role of the government be in assisting individuals to meet their retirement income expectations in relation to the support provided by the Age Pension, the level of compulsory savings and incentives to make additional savings? Should the role of government change as an individual's income increases over their working life?
- Q5.5 Do the settings of the retirement income system, such as the level of SG and access to concessions, adequately consider the needs and preferences of individuals both before and after retirement?
- Q5.6 Is the current level of superannuation income tax concessions appropriate and sustainable into the future? Are the current concessions properly targeted and, if not, how should they be reformed?
- Q5.7 At what age should an individual be able to access their superannuation and at what age should they become eligible for the Age Pension?
- Q5.8 What is the role of individuals in dealing with investment and longevity risk in accumulating and drawing down their retirement income? Do financial markets provide the means to deal with these risks? If not, is there a role for government to address these shortcomings?
- Q5.9 In what ways does the retirement income system impose undue complexity and cost on retirees and workers? How could this complexity be reduced?
- Q5.10 The Age Pension serves two roles, as a safety-net for individuals who are unable to sufficiently save for their retirement and as an income supplement for many individuals who do save. What should be the role for the Age Pension and means testing in a future retirement income system and what impact does this have on its sustainability into the future?
- Q5.11 In what ways does retirement income policy affect workforce participation decisions and what, if any, changes might reduce disincentives to work? Does the sustainability and cost of the retirement income system affect the workforce decisions of younger generations of workers?
- Q5.12 What impact could financial intermediation have on the effectiveness of retirement income policy?
- Q5.13 The cost of providing health and aged care to older Australians is currently met by government through the health sector. Should retirement income policy take into account projected increases in health costs for older Australians? If so, what would be the most effective mechanism and how might the transition to such a system be achieved?

Taxing business and investment

The tax system needs to evolve to respond to the opportunities, as well as challenges, arising from globalisation. Attracting investment to Australia, directed to activities with the greatest national return, will improve the returns to Australians from working and saving.

An internationally competitive business environment is necessary to attract investment and international businesses, consistent with an objective of increasing national income.

Achieving an internationally competitive business environment depends, in part, on getting the right balance of tax bases and rates.

The quality of investment is equally important. Improving the allocation of resources and investments, not discouraging risk taking, and removing tax biases that negatively affect business and household investment decisions, offers the potential to increase productivity and Australia's long-term prospects for economic growth.

Consultation questions

- Q6.1 Can the tax system be structured to better attract investment to Australia in a way that increases national income, and if so how? For any given revenue outcome, what are the relative merits of broader base/lower rate (comprehensive income tax) or narrower base/higher rate (a narrow income tax or an expenditure tax) approaches?
- Q6.2 What changes, if any, to the tax system would improve the ability of Australian companies to operate internationally orientated businesses? How should the tax treatment of companies and shareholders be integrated in an open economy?
- Q6.3 Can the tax system be restructured to improve resource allocation within the economy and minimise operating costs, and if so, how? What changes would reduce distortions to risk taking and encourage entrepreneurial activity?
- Q6.4 What principal goals should inform the taxation of capital gains in Australia, and what, if any, changes should be made to capital gains tax as a result?
- Q6.5 Should the tax system provide a more neutral treatment of different financing arrangements (debt, equity and retained earnings), and if so, how? What principles should inform approaches to entity taxation?
- Q6.6 Should the tax system be structured to cater for the specific circumstances of small business, and if so, how?
- Q6.7 Should the tax system be restructured to deliver a more neutral tax treatment for the different forms of return on household savings and investments, and if so, how?

Not-for-profit organisations

Not-for-profit (NFP) organisations perform a valuable role in Australian society. They are eligible for a range of tax concessions and receive direct government funding in support of their philanthropic and community-based activities.

The tax concessions for the NFP sector are complex and applied unevenly.

Gifts are an important source of funding for NFP organisations. The current gift deductibility arrangements impose compliance costs on individuals and provide higher income donors with a greater taxation benefit than lower income donors.

Consultation questions

- Q7.1 What is the appropriate tax treatment for NFP organisations, including compliance obligations?
- Q7.2 Given the impact of the tax concessions for NFP organisations on competition, compliance costs and equity, would alternative arrangements (such as the provision of direct funding) be a more efficient way of assisting these organisations to further their philanthropic and community-based activities?

Complexity — cost, risk and transparency

The tax-transfer system is very complex. To a degree this reflects the reality of the modern world. Some complexity is unavoidable in a system that also has equity and efficiency objectives. However, complexity adds cost and risk to day-to-day business and personal activities. It affects the choices individuals make to work, save and consume. The time and resources individuals and businesses spend understanding and complying with the tax-transfer system could be devoted to more productive or satisfying activities. Complexity also makes the system more costly to administer. These costs impact on Australia's international competitiveness and the efficient allocation of society's resources.

Complexity also reduces transparency — that is, the extent to which people understand how the system works and what it is trying to achieve. This can impact on people's attitudes to the system, including its perceived legitimacy and people's willingness to voluntarily comply.

Sources of complexity include the large number of taxes and transfers, detailed rules associated with each, the interaction between them, different jurisdictions applying similar taxes or transfers in different ways, and the way taxes and transfers are administered.

Accordingly, reducing complexity may demand: reconsideration of the range of complex policies and objectives embodied in the system; integration and streamlining its currently fragmented administration; and greater certainty, transparency and public engagement in the overall management of the system.

Consultation questions

- Q8.1 Which taxes or transfers are the most complex and impose the greatest costs? How should these costs be reduced (by abolishing the taxes or transfers or by making the rules applying to them simpler)?
- Q8.2 In what ways might the administration of Australia's tax-transfer system be changed to better meet the needs of individuals and businesses? How might the process of personal income tax returns be simplified, including by removing the requirement for some taxpayers to lodge returns? Should the administration of the system be more integrated (across taxes and transfers and between jurisdictions)? How might advances in technology assist?

- Q8.3 To what extent might policy objectives be traded off to achieve a simpler system? In what areas should efficiency, equity or choice be traded off for simplicity?
- Q8.4 How could the governance of the tax-transfer system be reformed to reduce complexity, uncertainty and cost, and to improve transparency, understanding and support for the system?

State and local taxes and transfers

A well functioning federal tax-transfer system is necessary if Australia is to meet the challenges of the coming century and make the most of future opportunities. Through a lack of coordination in policy and administration, the federation's tax-transfer system has become disjointed and complex, imposing unnecessary costs on all Australians.

Reforms which enhance the accountabilities, integration and efficiency of the federation's tax-transfer system can improve the functioning of the federation by reducing costs, removing complexity and improving resource allocation.

There are many issues that need to be taken into account when considering possible reforms to the way the tax-transfer system operates across the federation. Central to this is the trade-off that may occur in relation to the accountability (and other benefits) of State governments for raising their own revenue and the complexity and efficiency of the federal system. In addition, having different transfer policies in different States as well as multiple administering agencies for both taxes and transfers is a source of further complexity and possible inequities.

Consultation questions

- Q9.1 Noting the overall structure of Australia's federal financial arrangements, what changes, if any, should be made to the assignment of revenue raising powers and intergovernmental transfers in Australia?
- Q9.2 Given the widely held view in submissions that the current state tax arrangements need to be reformed, what changes should be made to state and local government own source revenue instruments? What scope is there for greater use of user charging to bring social, environmental or economic benefits?
- Q9.3 What is the appropriate allocation of the roles of the Australian and state governments in income redistribution?
- Q9.4 What opportunities could be pursued to deliver more seamless administrative arrangements of the tax-transfer system across the federation?

Tax and transfer impacts on housing

Housing plays an integral role in Australian society. It provides a source of shelter and a base for people to participate in communities and the workforce. It is the largest store of the nation's wealth and a major source of retirement savings for home-owners.

The tax-transfer system affects the housing market through a range of taxes, concessions and transfers, which in some cases are targeted at certain housing tenures or income levels. These

aspects of the system influence the type of homes people live in, the way they save and invest, including for their retirement, and the affordability of housing. Through its treatment of housing, the tax-transfer system also delivers significant assistance to particular groups of Australians, which affects the overall equity of the tax-transfer system.

Consultation questions

- Q10.1 What should be the objective of the tax-transfer system in respect of housing? Should there be assistance for housing over other assets or services? Should assistance be based on housing tenures? Should assistance be focused on people on low incomes? Should assistance differ between public and private tenants?
- Q10.2 What role, if any, should the tax-transfer system play in respect of housing affordability? Should the tax-transfer system be used to influence housing supply and/or demand to improve housing affordability? What changes, if any, should be made to housing-related transfers that assist disadvantaged households to find housing?
- Q10.3 Recognising the influence that some taxes and transfers have on the use of housing and residential land, what changes, if any, should be made to ensure the housing stock and residential land are used efficiently?

Taxes on specific goods and services

In addition to the broad-based GST, there is also a range of consumption or other indirect taxes levied on narrow bases, including excise collected by the Australian Government and other taxes collected by the States. Products subject to these narrow base taxes, are taxed relatively more heavily than other consumption goods.

The decision whether to tax some consumption goods more highly than others, and the optimal design of a particular tax, depend on the policy objective it is trying to achieve.

The current tax arrangements for beer, wine, spirits, tobacco and luxury cars reflect a range of competing policy goals. They exist in the context of other forms of regulation and the broader tax-transfer system.

Consultation questions

- Q11.1 Is it appropriate to use taxes on specific goods or services to influence individual consumption choices, and if so, what principles can be applied in designing the structure and rates of such taxes?
- Q11.2 Can the competing potential objectives of alcohol taxation, including revenue raising, health policy and industry assistance, be resolved? What does this mean for the decision to tax alcohol more than other commodities?
- Q11.3 What is the appropriate specific goal of taxing tobacco? Is it necessary to change the structure or rate of tobacco taxes?

- Q11.4 If health and other social costs represent the principal rationale for specific taxes on alcohol and tobacco, is any purpose served in retaining duty free concessions for passenger importation of these items?
- Q11.5 Are taxes on specific 'luxury' goods an effective way of making the tax system more progressive? If so, what principles should apply to the design and coverage of these taxes?
- Q11.6 Should the tax system have a role in influencing the relative prices of different types of cars, including luxury cars and higher polluting cars, and if so, on what basis? What does this mean for taxes on the purchase price of motor vehicles?

Fuel, roads and transport

The efficient movement of people and goods is an important contributor to productivity and wellbeing. Improving the structure of taxes and charges related to transport can improve efficiency.

Taxes on motor vehicle fuels provide a considerable share of revenue, but contribute little to reducing the location and time specific costs of motoring. Different tax treatments of alternative fuels may also further reduce the efficiency of fuel taxes. Different types of transport are also taxed in different ways, potentially altering economic behaviour.

There may be opportunities to replace existing taxes with more targeted taxes and charges that promote the efficient use of transport networks. In particular, emerging technologies may have a role in targeting the social costs of motoring such as air pollution, greenhouse gas emissions and damage to publicly funded roads.

Consultation questions

- Q12.1 How can motor vehicle related taxes and road funding arrangements be designed to improve the efficiency of transport of people and goods in Australia?
- Q12.2 What should be the role, if any, of fuel taxes? What does this mean for how fuels and their uses are taxed and the rates of tax applied?
- Q12.3 Do the existing tax arrangements lead people to make economically inefficient transport choices, and if so, how might they be improved?

Tax-transfer impacts on the environment

Australia faces significant environmental challenges in the 21st century, ranging from global issues, such as climate change, to local issues, such as water scarcity, land degradation and species loss. Economic development must be undertaken in an environmentally sustainable way, while also recognising that the environment itself has value.

Taxes may provide one means of improving environmental amenity. The tax-transfer system can also detract from environmental outcomes through the incentives it creates. Such incentives need to be carefully evaluated against other policy objectives.

Consultation questions

- Q13.1 Bearing in mind that tax is one of several possible instruments that can address environmental externalities, what opportunities exist to use specific environmental taxes to address Australia's environmental challenges?
- Q13.2 Noting that many submissions raise concerns over unintended environmental consequences of taxes and transfers, such as the fringe benefits tax concession for cars, are there features of the tax-transfer system which encourage poor environmental outcomes and how might such outcomes be addressed?
- Q13.3 Given the environmental challenges confronting Australian society, are there opportunities to shape tax-transfer policies which do not currently affect the environment in ways which could deliver better environmental outcomes?

Natural resource charging

Natural resources are an essential input to Australia's productive capacity. The way in which Australia uses its natural resources is an important determinant of the level of economic growth. It also affects the environment now and into the future.

Ensuring the community obtains maximum value from the appropriate use of its natural resources is an important part of an efficient tax system. The tax system can influence the rate at which resources are extracted and the capacity of future generations to enjoy the benefits of natural resources. Issues which need to be taken into account in considering the taxation of natural resources include the size of the recoverable stock of the resource and how quickly (if at all) it is able to renew, the effect of taxes on investment decisions, which level of government taxes the resource, and the alternative uses of resources outside commodity markets.

Consultation questions

- Q14.1 When considering the appropriate return to the Australian community for the use of its non-renewable resources, what relative weight should be given to the determinants of that return?
- Q14.2 What is the most appropriate method of charging for Australia's non-renewable resources, given they are immobile but that Australia needs to compete globally for mining investment?
- Q14.3 What is the role of the tax system in ensuring that renewable resources are used both sustainably and efficiently?

Introduction

In August 2008, the Panel invited submissions to the Review, guided by four broad consultation questions.

- Q1. What major challenges facing Australia need to be addressed through the tax-transfer system?
- Q2. What features should the system have in order to respond to these challenges?
- Q3. What are the problems with the current system?
- Q4. What reforms do we need to address these problems?

The Panel welcomes the considerable response to its initial call for community views. The Panel has received around 500 formal submissions from a wide cross-section of the community and a further 260 pieces of correspondence. Formal submissions to the review are available on the review website (www.taxreview.treasury.gov.au).

In August 2008, the Australian Treasury released a background paper – *Architecture of Australia's tax and transfer system (Architecture paper)* – and the Department of Families, Housing, Community Services and Indigenous Affairs (FaHCSIA) released the *Pension review background paper (Pension paper)*. Together with the public submissions, these papers provide an important part of the platform for the review.

In this paper, the Panel outlines the feedback to its consultation questions and provides information intended to help evaluate the views expressed. The Panel then asks a series of further questions intended to guide its forthcoming consultations and its thinking about the fundamental design features that Australia's future tax system might embody. These questions are deliberately open and are provided for general guidance only.

Section 1 discusses the key themes emerging from submissions within the context of the Panel's first two consultation questions. Sections 2 to 14 discuss more specific aspects of the tax-transfer system, presenting submission responses to the third and fourth of the Panel's questions.

The presentation of community views in this paper is intended to be a synthesis of the key messages that have emerged from the initial consultation process, rather than a listing of every issue raised. The issues the Panel has identified for further consultation are not exhaustive and are not intended to limit discussion.

The Panel has highlighted issues it considers to be central to the design of the tax-transfer system including:

- the mix of taxes through which revenue is raised;
- the fundamental structure of the tax, transfer and retirement income systems;

- the way individuals interact with the tax-transfer system; and
- the structure of taxation in our federation.

Scope of the review

Consistent with the 'root and branch' description of this review, the Panel's objective is to identify how the tax-transfer system should look at a structural level.

Consistent with its terms of reference, the Panel is taking a whole-of-system approach to examining the structure of the tax-transfer system. This approach encompasses the policy framework, the administrative structure and the policy and administrative processes that determine the structure and performance of the tax-transfer system.

In accordance with its terms of reference, the review will reflect the Government's policy not to increase the rate or broaden the base of the GST and to preserve the tax-free status of superannuation payments for the over 60s. The Panel notes the announcement in the *2008-09 Mid-Year Economic and Fiscal Outlook* that Government consideration of the previously announced aspirational personal income tax goals has been deferred until overall economic conditions improve (Australian Government 2008c).

It is not practicable for the review to encompass every aspect of public policy and administration relating to the tax-transfer system. For example:

- although several taxes are designed to meet industry policy objectives (for example, agricultural levies and customs tariffs) the Panel is not proposing to undertake a comprehensive review of the industry policies relating to those measures;
- although taxes form a central part of fiscal policy, the Panel is not reviewing fiscal policy itself (such as appropriate goals for fiscal balances);
- although taxes are implemented through laws, the Panel is not undertaking a review of the drafting of legislative instruments;
- although issues of federal fiscal relations are an important part of the terms of reference, the Panel considers matters relating to the roles of different levels of government, the quantum of intergovernmental transfers and horizontal fiscal equalisation to be beyond its scope;
- although a range of issues relating to tax policy formulation and administration are clearly and necessarily within the scope of the Review, the Panel does not anticipate undertaking a detailed and comprehensive review of all matters that relate to government policy and administration (for example, staffing and remuneration policies); and
- although in-kind benefits such as health and education services, and child support obligations, are important in determining the support available to individuals and families, they are beyond the scope of this review.

A framework for reviewing Australia's tax-transfer system

A key starting point for the Panel is to understand the challenges, opportunities and other 'drivers' expected to bear upon the tax-transfer system over the next few decades and the design outcomes for the tax-transfer system that are likely to best position Australia to achieve society's aspirations. Drawing on both the terms of reference and views in submissions, the Panel has identified seven key issues. They are:

- the type of society in which Australians might choose to live, including considerations about the role and size of government in Australia;
- increasing globalisation and the changing pattern of world economic activity;
- demographic change, including changing patterns of workforce participation;
- climate change, the environment and sustainable economic growth;
- intergovernmental relationships within the Australian federation;
- the process of policy formation and its administration; and
- the role of technological progress.

Any decision to change the tax-transfer system and how the changes could be made should be the outcome of a disciplined approach involving, where possible, evidence demonstrating the pros and cons of alternative tax-transfer design options and evaluation against a consistent set of principles. These principles are discussed in Section 1 and can be broadly categorised as equity, efficiency, simplicity, sustainability (including revenue adequacy), and policy consistency.

These principles may at times be in conflict. Inevitably, it will be necessary to make judgments about balancing different principles (where they conflict) and, in some cases, about the weight to be given to evidence where it is incomplete. The Panel recognises that not everyone will make the same judgments when faced with these conflicts and uncertainties. The Panel will strive to be open and explicit where judgments are made.

Bridging the gap between the current and desired tax-transfer structure will involve a transition path and, given the complexity of the existing system, transitional issues will require careful consideration. Decisions about the reform process will also need to take into account the balance between the short-term costs of change and the long-term benefits of reform, the distributional implications and revenue feasibility of reform, and potential macroeconomic implications.

The challenges, opportunities and principles outlined in Section 1, together with the considerations about the reform process, form a framework through which to identify desired outcomes and preferred transition paths.

A consultative process

Community participation is a vital part of a review of this scale. Based on the submissions already received, it is evident that many people support a comprehensive examination of the structure of the system from a long term perspective.

This paper will form the basis for the Panel's consultations with the community over the next 12 months. There will be many opportunities for people to participate in the review.

Any interested party can make a general submission to the review at any time up to Friday 1 May 2009. The Panel may also release more targeted discussion papers and call for submissions on specific topics during the remainder of the review period.

The Panel will host a series of public meetings in all capital cities and major regional centres from March 2009. We also plan to conduct bilateral and roundtable discussions with key industry and community groups between January and June 2009.

Recognising the significant social, environmental and economic challenges that Australia faces, and the need to consider international, theoretical and practitioner perspectives, the Panel will host a two day tax policy conference in June 2009. The conference will provide the opportunity for leading international experts, the academic and practitioner community, and industry and community organisations to share commissioned research, and discuss potential features of the tax-transfer system and their implications.

More detailed information on the consultation process will be posted to the review's website at www.taxreview.treasury.gov.au as it becomes available.

Improving the evidence base

While there is a large body of academic literature, both Australian and international, focused on tax policy issues, the scope of the review means that there are a number of issues where the available evidence is insufficient to allow the Panel to draw firm conclusions. To help remedy this situation and better inform debate, the Panel is commissioning a series of analytical papers to explore significant tax and transfer policy issues. It is envisaged that most of this work will be completed between March and June 2009. Some may be presented at the Review's tax and transfer policy conference scheduled for mid-2009. A list of the commissioned work and a brief summary of each item is at Appendix D.

1 Challenges and opportunities for reform

The Panel's four consultation questions from August were intended to elicit community perspectives about the way in which Australia's tax-transfer system should be structured. The first two questions focus on how to better position Australia to respond to developments over the next few decades, while the second two questions focus on problems evident in the existing arrangements.

Future developments are likely to have wide ranging effects on tax-transfer policy choices. This section provides an overview of these issues. The questions were:

- Q1. What major challenges facing Australia need to be addressed through the tax-transfer system?
- Q2. What features should the system have in order to respond to these challenges?

The key themes from submissions in response to these questions are presented in this section as part of a broader discussion of the influences that are relevant to the design of Australia's future tax-transfer system.

1.1 Challenges and opportunities facing Australia and what they mean for the tax-transfer system

Policy choices arising from this review will influence the shape of Australia's tax-transfer system for many years into the future. Accordingly, appreciating the factors that might shape Australian society over at least the next few decades is important when considering how Australia's tax-transfer system might be structured.

The terms of reference set an objective for the review of creating a tax-transfer structure that will position Australia to deal with its demographic, social, economic and environmental challenges and enhance Australia's economic, social and environmental wellbeing (see Appendix A).

Submissions identify the following broad challenges and opportunities:

- the type of society in which Australians might choose to live, including considerations about the role and size of government in Australia;
- increasing globalisation and the changing pattern of world economic activity;
- demographic change, including changing patterns of workforce participation;
- climate change, the environment and sustainable economic growth;
- intergovernmental relationships within the Australian federation;
- the process of policy formation and its administration; and

- the role of technological progress.

Section 1.2 discusses submission responses relating to the Panel's second question about the features a future tax-transfer system might have to best respond to these challenges and opportunities.

What type of society do Australians want?

The tax-transfer system is a fundamental part of Australia's social and economic infrastructure. It will both shape, and be shaped by, the evolution of society more broadly.

Several submissions explicitly talk about the type of society in which Australians might aspire to live, while in others it is implicit in the identified challenges and desired features of the tax-transfer system.

Summary of key messages from submissions

Many submissions see a role for the tax-transfer system in fostering improved living standards through stronger economic growth, as well as promoting opportunities for those experiencing entrenched disadvantage and transitioning from welfare. For example, one submission echoes the contributions of the 2020 Summit by setting an objective of Australia being the 'best place to live, work and do business with GDP per capita in the top five countries by 2012'.

Other submissions believe a fairer and more equal society is the main priority for reform of the tax-transfer system, with economic and market considerations supporting this goal. One submission along these lines states that the tax-transfer system should embody the values and expectations held by society and sets an objective of building 'a competent and compassionate Australia'.

Several submissions comment on the need to provide a more appropriate level of income support for the disadvantaged and facilitate transitions into employment and retirement.

Strengthening economic growth is the implicit starting point in many submissions. Equity is also seen as an explicit part of the design framework, along with maximising efficiency and minimising complexity.

A number of submissions see a general need to shift to a more environmentally sustainable society, while many others emphasise various environmental goals.

One of the inputs to the Australian Government's decision to establish the review was the report of the 2020 Summit, held in April 2008. The summit report illustrates how reform of the tax-transfer system can fit into a broader perspective on the future of Australia. It emphasises that taxation is one of many government functions that impact on the economy and can be considered alongside Australia's regulatory regimes and direct economic interventions by government.

The summit report saw the role of government as one means of '[creating] a truly national, efficient, sustainable and inclusive economy supported by seamless regulation.'

As noted above, many submissions are explicitly or implicitly framed by an objective of increasing economic growth. Economic growth is a key factor influencing the wellbeing of Australians, through its impact on incomes and living standards.

The *2007 Intergenerational Report* (Australian Government 2007) projects that, on the basis of established demographic and economic trends, Australia's rate of per capita economic growth will average around 1.6 per cent over the next 40 years, compared with a rate of 2.1 per cent over the past 40 years, due primarily to a decline in the proportion of the population of working age.

The tax-transfer system can have an important influence on the rate of economic growth. The system impacts on economic decision making, particularly on decisions about workforce participation and decisions that affect productivity, as well as through the economic costs of administration, compliance, avoidance, complexity and uncertainty.

Improving the efficiency of the tax-transfer system could help to ease the projected expenditure burden of our ageing population on working-age Australians.

The appropriateness of the existing income support arrangements is considered in Section 4. The adequacy of pensions and issues surrounding the transition to retirement are the subject of the separate Pension Review and retirement incomes consultation process due to report in early 2009.

The size of government in Australia

The size of government in Australia, including the transfer system, determines how much revenue the tax system needs to raise. It has implications for the way the system is designed and how it affects the community. The terms of reference require the review not to presume a smaller general government sector or a sustained increase in the tax to GDP ratio relative to its level in 2007-08. However, revenue neutrality will not be a rigid constraint on the Panel's recommendations for tax-transfer reform.

Most submissions do not comment on the size of government or the level of tax or total revenue as a proportion of GDP. Those that do, express differing views about the size of government. A range of submissions note the need for some revenue flexibility to avoid ruling out potentially important reforms with significant revenue implications.

Summary of key messages from submissions

Several submissions from community groups say the existing level of tax revenue is inadequate to fund Australia's social programs and economic infrastructure needs. One states that tax reform should strengthen, not diminish, future revenue to equitably support the costs of our ageing population and necessary investment in economic and social infrastructure.

Business submissions generally express or imply a view that the overall tax burden is too high and government spending should be reduced, noting all taxes impose costs to economic efficiency.

A number of business submissions argue that unilateral reductions in taxes on capital will provide a stronger economy and a lower per capita tax burden.

At around 31 per cent of GDP, Australia's tax to GDP ratio is reasonably typical of developed countries, though there is a considerable range across developed and developing countries.

A key issue for the review is how the role and size of government in Australia might change in the future. One possibility is that Australia could pursue a strategy of maintaining the size of government but with a higher rate of economic growth than government expenditure. This would allow some reduction in tax rates without reducing the absolute size of government. Whether this is possible in the face of strongly growing demands on government — particularly demands generated by demographic change — is difficult to say. On the other hand, Australians may choose to have a larger government sector as real incomes increase.

Consultation questions

- Q1.1 In considering the community's aspirations for the type of society that Australia should become over the next two decades and beyond, which key features should inform or drive the future design of the Australian tax-transfer system?
- Q1.2 Assuming that the absolute size of government will not fall, should (and can) Australia nonetheless aim to reduce the burden of taxation over time by promoting faster economic growth than public spending growth? Can it be demonstrated that alternative tax policies could help deliver that outcome?

Increasing globalisation and changing world economic activity

Australia is a small, open economy operating in an increasingly globalised world with freer flows of ideas, investment and labour. Increasing globalisation, particularly among more developed economies means social systems and economic infrastructure are becoming more uniform and tax settings may become relatively more important in decisions about where to invest and work.

The current crisis in financial markets shows the extent to which world economic systems are interlinked. It also shows the need for policy flexibility in responding to developments overseas.

The shifting pattern of world economic growth is also important. China and India now account for around 15 per cent of world GDP. The growth of these two economies has been a major factor in the strength in Australia's terms of trade recently, through mineral and agricultural commodity prices. Despite the current economic difficulties, these economies, and others in our region, are likely to continue to be an important influence on Australia's future prospects.

Globalisation and tax competitiveness

Many submissions, particularly those from business groups, identify global competition as a key challenge for Australia and a key determinant of tax-transfer design. This is particularly important for taxing investment income, especially corporate income, because investment can be switched with relative ease between alternative activities and locations and because profit can be shifted between jurisdictions. There are also concerns about the need to have personal taxes that competitively attract and retain skilled workers and promote entrepreneurial activity.

Summary of key messages from submissions

Several submissions point to the role of investment and cross-border capital flows in promoting economic growth and the living standards of Australians.

Global integration is generally seen as desirable. Several submissions highlight the need to foster entrepreneurship, new business activity and diversity in markets.

A key theme of business submissions is the need to promote increased tax competitiveness for the business sector. Reducing the corporate tax rate is seen as a key reform. Submissions cite the steady decline in OECD company tax rates in arguing for an Australian company rate of 25 per cent, with further reductions over the medium term. Business submissions also point to a range of other (base narrowing) reforms to promote tax competitiveness.

However, not all business groups support lowering the company tax rate in the near term. At least one would like to see the top personal rate aligned with the existing company rate rather than a reduction in the company rate.

Non-business organisations contest claims about the need to cut the rate of tax on capital income to maintain competitiveness. Equity considerations are seen to be more important, in one case reflecting a view that any benefit from cutting tax on capital income will go to shareholders only.

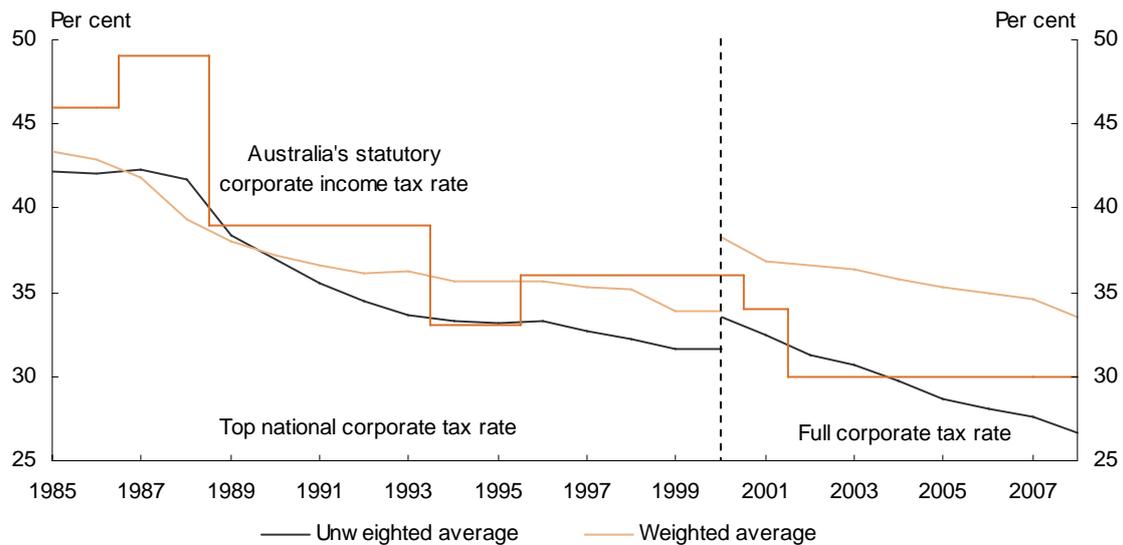
The need to attain an appropriately skilled workforce and the mobility of skilled labour is mentioned in several submissions, but does not feature as prominently as the taxing of capital income in terms of international tax competitiveness.

Several submissions refer to the recent instability in global financial markets, arguing that tax settings should be flexible enough to accommodate changing circumstances in international and domestic markets.

Taxation of capital income

A focal point of business concerns about taxation of investment income is Australia's 30 per cent corporate tax rate. Many submissions point to Australia's declining ranking relative to other OECD countries. The unweighted average company tax rate among OECD countries is steadily declining at a rate of about one percentage point per year, with a smaller decline in the GDP weighted average rate (Chart 1.1). Since 2001, when Australia's company rate was reduced to 30 per cent, Australia's company tax rate has moved from ninth lowest in the OECD to twenty-second lowest on 1 April 2008 (KPMG 2008).

Chart 1.1: Statutory company income tax rates of OECD countries (1985 to 2008)



Note: Rates are top national statutory company tax rates until 2000 (they exclude local and state company taxes imposed in some countries) and full company tax rates thereafter (they include company taxes from all levels of government). Averages are both GDP weighted and unweighted.

Source: Australian Treasury estimates; OECD Tax Database; KPMG (various years); Deloitte (2006); national governments.

To date, much of the impact of reducing company tax rates on revenue in OECD countries has been offset by legislative and economic broadening of the corporate tax base, though overall effective tax rates have declined. The company income tax rates of smaller economies have declined to a lower level than those of the major economies.

The scope for further base broadening is, arguably, now more limited among many OECD countries. This means that revenue and other constraints may weigh more heavily on decisions about company tax rates. However, the trend toward lower company tax rates may continue as countries compete to attract mobile capital and highly profitable firms.

Other submissions point to Australia's relatively high reliance on tax revenues from capital income, of which corporate tax revenue is a primary contributor, and Australia's high corporate tax to GDP ratio relative to other OECD countries. Section 3 examines this issue, noting that recent high corporate tax revenues are mainly due to strong growth in the corporate tax base.

One reason for the differences of view in submissions about the importance of reducing corporate tax is that they reflect different assumptions about who bears the economic burden of taxes on capital income. However, as discussed in Section 6, while shareholders may benefit from a reduction in company tax in the short term, it is likely that in the long-term,

labour will receive at least part of the benefit in the form of higher wages. This is due to increased investment, and a larger capital stock, leading to higher labour productivity.

In particular, increased foreign direct investment can lead to higher labour productivity. This happens through improvements in the way labour and capital are used through the introduction of new production techniques, knowledge, products, organisational synergies and process technologies. These can generate ‘spillover’ benefits for the rest of the economy, thereby increasing economic growth.

Labour mobility

Several submissions also highlight the increasing international mobility of individuals, particularly of more highly skilled individuals. Tight labour market conditions in recent years have led to high demand for skilled workers across a broad range of occupational groups. Permanent and temporary skilled migration has responded to this demand. The inflow of skilled workers has generally exceeded the outflow of skilled workers in recent years. While there will be strong cyclical elements in the demand for skilled labour, population ageing in Australia and many other countries could lead to increased international competition for skilled labour.

Electronic commerce

A further dimension of globalisation that receives relatively little attention in submissions is the evolution of the internet and e-commerce. This has reduced the connection between a person’s residence and their place of business and the consumption of some goods and services, such as those available over the internet. These developments represent a potential challenge to taxing some commercial activities and private consumption.

The changing pattern of world economic growth

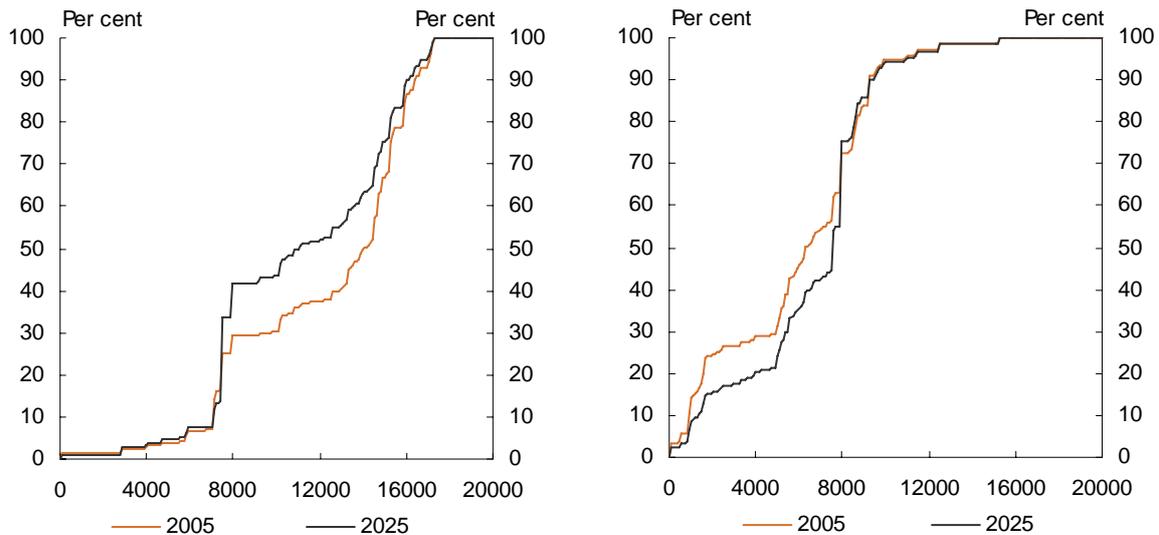
If the economies of China and India follow similar growth paths to those of the newly industrialised Asian economies, the pattern of world GDP will be substantially altered over the next few decades (Chart 1.2). While this will not substantially improve Australia’s economic isolation in an absolute sense, as the distances from Australia’s main capital cities to these locations are considerable, a relative improvement in Australia’s trade competitiveness, compared with many other OECD countries, may result in an increasing share of Australian trade in the Asian region.

Summary of key messages from submissions

A number of submissions see sustained economic growth in China and India – and other developing countries more generally – as an opportunity for Australia’s resource industries.

Other business submissions anticipate that as these countries accumulate human capital and sophisticated economic infrastructure, they will begin to compete with Australia for internationally mobile capital.

Chart 1.2: Distance in kilometres to world GDP (2005 and 2025)
Australia United Kingdom



Note: The chart shows the percentage of world GDP generated in countries within the distances in kilometres from each of Australia and the United Kingdom respectively.
Source: The Conference Board and Groningen Growth and Development Centre Total Economy Database, January (2008); Australian Treasury estimates.

The implications of an absolute and relative increase in economic activity in the Asian region are uncertain but could be significant for Australia, as has been the case with the rise in commodity prices in recent years. Possible implications of the projected growth in these economies include increased: competition for internationally mobile investment; employment opportunities for skilled Australians; and opportunities for two-way trade in commodity, product and service industries.

Demographic change in Australia

The *2007 Intergenerational Report* (Australian Government 2007) highlights the profound demographic changes Australia is likely to experience over the period to 2047. Australia's total population is projected to increase by close to 40 per cent, from 20.6 million in 2006 to 28.5 million people. Under the report's assumptions, migration is projected to account for around half of this increase.

The projected ageing of Australia's population is particularly significant, with a quarter of the population expected to be aged 65 years or over by 2047, almost double that of today. The fastest rate of population growth is projected to be among Australians aged 85 years or over. By 2047 there will be only 2.4 people of traditional working age (16 to 64 years) supporting each person aged 65 years or older, down from five working-age people in 2007. The increase in age dependency is only slightly offset by a projected reduction in child dependency.

The proportion of the population of traditional working age is projected to decline by around 8 percentage points, to less than 60 per cent of the population. Within the group of Australians of traditional working age, the fastest growing group will be 55 to 64 year olds, rising by nearly 50 per cent over the next 40 years.

The ageing of the population is projected to slow economic growth and lead to increased spending in areas such as health, age pensions, and aged care.

Many submissions recognise the significance of this demographic change. There is also an awareness that the higher the growth in real incomes for the population, the lower the proportion of income that will need to be taken in tax to provide government services to older Australians.

Summary of key messages from submissions

Many submissions identify an ageing population as a key challenge facing Australia. Many recognise the role that higher rates of workforce participation and economic productivity can play in reducing the impacts of an ageing population on the working population.

Income adequacy in retirement and its potential implications for government spending is identified as a key issue. A range of submissions say current policy does not ensure adequate incomes in retirement, with a particular focus on the adequacy of the 9 per cent superannuation guarantee and its scope.

Several submissions from the financial industry point to the prospect of increasing life expectancy and argue that greater reliance on income stream products will be required to address the income risks surrounding increasing longevity.

Given the significance of the tax-transfer system, both as a mechanism for funding government spending and a conduit for much demographically dependent spending, the efficient design of the system will be a critical element of Australia's response to its demographic challenge.

The design of the tax-transfer system can either contribute to, or hinder, Australia's economic performance over the next few decades. Minimising the effect of the tax-transfer system on individuals' incentives to work and on the productive use of our scarce resources can help sustain our economic growth. Similarly, tax-transfer policy has the potential to significantly affect the delivery and cost of achieving intended social policy outcomes.

The demographic challenges faced by Australia are also faced by many other OECD countries, as well as China and India. Australia has some advantages over many other countries in dealing with these challenges. For example, Australia's strong fiscal stance has enabled the elimination of government net debt and the accumulation of reserves to assist in meeting some of the anticipated future costs of our ageing population. However, the scale of the demographic challenge will require further major adjustments in Australia.

A changing pattern of workforce engagement

Changes in the structure of the Australian economy, following a long period of economic reform, and changing patterns of engagement in the workforce have resulted in structural changes to the labour market. In particular, we have seen: a fall in the predominance of male full-time jobs; an increase in female participation; and an increase in the number of older workers. Life-time work careers are also changing. More young, single people have

short-term jobs and the increased workforce participation of women has increased their average job durations.

These changes have resulted in a more flexible labour market. But they have also increased the complexity in individuals' lives as they balance work with education, caring responsibilities and preparation for retirement.

Submissions note the need for the tax-transfer system to support both increased workforce participation and higher rates of skills formation.

Summary of key messages from submissions

A range of submissions argue that the tax-transfer system should do more to promote workforce participation and be better adapted to the greater diversity of working patterns.

Several submissions propose introducing tax-advantaged saving accounts to provide for education and lifelong learning.

The tax-transfer system can affect incentives to work and invest in education and training. For example, for welfare recipients, the combination of high rates of benefit withdrawal and marginal tax rates can reduce the incentive for them to find a job. It can also influence decisions about investing in education and skills formation. In addition to their impact on investment decisions, the treatment of superannuation income and the application of income tests and assets tests to the pension incomes of older Australians influence the workforce decisions they make in their transition to, and during, retirement.

Environmental sustainability

The environment is of value to Australians. It also provides natural resources essential to Australia's productive capacity, and ecosystems that absorb and assimilate the waste generated by people and industry. While it may be possible to extract higher levels of economic growth in the short term at the cost of a degraded environment, over the long term these choices may not be sustainable. Economic growth is strongly linked to environmental sustainability.

A broad range of submissions identify climate change as an important challenge facing the Australian community. Business submissions express concern about the potential impact of the tax arrangements associated with the Carbon Pollution Reduction Scheme.

Some submissions address the broader issue of environmental sustainability.

Summary of key messages from submissions

An important theme in submissions from environmental groups is that, given its central importance to economic decision making, the tax-transfer system needs to be consistent with achieving sustainable economic growth. Some submissions see sustainable growth as requiring reductions in net consumption and the production of wastes.

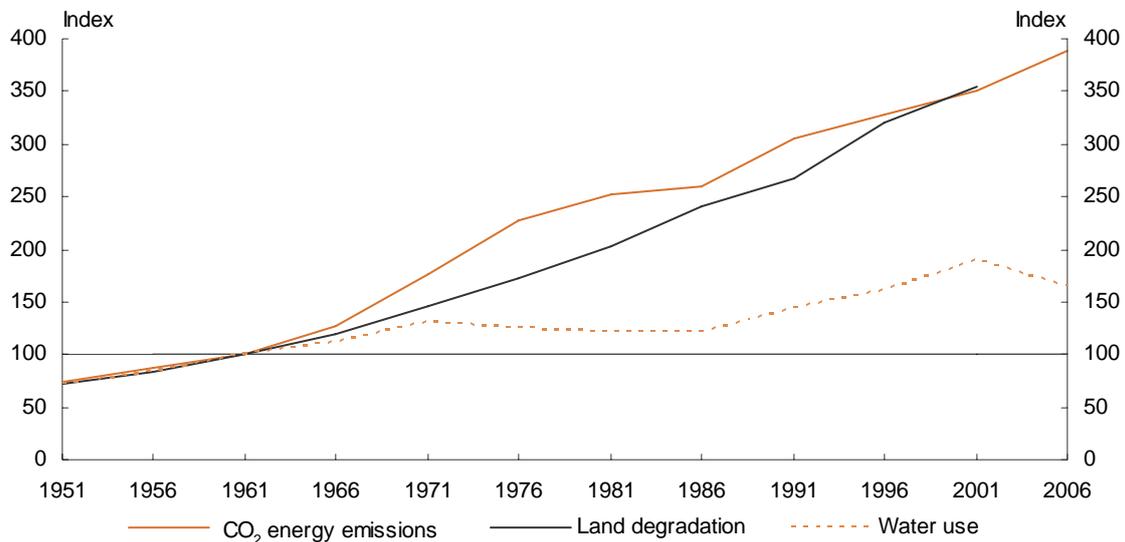
Many submissions argue that tax-transfer settings should be consistent with the objective of reducing carbon emissions. The potential costs of environmental protection are also a focus of attention, with a number of submissions arguing taxes relating to the Carbon Pollution Reduction Scheme should be designed to minimise the costs imposed on business.

Submissions propose a range of tax concessions aimed at enhancing the development and adoption of carbon-reducing technology. Some suggest that environmental taxes and charges provide a potentially significant alternative revenue source to conventional taxes.

Another theme in submissions is concern for the urban environment of our cities, including road congestion and air pollution, and whether these problems are exacerbated by a privileged tax treatment of motor vehicles.

Within the community and government, there is increasing awareness of the importance of Australia's natural environment and the environmental pressures emerging in areas such as land degradation, soil erosion and salinity, water use and climate change (Chart 1.3).

Chart 1.3: Indicators of Australian environmental pressures
1951-2006 (Index 1961 = 100)



Source: Commonwealth Scientific and Industrial Research Organisation, Australian Stocks and Flows Framework (unpublished); ABS (2004), ABS (2006d) and Australian Greenhouse Office (2006).

A greater understanding of environmental problems, arising from improved knowledge of environmental systems and their interactions, has led to a greater capacity to address environmental problems. As people's incomes and wealth have increased so too has their demand for environmental action. These factors will be an ongoing (and possibly greater) influence in the future.

Sustainable policy addresses the underlying incentives causing environmental degradation. Historically, governments have relied on regulation to achieve environmental outcomes. However, in some circumstances, corrective taxes, user charges and other market-based approaches provide alternative mechanisms for addressing environmental amenity.

Emerging technology may enhance the capacity to use these mechanisms. For example, it can enable direct charging for congestion and noise pollution from road transport (see Section 12).

Improving the Australian federation

A well functioning system of government can enhance economic performance and the broader wellbeing of Australians. There is general agreement, both within government and in the broader community, that the effectiveness of government in Australia could be enhanced. Improving the effectiveness of government has been a focus of the Council of Australian Governments in recent years.

The tax-transfer system spans the three levels of government, in terms of both the revenue raising and transfer functions. There is currently a relatively low degree of policy integration across levels of government and between the States. In recent years there have been repeated calls to improve the structure of the tax-transfer system of the federation. Reflecting the cost on business from differing regimes, the States have been working to harmonise payroll tax arrangements (other than rates and thresholds).

Improving federal fiscal relations and the federal structure of the tax-transfer system are seen as key issues for this review. There is broad consensus across submissions that the structure of taxation, and to a lesser extent transfers, needs to be improved. These concerns arise in respect of both the underlying structure of the tax-transfer system and its administration.

Summary of key messages from submissions

Submissions call for federal funding arrangements that adequately recognise the responsibilities of each level of government, including local government. There is an imbalance between the amount of revenue that state governments raise and the amount they spend. The revenue powers and expenditure responsibilities of government need to be addressed to make them more transparent. These submissions also call for more revenue certainty for each level of government.

Some submissions argue that federal arrangements should be designed in such a way as to create incentives for States to improve efficiency in tax collection and service delivery.

While there is a range of views about the merits of specific state taxes, a common theme is that many of the states' taxes need to be abolished or reformed.

Some submissions call for a single Australian government tax collection agency, in place of the nine existing tax administrations, to reduce administration and compliance costs.

Some submissions note the interactions between transfers provided by the Australian government and state and local government concessions, as well as the implications that these may have for reforms.

Section 2 provides an overview of the federal structure of the tax-transfer system. The issues arising from this structure and from the broader financial relationship between governments in Australia are discussed in Section 9.

Improving policy formation and administration

A key message in the *Architecture paper* and the *Pension paper* is that our tax-transfer system is very complex and imposes high costs on the community. This is highlighted by the number of taxes and transfers, the lack of coordination and harmonisation across jurisdictions of essentially similar taxes and transfers, and the complexity in the administration of the tax-transfer system.

The existing tax-transfer system is largely a product of Australia's history. However, it also reflects an incremental approach to policy development based on partial assessments of trade-offs between complexity, efficiency and equity, often made with limited information. This incremental approach has reduced policy coherence, with costs to both equity and efficiency. It has also contributed to higher levels of complexity and operating costs in the tax-transfer system.

Submissions reflect a general concern about the process of policy development and the ongoing maintenance of the tax system. Fewer concerns were expressed in respect of the transfer system.

Summary of key messages from submissions

A common theme in submissions is the need for the tax policy process to be more open and transparent, particularly around the trade-offs between efficiency, equity and simplicity. In expressing these views, submissions welcome the recent government announcement to engage with the private sector earlier in the policy and legislative design process.

Several submissions from peak organisations comment that there is a 'governance gap' in the tax system. The concerns underlying these comments vary across submissions and include limitations on competitiveness, opportunities for tax minimisation, missed technological opportunities and policy inconsistency. However, there is a degree of consensus that there should be a regular review process to complement less frequent tax reform exercises. Some submissions specify that an independent oversighting body should be established to undertake this review process.

Some submissions point to the need to build a stronger culture of tax compliance. A regular process of review and repair, aimed at addressing tax minimisation strategies that undermine the integrity of the tax system, would be an important step in this process.

Submissions from larger businesses express some concern about the negative impact on business decisions of changes in the interpretation of the law and delays in processing requests for rulings. Representatives of small business note that engagement with the Australian Taxation Office has improved over recent years.

An important design challenge is to lessen the influences that gradually erode the benefits of reform. To an extent these influences are cultural and difficult to change. A more coherent policy framework, enhanced governance arrangements and increased community awareness about the costs and benefits of alternative tax-transfer settings may assist.

The *Architecture paper* drew attention to several areas where knowledge is deficient, including the incidence and efficiency impacts of individual taxes and transfers and their operating costs. Addressing these information gaps is a major task and will take some time. To initiate this process the Panel is commissioning research into the efficiency and operating costs of Australia's tax-transfer system.

The role of technology

Advances in technology have had a profound impact on the way we live. Over the past 50 years, technological improvements have dramatically increased the productive capacity of the economy – in particular through the evolution of computer technology. Technological progress is accelerating as our ability to assimilate and build upon information improves.

Summary of key messages from submissions

A range of submissions identify investment in technology as an important part of Australia's future growth. Several mention that global integration and technological advances will be key factors affecting Australia's international competitiveness.

A range of submissions call for incentives for innovation and research and development.

A number of submissions state that technology should be used as a means to reduce compliance costs for individuals and business.

Submissions also note the important relationship between technology and the environment. One submission mentions that it will play a particularly important role in the future of transport and alternative energy.

One submission claims that technology is changing the nature of work, allowing greater flexibility in how and where work is performed and by whom.

In a competitive global environment, technology creates opportunities and challenges for our society. Our standard of living is determined as much by relative changes in our productive capacity as it is by absolute changes. The tax-transfer system can influence the rate of technological progress by affecting the incentives for entrepreneurs to be creative and the incentives to invest in research and development or to adopt new technology.

Emerging technology has the potential to redefine the way we design and administer the tax-transfer system, both in terms of feasibility and operating costs. For example, new technologies such as 'etag' and the global positioning system allow more economically efficient direct charging for road use. Improved information technology enables administrators and clients to process tax and transfer information more efficiently, potentially reducing administration and compliance costs. The evolution of tax software to assist small businesses, electronic filing and pre-filing of individuals' tax returns illustrates how technology can change the way users interact with the system. The Government's Standard Business Reporting project aims to streamline interaction with government by allowing businesses to provide information through a single internet portal.

The extent to which technology can streamline community interaction with government is influenced, in part, by the design of the tax-transfer system. Taking full advantage of past and future technological developments may require a different perspective on the design and administration of the system.

1.2 Tax-transfer features to respond to these challenges and opportunities

Submissions identify a range of features that Australia's future tax-transfer system should have. These can be broadly categorised according to whether they represent the principles that might guide the design and operation of the tax-transfer system or the structural features that a well designed system might exhibit.

Design principles for the tax-transfer system

Design principles identified in submissions can be broadly categorised as equity, efficiency, simplicity, sustainability (including revenue adequacy) and policy consistency. Consistent themes emerging from submissions are that the tax-transfer system should be equitable, impose low costs on society in terms of economic efficiency and operating costs, provide sustainable revenue to fund government and be consistent with broader policy objectives, including environmental sustainability.

Summary of key messages from submissions

The traditional tax design principles of equity, efficiency and simplicity are endorsed in a broad range of submissions.

Several submissions place primary emphasis on the need for a fair tax-transfer system. Behind this view is a progressive tax-transfer system with minimal opportunity for higher income earners to minimise their tax obligations. There is also a view that the system needs to support those experiencing entrenched disadvantage and help them move on to better outcomes.

Submissions acknowledge that the tax-transfer system should be efficient. It should support economic growth through minimal impediments to investment, entrepreneurship, innovation and workforce participation.

There is wide recognition that complexity and operating costs should be minimised. Submissions note that the tax-transfer system should be transparent and provide certainty to taxpayers and transfer recipients. Some express concern about the current balance between operating costs and ensuring integrity in the system.

A range of submissions identify the need for the tax system to deliver adequate revenue in a sustainable manner. Some express a view that the tax system should deliver a stable revenue base by minimising reliance on more volatile taxes.

A related theme, motivated by the recent financial market instability, is that the tax-transfer system should support flexibility in the economy to respond to changing circumstances.

Business submissions highlight the need for tax-transfer policy settings to be internally consistent and consistent with broader policy objectives. Consistency with environmental objectives, particularly in relation to climate change, is identified in a range of submissions as an area of concern.

An equitable tax-transfer system

There is no generally accepted benchmark for measuring how equitable the tax-transfer system is, or the extent to which equity is altered under different policy designs. Such assessments depend on individuals' value judgments. A diversity of views is reflected in the different perspectives presented in submissions.

One perspective on equity in submissions is that all individuals should have the opportunity to participate in society and achieve the things they value. Tax-transfer settings that enable

people to escape poverty and improve their lifetime opportunities through education and workforce participation are consistent with this view of equity.

A more common perspective is that taxes should be levied according to individuals' or families' ability to pay, with those who are more capable of bearing the burden of taxes paying more. Implicit in submissions is a general view that individuals or families with the same capacity should face the same tax burden. There is less agreement about the degree to which those with greater capacity should pay more, as reflected in different statements about whether the tax system is currently, or should be, progressive, proportional or regressive. There is also less agreement about exactly what 'capacity to pay' means. That is, whether it should include all income, treated on a consistent basis regardless of how it is derived, the significance of family circumstances, the role of assets, including owner-occupied housing, and choices about work and leisure.

In some cases the different perspectives about the merits of alternative policies reflect differences of view about who bears the burden of a tax, or benefits from a transfer. For example, the different perspectives about whether taxes on capital should be reduced, in part, reflect differences of view about whether the economic burden of taxes on capital is borne by the owners of capital or by Australian workers through lower real wages. Some perspectives on transfers also reflect views about who enjoys the economic benefit of transfers, for example, the extent to which transfers to the aged benefit the aged themselves or are transferred to the next generation through larger bequests. Section 2.2 discusses the economic incidence of taxes and transfers.

The equity of the tax-transfer system can also be affected in several other ways.

- Equity is influenced by the level of compliance with tax and transfer obligations and the ability of individuals to avoid paying tax or receive increased transfers through income planning arrangements. Some submissions point to the existence of significant opportunities for high income earners to reduce their effective tax liability through tax concessions, such as the 50 per cent discount for capital gains and salary sacrifice arrangements for superannuation, and through tax planning arrangements.
- The impact of complexity in the tax-transfer system tends to be regressive, falling most heavily on those with the least capacity to deal with it and the least means to get professional help. These people may make less advantageous decisions or be unaware of the transfers to which they are entitled.
- The allocation of operating costs between the administration and individuals also influences the overall equity of the tax-transfer system. All taxpayers share the cost of tax administration but compliance costs are borne by individuals based on their circumstances and choices.

Other perspectives on equity are:

- the beneficiary principle, which states that people should pay tax broadly in accordance with the benefits they receive from government spending, regardless of their income. This principle provides a rationale for user charging and is described in Section 3.4;

- inter-temporal or period equity, which is concerned with how the tax-transfer system affects individuals over time, particularly their decisions about work, saving, family and education;
- intergenerational equity, which is concerned with how the wellbeing of individuals alive today compares with that of future generations; and
- spatial equity, which is concerned with how the tax-transfer system affects individuals in different geographic areas with similar consumption opportunities. The geographic distribution of the people is changing with the ageing of Australia's population.

The costs of the tax-transfer system

The costs imposed by the tax-transfer system include efficiency and operating costs (administration costs and compliance costs), as well as the broader costs on individuals and businesses resulting from uncertainty and complexity.

Unlike perspectives on equity, submissions are in broad agreement that the tax-transfer system should raise and redistribute revenue with the least possible cost to economic efficiency and with minimal operating costs. There is also agreement that the broader costs of complexity should be minimised.

All taxes and transfers affect the choices individuals and businesses make by altering incentives to work, save, invest or consume things that are of value to them. These changes in behaviour can ultimately leave the economy and society as a whole worse off than if the revenue were raised (or distributed) without affecting behaviour. The size of these efficiency costs varies across different taxes and transfers, reflecting, in part, the extent to which they affect behaviour. The resources devoted to tax-transfer administration and the time and resources that individuals and businesses devote to understanding and complying with the requirements of the system, are diverted from more productive or satisfying activities and therefore also represent a significant efficiency cost to the economy.

Complexity in the tax-transfer system makes it difficult for people to understand their obligations and entitlements. This increases the risk of non-compliance and can make it harder for individuals to make the most beneficial decisions. Complexity can also give rise to tax-transfer planning opportunities that divert resources from productive uses.

Together with instability in tax-transfer settings, complexity may also reduce economic efficiency by increasing the level of uncertainty about the expected payoffs to long-term investment decisions, such as: investment in education; retirement products; long-lived productive assets; or the choice of business structure. Submissions also express concern about uncertainty in the interpretation and administration of the law.

The existence of these costs does not automatically imply that taxing and spending by governments reduces GDP or social wellbeing. Provided the goods and services supplied by government are of sufficient value to society to offset these costs, the overall wellbeing of society is enhanced. However, the tax-transfer system should operate at the lowest cost to society for a given set of outcomes. There is a clear message from submissions that current costs are excessive and need to be reduced.

Sustainability

The Panel views the design principle of sustainability from three perspectives. First, environmental sustainability is of such importance to Australia's future that the Panel regards it as a principle against which the current system and potential reforms ought to be tested.

Second, the Panel regards institutional sustainability as important. This includes whether the legal and administrative frameworks are robust and whether community attitudes to the system maintain its legitimacy.

Third, several submissions point to the need for a tax system that meets the revenue needs of Australian, state and local governments without recourse to inefficient taxes. Others point to the need for policies that contribute to a fair and equitable society and are affordable over the longer term, in light of the demographic changes facing Australia.

The Panel notes that a principal objective of the tax system is to raise revenue to fund the government programs, including transfer payments that Australians want. Access to broad revenue bases such as household consumption or income (broadly defined) gives governments the capacity to meet their spending responsibilities by imposing relatively low rates of tax on a broad range of economic activities.

Since many government functions, such as infrastructure projects and major defence acquisitions, require large expenditures over many years, the tax system needs to provide governments with a stable revenue stream that allows them to meet their spending responsibilities consistently and reliably over time. If the revenue stream from the tax-transfer system is too volatile from year to year, long-term government planning can be jeopardised and borrowing costs may be higher, diverting revenue from more productive uses. Short-term fiscal pressures created by unanticipated shortfalls in revenue may also force governments to resort to easily accessible but inefficient means of raising revenue, imposing higher costs on the economy.

Revenue stability is not, however, a goal that could reasonably be pursued at any cost. Features of the tax-transfer system that function as automatic stabilisers – injecting resources into the private sector in macroeconomic downturns and withdrawing them in times of economic expansion – help smooth demand in the economy without requiring policy action by government. However, taxes and transfers with these features may be more appropriate for the Australian government than for state and local governments.

In some cases, there may be a trade-off between revenue stability and economic efficiency. For example, a resource rent tax is a more efficient revenue raising mechanism than a flat, production based royalty. However, it produces a more volatile revenue stream than the royalty because revenue collections from a rent tax are more closely related to volatile world commodity prices.

Policy consistency within and beyond the tax-transfer system

The issue of policy consistency is mentioned in a range of submissions. For example, the policy impact of climate change is a focal point for this issue in many submissions, while others comment in terms of how well the tax-transfer system integrates with broader

government policies and objectives and in terms of the settings within the tax-transfer system.

Internal consistency in policy settings within the tax-transfer system can help people to understand the system and may assist in reducing complexity and uncertainty for taxpayers and transfer recipients. This can reduce the costs of the system and also increase equity by improving levels of voluntary compliance. If taxpayers cannot understand the system, or if the system is clearly inconsistent in the way it treats different taxpayers, transactions or activities, then taxpayers are less likely to comply with their obligations.

Consistency with the broader policy objectives of government can further improve understanding and transparency. Tax-transfer policy should not directly contradict policy in other areas of government activity. The extent to which particular features of the tax-transfer system can be designed to pursue policy objectives other than raising revenue is a matter that must be considered case by case. In some instances, attempting to use the tax-transfer system to pursue other goals may jeopardise the system's revenue raising capacity or increase the efficiency costs of raising revenue. It will often be necessary to compare the costs and benefits of different tax and non-tax policies available to pursue a given policy objective.

Structural features

While there is general agreement about the design principles of a tax-transfer system, there is less consistency in terms of what they mean for its design and how apparent conflicts between these objectives should be reconciled. Some of the key structural views raised in submissions are presented below.

Summary of key messages from submissions

There are mixed perspectives on whether the tax and transfer functions should remain largely separate, reflecting different roles and objectives, or more fully integrated, in order to reduce complexity and disincentives for individuals and families.

There is some consensus about the need to improve administration of the system. While there is broad concern about federal fiscal arrangements there is less consensus about how the problems should be resolved.

Submissions point to the need for sustainable policies for an ageing population. Proposals include increases in the level of self-provision through an increase in the superannuation guarantee, broadening its application to currently uncovered groups and adopting measures to reduce income risk due to poor financial planning.

Many submissions call for a reduction in the effective rate of tax on companies, either through a reduction in the company tax rate or a narrowing of the corporate tax base. Other submissions consider this a second order priority or regard it as inappropriate on equity grounds.

A range of submissions highlight the distortions in the treatment of different forms of capital income. Many call for the rate of tax on interest income to be reduced to bring it closer into line with other forms of capital income. Some call for improved neutrality by removing the concessional treatment of capital gains.

Summary of key messages from submissions (continued)

There is some interest in alternative capital tax structures, such as an allowance for corporate equity, flow-through taxation and the dual income tax approach.

Reform of state taxation, both policy and administration, and improved federal fiscal arrangements are identified as key issues in many submissions. Reform proposals range from removing less efficient state taxes through to revenue sharing arrangements.

Several submissions call for policy settings that are consistent with achieving environmental sustainability.

These issues are discussed in the following sections.

2 The structure of the tax-transfer system

Overview

Australia's tax-transfer system spans three levels of government. In legal form it is comprised of the many different taxes and transfers designed and administered by government. It can be considered a single economic system that, through complex interactions between elements, impacts on a broad range of choices made by individuals and business. While the various elements affect economic decisions in similar ways, key differences exist between, and within, taxes and transfers in terms of their underlying structural elements.

2.1 The legal structure of the tax-transfer system

The *Architecture paper* provides a detailed description of Australia's tax-transfer system. Chart 2.1 provides a schematic representation of its major elements and the key linkages between them.

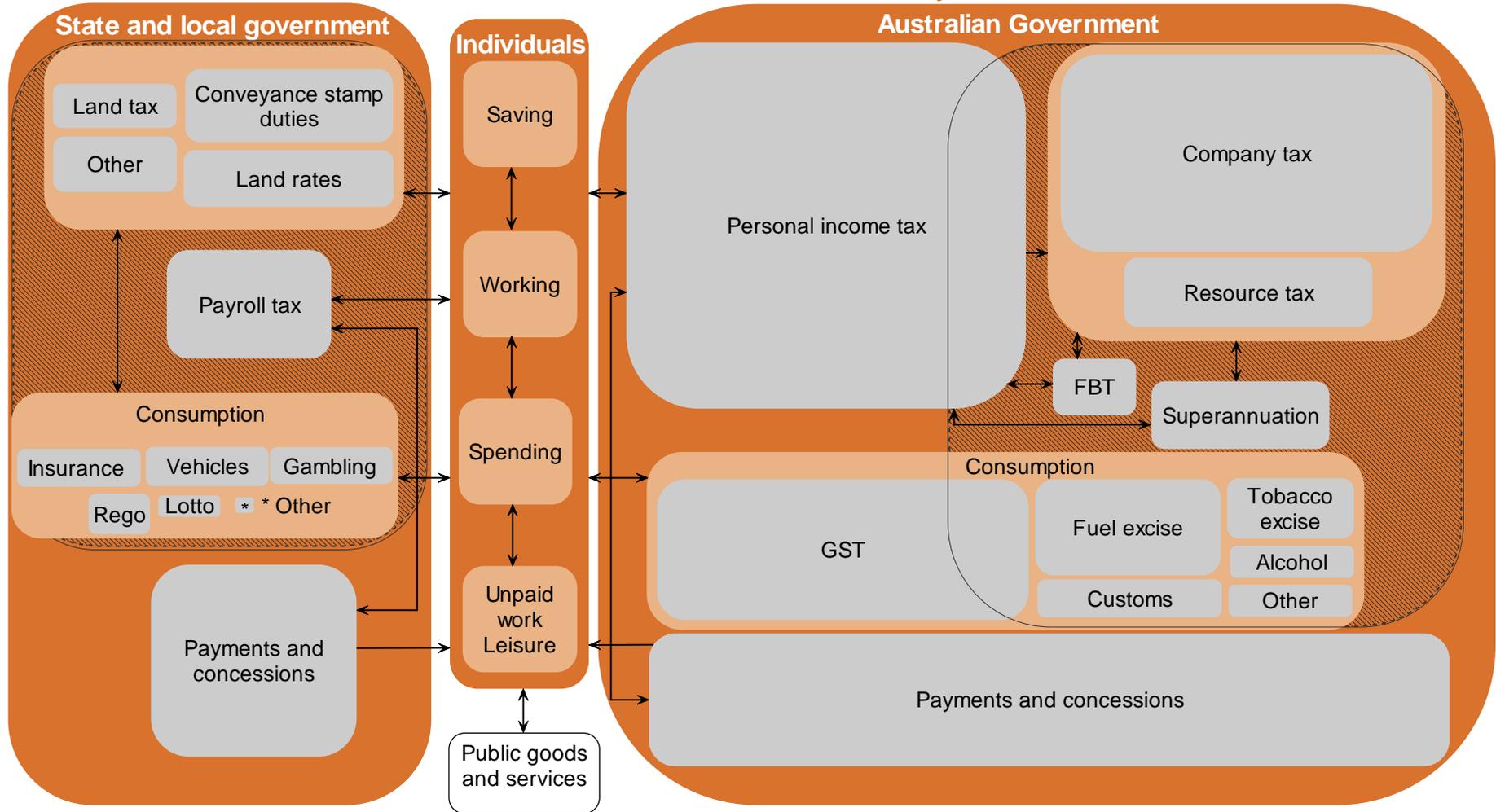
In Australia's federal system of government, taxes and transfers are administered by three levels of government. The Australian government's role is considerably larger than that of state and local governments. The types of taxes and transfers administered by each level of government differ, though there is considerable overlap in their roles and impacts.

Individuals interact directly with five elements of the Australian government tax-transfer system: personal income tax; family assistance; superannuation; taxes on goods and services; and income support payments and supplementary transfers (including cash payments and concessions). Through the personal income tax system, via dividend imputation, individuals also interact with company tax.

On the state and local government side, individuals interact with a more restricted transfer system and a range of indirect taxes and property taxes. They may also be indirectly affected by payroll tax via their employer.

The tax-transfer system not only impacts on individuals but also on business. Business remits most personal income tax to the Australian Taxation Office (ATO) through pay as you go (PAYG) withholding. Businesses may be required to pay fringe benefits tax (FBT) and make superannuation guarantee payments on behalf of their employees. Businesses also interact with the tax-transfer system in their own right – for example, through the company income tax system, the payment of payroll tax, GST, excise, various taxes on land, and a range of other taxes levied on business inputs (Chart 2.1). Businesses operating in more than one state, or nationally, interact with multiple Australian, State and local government tax systems.

Chart 2.1: Schema of the tax-transfer system



Legend

- Size of tax/transfer
- Grouping of tax/transfers
- Grouping of individual/system
- ▨ Interactions with Business
- Interactions not considered in diagram

2.2 The economic structure of the tax-transfer system

The separate Australian, state and local government systems are interlinked and can be thought of as one tax-transfer system with multiple components. At the core of the system are Australians who make choices about: investing in education; engaging in paid or unpaid work (such as family care responsibilities and home services); how much to spend and on what goods and services; and how much to save and allocate to alternative investments. The different elements can have similar economic effects, which combine to influence individuals' incentives and behaviour.

All taxes affect choices by encouraging individuals to shift from higher to lower taxed goods and services or activities, and by lowering their available purchasing power. Similarly, transfers can influence people's choices by increasing their available purchasing power and altering the relative price of particular goods or services. The *Architecture paper* captures this similarity in its reference to 'transfers act[ing] like reverse taxes'. The Panel's approach is to consider how the many elements of the tax and transfer systems combine to affect individuals' decisions.

In some cases, the income and relative price effects described above work in opposite directions, making it difficult to identify the net effect. For example, a higher tax on labour income may reduce a person's willingness to work (as the after-tax return from work is reduced) but also have an opposite incentive effect through the person's desire to make up the reduction in after-tax income caused by the tax increase.

Given the strong parallels between the impacts that taxes and transfers have on individuals' behaviour, it is important to apply a whole of system perspective when considering its implications for equity, efficiency and overall social wellbeing.

To illustrate this point, it is useful to consider how the tax-transfer system impacts on individuals' decisions about how much to work. In the absence of taxes and transfers, individuals make decisions to work and consume based on their preferences for leisure, home production, (see Box 2.1), volunteer work and income with which to purchase goods and services. Taxes reduce the income an individual derives from working and therefore can influence how much they work and how much time they spend on leisure or other private activities such as house repairs, housework and child care. The availability of transfers for people with low workforce connection might also reduce the attractiveness of being employed, resulting in an even lower level of workforce engagement.

Additional income may also reduce entitlements to other payments such as Rent Assistance, public housing subsidies, Child Care Benefit, the Education Tax Rebate and eligibility for other concessions, such as concession cards and in-kind benefits.

Box 2.1: Home production

Home production is the private production of goods and services within the household. This includes activities such as home repairs, washing, cleaning, other housework, and child care. It represents a sizeable part of the economy, although it is not included in measured GDP. The Australian Bureau of Statistics estimates that it was worth 40 per cent of GDP in 1997 (ABS 2001). The 2006 census found that 39 per cent of women contribute more than 15 hours of domestic work per week, while for men the figure is 13 per cent (ABS 2007a).

Since home production is untaxed¹, taxing paid employment can affect people's workforce participation choices. Within a household the tax-transfer system may influence the allocation of and specialisation in paid and unpaid work between members. Discussions about the equity of different taxation arrangements need to take into account the value of home production when considering household welfare.

1 Inputs to home production, such as electricity, are taxed through the GST, and homes cannot be depreciated for tax purposes, unlike work premises.

It is the interaction of these various elements of the tax-transfer system and people's awareness of them that influences behaviour. The complex interactions highlighted above are repeated throughout the tax-transfer system (Box 2.2 provides other examples). Understanding how they affect the economic decisions of individuals is challenging.

Box 2.2 Impacts of the tax-transfer system on decisions to save and consume

Several elements of the tax-transfer system interact simultaneously on decisions to save. In many cases, saving is likely to generate income that is taxed. Many forms of saving also affect transfer payments, through income and assets tests. Individuals are likely to consider the impact of savings, and the form of their savings, on tax liabilities and transfer entitlements as part of their savings decision.

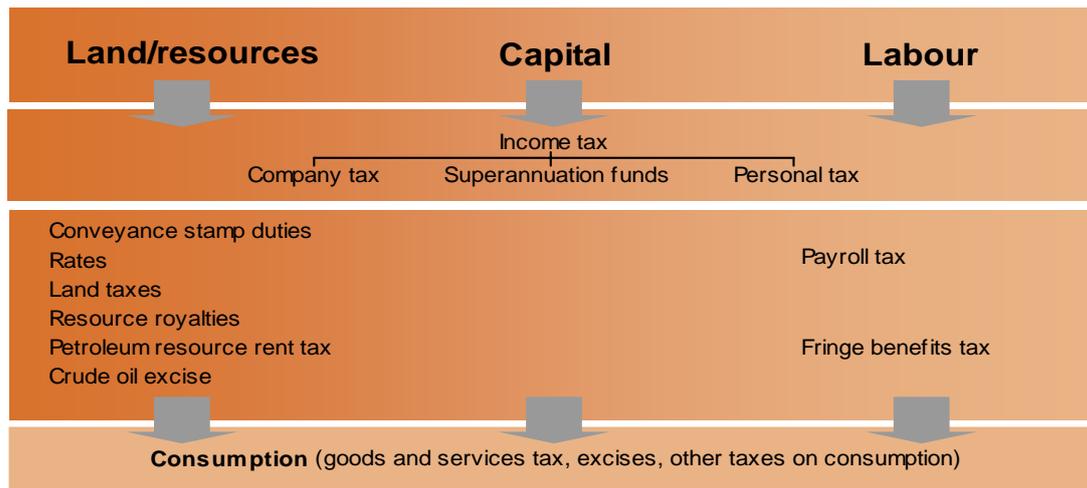
Decisions about consumption choices are also affected by the tax-transfer system in a number of ways. Different taxes are levied on different goods and services — for example, GST-free fresh foods and additional taxes on some goods such as alcohol and tobacco. Governments also provide a range of rebates, payments and concessions linked to particular items of consumption (such as private health insurance, education expenses, child care assistance, and transport and utilities) and provide a range of goods and services directly to individuals (such as education and health services).

The concept of a total effective tax rate provides a way of assessing the net financial impact of the system on the economic decisions of individuals. For example, in the above scenario the effective tax rate would, in principle, take into account the effect of the system on the return to the individual from working by including all taxes and reductions in transfer payments. In practice, such measures are more limited. They do not usually include all factors. Eligibility for rebates, concessions and in-kind benefits can be closely linked to individual circumstances, making them difficult to represent in a generalised measure.

Effective tax rates are often analysed on the basis of taxes levied directly or very closely on the individual. However, a much broader range of taxes can ultimately influence the returns

from working and other economic decisions of individuals. All Australian taxes are ultimately borne by individuals (resident or non-resident) on the earnings from the factors of production – labour, capital and land (including natural resources).¹ Taxes are levied either on the income derived from these factors or on the use of that income to consume goods and services. Individuals pay these taxes in a range of ways, including as consumers through higher prices, as employees through lower wages, or as shareholders or investors through lower profits. Chart 2.2 provides an overview of how some of the main Australian taxes relate to income derived from these factors of production.

Chart 2.2: Relationship between economic bases and taxes



It does not matter whether the taxes are levied on activities, entities, goods or transactions, all taxes are ultimately paid out of the incomes of individuals. Taxes can be shifted from one person to another through changes in the prices of inputs to the production process, the price of goods produced, or in the distribution of the returns to economic activity. The true burden of a tax is not its 'legal incidence' (the person who is required to pay the tax to the administering authority) but its 'economic incidence' (the person who ultimately bears the cost burden of the tax). The economic incidence of a tax is much less obvious than its legal incidence, but it is the economic incidence that is important when considering the efficiency and equity implications of the tax-transfer system.

Similarly, it can be difficult to determine who ultimately benefits from some forms of transfer payment. This is particularly the case for transfers delivered through markets or tied to the purchase of particular goods or services, such as child care subsidies, the private health insurance rebate and subsidies for renters in private housing. In these cases it can be unclear to what extent it is the individual or the provider who gains the benefit of the transfer. The Age Pension may be another example. Increases in Age Pension payments reduce the need for individuals to draw on their own savings to finance their retirement, which can result in them making larger bequests. Thus, the ultimate beneficiary may be the pensioner's descendants.

¹ The division of the factors of production into these three categories reflects both a traditional and very simplified approach. More complex divisions may be possible. For example, the returns to entrepreneurship and to education may embody elements of both capital and labour, as well as components that give rise to multifactor productivity. However, these more complex divisions are not necessary for the purposes of this section.

A system of two parts — taxes and transfers

Notwithstanding the integrated nature of the tax-transfer system in terms of the way it affects the economic behaviour of individuals, key differences exist between, and within, taxes and transfers in terms of their underlying structural elements. There are different definitions of income, assessment periods and treatments of assets. There are also different approaches in categorising individuals and units of assessment. Section 4 discusses the implications of these structural differences.

The definition of income

A range of approaches to defining income are applied within the tax-transfer system. This means different forms of income have different impacts on tax liabilities and transfer entitlements.

The general principle guiding the existing income definition for taxation is that the costs of producing income should not be included in the tax base. For example, work-related expenses and the costs of investment are excluded. Certain other amounts (such as contributions to charities) are also excluded, as are fringe benefits (which are largely taxed in the hands of the employer). However, certain taxes and liabilities (such as the Medicare levy surcharge and the Higher Education Loan Program) are based on a broader definition of income, which includes some types of exempt income (such as foreign income) and fringe benefits.

Income support payments (pensions and allowances) use an even broader definition of income. This definition includes a range of income types on a gross receipts basis. Income defined in this way is not reducible by losses and is only reducible by deductions in limited circumstances. Eligibility for certain other transfer payments is based on taxable income with adjustments to make it more comprehensive. These transfers include Family Tax Benefit, Child Care Benefit, the Child Care Tax Rebate and the Commonwealth Seniors Health Card.

The income assessment period

Taxes are generally assessed on annual income, though regular tax payments may be made throughout the year. For example, for most personal income taxpayers, employers withhold amounts on a regular basis through the year as part of PAYG withholding, and the individual's final liability is assessed after the end of the year.

Transfer payments have various assessment periods. The assessment and payment period for allowances is generally a fortnight. This is intended to make both the entitlement and the rate of payment responsive to changes in the individual's circumstances. For pension payments, unearned income is assessed annually, even though pensions are paid fortnightly. While earned income is annualised for Age pensioners, it is assessed fortnightly for other pension payments.

Eligibility for family assistance is assessed against annual income, although it is generally paid on a fortnightly or quarterly basis. Family assistance is, in effect, pre-paid during the year, with amounts reconciled after the end of the income year.

The treatment of income from assets and asset holdings

The tax and transfer systems have very different treatments of the income earned from assets. The personal income tax system includes earnings from capital as part of an individual's assessable income, and taxes capital gains upon disposal at half the rate applied to other income.

The definition of adjusted taxable income used for family assistance (and certain taxes) follows this treatment. In contrast, the concept of income that underpins entitlement to pensions and allowances includes actual earnings on non-financial assets, such as real estate (excluding net losses) and a deemed rate of earnings on financial assets.

While the personal tax system generally does not tax asset holdings, certain transfer payments are affected by the value of an individual's assets, other than their home, and those of their spouse. Assets over a certain threshold value reduce entitlements to income support. Recurrent taxes based on asset values are similar in effect to an income test with a deemed rate of return. Neither the value of a person's own home nor the value of the rental services derived from their home are assessed when determining taxes or transfers.

Categorical structures

The tax and transfer systems adopt different approaches to the categorisation of individuals.

The transfer system provides different income support payments for retired people, unemployed people, those with dependent children, those with other caring responsibilities, students, and people with disability who have little or no capacity to work. People demonstrate their membership of these categories in various ways, such as by fulfilling an age requirement, having an eligible disability, or by meeting an activity test relating to work, study or training.

Some commentators note that such an approach offers a way for governments to separate the population into groups and offer them different outcomes according to notions of who is most deserving or needy and how different groups are likely to respond to different incentive structures. However, categorical approaches create an incentive for individuals to try to change their category (Akerlof 1978, Moffit 2008). Family assistance is mostly provided to eligible families without reference to the way parents approach their role.

The tax system is less categorical. In general, individuals face the same requirements regardless of their activities or status. There are two key departures from this approach. One is age-based taxation – the effective impact of the senior Australians tax offset is to provide a higher tax-free threshold for those of Age Pension age. The second is through occupation and sector-specific benefits, such as income exemptions for certain defence force and foreign income, and through special FBT provisions for not-for-profit sector employees (see Section 7).

The unit for taxation and transfers

All transfer payments are assessed and paid on a couple or family basis. Income support payments take into account the income of a spouse or partner, while for Youth Allowance, parental income is taken into account. Family assistance is also based on couple income, but the number and age of children determines the level of payment. There is also consideration of child income. However, the way in which the couple's income is assessed varies. For

pensions and most family assistance payments, it is pooled for assessment purposes, while for allowances and Family Tax Benefit Part B, there is different treatment according to which partner receives the income.

The primary taxation unit is the individual, which is used for the assessment of personal tax. The individual's various sources of income are drawn together and taxed as one whole. Income from directly carrying on a business or through a partnership is included in the income of the individual.

Some minor elements of the tax system are based on couple or family units. In some cases, these entail pooling of income entitlements of a couple. This applies to the Medicare levy low income phase-in, the Medicare levy surcharge and the Education Tax Refund (through its link to Family Tax Benefit Part A). Other elements are calculated with separate reference to the incomes of both members of a couple (without pooling), as is the case with the dependent spouse rebate and the senior Australians tax offset.

Individuals may choose to conduct their affairs (business and investment) through trust arrangements. Trusts, especially discretionary trusts, provide opportunities to allocate income between different individuals. Many trusts are constructed around family relations, which can effectively give rise to a form of family-based taxation. A number of submissions express concern that people who can access this mechanism are able to minimise the tax payable on a given amount of income by allocating it to individuals with lower personal tax rates.

Individuals may also conduct their affairs through companies. Companies are taxed as a distinct entity. They file their own tax returns without reference to the financial position of their shareholders. Imputation, whereby individual shareholders receive credits for underlying Australian company tax paid on distributed dividends, creates a degree of integration with the individual unit for tax purposes. However, this integration is incomplete. For example, when companies retain rather than distribute earnings, those earnings are taxed at the company rate, rather than at the shareholder's tax rate. There are also differences in the treatment of some types of income or expense, such as capital gains and losses.

'Closely held' private companies can offer similar opportunities to trusts in achieving family-based taxation. This can arise where companies are owned by family members, pay wages to family members or allow family members to use company assets for private purposes.

Most individuals hold savings in superannuation funds. While these holdings are based on individual accounts, the taxation of these accounts is independent on the individual's circumstances. Earnings within an individual's superannuation account in a taxed fund are taxed at a flat rate of 15 per cent regardless of the income level of the individual. Some degree of integration occurs when funds are drawn before the age of 60 years or from untaxed funds after the age of 60 years.

Indexation

The tax and transfer systems use a range of different approaches to maintaining the value of rates and thresholds over time.

Personal income tax thresholds are not indexed. Instead, governments may counter the effects of inflation by taking specific decisions to provide tax cuts through a combination of changes to rates, changes to thresholds or adjustments to the low income tax offset. While the general rates and thresholds are not indexed, some components of the personal income tax system are indexed, either by wages or prices. For example, the dependency tax offset amounts are indexed by consumer price index (CPI) (provided this entails an increase); the superannuation co-contribution and spouse superannuation contributions offset are indexed by average weekly ordinary time earnings; while the senior Australians tax offset, the mature age worker tax offset (MAWTO) and the Medicare levy low income phase-in are not automatically indexed.

Most payment rates and thresholds within the transfer system are indexed, given its goal of responding to income needs. Pensions are indexed to a male total average weekly earnings (MTAWE) benchmark, ensuring they maintain their value relative to MTAWE over time. By contrast, allowances are indexed by CPI, ensuring they grow at the same rate as general prices. This distinction is resulting in an ever-widening gap between pension and allowance rates. Family assistance is indexed by CPI, with additional provision for increases in accordance with a MTAWE benchmark for the standard rates of Family Tax Benefit Part A. Supplementary payments are indexed by CPI.

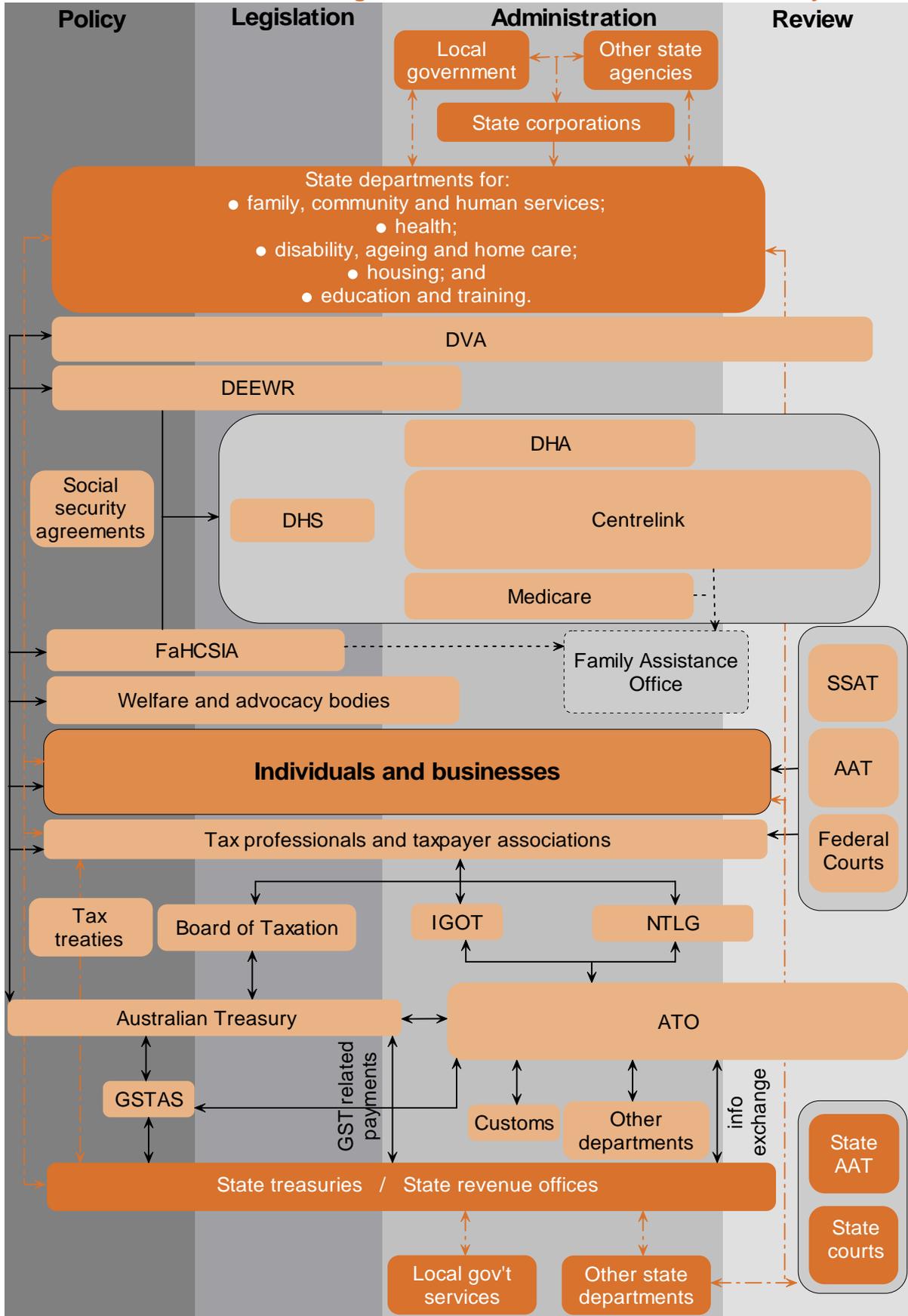
In addition to influencing the value of rates and thresholds over time, inflation influences the value of income generated by assets. Parts of the income generated by assets reflect compensation for inflation that occurs during the period the asset is held. No indexation is applied in calculating the measured income from assets in the tax-transfer system.

2.3 The administrative structure of the tax-transfer system

Chart 2.3 outlines the administrative framework of the tax-transfer system from a broad perspective that includes policy formation, implementation and the resolution of disputes between administering authorities and taxpayers/transfer recipients. Section 2.10 of the *Architecture paper* contains a detailed description of the administrative arrangements governing Australia's tax-transfer system.

The transfer system is reflected in the upper half of Chart 2.3, the tax system in the lower half. While represented as spatially separate, there are strong links between the tax and transfer components at the Australian government level. These links exist through the income tests that apply to transfers and because some transfers are delivered through the tax system. At the state level, there are also interdependencies between the tax and transfer systems, with both mechanisms being used to deliver assistance to target groups.

Chart 2.3: Administrative and governance framework of the tax-transfer system



——— Relationships with the Australian Government - - - - - Relationships with State governments
 Relationships with the Family Assistance Office

The state tax and transfer systems operate parallel to the Australian government systems, again with links between them. For example, some state transfers such as subsidies and concessions are linked to Australian government transfer policy through concession card arrangements. GST policy is coordinated through the GST Administration Sub-committee (GSTAS). The states also interact more broadly with the Australian Taxation Office (ATO) under information sharing agreements to ensure that consistent information is used across the Australian government and State tax systems.

Another important aspect of the administrative system, broadly defined, is the private sector industry devoted to compliance with tax and transfer law. A higher proportion of Australians use tax agents than in most other OECD countries. Two major studies of the cost of complying with the main Australian Government taxes, both conducted before the significant reforms contained in *The New Tax System* and the *Review of Business Taxation*, estimated total taxpayer compliance costs between 1.4 and 2.1 per cent of GDP (Evans et al 1997, Pope 1994).

3 The revenue mix

Overview

The revenue mix can be considered at several levels: the balance between the underlying sources of government revenue; the balance between taxes faced by individuals; and the balance of approaches taken to raising revenue.

The short-term balance between government revenue from the three tax bases – labour, capital and consumption – is sensitive to economic conditions and government policy decisions. There has been a marked change in the balance of taxes from labour to capital since 2000-01. It is unclear how this balance will be influenced over the long-term by pressures such as the ageing of the population. However, it is possible that there will be a continuation of existing pressures on capital and labour taxes as a revenue source, suggesting an increased reliance on consumption taxes.

The relative taxation of the returns to work compared with the returns to saving can affect individuals' choices about working, saving and consuming. These choices can have important implications for the efficiency and equity of the tax-transfer system. There are strong and conflicting views about the relative reliance on these bases.

Alternative arrangements, such as user charges, have the potential to play an important role in improving efficiency through the pricing of public resources and to provide an alternative source of revenue to more conventional taxes.

Consultation questions

- Q3.1 What problems, if any, are generated by the overall mix of taxes in Australia on business and labour income, consumption, transactions and assets, and what changes, if any, should be made?
- Q3.2 Does Australia's tax system penalise (or favour) the returns to savings relative to other activities and should this lead to changes in the structure of taxes and means tests?
- Q3.3 Does Australia's tax-transfer system appropriately deal with property and wealth, or should new approaches be introduced? What, if any, implications would any changes have for the taxation (or means testing) of capital income flowing from property and wealth?
- Q3.4 Assuming no increase in the rate or base of the GST, what principles should guide the future development of other consumption taxes in Australia, and is there a need to change the role and structure of such taxes?
- Q3.5 Could greater application of user charges, rather than general taxes, in the funding of government services or infrastructure bring social, environmental or economic benefits?

A key issue for tax design is the mix of revenue from taxes on labour income, capital income, consumption and accumulated wealth, taking into account interactions with the transfer system. Decisions about the mix of taxes need to reflect the way in which a particular combination will affect the choices that individuals make and their disposable incomes. This requires balancing the equity, efficiency, simplicity and sustainability implications inherent in using any particular tax base. In general, government seeks a mix that raises the required revenue in a sustainable manner while best meeting society's equity objectives at least cost to the economy.

The *Architecture paper* highlights that, as a share of total tax revenue, Australia has a relatively low reliance on tax revenue from labour income and consumption compared with other OECD countries, and a correspondingly high share of tax revenue derived from capital income (the highest in the OECD in 2005). It left open the question of whether Australia's high reliance on capital tax revenue is an issue in terms of Australia's ability to attract foreign investment and maintain economic growth.

The *Architecture paper* also noted that the findings of a recent OECD study (Johansson et al 2008) suggest that taxes on capital income are more likely to have a detrimental impact on growth than taxes on property, labour income or consumption.

Australia's relatively low reliance on taxes on labour income partly arises because Australia, unlike most OECD jurisdictions, does not levy social security contributions on wage and salary income. If the superannuation guarantee were treated as a social security contribution, for the purpose of this comparison, taxes on labour income in 2007-08 would have accounted for around 46 per cent of total tax revenue (compared to 39 per cent). The shares from capital and consumption would have been around 30 per cent and 24 per cent, respectively (compared to 34 per cent and 27 per cent). Even after making such an adjustment, Australia would still have a relatively high reliance on capital taxes and a relatively low reliance on labour taxes compared to other OECD countries.

This section further examines Australia's tax mix and discusses the appropriate balance of taxes on the returns to work and saving by Australian residents. It also discusses the taxation of consumption, including instances where particular types of consumption might receive a different tax treatment. Finally it considers the potential role for user charging and beneficiary taxation as a revenue source.

3.1 The mix of conventional taxes

Summary of key messages from submissions

A number of submissions argue for a reduction in taxes on income and an increase in taxes on consumption. Some submissions propose an increase in the rate of the GST, although they generally acknowledge that increasing the base or rate of the GST are outside the terms of reference of the review. However, some also oppose a shift toward taxes on consumption, or advocate reducing existing taxes on consumption, citing equity concerns.

Many submissions, mostly from business, call for a reduction in taxes on capital, particularly corporate taxes. Australia's relatively greater reliance on revenue from corporate taxes is seen as a key issue, with submissions highlighting concerns around capital mobility and international competitiveness.

Other submissions comment on the equity implications of the concessional treatment of some forms of capital income, noting that these arrangements tend to favour high income taxpayers.

Some submissions suggest more radical changes to the basis of tax, such as proposing a tax on financial transactions to fund reductions in taxes on income.

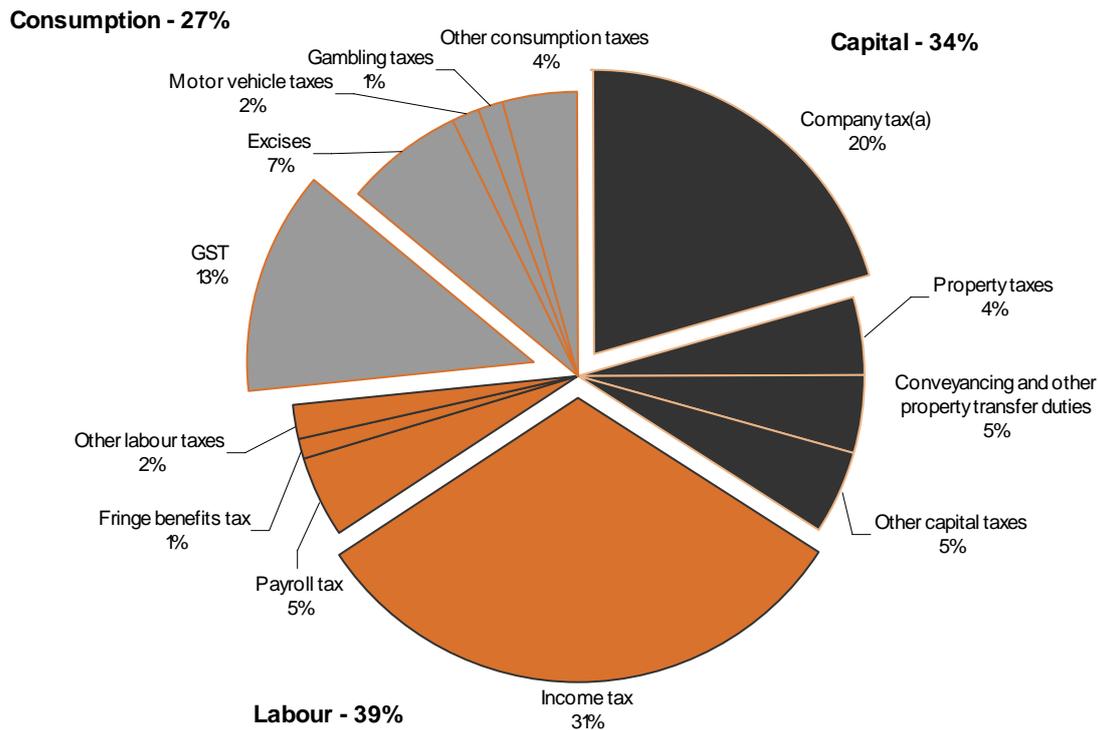
The composition of tax revenue in 2007-08

Chart 3.1 details the composition of Australia's tax revenue collected across all levels of government in 2007-08.

Taxes on labour provided an estimated 39 per cent of total tax revenue. The largest component, personal income tax on labour income, contributed around 31 per cent of total tax revenue. Payroll tax contributed 5 per cent of tax revenue, with a further 3 per cent arising from taxes on fringe benefits and superannuation contributions.

Taxes on capital accounted for around 34 per cent of total tax revenue, of which around 20 percentage points was from corporate tax (including petroleum resource rent tax, crude oil excise and taxes on the earnings of superannuation funds) and 9 percentage points was from annual taxes on real property and conveyancing and other stamp duties, in roughly equal proportions. Taxes on individuals' capital income, such as interest, net rental and business income, capital gains and dividends, and some state government taxes on financial and capital transactions accounted for the remaining 5 percentage points of capital tax revenue.

Chart 3.1: Contributions to Australia's tax mix
All Australian governments (2007-08)



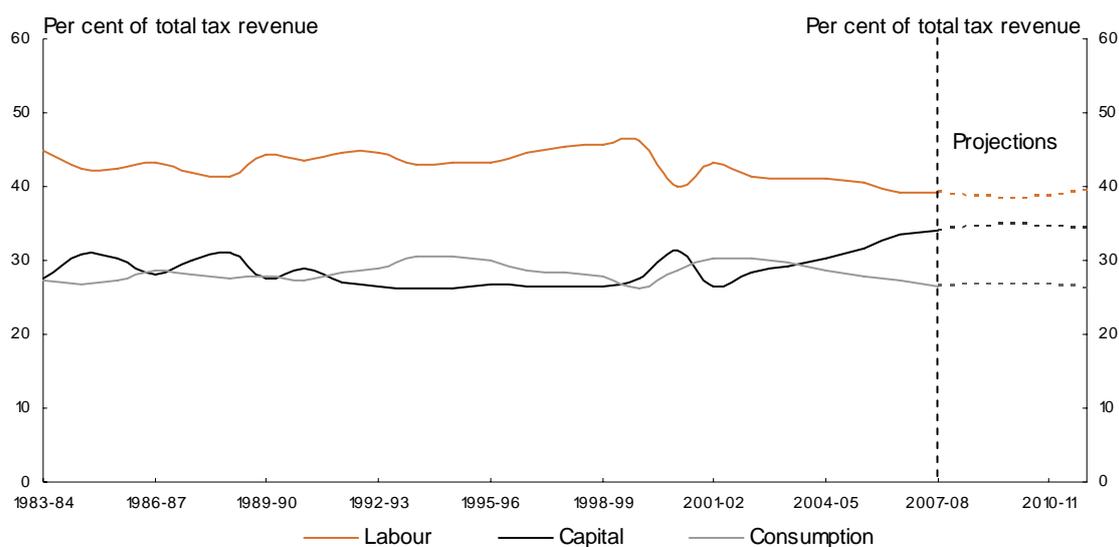
(a) Includes petroleum resource rent tax and crude oil excise and tax on earnings of superannuation funds.
Source: Australian Treasury estimates.

Taxes on consumption contributed around 27 per cent to total tax revenue. The largest single item was the GST, contributing around half of total consumption tax revenue. Excises contributed around 7 per cent of total tax revenue, while a range of state taxes – including on motor vehicles, gambling, and insurance – accounted for a further 7 per cent.

Recent changes in Australia's tax mix

Over recent years Australia has been relying less on tax revenue from labour income and more on tax revenue from capital income. The revenue projections in the *2008-09 Mid-Year Economic and Fiscal Outlook* (Australian Government 2008d) imply that this trend will stabilise over the next few years, partly reflecting the influence of developments in world financial markets and their likely impact on economic growth (Chart 3.2).

Chart 3.2: Tax revenue from labour, capital and consumption
All Australian governments (1983-84 to 2011-12)



Source: Australian Treasury estimates.

Chart 3.2 indicates that capital tax revenue has exceeded 30 per cent of total tax revenue on previous occasions. During 1988-89, the peak of the last economic cycle, the capital tax share was around 31 per cent and the labour tax share around 41 per cent. During the early 1990s recession, the capital tax share fell to around 27 per cent, with the labour tax share rising to around 45 per cent. This suggests a cyclical element, which is not surprising given that capital tax revenue is driven largely by receipts from corporate taxes, personal taxes on capital income, and property taxes, all of which tend to rise during periods of strong or sustained economic growth.

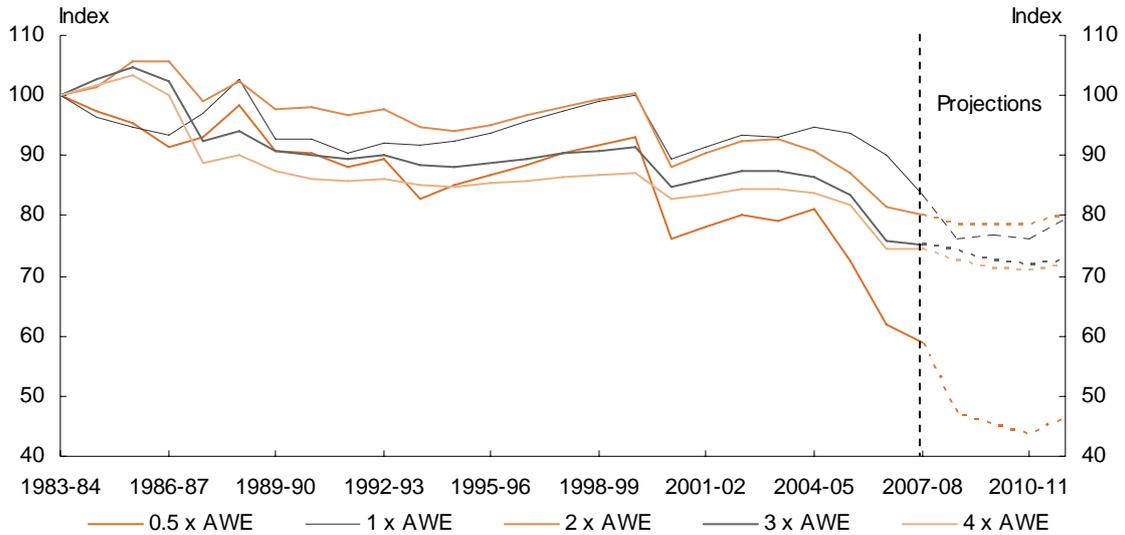
However, the dominant feature in Chart 3.2 is the persistent upward trend in the share of capital tax revenue since 2001-02 and the downward trend in the shares of labour and consumption tax revenue. Up to that point, nominal revenue collections from the three bases had grown at approximately equal rates. Since 2001-02, nominal revenue from capital income has grown faster than revenue from labour and consumption.

Changes in labour tax revenue

As a share of GDP, revenue from personal taxes on labour income has declined from over 11 per cent in the late 1990s to an estimated 9.7 per cent in 2007-08. Two key factors have contributed to this decline. The first is a reduction in the wages share of total factor income, from over 55 per cent in the late 1990s to an estimated 53.4 per cent in 2007-08, reflecting a bias in national income growth toward corporate profits. The second is successive personal income tax reductions.

Starting in 2000, personal taxes have been reduced seven times, most recently in the 2008-09 Budget, with further reductions scheduled to take effect from 1 July 2009 and 1 July 2010. In addition the low income tax offset (LITO) increased from \$150 in 1998-99 to \$1,200 in 2008-09 and the senior Australians' tax offset (SATO) was introduced. As a result, average personal income tax rates are currently at their lowest point since 1983-84 (Chart 3.3).

Chart 3.3: Change in average personal income tax rate at selected multiples of average weekly earnings^(a)
 1983-84 to 2011-12 (Index 1983-84 = 100)



(a) Includes low income tax offset but does not include Medicare levy or other tax offsets based on personal circumstances. Source: Australian Treasury estimates.

Changes in capital tax revenue

The more rapid increase in capital tax revenue since 2001-02 is due largely to strong growth in corporate tax revenue (from 3.7 per cent of GDP in 2001-02 to around 5.7 per cent in 2007-08) and increased stamp duty revenue from property conveyancing.

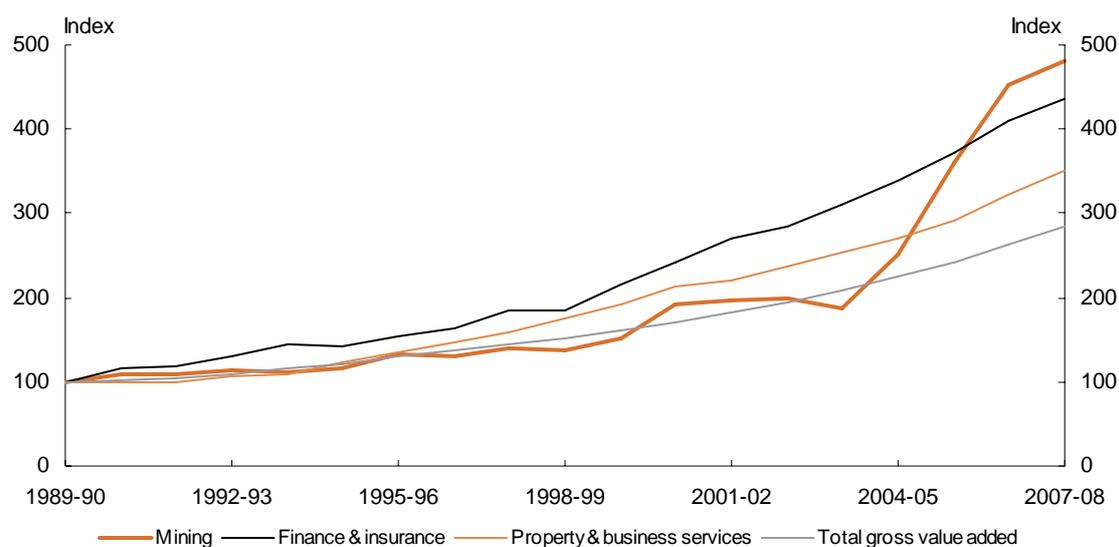
Corporate tax revenue

Corporate tax revenue has increased from around 11 per cent to 20 per cent of total tax revenue in the past 10 years or so, accounting for the vast majority of the increase in the capital tax share of revenue.

Corporate tax revenues are a product of the level of corporate economic activity, the rate of company tax, and the breadth of the statutory corporate tax base. Growth in corporate profits has been very strong in recent years, underpinned by the expansion of the Australian economy and the rising terms of trade. Profits as a share of total factor income have risen from around 23 per cent in the late 1990s to just over 27 per cent in 2007-08.

The resources sector has been an important contributor to the recent profit growth in the economy, owing to increased bulk commodity prices. Profit growth has also been strong in the financial sector and property services sector (Chart 3.4).

Chart 3.4: Change in industry gross value added
1989-90 to 2007-08 (Index 1989-90 = 100)

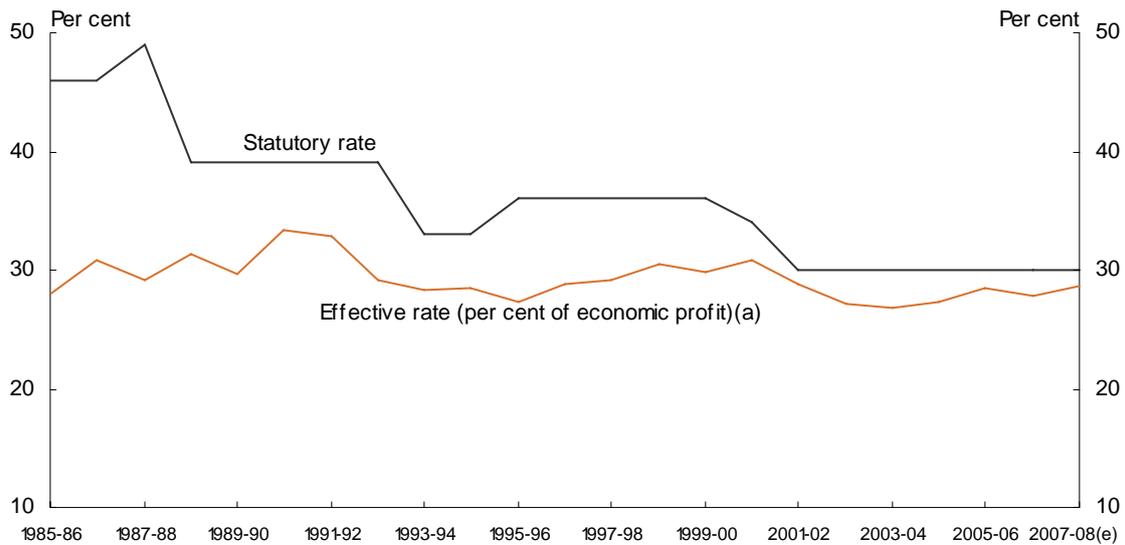


Source: ABS (2008b).

To the extent that the increase in revenue reflects an expansion in corporate profits, the change in the tax mix toward capital should not be of particular concern. However, this does not imply that the present corporate tax system is appropriate in terms of maximising the wellbeing of Australians. Issues concerning company tax and resources are discussed in Sections 6 and 14.

The statutory company tax rate has remained at 30 per cent since 1 July 2001, after being reduced from 36 per cent in the previous two years as part of a reform package involving the removal of accelerated depreciation and other base broadening measures. Since then changes to the statutory company tax base have been limited. Reflecting this, the effective average corporate tax rate has remained relatively stable (Chart 3.5) and below the statutory company tax rate.

Chart 3.5: Measures of the company tax rate in Australia (1985-86 to 2007-08)



(a) Economic profit is defined as corporate gross operating surplus as measured by the national accounts, less depreciation. An adjustment has been made for conceptual differences between national accounts and standard accounting definitions of net income. The income of government enterprises not subject to tax has been excluded from economic profit. CGT has not been included on the basis that realised capital gains have no direct relationship with current economic activity.

(e) Estimate.

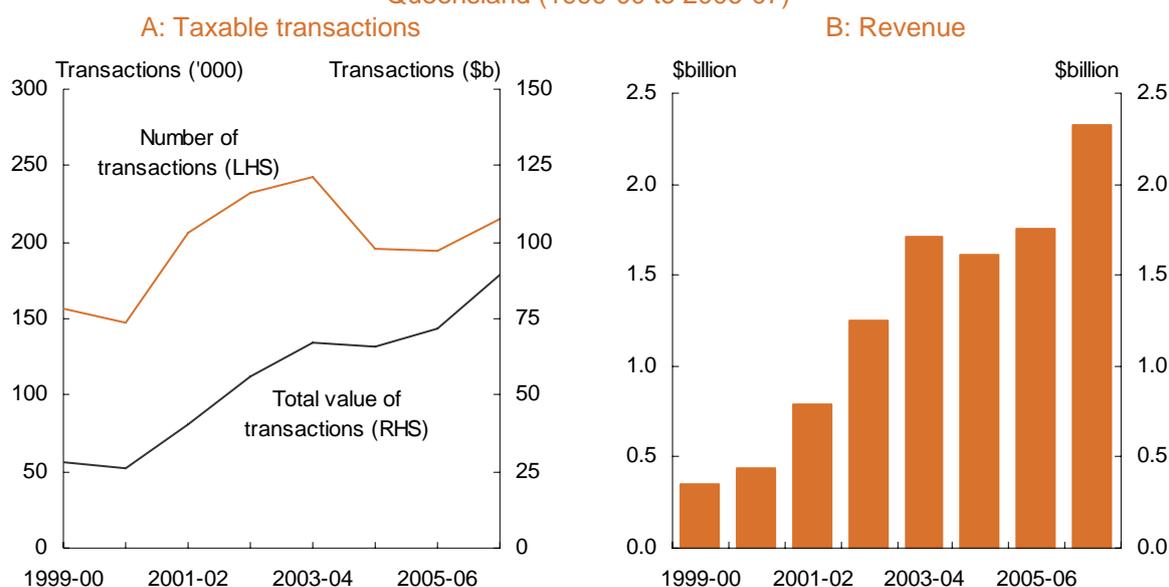
Source: Australian Treasury estimates.

Revenue from stamp duty on property conveyances

Revenue from stamp duties on property conveyances increased between 2001-02 and 2007-08 from around 3.4 to 4.2 per cent of total tax revenue. These taxes have been an increasingly important source of revenue for the States.

The increase in this stamp duty revenue is mainly the result of higher property prices feeding through to a higher value of taxable transactions. For example, in Queensland, the value of taxable transactions increased by over 200 per cent between 1999-00 and 2007-08, with an even larger increase in revenues from stamp duties on these transactions (Chart 3.6). Recent economic developments appear likely to dampen property conveyance revenues. For example, the NSW Government's November 2008 Mini-Budget (NSW Government 2008) included a downward revision of more than 20 per cent to 2008-09 conveyancing duty revenue.

Chart 3.6: Taxable transactions and revenue from land transfer duty
Queensland (1999-00 to 2006-07)



Source: Queensland Government estimates.

Source: Queensland Government estimates.

Changes in consumption tax revenue

In 2007-08, taxes on consumption contributed around 27 per cent to total tax revenue. This has been broadly constant over the past 25 years. The slight downward trend in evidence over the past five years largely reflects the relatively stronger growth in capital tax revenue. Represented as a proportion of GDP, taxes on consumption have declined from around 9 per cent in 2001-02 to around 8 per cent in 2007-08.

The most notable policy change affecting the composition of consumption tax revenue in the past 25 years was the introduction of the GST in 2000, accompanied by the abolition of the wholesale sales tax and a range of state taxes. The abolition of fuel excise indexation in 2001 was a further significant policy change, from which the cumulative revenue loss by 2007-08 is estimated to be in the order of \$14 billion.

Longer term influences on the tax mix

The longer term prospects for the tax mix are difficult to discern. The change in the forward estimates of revenue between the 2008-09 Budget (Australian Government 2008a) and the 2008-09 *Mid-Year Economic and Fiscal Outlook* (Australian Government 2008d) indicate the sensitivity of the tax mix to economic conditions. Over the short to medium term a key influence on the tax mix will be movements in the terms of trade. Declining asset prices will reduce capital gains tax revenue for individuals, companies and superannuation funds. In addition, revenue from consumption taxes may grow more slowly.

A key question is to what extent the projected changes in the Australian population might influence the tax mix. Implicit in the economic growth projections in the 2007 *Intergenerational report* (Australian Government 2007) is an assumption that the capital to labour ratio in the economy will remain unchanged. Such an assumption reflects the profound difficulties in defining an alternative scenario. It is also difficult to project how the

relative contribution to revenue from taxes on capital and labour might be affected by demographic change.

For example, if the relatively smaller working age population were to result in a relative scarcity of labour compared to capital, the effect would be to bid up real wages, implying a shift in relative factor shares toward labour income. If the larger proportion of the population moving into retirement and drawing down accumulated assets were to result in a relative scarcity of capital, the price of capital could increase relative to labour, implying a shift in relative factor incomes toward capital. These types of effects would not be confined to Australia. Similar demographic shifts are expected to play out in many developed countries over the next 40 years.

It is unclear how this might affect the global supply and demand for capital and labour, and how it might affect the relative price of capital and labour in Australia. International changes in capital and labour may have additional implications through international tax competition in either market. These pressures may point to an increasing future role for consumption taxes, but these too are incident on individuals and can affect competitiveness accordingly.

Consultation question

Q3.1 What problems, if any, are generated by the overall mix of taxes in Australia on business and labour income, consumption, transactions and assets, and what changes, if any, should be made?

3.2 Taxing the returns to work and saving

The tax burden on the returns to work and saving of Australian residents potentially has important implications for economic efficiency and the perceived fairness of the tax-transfer system. In considering the tax burden on capital income, the focus in this section is on the way in which tax affects the choice between consumption and saving. The impact of the tax system upon the form in which saving occurs and the decision about how savings are to be invested is examined in Section 6 (which also argues that Australia's total investment level is determined by broader factors than domestic saving).

Choices that Australians make about working and saving affect their lifetime level of consumption and how that consumption is distributed through their lifetime. Tax-transfer arrangements, particularly the balance of taxes on earnings from work and from saving, affect these choices and can have important equity and efficiency implications.

Summary of key messages from submissions

A number of submissions, including from welfare groups, argue for greater taxation of the returns to saving. Some of these submissions suggest taxing returns to saving more heavily than returns to work.

A number of other submissions, including from individuals, business groups, and business advisory organisations, argue in favour of reduced taxation of the returns to saving. Some of these submissions argue that taxing savings penalises people who exhibit thrift.

Submissions also identify the treatment of inflation as an issue. Some call for the exclusion of inflation from the taxation of interest income, while others call inflation to be excluded for all savings income.

A number of submissions support consideration of a direct, recurrent tax on household net wealth. These submissions generally support a low rate and a broad base, including all assets and deducting all liabilities. Proposals often feature a threshold high enough to ensure that only high wealth individuals would have a tax liability. Most submissions proposing a wealth tax envisage it as a supplement to taxes on capital income.

Some submissions also canvass the possibility of wealth transfer taxes, again with a threshold to ensure that only large estates, or inheritances or gifts are affected. In some cases, proposals include concessional treatment for particular classes of recipients, especially spouses and children.

The relative taxation of the returns to work and saving

Many transfer payments are calculated with reference to an individual's income from work, savings and their holdings of assets. Section 2.2 discussed how income and asset tests have effects that are economically equivalent to taxes. In this section, the term 'taxes on the returns to work' refers to both traditional taxes as well as reductions in transfer payments due to income tests. Similarly, the term 'taxes on the returns to saving' refers to both traditional taxes and to reductions in transfer payments under income and asset tests that are due to income from savings and holdings of wealth.

Equity implications

It was noted in Section 1.2 that there is no universally agreed view as to what constitutes an equitable tax-transfer system. As noted above, there is a range of views in submissions as well as more broadly, about how the returns to saving should be taxed relative to the returns to work. These differences of view reflect different conceptual benchmarks and perspectives on horizontal and vertical equity.

The 'nominal income tax' benchmark reflects a view that all income represents an addition to the resources at the taxpayer's disposal. Under this view, individuals who have the same increment to their resources should pay the same amount of tax, irrespective of whether this income is compensation for work or for deferring consumption through saving. Those that have a greater increment to their resources should pay more tax.

A 'real income tax' benchmark reflects a view that a portion of the return to saving merely maintains the purchasing power of the saved income in the presence of inflation. As such, it does not add to the resources of the taxpayer as measured by what they are able to consume. Under this view it is considered appropriate to only tax the real return to saving, but to do so in an equivalent manner to other sources of income, such as the return to work.

An 'expenditure tax' benchmark reflects a view that the portion of the return to saving that is compensation for the taxpayer deferring consumption (the minimum required rate of return of the taxpayer) does not reflect an addition to the value of lifetime consumption experienced by the taxpayer. Thus, under this view, it is considered appropriate to levy tax only on the excess of the taxpayer's required return on deferred consumption. The Meade Report (1978) described this approach as one that taxes an individual based on the resources they take out of the economy (through consumption), rather than the resources they contribute to the economy.

The *Architecture paper* (see Box 6.1) includes a more detailed discussion of the characteristics of the expenditure and income tax bases.

An additional dimension to some people's views about taxing the returns to saving is that saving, and the wealth that it can create, tends to be biased toward those who are better off in society. A lower rate of tax on income from wealth, or deferral of taxation until the point of consumption, might be seen as undermining vertical equity. Two perceptions that might underlie these concerns are that holders of wealth receive benefits from holding wealth, such as financial security, power and influence, and that deferred taxation might not be recovered for an extended period of time.

Some proponents of an expenditure tax base argue that taxes on wealth transfers or on wealth holdings could be an important mechanism for ensuring equitable outcomes if taxation of saving were reduced or removed. Box 3.1 discusses taxes on wealth transfers and recurrent wealth taxes.

Taxes on wealth transfers may help to promote equality of economic opportunity by taxing large fortunes handed down from generation to generation and by limiting the acquisition of wealth without personal effort. On the other hand, bequest taxes may fall disproportionately on families where a death is unexpected relative to those that have had time to plan the management of the estate, although this would depend on the design of the tax. Also, bequest taxes would have to be designed to provide the appropriate treatment of intergenerational transfer of some particular asset types, such as business assets within a family.

Taxes on wealth holdings have similar properties to taxes on the income generated by asset holdings. Therefore a wealth tax is not entirely consistent with an expenditure tax approach, but could reflect a decision to tax savings at a different rate compared to the returns to work.

Analogous issues arise in relation to the transfer system. An additional consideration is that, irrespective of the application of an income test, some people consider that private wealth (and hence savings) should be called upon before any entitlement to transfer payments.

Box 3.1 Wealth taxes

Taxes on wealth transfers

Australia is one of only three OECD countries that do not levy taxes on transfers of wealth, such as estate, inheritance and gift taxes. While the majority of OECD countries raise some revenue from such taxes, in no case are they a major source of revenue. The OECD average is 0.4 per cent of total tax revenue. Only Japan, France and Belgium raise more than 1 per cent of tax revenue from such taxes. Australia has had no such taxes since the early 1980s when all States and the Australian government abolished their death and gift duties.

Recurrent taxes on wealth holdings

In Australia, council rates and state land taxes are the only significant recurrent taxes on asset stocks. In the transfer system, assets tests and the deemed rate of return on financial assets are examples where tax liability (or transfer reduction) is determined with reference to the stock of wealth, rather than the flows from it.

As the value of an asset generally reflects the flow of future benefits that it is expected to generate, recurrent wealth taxes are economically similar to taxes on capital income. There are several arguments for and against a greater use of wealth taxes compared to taxes on capital income.

Wealth taxes may improve equity, as they effectively tax non-monetary returns to holding assets (for instance power, security and prestige). Taxes on capital income flows generally exempt these non-monetary returns. If it is easier to measure asset values rather than capital income flows, wealth taxes may be able to provide more neutral treatment of particular assets.

However, wealth taxes may create cash flow difficulties for people who are relatively well off in terms of assets but live on relatively low incomes. In contrast, levying tax on income flows generally imposes tax liabilities in the same period that cash flows arise.

Efficiency implications

Taxes on the returns to work and taxes on the returns to saving create efficiency costs.

Taxes on the returns to work change the relative price to an individual of market consumption compared to non-market consumption and production. These taxes discourage individuals from working as much as they otherwise might in the absence of tax and encourage them to devote more time to activities such as leisure and home production.

Taxes on the returns to saving also create efficiency costs by discouraging people from deferring consumption and by discouraging people from working, as the tax on the returns to saving creates an additional wedge between the pre-tax returns to work and the amount of consumption that work generates.

An efficiency argument for taxing the returns to work and saving on an equivalent basis is that a broad income tax base with uniform rates of tax will result in fewer distortions to individuals' behaviour. Within this paradigm it has generally been acknowledged that applying such a treatment to the real return to saving (as opposed to the nominal return) is appropriate.

However, taxing savings results in a higher tax burden on deferred consumption relative to immediate consumption (see Box 3.2). This discourages saving and results in efficiency costs. It can be shown that under a range of assumptions the efficiency benefit from removing taxes on savings (which impact on choices to work and save) outweighs the additional inefficiency that would be created by increasing taxes on work.

More recent literature has questioned the relative efficiency of exempting savings through an expenditure tax approach, suggesting a range of reasons why it may be efficient to tax the returns to saving under an income tax. However, that literature also tends to suggest that the tax rate on the returns to saving should be lower than that applied to the returns to work. These issues have been examined in detail in the Mirrlees Review (see Diamond and Banks 2008, Hall 2008, Kay 2008 and Pestieau 2008).

Table 3.1 summarises the various efficiency and equity arguments for the different tax treatments of the returns to saving.

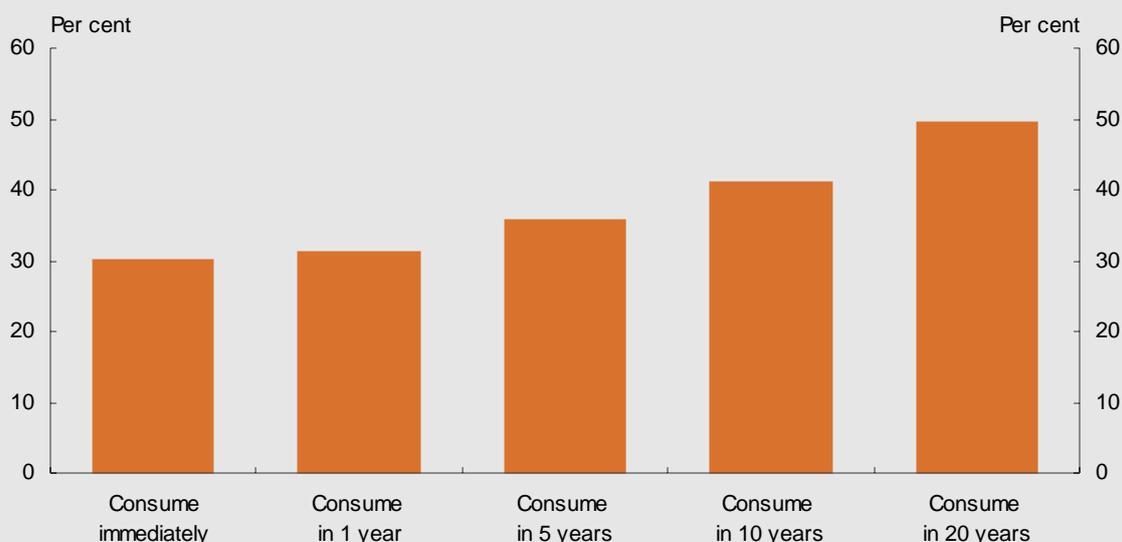
Table 3.1: Efficiency and equity arguments for different approaches to taxing saving

Tax treatment of savings		
'Nominal income tax base': Tax all nominal returns	'Real income tax base': Exclude inflation	'Expenditure tax base': Exclude inflation and the returns for deferring consumption
Efficiency arguments		
<p><i>Efficiency arguments for taxing the returns to saving</i></p> <p>Uncertainty about future wage prospects can mean it is efficient to levy some tax on the returns to saving.</p> <p>Working decisions vary with age, which means taxes that vary with age can be more efficient. Taxing savings can be a proxy for age-based taxation.</p> <p>Saving rates may vary with earning capacity, which can make some taxation of saving efficient.</p> <p>Large accumulations of savings in the hands of a few individuals may cause detrimental concentrations of power.</p> <p>Tax system integrity is easier to safeguard for unincorporated businesses and closely held companies.</p>		<p><i>Efficiency arguments for not taxing the returns to saving</i></p> <p>The double taxation of deferred consumption means that replacing taxes on savings with higher taxes on labour is often efficient.</p> <p>The presence of intergenerational transfers mean the cumulative distortion from savings taxes becomes very large in the long term, implying a zero rate of tax on savings (although the same arguments suggest a very high rate of tax on savings in the short term).</p> <p>Individuals are myopic and don't save enough (although the pension and superannuation guarantee are retirement savings policies to address this, and government intervention on this basis risks detracting from wellbeing by encouraging too much saving).</p>
		<p><i>Efficiency argument for not taxing inflation returns</i></p> <p>Taxing inflation returns reduces savings and increases the variance of real after-tax rates of return between projects and through time.</p>
Equity arguments		
<p>All income constitutes additional resources and should be taxed.</p> <p>Taxes on savings are taxes on the wealthy.</p>	<p>All real income is additional resources and should be taxed. Returns reflecting inflation are not increases to the real quantity of goods and services the individual can buy and should not be taxed.</p> <p>Taxes on savings are taxes on the wealthy.</p>	<p>All increases to a person's lifetime consumption possibilities, as valued today, should be taxed. Returns to saving do not reflect increases in lifetime consumption possibilities; instead they are compensation for consumption that has been deferred in the past.</p> <p>Taxes on savings are taxes that fall on people who have saved in the past and benefit people who consume their income as soon as they earn it.</p> <p>People should be taxed on what they take out of the economy (consumption) rather than what they contribute (income).</p>

Box 3.2: The cumulative impact of taxes on the returns to saving

Taxing the returns to saving, as well as the returns to work results in higher tax rates on consumption that is deferred through saving than it does for immediate consumption. The additional effective tax rate depends on how long the consumption is deferred. Chart 3.7 shows how imposing a 30 per cent tax on the returns to both work and saving results in a greater tax liability (in net present value terms) the longer the taxpayer defers their consumption. In this example the individual faces an effective tax rate of 30 per cent on immediate consumption and of about 50 per cent on consumption that is deferred for 20 years.

Chart 3.7: Effective tax rates on consumption with a 30 per cent income tax



Note: Calculated for an individual taxpayer on a 30 per cent personal tax rate and a 6 per cent nominal rate of return on savings with no inflation.

Source: Australian Treasury estimates.

Mechanisms for taxing the returns to work and saving differently

If considered appropriate, differential taxation of the returns to work and saving could be achieved in a number of ways depending in part upon the rationale for doing so. All potentially involve issues in identifying the capital and labour components of the return to unincorporated businesses and closely held companies.

Excluding the inflation component

There are several means by which the inflation component of the returns to saving can be excluded from tax.

The most accurate method is to provide a deduction equal to the inflation that occurs during the saving period. In the case of assets generating capital gains, this is typically done by indexing the cost of the asset. Australia used this method for capital gains tax between 1985 and 1999. However, it is difficult to apply this method to some assets.

An alternative to providing a specific allowance for inflation is to provide a proportionate reduction in tax as a proxy for inflation. There are two approaches to achieving this: exempt

a proportion of the returns to saving; or provide a proportional reduction in the tax rate that applies to the returns to saving.

These two approaches have largely equivalent effects. The main difference is that exempting a proportion of the return results in slightly less progressivity compared to a proportional rate reduction. However, the base reduction method may involve less complexity in the context of a progressive personal tax scale.

Under these two approaches, real effective tax rates would continue to vary with changes in inflation, although the impacts would be reduced. In an environment of inflation targeting this may not be a major concern. More importantly, a proportional adjustment provides a disproportionate benefit to assets with high real returns, compared to assets with low real returns.

Excluding inflation and the return for deferring consumption

There are a range of approaches for achieving a policy objective of excluding both inflation and that part of the return that is compensation for deferring consumption. These approaches generally only tax the return to risk and unexpected variations in returns.

One approach is to extend the first method for excluding inflation such that the indexation/deduction equals the risk-free return on capital (such as the government bond rate) rather than the current period inflation rate. Here the risk-free rate is used as a market proxy for the individual's required compensation for deferring consumption. This approach allows for a progressive tax rate structure. This method is conceptually similar to the allowance for corporate equity, which is discussed in the context of investment in Section 6.

Another approach is to use a 'post-paid' expenditure tax, which involves taxing the returns to saving at the time it is withdrawn to undertake consumption. A cash-flow tax is one example of such an approach. Under a cash-flow tax, all incomings from work and savings are taxed but there is an immediate deduction for net additions to savings. The deduction means that tax only applies to income in the period it is consumed. Similar to the first approach discussed above, a cash-flow tax effectively excludes the risk-free returns to saving. However, unlike the approach discussed above, a cash-flow tax does not need to explicitly exempt a deemed rate of return to achieve this. A cash-flow tax can be implemented to incorporate either a progressive rate structure or a flat rate structure.

Another broadly equivalent approach is a consumption tax, such as the GST. A consumption tax (considered alone) has similar properties to a cash-flow tax. Returns to saving up to the risk-free rate are effectively untaxed while both labour income and any returns to saving in excess of the risk-free return to capital are effectively taxed. Unlike the two approaches discussed above, it is not possible to impose a consumption tax at progressive rates on an individual basis. Shifts toward consumption taxes or cash-flow taxes can effectively impose an additional tax on past savings.

Yet another approach is to use a 'pre-paid' expenditure tax. This involves taxing income from work in the period when it is earned, and exempting the returns to saving from any further tax. This approach excludes both the inflation and risk-free returns to saving from tax, but also excludes any return to risk and unexpected variations in returns.

Providing an arbitrary reduction in the tax applied to savings

Another approach is to provide an arbitrary reduction in the tax applied to savings, relative to that applied to work. In addition to excluding a proportion of the returns to saving from tax or providing a proportional reduction in the tax rate on the returns to saving, an arbitrary reduction could be provided by rebalancing the overall tax mix toward taxes that only target the returns to work or consumption. Such taxes include payroll tax, which is generally thought to only apply to labour income (although its incidence might be different in some circumstances), social security contributions, as implemented in many European countries, or taxes on consumption.

Taxing savings at a flat rate

There are some efficiency and equity issues with levying progressive taxes on the returns to saving. Many assets generate significantly different returns from year to year. Progressive capital taxes mean that these variations may be taxed at different rates. This can create period inequity, where two savings projects that generate the same overall return are taxed differently due to the pattern of those returns.

Some countries have adopted systems that impose flat taxes on savings, while retaining progressive taxation of work and benefit income. An example of this approach is the Netherlands' dual income tax system, which taxes personal income from savings at a lower (flat) rate than income from work. It should be noted that even systems with flat rates of tax on the returns to saving are typically redistributive (though less so than under a progressive rate structure), as taxpayers with more income from savings contribute more to government.

A flat rate of tax on savings would facilitate final tax withholding, which may expand opportunities to streamline personal tax administration. For example, banks could withhold tax on deposits and companies could withhold tax on dividend distributions, without the need for further individual-level tax calculations.

The existing tax system in aggregate

Given the mix of taxes in Australia, and the existing concessional tax treatment of some forms of saving, it is possible to characterise the aggregate tax system as providing a mixture of the income and expenditure tax concepts. The issue then is whether to shift this mix further in one direction or the other, if at all.

Consultation questions

- Q3.2 Does Australia's tax system penalise (or favour) the returns to savings relative to other activities and should this lead to changes in the structure of taxes and means tests?
- Q3.3 Does Australia's tax-transfer system appropriately deal with property and wealth, or should new approaches be introduced? What, if any, implications would any changes have for the taxation (or means testing) of capital income flowing from property and wealth?

3.3 Taxing consumption

Taxes on consumption are generally considered to impose lower economic efficiency costs than taxes on labour and capital income, particularly where they are applied broadly at a uniform rate. A recent OECD study (Johansson et al 2008) of the impact of different taxes on economic growth ranked taxes on consumption ahead of taxes on labour and capital, in terms of imposing the least detriment to economic growth. The introduction of the GST was underpinned in part by such considerations.

By contrast, taxes on transactions, particularly on a narrow base, are generally thought to be relatively inefficient in economic terms. These taxes both discourage production and consumption of goods and services, but also discourage the reallocation of assets to their most valued use.

The operating efficiency of taxes can often be quite different from their economic efficiency (resource allocation). The GST has relatively high operating costs, while many transaction taxes are simple and low cost to operate.

Summary of key messages from submissions

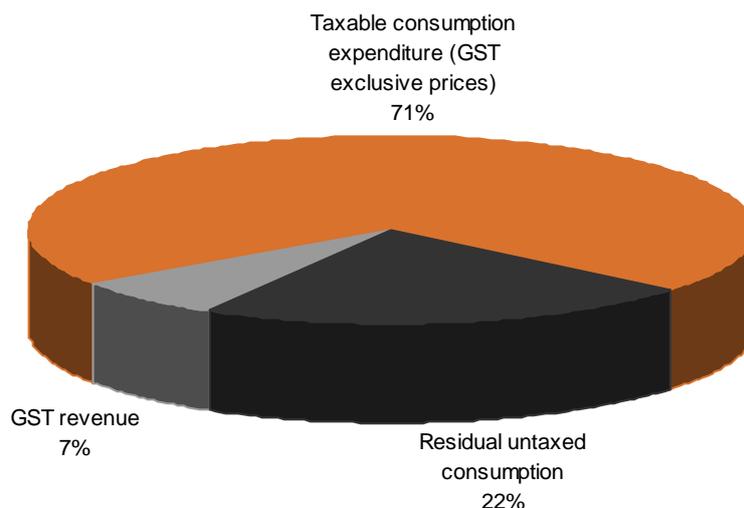
A number of submissions note that increasing the rate and broadening the base of the GST is beyond the scope of this review, but either suggest that the review be expanded or note that the GST's role will need to be considered at some time. Some suggest abolition of the GST, while others call for the replacement of all existing taxes with an extended GST (technically, reducing or abolishing the GST is within the scope of the terms of reference).

Submissions raise a range of issues with secondary taxes on consumption (such as alcohol and tobacco). Some submissions support these taxes on various grounds, such as health impacts. Others suggest these taxes are overly complex.

Submissions present different views regarding other taxes on transactions. Some argue that existing taxes on transactions, such as stamp duty on property conveyance, are inefficient and should be reduced or abolished. Others argue in favour of more extensive use of taxes on transactions, for example, by replacing all other taxes with a broad-based financial transactions tax.

The GST

The GST is a broad-based tax on goods and services. The breadth of the GST makes it a relatively efficient tax, with limited distortions to consumption choices. Estimates from the national accounts suggest that the GST covers around three quarters of household consumption (see Chart 3.8). A number of household consumption items are GST-free (basic food, health and education) or input taxed (residential rent and financial services).

Chart 3.8: GST revenue relative to household consumption expenditure (2007-08)

Note: Taxable consumption is derived from actual GST revenue, and subtracted from total household final consumption expenditure to give the residual untaxed amount. It does not include GST paid by businesses making supplies that are input taxed.

Source: ABS (2008b), GST revenue from Australian Government (2008d).

Secondary taxes on consumption

More narrowly based taxes may also have a role to play in the revenue mix on efficiency, equity and simplicity grounds.

Like most countries, Australia raises significant revenue, in addition to the GST, from specific commodities including fuel, alcohol and tobacco products, and motor vehicles. The States also impose a range of taxes on specific commodities or activities (see Section 9), although the Constitution does not allow them to impose excise taxes.

Narrow-based consumption taxes can have very different distributional outcomes to a broad tax like the GST.

Looking at international practice, Cnossen (2005) has identified five potential objectives for product-specific taxes.

1. *To raise revenue for general purposes.* The consumption of some goods may be particularly unresponsive to price. This means that additional taxes may not significantly alter individual consumption choices, and therefore impose low efficiency costs.
2. *To reflect external costs.* In some cases, taxes provide a price signal to the user of a good. For example, where the private use of a particular good is closely related to quantifiable social harm (for example, sulphur dioxide pollution), a specific tax may be employed to reflect the true social cost in the price, and therefore induce a reduction in demand.
3. *To discourage consumption.* A tax may be imposed to counter perceived information failure, possibly in relation to harmful or addictive products. This may be driven by public health objectives.

4. *To charge for government-provided services.* Specific taxes may be viewed as a mechanism to charge for the cost of providing a good or service.
5. *Other objectives.* Governments may apply specific taxes to achieve specific objectives, such as to make the tax system more progressive.

To achieve many of these objectives, tax is used as an instrument to affect market prices and, therefore, to deliberately change the behaviour of producers and consumers. However, while taxing particular products can be used as a tool to regulate the market, it may be a 'blunt instrument' for meeting some policy goals.

In many cases the ability to target taxes is constrained by the cost of gathering the information upon which to calculate the tax, as well as ensuring compliance with the tax law. This is why, historically, excises have been levied on goods that are produced at a few, easily controlled sources.

Section 11 discusses specific taxes on alcohol and tobacco and luxury cars. Section 9 discusses gambling and insurance taxes levied by the States. Section 13 discusses environmental taxes and Section 12 considers fuel and motor vehicle taxes.

Transfers are also sometimes linked to consumption of particular goods and services. For example, rent assistance and child care subsidies can be considered in a similar way to differential taxation of consumption. They are typically imposed in pursuit of one or more of the five objectives identified above, such as encouraging (rather than discouraging) consumption of a particular good or service, or targeting assistance at particular groups. Section 4.8 discusses these issues in further detail.

Transactions taxes

Taxes on financial transactions and asset transfers are generally considered to be highly inefficient. Transaction taxes create an efficiency cost by discouraging transactions, which are the means by which resources are allocated to their most valued use.

Transactions taxes are also often considered particularly inequitable. They change the prices of goods and services in an arbitrary way, depending on the frequency of transactions. Thus higher taxes are imposed on people who undertake more frequent transactions, such as frequently moving house in the case of stamp duty on property conveyance.

Currency transaction taxes

A number of submissions propose the introduction of a tax on foreign currency transactions, commonly known as a 'Tobin tax'. The primary reason given in submissions for such a tax is to reduce exchange rate volatility, though other rationales have been raised in other contexts (such as funding foreign aid).

The Panel notes that this proposal has been widely criticised and has serious shortcomings. Tobin taxes are also virtually impossible to implement unilaterally. Any unilateral tax would be expected to result in substantial avoidance through trading outside of Australia's jurisdiction.

Consultation question

- Q3.4 Assuming no increase in the rate or base of the GST, what principles should guide the future development of other consumption taxes in Australia, and is there a need to change the role and structure of such taxes?

3.4 User charges and beneficiary taxation

In addition to conventional taxes, government raises revenue from a number of different sources, including user charges and beneficiary taxes. The relative merits of these different instruments and their potential use is an issue for consideration as part of this Review.

User charging involves the government charging a fee in return for providing a good or service to a person or business. Examples include bus and train tickets, stamps, national park entrance fees, royalties from natural resource use, motor vehicle licences and the sale of rights to electromagnetic spectrum. User charges can improve pricing, reducing the over-use of such resources, while also providing governments with revenue. However, they can also reduce efficiency if they are set inappropriately.

Beneficiary taxation involves the government imposing a fee on an activity for the benefit of the general community. In contrast to user charging, beneficiary taxation may involve little or no provision by government of goods or services to the taxpayer. Examples include the noise levy on plane arrivals at prescribed airports, where the airline owners 'benefit' from being allowed to land their planes. Another example is agricultural levies where fee-payers benefit indirectly from the spending of the money raised. Beneficiary taxation can improve equity by allocating the cost of public goods and services to the people who benefit from them.

This section considers the role that might be played by these sources of revenue. The issues of environmental taxation and resource charges are considered in Sections 13 and 14, respectively.

Summary of key messages from submissions

A range of submissions comment on particular user charges, claiming they are set at the wrong rate or that the administrative costs of collecting them make them inefficient. There are various views about different beneficiary taxes. Some argue that these taxes can be both equitable and efficient. Others argue that these charges are inefficient and the relevant services should be funded out of general revenue.

Some of the submissions that argue for the replacement of most existing taxes with a single tax – on land, financial transactions or household consumption – also argue for the retention of non-tax user charges for cost recovery purposes.

Public transport advocates argue for recovery of the costs of the road system from road users. Some suggest that fixed or periodical charges be restructured so they vary according to the level of motor vehicle use. Other submissions argue that public transport should be free to users on the grounds that this would put public transport on an equal footing with private road transport, which does not pay (at least directly) for access to most roads.

Summary of key messages from submissions (continued)

Some motorist groups recommend a two-part charging regime for road users: a small access charge to cover the costs of vehicle registration and other fixed costs; and a variable user charge to cover the external costs of road use such as pavement damage, air and noise pollution and congestion. Giving motorists the option of converting existing fixed charges into distance-based variable charges is also suggested.

Some submissions argue that the Australian government imposes a number of small taxes in the telecommunications sector that have various cost recovery rationales but which impose high collection costs relative to the amount of revenue they raise. For example, the National Relay Service (NRS) is a telephone access service for people who are deaf or who have a hearing or speech impairment. The NRS is funded by the NRS levy, which in 2007-08 was paid by 32 telecommunications carriers and raised \$12 million.

Airlines argue that the quarantine services funded through the Passenger Movement Charge are not directly related to the aviation industry and that the community as a whole is the principal beneficiary. On this basis they argue that the services should be funded out of general tax revenue.

Infrastructure charges are a concern for housing developers who argue that the costs of infrastructure should be borne by the community as a whole, rather than by landholders or the buyers of dwellings in new developments.

User charges

User charging tends to improve efficiency where governments provide services that are inherently 'private' in nature. Private in this case does not mean provided by the private sector. Instead, it is a technical term meaning 'rivalrous' in consumption — that is, one person consuming the good or service stops another person from doing so, such as occupying a seat on a crowded train.

The types of commodities that could potentially be subject to improved user charging include (rivalrous) natural resources (including water), electricity and transport services (including roads and rail), and even health and education services.

Efficient user charging improves resource allocation by providing a price signal. When faced with a price that reflects the cost of the service, potential users will not consume a good or service if they value it less than the cost of supplying it. User charges also provide direct feedback on the value of services to producers. Moving toward efficient user charging, as an alternative to conventional taxation, can have a 'double benefit' in the form of improved efficiency from the pricing of the rivalrous commodity, as well as a reduction in the efficiency costs associated with conventional taxation.

Even where user charging is practical and efficient, there may be equity or other social reasons for not applying it. Efficient user charging may impose high costs on particular groups of people or restrict access to goods and services deemed important to social inclusion. Rationing may be more socially acceptable in these circumstances.

In order to apply user charging efficiently, the government needs to determine the social marginal cost of the good or service. In the absence of a market, government agencies may find this difficult. User charges that are too high act like a tax (see Box 3.3). For example, some submissions suggest the Passenger Movement Charge over-charges for the cost of providing the services it funds.

Beneficiary taxation

A beneficiary tax, like a user charge, attempts to recover the cost of providing a good or service from those who benefit. However, where a good or service is a 'public' rather than a 'private' good, the marginal cost of providing the good to an extra person is zero, that is, a person could benefit from the good or service, without imposing any additional costs on others. Charging for these goods or services tends to be inefficient, because it means that some people are excluded even though the marginal cost of providing the good or service to them is zero or close to zero. However, in some cases beneficiary taxes are seen as an equitable way to recover the cost of public goods where only a sub-set of the community benefits, for example for the large up-front costs of public infrastructure.

One example of beneficiary taxation is the set of Australian Government agricultural levies. There are a range of levies for different products that apply at low rates. The revenue collected is used to fund marketing and research and development (R&D) for the respective agricultural sectors. Industry participants do not receive a direct benefit in exchange for the levy, but receive indirect benefits through the marketing and R&D conducted on behalf of the industry. Submissions support agricultural levies as an equitable and efficient way of raising funds for collective action by particular industries.

Beneficiary taxes are often applied to goods that are related to the provision of a particular service. For example, fuel taxes are sometimes justified as a form of beneficiary taxation for the capital cost of building public roads. The rationale is that those who use public roads the most (indicated by their fuel use) get the greatest benefit, and should therefore compensate the budget for the expense of providing them.

Opportunities for beneficiary taxation may exist in relation to pricing some road and transport services (Section 12), environmental goods (Section 13), and pricing of (non-rivalrous) natural resources (Section 14).

The role of technology

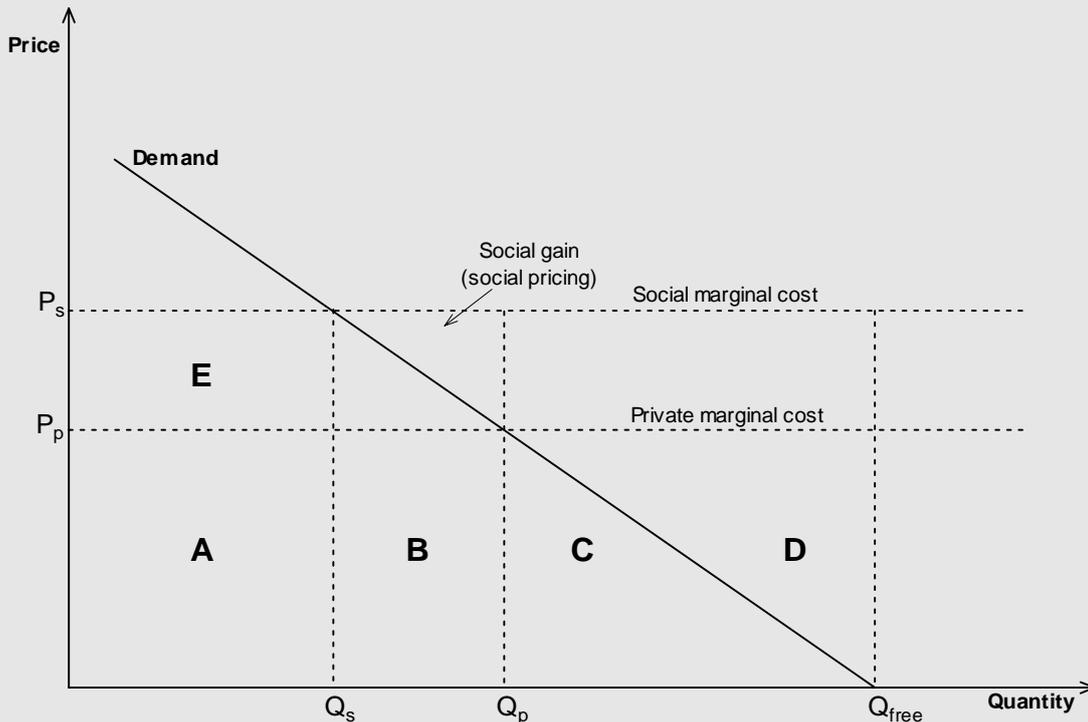
Improvements in technology may extend the range of activities for which it is practicable to apply user charging and beneficiary taxation. User charging can be applied only if the amount of the good or service provided to the fee payer is able to be measured. Improved technology can allow better measurement. For example, electronic tolling systems can measure exactly how far and at what times a particular vehicle travels on a road system.

Box 3.3: User charging and taxation

The ABS Government Financial Statistics (GFS) defines a tax as a compulsory levy imposed by government, usually with no clear and direct link between the payment of the tax and the provision of goods and services (ABS 2005). By contrast, user charges refer to levies imposed to cover the costs of providing a particular good or service to an individual or business.

Chart 3.9 illustrates the distinction between taxes and user charges for a government provided commodity (Q) which imposes a cost on others when consumed.

Chart 3.9: Charging for government-provided services



When government provides the commodity free of charge, demand equals Q_{free} and the government must find revenue of $A+B+C+D$ to meet the cost of providing the good. Moving from free provision to market pricing (P_p) would see revenues of $A+B$ flowing to government, which would cover the cost of provision, and a social gain (D) in terms of improved resource allocation.

If there were no social cost associated with the consumption of the commodity, but the government chose to charge P_s , area E would be considered a tax, while A would be a user charge. Government fees can therefore have both tax and user charge components.

However, where there is a social cost associated with the use of the good, the market price (P_p) would allow too much consumption. In this case consumers do not take sufficient account of the cost they impose on others. The government could therefore charge a higher and more efficient price (P_s), at which there is a further social gain.

Box 3.3: User charging and taxation (continued)

If this revenue was used to meet the cost of providing the commodity to consumers (for example, if revenue E was spent regulating the application of the fee), this would be an efficient user charge. If, instead, government did not need to spend any resources in providing the commodity, area E would be considered tax revenue.

Further, whether a government fee is a user charge or a tax does not depend on the form or intent of the legislation. For example, certain types of licence revenues are, at least in part, taxes, including taxi licences and motor vehicle registration fees.

Consultation question

- Q3.5 Could greater application of user charges, rather than general taxes, in the funding of government services or infrastructure bring social, environmental or economic benefits?

4 Personal tax and transfers

Overview

The personal income tax and transfer systems have far-reaching implications for the wellbeing of Australians and their choices to work, save and acquire skills.

Tax and transfer policies involve trade-offs between the adequacy of payment rates, incentives to work, and the complexity individuals and families face. Higher payment rates can lessen individuals' incentives to work and to invest in skills. The application of means tests for transfers leads to a more targeted but more complex system. Most critically, incremental reforms generally involve a trade-off between equity objectives on the one hand and efficiency and simplicity on the other.

With the ageing of the population and increasing global competitiveness, the structure and settings of the tax-transfer system and resulting incentives are key components in meeting these challenges.

Reforms which reduce complexity and deliver adequate incentives will improve resource allocation, productivity and participation. However, there are significant tensions between such objectives, and with targeting, equity and fiscal sustainability.

Consultation questions

- Q4.1 How might the personal tax system be changed to better achieve the goals of greater simplicity, transparency, equity and efficiency?
- Q4.2 What is the appropriate distribution of income tax across income levels and how should it differ from the current distribution? Should governments seek to maintain a similar distribution over time, or should they fix the value of current tax thresholds through indexation?
- Q4.3 Is the personal income tax base appropriately defined? Should reforms such as changes to the scope of deductions or other measures be considered?
- Q4.4 Should the tax treatment of transfer payments be reconsidered? Should transfer payments be taxed at the same rate or a lower rate than earned income?
- Q4.5 Should people in different circumstances be taxed differently (for example, by age, occupation, location), and what might be the implications of such arrangements? Are tax offsets the best way to achieve differential taxation?
- Q4.6 How can fringe benefits tax be simplified while maintaining tax integrity? Would it be better to adopt the general OECD practice of taxing fringe benefits in the hands of employees, rather than employers?

Consultation questions (continued)

- Q4.7 Are the current categorical distinctions for income support, including rates of payment and income tests, still relevant? If not, would other categories be better? What goals or principles should guide categorical distinctions and associated payment rates?
- Q4.8 What priority should be given to the different objectives associated with family assistance, such as poverty alleviation, recognising the social value of child rearing, facilitating workforce participation of parents, and early childhood education? Would it be better to provide less family assistance to higher income earners?
- Q4.9 What are the key factors that should affect rates of transfer payments? What should be the relative importance of duration on income support, costs of work and job search, costs of children, value of home production and the level of the federal minimum wage?
- Q4.10 Should transfer payments have a common benchmark? If so, should it be a proportion of a wage measure, and if so, which one? Or is there a better benchmark? Should there be a common indexation arrangement?
- Q4.11 Should payments for retired people remain linked to payments for people of working age?
- Q4.12 In a targeted system there is a trade-off between the level of income support and workforce incentives. Given this, what priority should be given to reducing the disincentives to work?
- Q4.13 What structure of income tests and taxes would best support the increasing diversity of work and the need to increase workforce participation, and where should improved incentives be targeted?
- Q4.14 Does the tax-transfer system create disincentives for individuals seeking to acquire new skills or upgrade existing skills? If so, what sort of tax or transfer changes would provide better incentives?
- Q4.15 Given the competing demands of targeting assistance to people when they need it and minimising unnecessary transactions, what changes could be made to existing tax and transfer policies?
- Q4.16 Should the different bases of assessment for tax and transfers be reconsidered (including the unit of assessment, income definitions, period of assessment and assets treatment)?

The personal tax and transfer systems have, in part, evolved separately. While in the past individuals were more likely to be either in one system or the other, today they are more likely to be in both. This has not only resulted in overlapping administration, but also potentially adverse interactions between the two systems. The interaction of the two systems

determines not only the disposable income of an individual or family and its distribution, but also incentives to work and invest in education and training.

This section considers the personal income tax system, including the tax base, rates, thresholds and indexation, and the taxation of fringe benefits. It also outlines the key structural features of the transfer system and examines the issue of payment adequacy. It examines the way the combined tax-transfer system affects incentives to work and invest in education and skills and implications arising from the choice of unit and mechanism for delivering assistance.

4.1 Personal income tax

Personal income tax is the single largest source of tax revenue, accounting for around 44 per cent of total Australian Government revenue collections and around 36 per cent of revenue from all levels of government. Its structure and interactions with the transfer system are central to how government collects and seeks to redistribute revenue.

The personal income tax system has evolved over time, with a wide range of provisions beyond the basic framework of marginal rates and thresholds. This section examines issues arising from the structure of the personal income tax system – the income tax base, personal tax rates and progressivity, offsets and levies, and the overall impact on different groups.

Summary of key messages from submissions

A number of submissions call for greater progressivity in the personal tax system (for example, higher marginal rates for high income earners). Others argue that high personal tax rates reduce incentives for skills acquisition and for high skilled workers to stay in Australia.

Submissions also suggest that the top personal tax rate should align with the company tax rate to create incentives to attract and retain high skilled labour and reduce incentives for tax minimisation.

A number of submissions note that private company and trust structures are used as a tax minimisation arrangement for high-income earners.

A number of submissions suggest limiting or removing deductions, while others suggest capping deductions for high-income earners. Some submissions suggest allowing additional types of deductions.

Several submissions raise concerns about tax offsets for complexity or equity reasons, and related to this, a number raise concerns that some transfer payments are taxable while others are not.

On the grounds of reducing complexity, some submissions suggest removing the Medicare levy and incorporating it into the personal income tax rate scale.

Summary of key messages from submissions (continued)

Most submissions that mention the senior Australians tax offset implicitly accept the idea that people aged 65 years or over should be taxed differently and propose specific changes that could be made to benefit this group. Other submissions that raise the issue of age mention the inequity of providing tax benefits to retirees and not to people of working age.

A number of submissions call for indexation of the personal tax thresholds, either to the consumer price index or to an index of wages growth.

The personal income tax base

Australia's personal income tax is applied against most receipts that have the character of income. The income tax system does not generally distinguish between income from capital and income from labour. There are a few notable exceptions from the income tax base:

- unlike in most other countries, fringe benefits are taxed in the hands of the employer rather than in the hands of the employee (see Section 4.2);
- the range of deductions that can be claimed against income for tax purposes is broad by international standards;
- owner-occupied housing is a significant exemption from the tax base (see Sections 6.7 and 10.1); and
- income from some forms of savings, such as superannuation and capital gains, is treated differently to other income (see Sections 5 and 6).

Many countries specify a limited number of non-business items that are deductible by individuals. Australia allows deductions for non-private and non-capital expenses incurred in gaining or producing assessable income. As such, Australia's personal income tax system provides for a wide variety of non-business deductions. These amounted to \$27 billion in 2005-06, equivalent to around 5.5 per cent of the \$483 billion in declared income. Submissions indicate a range of views on deductions, from further broadening to tightening or capping allowable deductions.

Under Australia's approach, individuals are able to claim a broad range of work-related and other expenses against their assessable income. However, this adds complexity and provides greater scope for personal expenses to be claimed as work-related expenses. Approaches in other countries tend to be more prescriptive and, in some cases, cap the deductions that can be claimed or allow a standard deduction in lieu of individual deductions. These approaches are advocated in some submissions.

A number of submissions call for changes to the tax treatment of transfers to achieve greater consistency and equity between recipients of transfer payments. The tax treatment of transfer payments differs depending on the payment. This reflects both program-specific considerations and the historical development of payments. The majority of income support payments, including Newstart and the Age Pension, are taxable. The majority of supplementary payments and family payments are non-taxable. The tax treatment of some payments depends on the recipient's age (for example, the Disability Support Pension), and

in the case of the Carer Payment, on the age of both the recipient and the person being cared for.

Tax offsets are available for transfer payments that are taxable. This means no tax is payable by recipients of taxable transfer payments unless they earn sufficient additional private income to generate a tax liability that exceeds the value of the offset. For example, the beneficiary tax offset² (which applies to Newstart and Youth Allowances) and the pensioner tax offset³ (which applies to some pensioners who receive a taxable pension payment) ensure that full-rate pension and allowance recipients pay no tax.

Additional income is treated differently depending on the type of income support payment. The type of payment also determines the rate of withdrawal of the payment, where there is additional income. Where the transfer is taxable, additional income is generally taxed as the top slice of the individual's income.

Personal tax rates and progressivity

Submissions present a mix of perspectives on the appropriate degree of progressivity within the tax-transfer system. These reflect concerns with equity and incentives.

Australia has a progressive personal income tax system. The personal rate scale has four personal income tax rates, as well as a zero rate of tax below the tax-free threshold. In addition, other elements such as the low income tax offset (LITO) alter the effective rate of taxation. A progressive income tax could also be achieved with a tax-free threshold and a single rate of tax above this point. While this would be less progressive than the current system, it would be simpler and could potentially provide better participation incentives.

A progressive tax system is characterised by average tax rates that rise with income, in line with the idea that reductions in income (caused by taxation) reduce the wellbeing of low income earners more than high income earners. It allows revenue to be collected with lower tax rates for those on lower incomes. In 2005-06, a revenue-neutral flat rate of tax would have required a 24 per cent tax rate. This would have resulted in almost 80 per cent of taxfilers paying more tax (those with a taxable income less than \$55,200 in that year).

The design features of the personal income tax system, including progressive tax rates, may contribute to system complexity, particularly once the interactions with transfers are taken into account. They can also lead to inefficiencies and inequity where taxpayers experience volatile incomes, or can share home production and paid work within their family. Some studies suggest that progressive taxation can dampen entrepreneurial activity, and some submissions suggest that it is a driver of international labour mobility (or that the current top personal tax rate has this effect). The OECD (2008a) has noted that reforms to enhance labour competitiveness and encourage entrepreneurialism also need to consider the desirability of their equity outcomes.

2 In the vast majority of cases, the low income tax offset (LITO) could render the beneficiary tax offset (BTO) superfluous.

3 The pensioner tax offset (PTO) is larger than the BTO in that it covers not only pension income, but also private income up to and a little over the level where it starts reducing the pension. Pensioners of Age Pension age receive instead the senior Australians tax offset (SATO), which is even larger.

Interactions between personal tax rates and offsets

Offsets reduce the tax burden on individuals in particular circumstances, but can add to complexity and affect participation incentives. They can be used to selectively reverse the tax levied by the personal tax rate schedule.

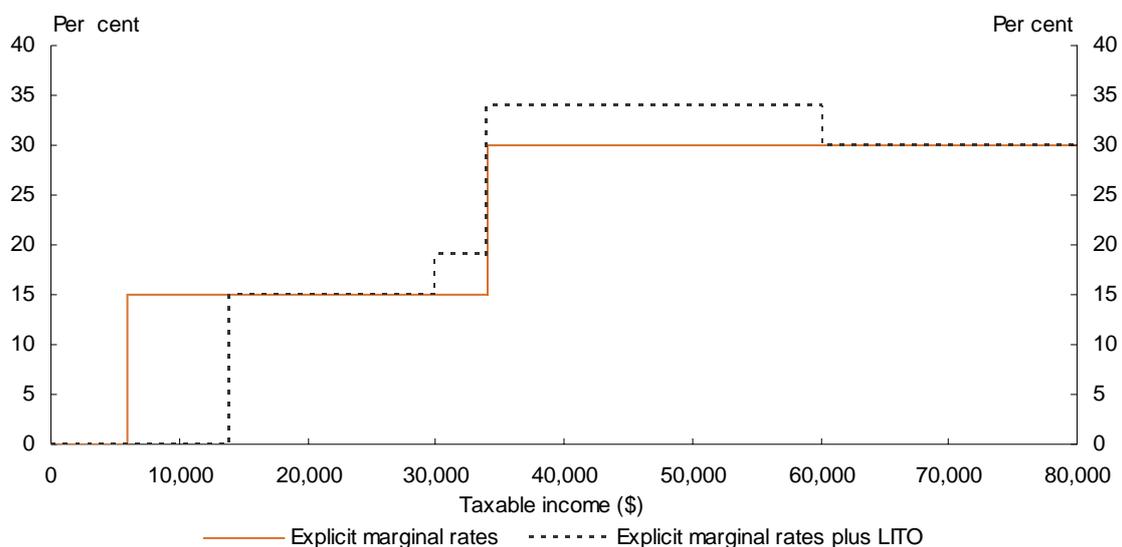
The most widely available offset is the LITO. It was used by over five million individuals in respect of the 2006-07 income year, when it was half its present size. The Commissioner of Taxation takes into account half of the LITO when determining the pay as you go (PAYG) withholding schedules, reducing the amount of salary and wages withheld.

The explicit tax-free threshold has remained at \$6,000 since 2000-01. However, the effective tax-free threshold has risen with the increase in the LITO from \$150 in 2002-03 to \$1,200 in 2008-09. At its current level, the LITO results in an effective tax-free threshold of \$14,000.

A larger explicit tax-free threshold could reduce or remove the need for LITO and various other offsets — in 1983-84 the tax-free threshold exceeded the maximum level of pensions and allowances. Some submissions argue that this is desirable as it would increase transparency, enhance progressivity and reduce complexity.

Increasing the LITO costs less in forgone revenue than increasing the tax-free threshold. This is because increases to LITO do not flow to higher income taxpayers, as LITO is currently withdrawn over the \$30,000 to \$60,000 income range. However, the withdrawal of LITO creates higher effective personal tax rates in this range (see Chart 4.1). For more detail on effective tax rates, see Box 4.1 (Section 4.5). The same effect could be achieved through changes in the explicit thresholds and rates. This would result in less complexity and greater transparency.

Chart 4.1: Marginal rates including the low income tax offset
By taxable income (2008-09)



Note: Does not include Medicare levy.
Source: Australian Treasury estimates.

Delivering changes to the tax-free threshold through LITO can obscure the returns from work. Unlike an increased tax-free threshold, which can be fully incorporated into PAYG withholding schedules and directly affect a person's regular pay, only half of LITO is

currently available through PAYG withholding. The other half of LITO is payable on assessment, which reduces the possibility of tax debts (the final amount of LITO available to a taxpayer depends on their annual income). A consequence of withholding greater amounts than necessary until assessment may be to dampen the participation incentives compared to what might otherwise be achieved with a higher tax-free threshold. It also has a negative impact on personal finances throughout the year.

Levies

In addition to the general rates and thresholds, tax revenue can be collected through specific levies.

The Medicare levy is a structural element of the personal income tax system. For most people, it is levied at a rate of 1.5 per cent of a taxpayer's income (in addition to the personal tax rates). It is not a hypothecated tax, as it is paid into Consolidated Revenue and represents only a portion of total Australian Government health spending.

By operating separately, the Medicare levy adds complexity to the system. Some taxpayers do not pay the Medicare levy, such as certain Defence personnel and Disability Support pensioners who are permanently blind. For others, there are a series of low income thresholds where the levy begins to shade in, based on family rather than individual income. There are different thresholds for single people, people in families, pensioners below Age Pension age, and senior Australians tax offset (SATO) recipients. Some of these are designed to ensure that certain groups, such as pensioners, do not pay the levy where they do not have a tax liability. Also, unlike other tax, the Medicare levy generally cannot be reduced by offsets. Some submissions advocate removing the Medicare levy and incorporating it into the personal income tax rates.

Specific levies can gain more community support than general tax increases, particularly in cases where the purported use of the revenue is for a cause that is supported by taxpayers. The downside of levies is that they: limit budget flexibility; are less able to deal with equity concerns than a progressive rate schedule (flat rate levies); are a relatively inefficient way of raising revenue; and generally add a layer of complexity to the system.

Taxing people differently

While people face the same personal income tax schedule, they are taxed differently through mechanisms such as offsets, the exemption of certain forms of income and different fringe benefits tax arrangements. Differences arise in terms of age, occupations, marital status and location. These differences can assist certain policy outcomes, such as enhancing the participation incentives of older workers, levying lower taxes on older people, or assisting particular family types. However, the policy intent must be weighed against the equity, transparency and complexity outcomes that result from different tax treatments.

Age

One outcome of the current tax arrangements is that people of different ages have different average tax rates for the same level of income, due primarily to the senior Australians tax offset (SATO). Table 4.1 illustrates this point.

A number of submissions propose lighter tax treatment of those aged 65 years or over. Allowing personal tax rates to vary with age may enhance economic efficiency if there are substantial differences in the labour supply elasticities of different age groups. If this were to be the goal, it would be necessary to differentiate between labour income and passive income. SATO does not do this but the mature age worker tax offset does. (Section 3 discusses arguments for taxing labour income differently to passive income.)

Table 4.1: Various effective tax-free thresholds (2007-08)^(a)

Taxpayer type	Threshold (per annum)
Person not receiving income support	\$11,000
Allowee under Age Pension age	\$14,511
Pensioner under Age Pension age	\$22,922
SATO recipient	\$25,867

(a) An effective tax-free threshold is the maximum level of taxable income (including government payments but excluding superannuation) that is allowed before incurring a tax liability.

Income types

Certain forms of taxable income can have their tax treatment altered through specific offsets. For example, as previously noted, offsets mean that people who receive maximum rate pensions or allowances from government do not pay tax on this income. As noted above, it is arguable that this could be achieved more simply and equitably by raising the explicit tax-free threshold.

Income received as certain types of fringe benefits (for example, cars) are taxed more concessionally than cash income. This is discussed in Section 4.2. Salary sacrificed income (for example, salary sacrificed to superannuation) is also treated more concessionally than income from salary and wages. Several submissions note that salary sacrifice arrangements create an uneven playing field by allowing some people to reduce their tax liability. One submission notes that they are regressive as the largest benefit accrues to those on higher incomes.

Some lump sum payments from employers are concessionally taxed through eligible termination payment offsets.

Occupations

Personal income tax can also vary for people in different occupations, such as defence force personnel and farmers. Some submissions argue this is inequitable, being based on government decisions about the value of particular work. Generally, submissions argue for a broadening of the available concessions (for example, fringe benefit concessions for employees of not-for-profit organisations) to include their occupation, either because they consider their work to be sufficiently 'valuable', or because, as employers, they have to compete for employees with industries receiving the concessions.

In some cases, such as tax offsets for Defence personnel, the effect is simply to shift costs within the government budget. In other cases it represents a transfer to particular groups. Examples include the FBT concessions for some not-for-profit organisations (see Section 7) or the income smoothing provisions for primary producers.

Family types

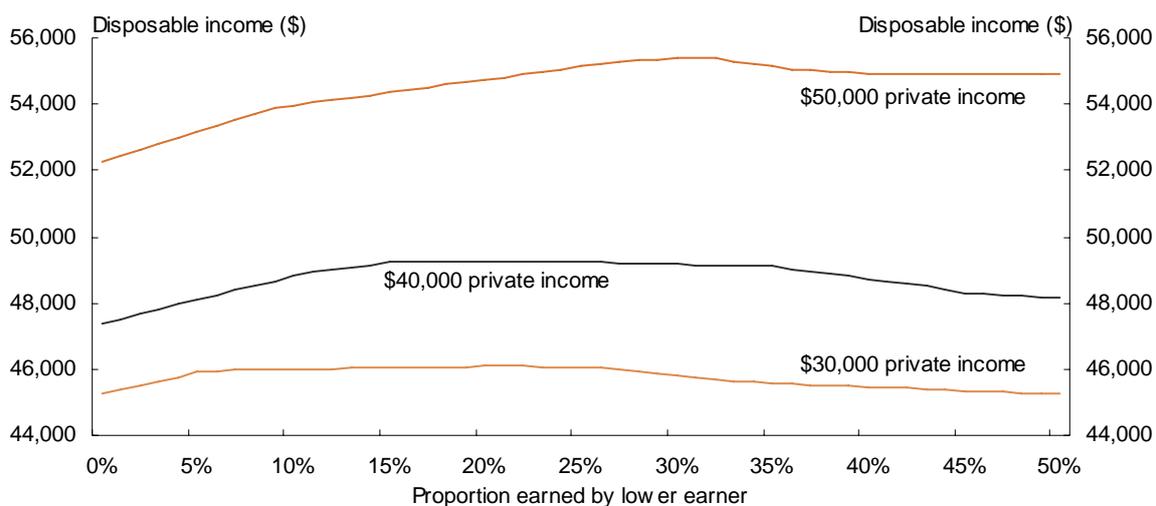
While the individual is the primary unit for the personal income tax system, there are elements which depend on family circumstances. For example, in the tax system there are dependant rebates which reduce the tax paid by certain people with low income dependants, such as a spouse.⁴ The Medicare levy has thresholds which depend on family income, while SATO can be shared between spouses. (See Section 4.7 for discussion on the unit of assessment.)

Several submissions note concerns that income splitting across families, through the use of private company and trust structures, is exploited to reduce taxes and increase family payments.

The tax-transfer system results in different levels of net taxation (taxes less transfer payments) for different family types. Outcomes vary with the number and age of children, and the presence of a partner and their earnings.

While some elements of the system, such as FTB Part A, depend only on total family income, for other elements, such as FTB Part B, the distribution of income within the household is important (Chart 4.2).

Chart 4.2: Family disposable incomes by lower income earner's share
 Couple with two children aged 11 and 13, at selected levels of family private income



Note: Income support (where payable) is Newstart Allowance.
 Source: DEEWDR estimates.

Passive income of minors in excess of \$416 per year is taxed at the highest personal tax rate to limit parents' ability to claim their income as that of children who are minors. However, the availability of LITO allows minors to receive \$2,667 in passive income for 2008-09 before tax is incurred.

Locations

The zone rebate means that people in different areas in Australia face different levels of tax. The current zoning arrangements were introduced in 1945 and have not been updated since

⁴ Rebates are also available for other dependants, such as child housekeepers and invalid relatives.

1958-59 (for example, Darwin and Cairns are included as concessional locations). Submissions note that fly-in-fly-out arrangements weaken the targeting of residents in some locations and highlight concerns over where boundaries are drawn and how qualification for such rebates is determined.

In certain circumstances, the employment income of Australians working overseas is exempt from Australian income tax.

Maintaining the system over time

The coherence of the tax system involves more than point-in-time considerations. Interactions between elements that only change due to particular government decisions, such as the income tax thresholds and LITO, and elements that are indexed, such as the pensioner tax offset (PTO), can result in unintended consequences. As an example, the current impact of SATO is that both Age pensioners and self-funded retirees have the same effective tax-free threshold. However, the wage-driven growth in the PTO will mean that it will soon become more generous than SATO. Similarly, while the amount of LITO is expected to continue to increase over the next few years, its maximum rate phase-out point is set to remain pegged at \$30,000. This means that its relationship with other offsets will change. At present, SATO is viewed as an additional offset for seniors, and begins to phase out before LITO does. However, by 2010-11, LITO will begin to phase out before SATO.

Indexation

Regular adjustment of the tax thresholds maintains the progressivity of the system by ensuring people only move into higher tax brackets when their real income increases.

Automatic indexation ensures that governments cannot use implicit tax increases to collect revenue. Some countries index their income tax thresholds each year to price rises to achieve this outcome. Another option is to index thresholds to wages growth. This would ensure that real income increases would not attract an increased tax liability as long as they are in line with average changes in wages. Linking thresholds to wages would significantly limit the growth in tax revenue over time. Both price and wage indexations of thresholds are proposed in submissions.

Australia relies on discretionary adjustments to personal tax thresholds. Implicit tax increases are revealed in published tax to GDP ratios, which make transparent the degree to which fiscal drag is returned. Australians at all income levels have lower tax liabilities now than they would have if the 1985-86 or 2000-01 personal income tax schedules had been indexed to growth in either prices or wages.

Not locking in a particular income tax schedule provides flexibility to government to determine the distribution of taxation and respond to economic circumstances. For example, automatic indexation could result in fiscal policy working in conflict with monetary policy in times of high inflation. The discretionary approach allows government to not only accommodate growth in prices or wages, but also allows for more nuanced goals, such as limiting the proportion of taxpayers facing high personal tax rates, which may not occur under automatic indexation.

It might be expected that indexation of the tax thresholds would enable the tax and transfer systems to move with greater synchronicity. However, there are currently a number of

different approaches to indexation within both systems. Keeping relativities constant would be difficult and would involve significantly greater reform than simply indexing personal tax rates, including consideration of the indexation arrangements for offsets, levies, and rates and thresholds of transfer payments.

Consultation questions

- Q4.1 How might the personal tax system be changed to better achieve the goals of greater simplicity, transparency, equity and efficiency?
- Q4.2 What is the appropriate distribution of income tax across income levels and how should it differ from the current distribution? Should governments seek to maintain a similar distribution over time, or should they fix the value of current tax thresholds through indexation?
- Q4.3 Is the personal income tax base appropriately defined? Should reforms such as changes to the scope of deductions or other measures be considered?
- Q4.4 Should the tax treatment of transfer payments be reconsidered? Should transfer payments be taxed at the same rate or a lower rate than earned income?
- Q4.5 Should people in different circumstances be taxed differently (for example, by age, occupation, location), and what might be the implications of such arrangements? Are tax offsets the best way to achieve differential taxation?

4.2 Fringe benefits tax

Fringe benefits tax (FBT) is intended to ensure that remuneration is treated consistently, irrespective of the form in which income is received (cash or in-kind). In this way, FBT acts as an integrity measure, by ensuring a potentially significant loophole in the income tax law is not created.

This section considers Australia's approach to taxing and valuing fringe benefits and explores some implications of the existing FBT exemptions and concessions. The FBT arrangements for not-for-profit organisations are explored in Section 7.

Summary of key messages from submissions

Submissions highlight concerns over the inequity of the current FBT system, particularly in relation to the application of the top personal tax rate.

Submissions focus on the ongoing appropriateness of the FBT arrangements, particularly their legal incidence. A number of submissions suggest fringe benefits should be taxed in the hands of employees rather than employers.

The current FBT arrangements are seen by business as complex and administratively burdensome. The reporting requirements are a particular concern, with a number of submissions arguing that the reportable benefit threshold is too low to remove the need for detailed record keeping on minor benefits (that is, businesses must keep comprehensive records simply to ascertain whether a reporting or payment obligation exists). Submissions suggest several options to minimise FBT compliance costs, ranging from a comprehensive rewrite of the current FBT legislation to the application of broad and streamlined formulas for compliance.

A number of submissions, particularly from business, call for the adoption of the general OECD practice of taxing fringe benefits at the marginal tax rate of the employee, as suggested in *A Tax System Redesigned* (Review of Business Taxation 1999). However, several submissions explicitly reject this approach.

Several submissions call for rationalisation of the existing FBT exemptions and concessions.

The majority of submissions by individuals raise the environmental impact of the statutory formula for valuing car benefits (see Section 13.2).

Australia's approach to taxing fringe benefits

FBT applies where non-cash benefits are provided by an employer to an employee — for example, through the provision of free or discounted property. It is paid by employers (including government employers) at the top personal income tax rate plus the Medicare levy (currently 46.5 per cent) irrespective of the income of the employee receiving the fringe benefit. Where the employer is entitled to credits for GST paid on the goods and services acquired to provide the benefits, these credits are taken into account in the calculation of the FBT liability.

The cost of providing a fringe benefit (and thus its taxable value) may be reduced by employee contributions. For example, rent paid by an employee receiving a housing fringe benefit is deducted from the market or statutory value of the benefit, which is then used to calculate its taxable value.

The value of a reportable fringe benefit is included on an employee's payment summary on a 'grossed-up' basis — that is, the value of the fringe benefit is increased to reflect the value of income tax (at the top personal rate) that would be paid if the fringe benefit were purchased out of after-tax income by the employee.

Several submissions suggest the application of the top personal income tax rate promotes vertical inequity in the FBT system by discouraging employees with lower personal tax rates from accepting non-cash benefits, even where this may be beneficial to them. Submissions also express concern that the FBT system gives rise to horizontal inequity, as fringe benefits are not equally accessible to all employees.

While taxing fringe benefits in the hands of the employee might address the equity concerns described above, it would not necessarily result in simplification of the system. To ensure tax system integrity, employers would still be required to value benefits provided to employees for reporting purposes. It would therefore be likely to have a minimal effect on compliance costs.

Treatment of fringe benefits for transfer payments

While means-tested tax programs take into account the 'grossed-up' value of fringe benefits, transfer programs generally only include the net or 'cash' value (the income test to assess child support liability is an exception).

While a measure from the 2006-07 Budget was due to apply the grossed-up value to family assistance payments from 1 July 2008, the Australian Government reversed this measure on 20 June 2008, citing concerns over the implications for charitable sector employees. These employees were concerned that the grossed-up amount overstated the pre-tax value of the benefits provided to those on a lower personal tax rate. A small number of submissions express strong support for the reversal.

The Government has asked the Panel to examine the complexity of the existing fringe benefit arrangements for the not-for-profit sector and make recommendations to improve equity and simplicity in the longer term (see Section 7).

Valuation

The current approach to valuation is to use 'market value' in some cases (for example, for the purpose of calculating stamp duty on motor vehicles), complemented by a large number of statutory valuations. Some submissions raise the complexity of the current arrangements and express concern over the practical difficulties in determining the value of the benefits to the employee.

An alternative approach might involve the valuation of *all* benefits at their market value, as currently occurs for non-cash business benefits. Broadening the base of FBT in this way might involve removing the concessional treatment of some benefits (for example, cars). A submission also proposes the valuation of all benefits at cost. As the accounting value of fringe benefits is likely to be lower than their market value, valuation at cost would promote horizontal and vertical inequity by favouring individuals receiving fringe benefits rather than cash income.

FBT exemptions and concessions

In 2008-09, estimated tax concessions for fringe benefits were \$3.3 billion.⁵ In comparison, FBT revenue collections were \$3.8 billion.

Some submissions call for the removal of specific FBT exemptions and concessions (particularly in relation to cars, as discussed in Section 13.2), while others support extending the exemptions and concessions to other benefits, such as off-site child care.

Fringe benefits exempt from FBT include:

- infrequent minor benefits (currently subject to a threshold of \$300);
- recreational or child care facilities on employer premises;
- small business employee car parking;
- housing benefits provided to employees in remote areas;
- certain eligible work-related items; and
- taxi travel to or from the workplace in certain circumstances.

In addition, FBT concessions apply, among other items, to: cars; certain types of meal entertainment; and holiday travel by employees posted overseas.

The current FBT exemptions and concessions exist for several reasons, including practical difficulties in respect of valuation (for example, where multiple employees share the fringe benefit). The compliance costs of valuing certain benefits could outweigh the equity benefits of valuation.

Historically, exemptions and concessions were also extended to organisations that were exempt from paying income tax. Several submissions suggest the ongoing justification for this treatment is not readily apparent, particularly given the economic incidence of FBT is generally considered to fall on the employee.

These exemptions and concessions are likely to distort demand for goods and services. For example, as noted in *A Tax System Redesigned* (Review of Business Taxation 1999), the concessional treatment of car fringe benefits provides a strong incentive for some employees to take a car as part of their remuneration package and to skew their consumption toward motor vehicle services.

Consultation question

Q4.6 How can fringe benefits tax be simplified while maintaining tax integrity? Would it be better to adopt the general OECD practice of taxing fringe benefits in the hands of employees, rather than employers?

⁵ As reported in the *2007 Tax Expenditures Statement* (Australian Treasury 2007). Since the publication of the TES, several FBT integrity measures for eligible work-related items, meal cards and jointly-held assets have been announced which reduce the concessionality of these items.

4.3 The transfer system

The transfer system is the means by which the Australian Government redistributes around \$70 billion of income each year. While much of this redistribution is targeted to those on low incomes, some transfers assist middle and higher income individuals and families. The transfer system has evolved over time, with a range of provisions that are complex for recipients.

Summary of key messages from submissions

A number of submissions identify problems with the categorical structure of income support, including its division into pensions and allowances. A key concern is that the difference between the two kinds of payment creates workforce disincentives, both because of the different rates of payment and also because of payment conditions such as activity testing.

Other concerns raised about the categorical nature of income support are that the system is unfair for people on allowances. Some submissions argue that all income support recipients should be paid at the same basic rate, possibly with tailored add-ons. Others contend that rates should be differentiated but on a basis other than the current pension/allowance distinction.

Family assistance is primarily a focus of submissions in relation to its impact on incentives for parents to work. Some submissions indicate a preference for a system that encourages families to move from one to two incomes.

Submissions raise concerns about the level of Rent Assistance relative to the costs of renting, particularly given that people in different parts of the country face a wide diversity of rents. Concern is also raised about the sharers' rate of Rent Assistance, which could be seen as penalising those who share housing.

A number of submissions comment on the relative support available to private renters through Rent Assistance, and to homeowners through the generous treatment of a person's home for the purpose of the assets test. Several submissions propose changes to the treatment of a person's home, such as including more valuable homes in the assets test.

Some submissions note that much of the assistance provided through supplementary payments and concessions advantages retired people, including relatively wealthy retirees, with much less benefit to people of working age. Some submissions indicate that cash payments give people greater control over resources, while others indicate a high level of support for concession cards.

Some submissions identify the complexity of the transfer system as a problem, including the observation that those facing this complexity include members of society who are least equipped to do so.

The Australian Government transfer system has several elements. Income support provides assistance for the basic living costs. Family assistance, Rent Assistance, other payments and concession cards provide additional assistance to income support recipients. Some are also paid to those who have other basic means of support. State transfers are primarily provided

through concessions and subsidies, often based on entitlement to a Commonwealth concession card.

Categorical income support

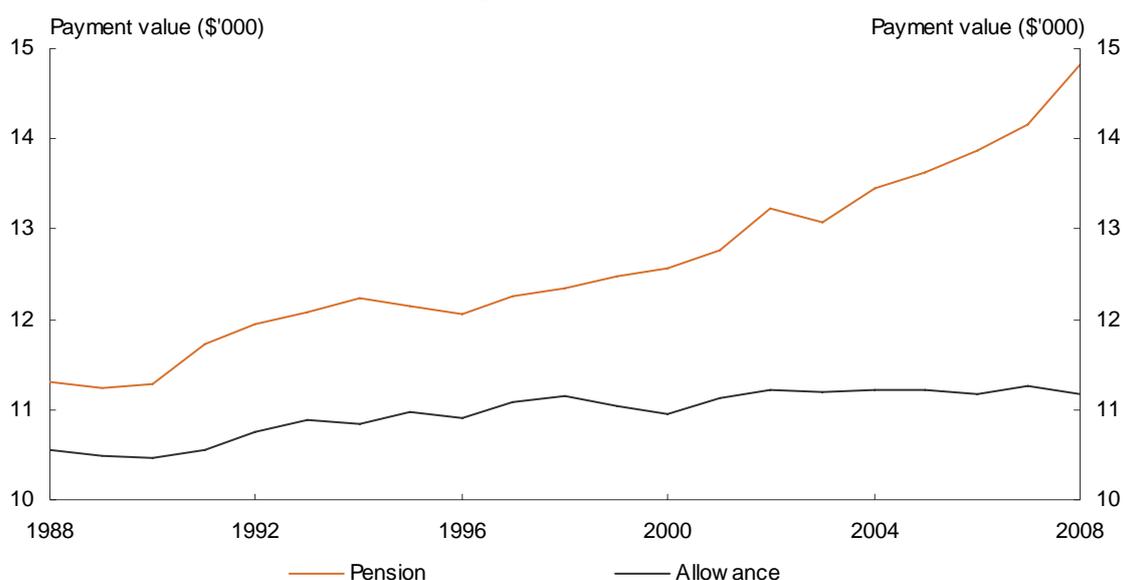
Categorical eligibility and means testing requirements are imposed on income support recipients — that is, pensioners and allowees. Categorical eligibility requirements are the conditions that entitle people to certain kinds of support. Pensions are paid to people meeting age requirements (for Age Pension and some service pensions), with caring commitments (Carer Payment and Parenting Payment Single), or with a significant disability (Disability Support Pension). Allowances are generally paid to people with work and study obligations (such as Newstart, Austudy and Youth Allowance). While categorical systems are the norm internationally, several submissions proposed various forms of negative income tax, which might not be categorically based.

Pensions have traditionally been paid to people who were not expected to work, such as widows, sole parents, people with disability, certain veterans and the aged. The more generous pension conditions applying to such groups relate not only to rates of payment, but also to the amount of money a person can earn or receive without affecting their payment rate, the withdrawal rate for the payment, and the way in which the payment is indexed over time.

By contrast, allowances have historically been paid to unemployed people, who were not expected to need support for an extended period, reflecting that high unemployment was not typical when unemployment benefits were first introduced in 1945.

Since 1984, when allowance rates were temporarily frozen, there has been a difference in the rates of payment made to pensioners and allowees. The gap between the two sets of rates has been widening since 1997, when pension rates were benchmarked to 25 per cent of male total average weekly earnings (MTAWE). This gap is illustrated in Chart 4.3.

Chart 4.3: Real rates of the single pension and allowance (1988 to 2008)^(a)



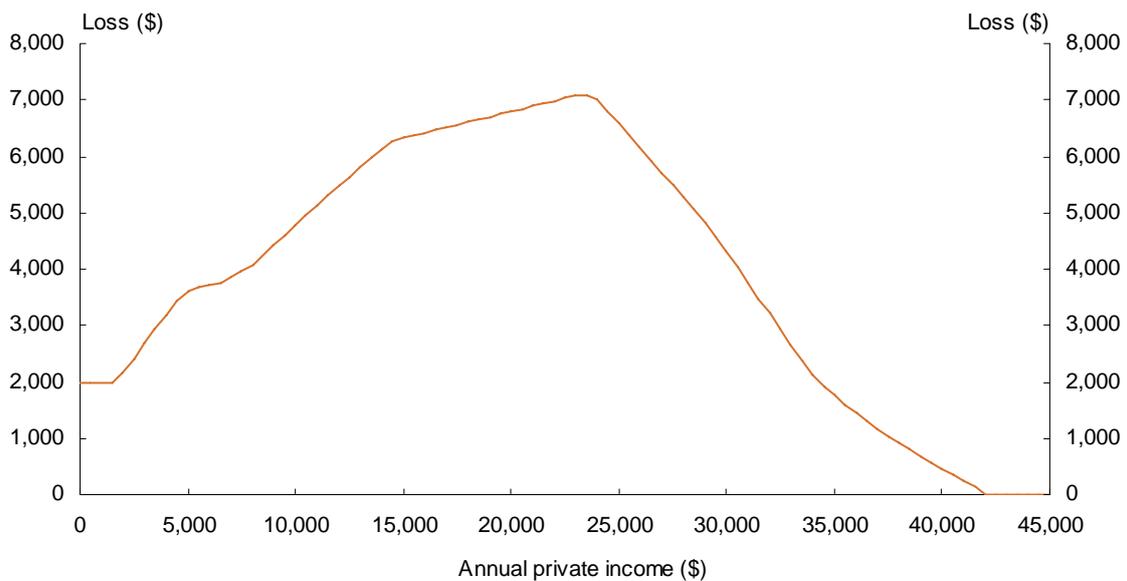
(a) Rates for all years are expressed in 2008 dollar values.
Source: FaHCSIA estimates.

The higher rates for pensioners have several implications. The first is that if a person is paid an allowance for an extended period of time, the rate of payment may not be considered adequate. Some submissions suggest that this may be the case for people who spend long periods on Newstart because they cannot find or take up a job. It may also apply when a person has a disability but can still work more than 15 hours per week. These people may only have capacity for part-time work and so may be reliant on Newstart for many years. Similar conditions are created for sole parents with children aged eight years or older.

A second implication is that people have a strong incentive to receive pensions in preference to allowances. A person with some level of disability or caring responsibility experiences a material financial advantage if that disability or caring responsibility is significant enough for them to meet pension requirements. Once a person is paid a pension, there is a strong incentive not to jeopardise their more secure and financially generous arrangements by taking on significant amounts of work.

Several submissions discussed the significant drop in income support that results when a person moves from a pension to an allowance. For example, moving to the lower single rate of Newstart Allowance produces a drop of over \$100 per fortnight. The drop is even higher if the person has private income. A sole parent working 15 hours a week (to meet their activity test obligations) at the minimum wage could experience a drop of over \$200 per fortnight in their transfer income. Chart 4.4 illustrates the net impact on disposable income of moving from pension to allowance rates, depending on the amount of private income received. Significant reductions resulting from the move from pension to allowance rates are the experience of many sole parents when their youngest child turns eight years of age, or if they form a new relationship with a person on income support or in low-paid work. Significant reductions in disposable income can also occur for carers when their caring role ends or diminishes.

Chart 4.4: Loss of disposable income experienced on switching from Parenting Payment Single to Newstart Allowance
By annual private income (2008-09)



Source: DEEWR estimates.

A common payment for people of workforce age, as called for by some submissions, is one approach to lessening the distinctions between payments, and would diminish the incentives for people to receive pensions over allowances.

The preferred approach will depend on the income support goals for each of the categories or circumstances of various recipients. At this time, it is not clear to the Panel what the goals are, or should be. In general, all that can be said is that the assistance goals for each category are implicit in the payment rates.

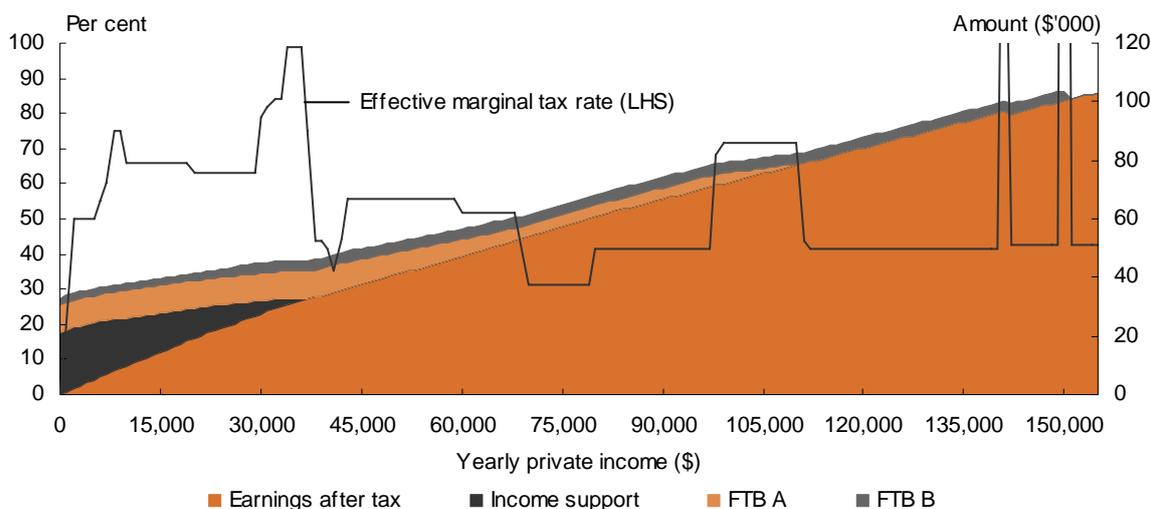
Family assistance

Key ongoing forms of family assistance include Family Tax Benefit (FTB) Parts A and B, Child Care Benefit and the Child Care Tax Rebate. In addition, the Australian Government has asked the Productivity Commission to consider possible ways to introduce paid parental leave and to report by February 2009.

FTB Part A is paid on a per-child basis. FTB Part B is paid to single income families on a per-family basis. If the primary purpose of the payments is considered to be part compensation for the direct and indirect costs of having children, it could be argued that they should not be income-tested. While this would lower effective marginal tax rates (EMTRs) (see Box 4.1, in Section 4.5) and possibly improve workforce incentives, it would be more costly. On the other hand, if the payments are directed at reducing child poverty, arguably they could be more tightly targeted. This could worsen workforce incentives for some groups and improve them for others. According to submissions, the way the system seeks to address disparate goals is considered by many parents to be very complex.

Chart 4.5 illustrates the responsiveness of the tax and transfer systems to variations in earnings. This contrasts with overseas systems that distinguish assistance, such as family assistance, according to whether or not the recipient is in paid employment. A relatively seamless transition between no earnings, moderate and higher levels of income reflects the contemporary labour market, with its substantial levels of part-time and casual work.

Chart 4.5: Effective marginal tax rates and disposable incomes^(a)
By yearly private income, single earner couple with two children



(a) Effective marginal tax rates (EMTRs) are calculated using a \$1000 income increment. Spikes in EMTRs at \$140,000 and \$150,000 reflect the imposition of the Medicare levy surcharge and the loss of FTB Part B respectively. Source: DEEWR estimates.

While FTB provides integrated assistance to families with children, it is seen by many parents as very complex. Eligibility for FTB is assessed on an adjusted form of taxable income, requiring parents to estimate their combined taxable income for a year. In other words, they are, in effect, pre-paid their entitlement during the year. The difficulty of estimating income is seen in the significant number of overpayments made since the system was introduced. Particular complexity can arise for parents who separate during an income year. Some submissions also raise the difficulty that families receiving FTB Part A experience when a child turns 16 years of age in determining whether their overall package of assistance would be more favourable if they accept the lower rate of FTB Part A or if their child claims Youth Allowance.

Rent Assistance

Rent Assistance may be paid as a supplement to a person's income support payment or with FTB Part A where a family receives above the base rate. People receiving Rent Assistance can have very different levels of income (Table 4.2). Rent Assistance is generally paid at lower rates to single people who share accommodation. Submissions raise concerns about the equity of these arrangements.

Table 4.2: Level of private income at which Rent Assistance cuts out

Primary payment recipient	Amount
Newstart allowance, single	\$26,762
Pension, single	\$47,655
One child family receiving FTB Part A	\$72,854

Several submissions raise the issue that the level of Rent Assistance does not reflect the changes over the past decade in house prices and rents, or the diversity of prices across different locations. Rent Assistance is indexed by the CPI; relativities are only maintained where rental prices increase in line with the whole basket of goods and services comprising the CPI.

While Rent Assistance is paid to private renters, public renters also receive subsidies for housing. Home owners who are income support recipients have an assets test treatment that tends to favour saving through a home over other forms of savings. This is provided by way of an assets test threshold that assigns the low notional value of \$124,500 to a person's home, regardless of the actual value of the home.

Housing issues are considered further in Section 10.

Delivering assistance through other supplementary payments and concessions

Certain costs are recognised via supplements, primarily for pensioners and for self-funded retirees. These include Telephone, Utilities, Pharmaceutical and Seniors' Concession Allowances. The transfer system also provides concession cards, with the most generous being the Pensioner Concession Card. A more limited set of concessions is available to self-funded retirees through the Commonwealth Seniors Health Card, and to allowees and low-income individuals and families through the Health Care Card.

The system provides higher levels of support through payments and concessions to retirees (including self-funded retirees) than to working-age people. This disparity is a point of concern in a number of submissions.

Many State government and private concessions are available to individuals with concession cards. This form of delivery can be less targeted than other mechanisms because concession cards cannot be provided on a partial basis. Some submissions propose changes to the eligibility rules for concession cards.

Supplementary payments would be likely to feature in proposals for a single payment for people of working age, as proposed in some submissions. These might recognise costs such as the costs of working, including for people with disability, and the indirect costs of sole parenthood, particularly for those whose children are young.

See Box 4.2 at the end of Section 4 for a further discussion of alternative means of delivering support.

Consultation questions

- Q4.7 Are the current categorical distinctions for income support, including rates of payment and income tests, still relevant? If not, would other categories be better? What goals or principles should guide categorical distinctions and associated payment rates?
- Q4.8 What priority should be given to the different objectives associated with family assistance, such as poverty alleviation, recognising the social value of child rearing, facilitating workforce participation of parents, and early childhood education? Would it be better to provide less family assistance to higher income earners?

4.4 The adequacy of support for people of working age

The adequacy of payments and other support underpins the living standards of people in receipt of support, as well as influencing their incentives to work and to develop and improve their skills. The generosity of transfers affects both those who are out of the workforce and also the decisions of many people who are in work.

Adequacy has been a focus of the Pension Review, with an emphasis on the Age Pension, Disability Support Pension and Carer Payment. There is no consensus as to how to measure adequacy. Any judgment needs to take into account the standard of adequacy being sought and the value of non-cash as well as cash benefits. It also needs to recognise that the same level of income can lead to different outcomes for different people, depending on their circumstances, preferences, skills and any other resources they can call upon.

Summary of key messages from submissions

A number of submissions express concern about the adequacy of income support and transfer payments more generally. Some organisations note that payment rates are below a number of indicators such as the Henderson poverty line.

Working-age allowance recipients are identified as a group for whom payment rates are particularly low. Another group associated with adequacy concerns is low-income people renting in the private housing market. Many submissions to the Pension Review argue that payment rates and overall support packages are not adequate.

Several submissions propose a change to indexation or benchmarking arrangements, with several organisations supporting the development of a new single benchmark based on a range of research and data.

The gap between pension and allowance rates, and its continuing growth, is a concern expressed in many submissions. Some people believe payment rates should be the same for pensioners and allowees, while others argue payment rates should be differentiated but on some basis other than the current pension/allowance distinction.

In terms of the design and level of payment rates, submissions point to the need to 'make work pay', including through a smooth transition into work from income support.

Some submissions compare arrangements for retired people and those of working age, expressing a range of views as to whether existing links should be maintained or the retirement income system separated.

The need for compensation for the effects of the Carbon Pollution Reduction Scheme is identified as an issue in some submissions.

Defining adequacy

Government uses several mechanisms for adjusting or setting rates that affect a significant proportion of the population. As discussed above, both price and wage indices are used to adjust pension rates and the consumer price index is used to adjust allowance rates. A separate independent process is used for setting minimum wages.

The adequacy of payments could be assessed by means of a range of indicators. These include distributional measures (such as half median household equivalised disposable income⁶), replacement rates, budget standards, the Henderson poverty line and financial hardship measures. These indicators are described in the *Architecture paper*. Each measure yields different results, and often markedly so.

Choosing one or a combination of these indicators embodies a set of implicit judgments, as does any other method of payment rate-setting. Submissions that cite such indicators do so to support their views and judgments about issues such as how to balance the adequacy of

6 Equivalised incomes take into account different household sizes and structures by identifying the amount needed to provide an equivalent standard of living to that of a single person.

support against incentives to work, and how to balance income available to young adults against expectations of parental support.

Factors affecting payment rates

Payment rates arguably reflect a range of judgments made over time about the relative needs, incentives and expectations applying to particular groups of income support recipients. This section outlines some relevant considerations potentially underlying the rates of payment.

The first consideration may be expected duration on income support. As discussed in Section 4.3, pensions were historically paid to people who were not expected to work again, while allowances were paid to unemployed people, who were not expected to need support for an extended period. Although most working-age people once tended to have short periods of income support receipt, Table 4.3 shows that a substantial proportion of working-age people have long periods of receipt. This may not be continuous or on the same payment.

Table 4.3: Average time on working-age income support over the period July 1999 to July 2008

For new recipients in 1998-99 or existing recipients at the beginning of 1998-99^(a)

Recipient type	Average number of years in receipt of income support	Average years as a percentage of the whole period
New recipient in 1998-99	3.1	34.2%
All recipients on 1 July 1998	4.8	53.0%

(a) Excludes time spent on the Age Pension. New recipients are individuals who had previously had at least a six week period without income support, or 13 weeks where a previous period of income support was greater than 46 weeks.

Source: Australian Government administrative data.

While groups that have traditionally been paid pensions continue to have long durations on income support (on average and not necessarily on the same payment), there has been some compositional shift not only in the groups themselves, but also in the labour market and in societal expectations about employment. For example, while in the past a sole parent was not expected to seek and find employment, the Welfare to Work changes introduced from 2006 require sole parents to start looking for work once their youngest child turns six. When their youngest child turns eight they may lose entitlement to Parenting Payment Single and may shift to allowance payment rates and conditions, underlining the expectation that they are now regarded as being available for part-time work.

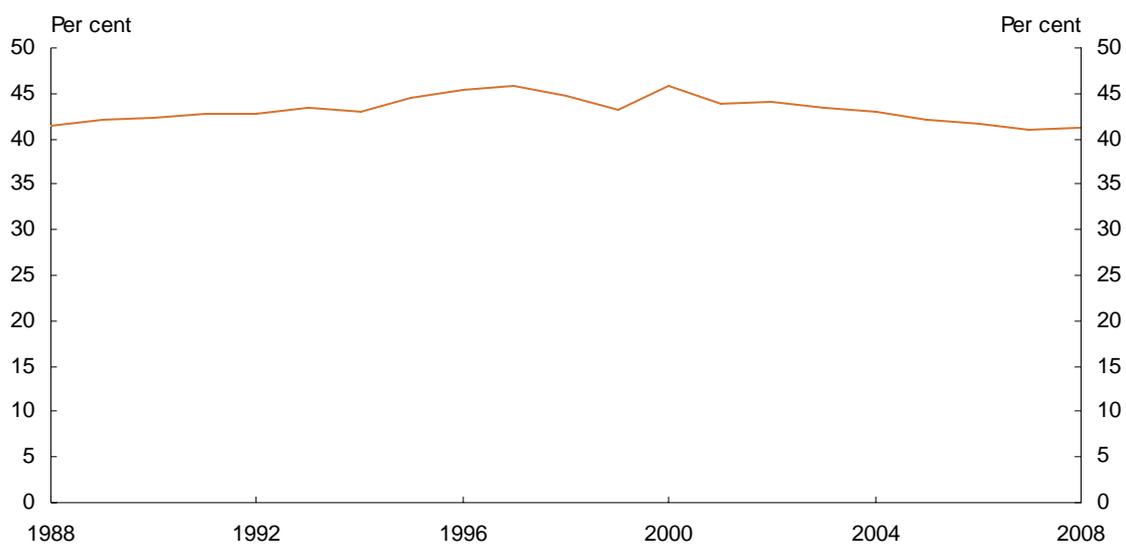
A second consideration in setting payment rates may be the costs of work and of looking for a job. There is little evidence on these costs, although they could be expected to vary considerably according to such factors as the cost of travel and people's need for child care.

The direct and indirect costs of having children may be a third consideration in setting payment rates. Research indicates that direct costs increase as children get older. By contrast, the indirect costs, such as the cost of taking time out of the workforce, are likely to be highest when children are very young. Indirect costs are particularly relevant for sole parents, because they are less able to share the responsibility of child-raising which can affect their availability for work. Indirect costs are also important for partnered parents, particularly when children are very young. These costs are reflected in the part-time activity testing requirements for partnered parents.

A fourth consideration may be the value of home production, other than child rearing activities. The amount of time available to individuals to undertake home production can make a material difference to the standard of living they are able to achieve.

A fifth factor affecting payment rates may be the level of the federal minimum wage (FMW). The levels of both the FMW and transfer payment packages have varied over time. Under current arrangements, an allowee undertaking substantial part-time work can earn 80 per cent of the FMW and still receive income support, while a pensioner can earn substantially over the FMW while still retaining some residual income support. People's incentive to work for low wages, whether part-time or full-time, can be influenced by income available to them through the transfer system. Chart 4.6 shows the stability of the relationship between allowance rates and the FMW over the past 20 years.

Chart 4.6: Allowances as a percentage of the minimum wage (1988 to 2008)



Source: DEEWR estimates.

A related consideration may be the relativity between single and partnered rates. Under current arrangements, a single pensioner receives 60 per cent of a couple's entitlement, while a single allowee receives 55 per cent of a couple's entitlement.⁷ There are a range of views on the appropriate relativity.

Benchmarks of adequacy

Submissions note that rates of pensions and allowances can be defined with regard to a range of benchmarks of adequacy, including by reference to general community standards as measured by wages or an externally determined minimum standard of living. The various benchmarks of adequacy reflect different judgments about the actual standard of living that a person reliant upon transfers should be able to achieve. In making this judgment, governments consider a range of factors such as incentives to work, costs of work, equity with low paid workers, and the capacity and willingness of taxpayers to support transfers.

⁷ If the single allowee has a child or is aged over 60 and has been on allowance for over nine months, they receive 60 per cent of a couple's entitlement.

An issue for consideration is whether there should be a common basis of benchmarking across pensions, allowances and other transfer payments. Currently pensions are benchmarked to MTAW, whereas allowances reflect historical judgments about adequacy, as indicated by movements in prices. At the same time, there is an independent process for establishing minimum wages.

The relationship between transfers for retirees and working-age people

The key financial supports for most retired people are income support payments and private superannuation. The Age Pension is currently available to men from age 65 years and women aged from 63 and a half years. Superannuation is currently preserved until age 55 and superannuation benefits paid to a person of age 60 years or older are tax-free when paid from a taxed superannuation fund.

Other entitlements also become available to older people at varying ages between 55 years and Age Pension age, and many people move to the Age Pension from another payment. The issue of age-based taxation is discussed in Section 4.1. There is no distinct age of retirement. In part, this reflects changes in the relationship between people of working age and retired people.

With increasing life expectancy, a growing number of people are reaching Age Pension age and receiving payments for a longer period than has previously been the case. In response to this trend, and as part of a broader scaling back of the generosity of pension schemes, a number of countries, including the United Kingdom and the United States, are increasing their Age Pension age, typically to 67 or 68 years.

There is also a greater dispersion in the wealth of Age pensioners. With the maturity of the superannuation guarantee (SG) system in 2037, the proportion of Age pensioners with significant levels of private income is expected to grow. However, there will still be some pensioners with little private income or assets, as they may have spent time out of the paid workforce or worked mostly in a pre-SG environment.

With the proportion of working-age people projected to decline as Australia's population ages, there is increased community acceptance that older Australians will increase their traditionally low level of workforce participation. Many older Australians have increased retirement income expectations, which have increased their willingness to work. Australians are also now living longer. Coupled with greater workplace flexibility, this now allows older people to be more active in the workforce.

Consultation questions

- Q4.9 What are the key factors that should affect rates of transfer payments? What should be the relative importance of duration on income support, costs of work and job search, costs of children, value of home production and the level of the federal minimum wage?
- Q4.10 Should transfer payments have a common benchmark? If so, should it be a proportion of a wage measure, and if so, which one? Or is there a better benchmark? Should there be a common indexation arrangement?

Q4.11 Should payments for retired people remain linked to payments for people of working age?

4.5 Participation incentives and the tax-transfer system

Increased workforce participation can reduce the potential impact of an ageing population on future workers through higher economic growth and also have substantial social benefits by reducing exclusion and improving the distribution of income.

This section examines the impact on the incentive to work arising from the interaction of taxes and income tests on working-age income support payments, such as Newstart, Disability Support Pension, Parenting Payment and family assistance.

Summary of key messages from submissions

Several submissions argue that our ageing population will create budgetary pressures, which can be met by increasing workforce participation.

Some submissions argue that the tax-transfer system can be a disincentive to part-time work, such as through high effective marginal tax rates. Submissions also recognise there are significant trade-offs between incentives, adequacy and affordability.

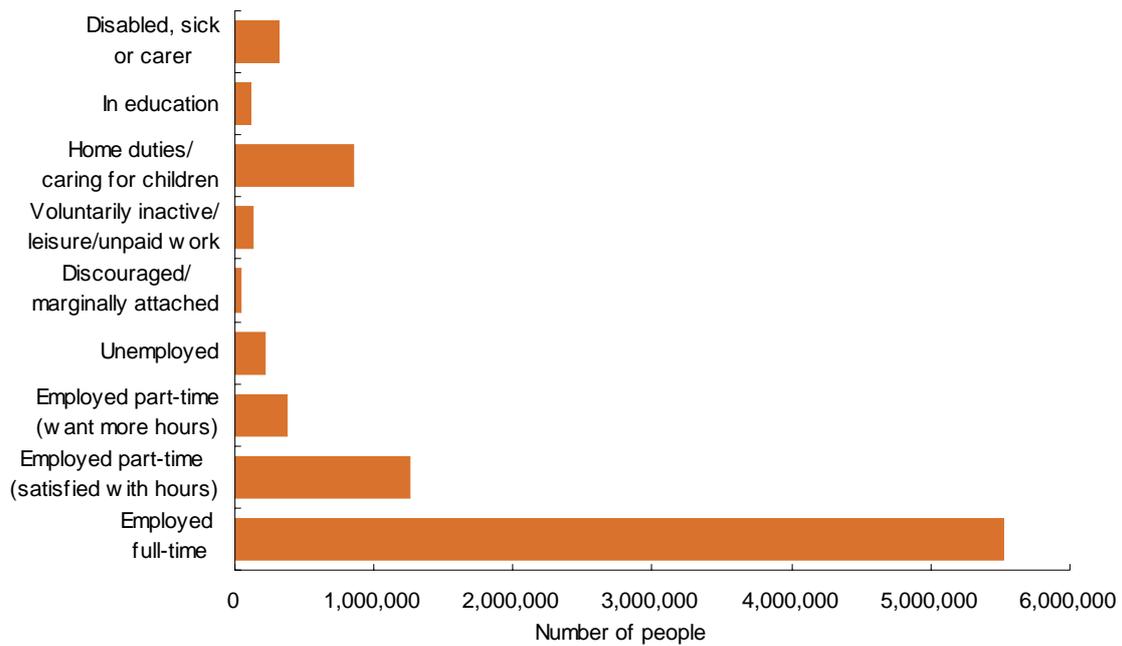
A number of submissions suggest that reductions in EMTRs could increase participation. They propose several ways this could be achieved, including through: reductions in income test taper rates for Newstart; the introduction of a single income test on cash transfers to reduce the overlap of income tests; the introduction of an earned income tax credit; and a change to income testing for FTB to reduce effective tax rates on second earners.

Other submissions focus on the disincentives in the tax-transfer system for women's workforce participation, such as the structure of the allowance income test, the income test on Family Tax Benefit, and interactions with child support.

Ageing and participation

Recently, Australia has achieved historically high labour force participation rates (76.2 per cent for people of working age) that are above the average of OECD countries (70.7 per cent) (OECD 2008a). The primary reasons for people aged 25 to 54 years being outside the labour force are health (disability, sickness or caring), home duties or care of children (Chart 4.7).

Chart 4.7: Labour force status of 25 to 54 year olds (2007)



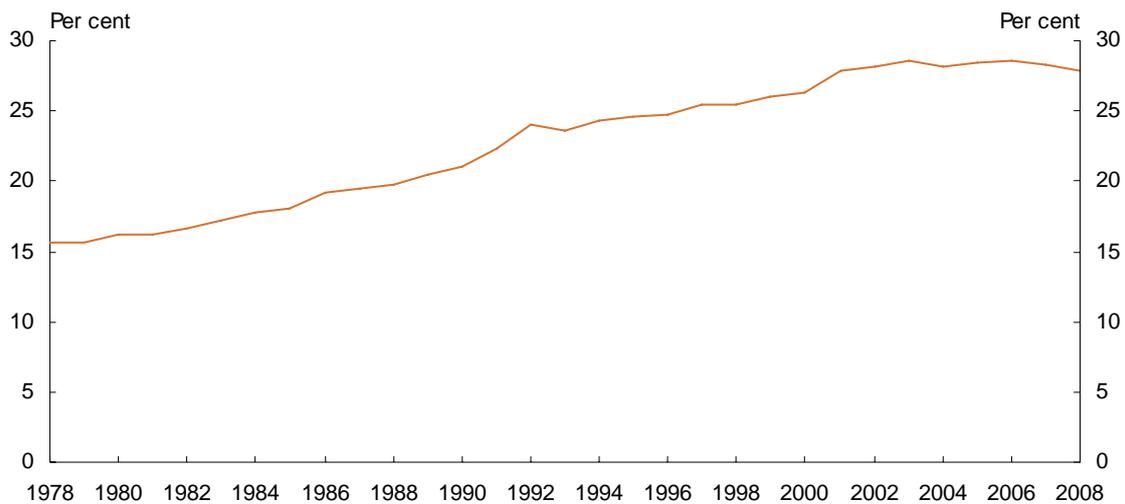
Source: DEEWR estimates.

The Productivity Commission (2007) considers further increases in participation are possible, particularly amongst these groups and older workers. However, they note that the full costs and benefits to the individual and society of reducing impediments to participation by these groups need to be identified. These could include child care, training, costs of work, and changes to income tests and taxes.

Part-time work

A number of submissions highlight that existing tax-transfer arrangements are not sufficiently supportive of people who prefer to work part-time. This is a major issue for policy design.

The number of people in part-time work has increased from around 15 per cent of the workforce in 1978 to 28.4 per cent in 2008 (Chart 4.8). This shift reflects a significant increase in female participation, especially mothers, for whom part-time work may provide balance with caring for their children. It also reflects increased participation by people with disabilities. More students also work part-time than in the past.

Chart 4.8: Part-time workers as a percentage of all workers (1978 to 2008)

Source: ABS (2007e).

Research shows that some groups, such as mothers, are more responsive to financial incentives than working-age men (see for example, Dandie and Mercante 2007). It also shows that the net financial return from work has more effect on the decision to work than on the decision to change hours of work. This is consistent with the view that taking a job involves large fixed costs and benefits. Fixed costs of working include the time spent commuting, while fixed benefits include the psychological benefit of working.

These developments call for a careful consideration of the goals of participation policies. There are trade-offs between the level of benefits, the cost of the program and the financial incentives to participate (Box 4.1).

Policies encouraging part-time participation through low EMTRs at the bottom of the income scale target those most responsive to financial disincentives, but can result in increased EMTRs further up the income scale. These higher EMTRs may affect more people and will tend to discourage them from taking on more work, possibly resulting in a 'low income trap'.

On the other hand, policies leading to high EMTRs at the bottom of the income scale can keep people out of work, resulting in an 'unemployment trap'.

The final effect on labour supply will be determined both by how many taxpayers face the various effective tax rates and how responsive they are to them.

Box 4.1. Effective tax rates

The tax-transfer system drives a wedge between the gross pay that people earn and the take-home pay they actually receive. Part of this wedge is from taxes on personal income. Australia's targeted transfer system, withdrawing payments as incomes rise, can also reduce the financial gains from extra private income.

Effective tax rates attempt to measure all of these effects to provide a measure of the total wedge people experience. However, effective tax rates do not typically account for other changes such as increases in the costs of public housing, child support payments, Higher Education Loan Program (HELP) repayments, the value of lost concession cards, and the costs of child care necessary to facilitate work.

There are also issues with including elements that have a delayed impact on take-home incomes, for example those where the effects only become apparent after filing a tax return.

Effective marginal tax rates (EMTRs) measure the percentage of an additional amount of income that is lost through mechanisms such as tax and benefit withdrawal. Different sized income increments can be used for different purposes: small (one dollar) increments can provide a finely detailed picture of the effects of interactions in the tax-transfer system, while larger increases are useful for examining the effects on more realistic changes in income that people experience.

One key area of interest is looking at the effective tax rate when moving from outside the workforce into work. In this case, the increment is a person's entire gross pay, and the result is often referred to as a participation tax rate (PTR).

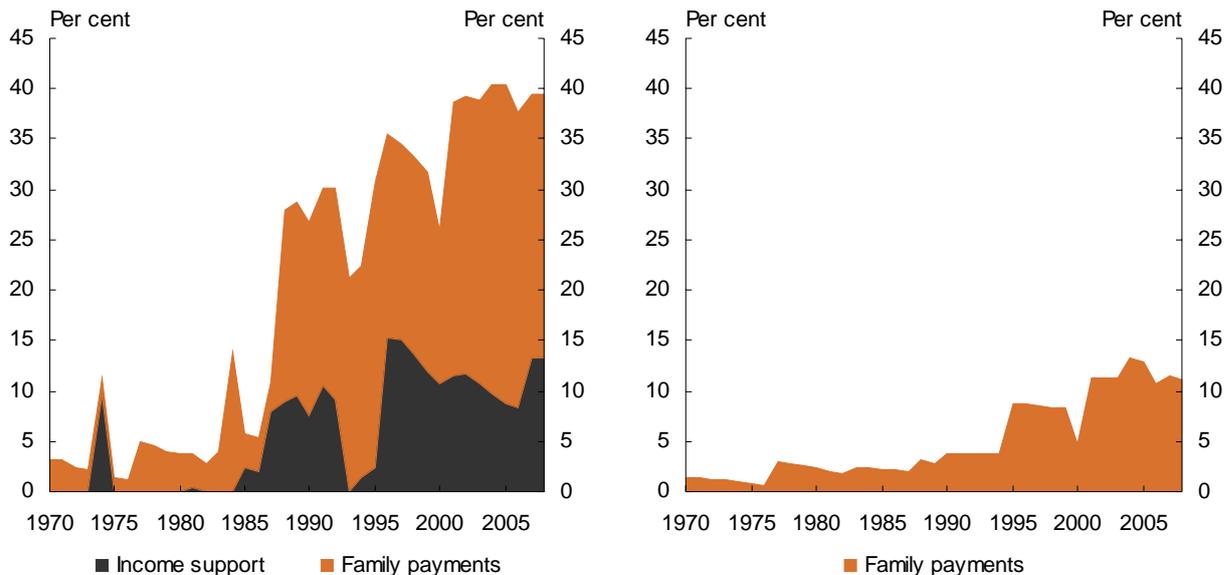
High effective tax rates can act as a disincentive to taking up work, increasing hours or moving into a higher paid job. However, effective tax rates need to be considered in light of the numbers of people actually or potentially experiencing them (the distribution) and the responsiveness of these people to them (their labour supply elasticities). Distributional analysis can highlight that some measures which reduce effective tax rates for a target group (for example, reducing tapers) can actually raise rates for more people outside the target group. Financial incentives have different effects on different groups, as there are other factors such as social expectations which affect labour supply decisions.

There are some constraints on the ability to reduce effective tax rates. For example, a single person with no private income can receive \$11,680 of Newstart Allowance, while the same single person earning \$100,000 will pay \$27,500 in tax. Thus the tax-transfer system must collect \$39,180 (claw back the Newstart Allowance and raise the tax) over the intervening income range. This would imply an average effective tax rate of almost 40 per cent, and for any income ranges where the effective tax rate is below this average there would need to be income ranges where it is above this average. To reduce effective tax rates for the entire income range in the above example would either require the Newstart Allowance to be reduced or tax reduced. Without changing payment levels or revenue requirements, the disincentive effects can only be minimised by targeting effective tax rates over the income range in accordance with the responsiveness of people in the income range — that is, lower effective tax rates for those groups who are more responsive and vice versa.

In recent decades, the progressive easing of income tests for income support payments has allowed recipients to work part-time and still receive some payment. This has encouraged more people to work part-time.

The loosening of the income tests on both family payments and income support means that couples, particularly those with children, can receive substantial cash support even while working full-time (Chart 4.9).

Chart 4.9: Proportion of disposable income from cash transfers
 Single income couple with two children under age five, not renting (1970 to 2008)
 Earning the minimum wage Earning average weekly earnings



Source: DEEWR estimates.

The changes to benefit withdrawal have been partly motivated by the increase in available part-time work and recognition that part-time work helps balance work and family responsibilities. The OECD notes that participation policies can adversely affect women’s choices between paid work and having children (OECD 2002). These choices also have implications for economic security and retirement incomes.

Another consideration has been the effect of part-time and intermittent work in maintaining work skills. There is evidence that part-time work can act as a ‘stepping stone’ to fuller engagement in the labour market. However, further research is needed on the extent to which encouraging part-time work through tax-transfer design acts as a low pay or part-time work trap.

The United Kingdom (UK) has a different approach to these issues in its tax-transfer system. It uses in-work benefits to supplement its unemployment and other direct welfare payments. To receive income support in the UK – equivalent to Australia’s Newstart Allowance – a person must, among other things, have ‘usual working hours’ of less than 16 hours a week. This is in contrast to Australia, where it is sometimes possible to receive Newstart while working full-time.

However, the UK also has several in-work cash benefits, of which the largest and most significant is working family tax credit (WFTC). WFTC plays a role similar to FTB in Australia in supporting the incomes of families with children. It also serves a similar purpose

to the earned income tax credit (EITC) in the United States (US) in that it is specifically attached to work. To get the WFTC a person or couple must have 'usual working hours' of 16 hours a week or more, so it is not possible to simultaneously get income support and the tax credit. Unlike the US tax credit, it is common for the WFTC to be paid fortnightly in cash.

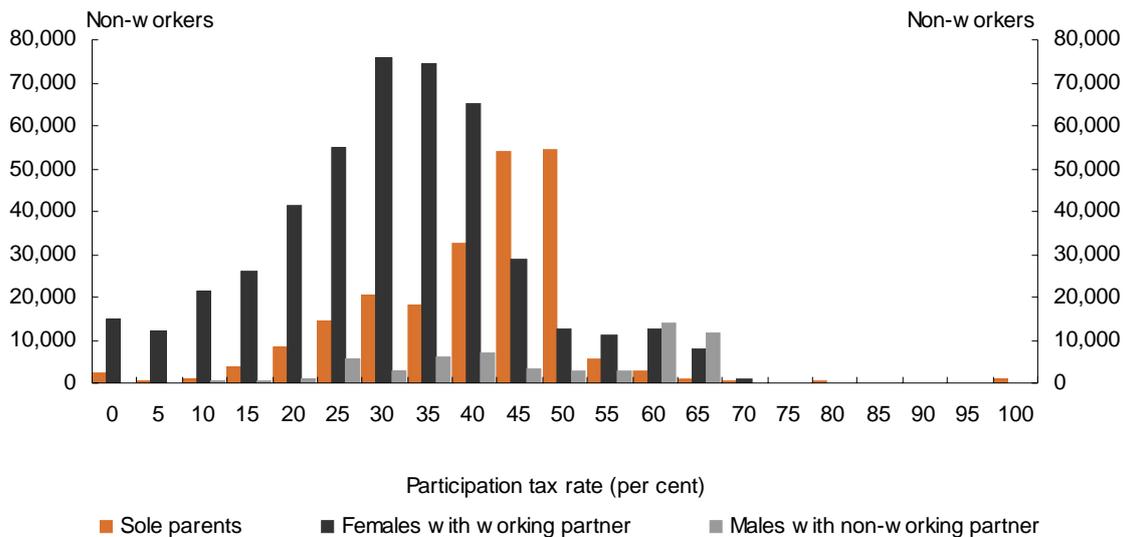
High effective marginal tax rates and workforce participation

There have been policy changes in the past decade which have reduced EMTRs for different people at different parts of the income distribution. For example: marginal rates in the tax system have fallen; the income test taper for pensions has been reduced from 50 per cent to 40 per cent (2000); one of the tapers in the Newstart income test has been reduced from 70 to 60 per cent (2006); and the first taper on FTB Part A was reduced from 30 to 20 per cent (2004). These and other changes over the past decade have reduced the number of working age Australians facing EMTRs above 80 per cent. However, there has been an increase in the proportion of people facing EMTRs above 50 per cent (AMP.NATSEM 2006). Almost two thirds of these are members of couples with dependent children, reflecting the widening eligibility for family assistance over the period. This widening eligibility for family assistance has focused attention on second earner incentives.

Generally, issues with the incentives for second earners arise from the use of a joint assessment of income for items like FTB Part A and the Medicare levy low income thresholds. Joint assessment means that income test thresholds may be fully utilised by the first earner, thereby increasing the EMTR for the second earner relative to if they were single. Second earner EMTRs may also be increased through the withdrawal of entitlements that have a separate second earner income test, such as FTB Part B or the dependent spouse tax offset. The separate test can operate in tandem with other withdrawals or liabilities. A consequence of these features of the tax-transfer system is that for couples there are some combinations of first and second earner incomes where the second earner faces a higher EMTR than the first earner.

Participation tax rates (PTRs) give a better indication of the financial disincentives for those moving into work than EMTRs. Chart 4.10 shows the estimated distribution of PTRs for non-workers in families with dependent children. The largest group, women with a working partner, tend to face PTRs below 50 per cent. Relatively few sole parents face PTRs over 50 per cent. Males in jobless households tend to face higher PTRs, but there are fewer of them.

Chart 4.10: Estimated distribution of participation tax rates
 For non-workers with dependent children (2008-09)



Source: Australian Treasury estimates using Melbourne Institute Tax Transfer Simulator.
 Note: Wage rates and potential hours are imputed.

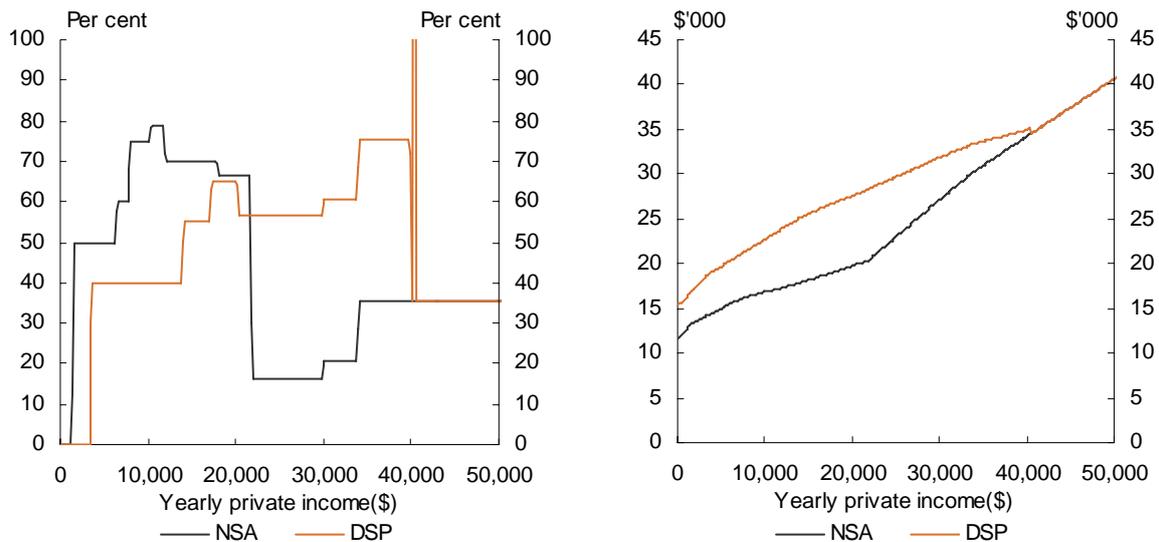
There are trade-offs involved in such a distribution and the benefits of reform options need to be carefully considered. For example, research suggests working-age men are less responsive to financial disincentives than mothers – that is, prime-aged men have a relatively inelastic labour supply.

A number of submissions note that the benefits of easing social security income tests are not clear cut. This is because it is necessary to balance the impacts on the labour supply of individuals with lower incomes (for example, part-time versus full-time work) with the decisions of individuals with higher incomes, who might reduce their work effort.

Submissions recognise that a gain for one group is often at the expense of others and therefore the overall costs and benefits of policy changes must be carefully considered. Poorly designed changes to income tests could reduce overall work and output, while leading to higher average tax rates.

As discussed in Section 4.3, submissions note that the different payment rates, activity requirements, and income tests associated with pensions and allowances can affect participation incentives. For example, there could be an incentive to obtain and maintain eligibility for Disability Support Pension rather than Newstart, given the differences in rates of payment and income tests (Chart 4.11).

Chart 4.11: Newstart (NSA) and Disability Support Pension (DSP) compared^(a)
 EMTRs by yearly private income^(b) Disposable incomes by yearly private income



(a) For single people.

(b) The spike in the Disability Support Pension effective marginal tax rate (EMTR) at around \$40,000 reflects the loss of Utilities and Pharmaceutical Allowances.

Source: DEEWR estimates.

The UK is considering similar issues in its working-age income support, with a view to implementing policies that assist people to prepare for and return to work, rather than provide incentives to stay on benefits (Department for Work and Pensions 2008). Options include a reduction in both the number of payment types and the differences between them.

Consultation questions

- Q4.12 In a targeted system there is a trade-off between the level of income support and workforce incentives. Given this, what priority should be given to reducing the disincentives to work?
- Q4.13 What structure of income tests and taxes would best support the increasing diversity of work and the need to increase workforce participation, and where should improved incentives be targeted?

4.6 The tax-transfer system and skills acquisition

As well as affecting workforce participation incentives, the tax-transfer system can also affect decisions to undertake education and training.

Summary of key messages from submissions

Submissions note the importance of encouraging appropriate investment in education and training to respond to Australia's demographic and economic challenges.

Some submissions argue there is a need to ensure there are incentives for people to invest in education and training to lift productivity. A number of submissions also argue that the current tax-transfer system has adverse impacts on lower income students and affects the type of degrees they undertake.

Other submissions also note the need for a comprehensive examination of the implications of different tax reform proposals for skill formation.

Submissions note that deductibility of education expenses is only available to individuals undertaking study related to their current job, rather than to those seeking to acquire new and different skills.

Some submissions argue that people's lives are now more diverse and complex and that access to tax-favoured savings accounts for education and skills could help people to manage their changing needs. There are differing views on the respective roles of tax and transfers in supporting investment in education. Some prefer tax-based policies while others prefer direct government grants.

The amount of investment in skills

Australia has a system of compulsory schooling which, in most states, currently extends to age 16 years. After this age, individuals make choices about whether to pursue further education or enter the workforce. Factors influencing these choices include: the formal costs of education courses; income forgone while studying; the benefits of higher wages; and any other non-monetary benefits of education. Individuals are likely to compare these trade-offs with other options, such as working and/or investing money in financial or physical assets rather than human capital.

There has been little analysis in Australia of the impact of the tax-transfer system on incentives to invest in human capital. The Panel is commissioning a background paper to further examine how effective tax rates affect human capital investment decisions. Identifying how these tax rates compare with the tax on other investments is required to determine whether the tax-transfer system encourages individuals to over-invest or under-invest in human capital.

Table 4.4 outlines the tax-transfer treatment of the various private benefits and costs of education.

Table 4.4: Tax and transfer treatment of the private benefits and costs of education

Benefits	Tax-transfer treatment
Monetary benefits to the individual, such as higher wages and ability to respond to involuntary unemployment	Taxed at progressive rates
Non-monetary benefits to the individual, such as improved leisure opportunities and more satisfying jobs	Exempt from tax
Costs	Tax-transfer treatment
Costs of tuition	No deduction is provided for costs of tuition, except where the tuition is related to the individual's current earning activities. Costs of tuition are generally subsidised. Subsidies vary, and the value to the individual may be higher or lower than immediate (or amortised) tax deductibility.
Costs of time spent in tuition (forgone earnings and/or leisure)	Costs related to forgone earnings are effectively immediately tax deductible (see Box 4.2). No deduction is provided for costs related to forgone leisure.
Costs of course materials and other ancillary expenses	No deduction is provided for the cost of course materials, except where the course is related to the individual's current earning activities.

The overall effective tax rate depends on the proportion of costs covered by tax deductions and subsidies, compared to the proportion of benefits that are taxed. If the deductions and subsidies are provided at the same rate as the tax applied to the benefits, the effective tax rate may be zero (this is similar to the cash-flow treatment discussed in Section 6.2). This treatment would be broadly similar to the current treatment of investment in an individual's own home and more generous than the current treatment of some other investments in real estate and most financial assets.

In practice, the deductions and subsidies are likely to be at different rates to the tax applied to benefits. This can arise due to the different effective tax rates created by the tax-transfer system, different rates of subsidy for different courses and the exemption of the non-monetary benefits from tax. If the deductions and subsidies are at a lower rate than the tax applied to benefits, the overall effective tax rate is likely to be positive, and vice versa if the deductions and subsidies are higher.

Table 4.4 only covers private costs and benefits, and does not include potential social and economic spill-over effects. Other considerations that may justify concessional treatment of education relative to alternative investments include: agency and equity problems (not all parents are in a position to maximise their children's future incomes); spill-over effects (high productivity people may raise others' productivity); capital market imperfections (it can be difficult to borrow against future earnings); and non-monetary benefits of education (such as a more tolerant and cohesive society).

Box 4.2 The tax treatment of forgone earnings in education

The tax treatment of investments made by forgoing earnings is equivalent to providing an immediate deduction for investment in a physical asset.

Consider the example of a taxpayer investing in a physical asset from which they expect to generate returns in the future. If a taxpayer with a 30 per cent tax rate invests \$20,000 in an immediately deductible physical asset, the deduction reduces their taxable income by \$20,000, which reduces their net tax liability by \$6,000. Thus, the net impact on their disposable income of making the \$20,000 investment is \$14,000.

Suppose that instead of investing \$20,000 in a physical asset, the taxpayer reduces their working hours to study part-time. Assume they make an equivalent investment in their human capital. That is, their time off work reduces their pre-tax income by \$20,000. The reduction in their pre-tax income is the opportunity cost, in terms of lost income, of them studying rather than working. Their taxable income falls by \$20,000 and their net tax liability falls by \$6,000. Assuming their investment in human capital is valued at \$20,000, the net impact on their disposable income of that investment is \$14,000.

The size of the effective deduction depends on both the reduction in the individual's tax liability and any additional transfer payments they are entitled to receive. For example, someone on a low income who does not earn enough to generate a tax liability will not reduce their tax by working fewer hours. However, they may be eligible for additional transfer payments, such as Youth Allowance.

Lifelong learning

The OECD recommends that governments adopt a whole of lifecycle approach to learning, from early childhood through adulthood (OECD 1996).

There is a considerable body of labour economics literature examining the relationship between formal education and labour market outcomes. While this literature has found a strong relationship between formal education and outcomes, the evidence is much less clear on whether participation of adults in training beyond the initial education experience improves their outcomes sufficiently to justify the costs. The literature is even less clear in respect of lower-skilled workers.

One finding from labour market research is that skills and the likelihood of gaining employment decline if people are out of work for long periods. The high proportion of people aged 55 to 64 years who are outside the workforce, some of whom may be involuntarily retired, suggests that there may be large potential benefits from establishing an appropriate balance between the individual, the employer and government in adult education and training.

Some countries allow individuals to draw temporarily on retirement savings accounts to fund training. This gives individuals a greater incentive and responsibility in determining the type of training that is of greater value to them.

Consultation question

- Q4.14 Does the tax-transfer system create disincentives for individuals seeking to acquire new skills or upgrade existing skills? If so, what sort of tax or transfer changes would provide better incentives?

4.7 Combined impacts of the tax and transfer systems

The tax and transfer systems have in part evolved separately. As a result of this and an active decision to target policies in the two systems in fundamentally different ways, they have remained relatively separate in their operation. While the systems are separate the interaction of both taxes and transfers determines an individual's or family's final income.

Summary of key messages from submissions

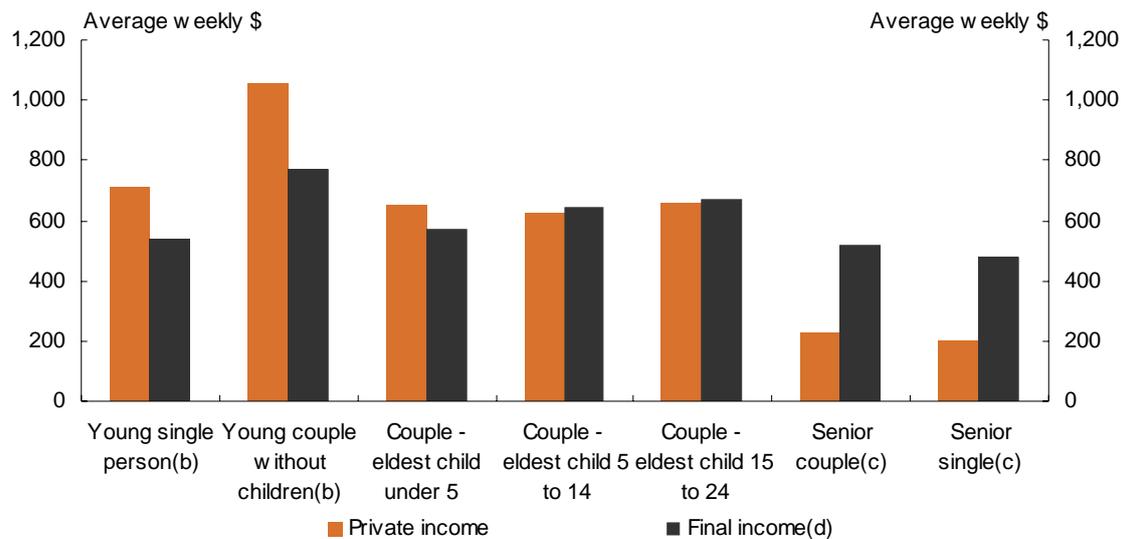
Many submissions raise concerns about the complexity of the interactions between the tax and transfer systems. Several submissions also support increased harmonisation of the tax and transfer systems, or even integration. A number of submissions propose alternative models, such as a negative income tax, as a potentially simpler approach.

Of those submissions that raise churn as an issue, some view it negatively on the grounds that it is inefficient, citing administrative duplication and compliance costs. Others view it more positively, valuing the ability of the tax and transfer systems to pursue their separate goals of revenue raising, poverty alleviation and supporting socially valued activities such as child rearing.

Some submissions, particularly from individuals, argue that family unit taxation would be fairer than the individual basis of the existing system. These arguments are based on a view of couples or families as the primary economic unit. Other submissions argue that individual taxation is fairer and has more efficient outcomes in terms of incentives to work, particularly for mothers.

Many people deal with both systems at any given time as well as over their lifetime. Chart 4.12 shows that, viewed over an individual's lifetime, there are periods when people are typically net recipients and other periods when they tend to be net payers. The targeted tax and transfer systems smooth income between periods of higher need, such as when a person has young children or in old age, and times of higher capacity, such as during the period before children or during the prime working years.

Chart 4.12: Incidence of taxes and government assistance^(a)
Selected lifecycle groups (2003-04)



(a) Figures are equivalised to take into account different household sizes and structures by identifying the amount needed to provide an equivalent standard of living to that of a single person.

(b) Reference person aged less than 35 years.

(c) Reference person aged 65 years or over.

(d) Final income includes government-provided health and education services.

Source: ABS (2007b).

Churn

Churn refers to situations where an individual or family pays tax and also receives transfer payments. It generally refers to events occurring within a short time period, such as a fortnight or a year, although it can also be viewed in terms of a person's lifetime.

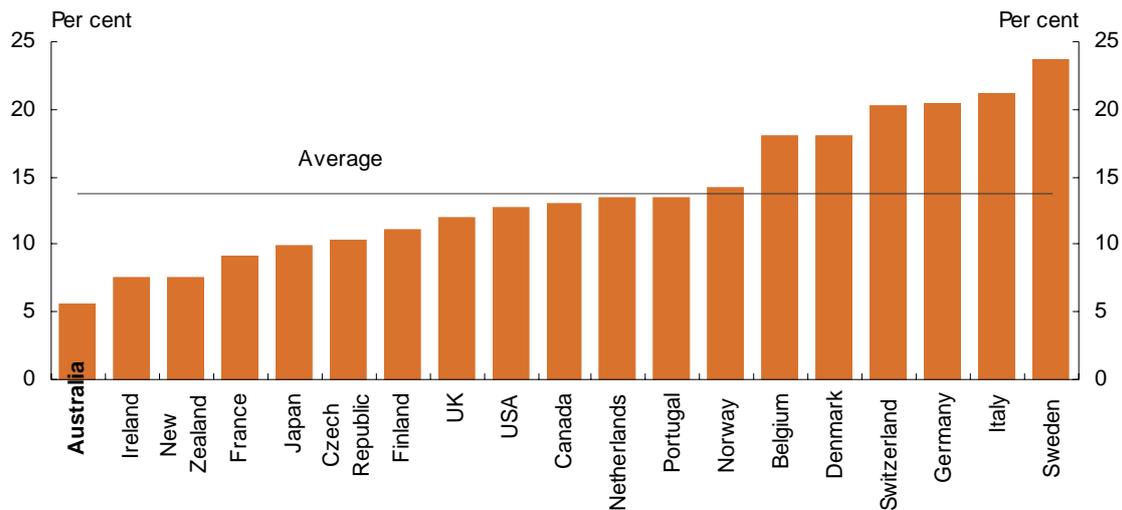
Individuals and families experience churn in a range of ways. A typical situation is when a person is eligible to receive fortnightly support through the transfer system, but is assessable for tax over the course of the year. This includes situations where people are unemployed for part of a year, or work part-time and receive some income support in a form that responds to changes in their earnings or other circumstances. Another key area where churn occurs is when parents receive family payments and are also working and paying tax. With the level of family payments being high by historical standards and available to relatively high-income families, many families with children are subject to churn.

Targeting is one key cause of churn. The redistributive system directs income in ways that focus on timeliness and assessment periods, the needs of families as opposed to those of individuals, and the kind of income and assets available to the individual or family.

Another perspective on the cause of churn is a lack of information. In principle, if government had perfect information about the circumstances of people it could always pay or receive net amounts, effectively eliminating churn.

Australia's system has been judged as having the lowest level of churn of a group of OECD countries, as illustrated in Chart 4.13. It is among the most progressive, targeted and redistributive of the OECD. Nevertheless, there may be scope for more efficiency in the design of the tax and transfer systems.

Chart 4.13: Churn in OECD countries^(a)
As a percentage of disposable income and direct taxes (around 2000)^(b)



(a) Churn is calculated by comparing the annual level of transfers received by each decile with the level of direct taxes paid by each decile. Where transfers exceed taxes, churn is the level of taxes and where taxes exceed transfers, churn is the level of transfers. The level of churn is the average of these amounts across all decile groups, weighted by the decile shares of disposable income. Some OECD countries have been omitted where taxation data are not available.

(b) The data are from around 2000, varying slightly by country.

Source: Whiteford (2007).

Churn could be reduced through greater integration of the tax and transfer systems. This would entail greater alignment of the two systems across the key structural elements — the unit and period of assessment, the treatment of income and assets, and the categorical aspects of the two systems (discussed in Section 2.2). There are a number of ways in which this could be done. For example, a single delivery system could provide all entitlements and determine all liabilities on a single unit and period of assessment with a single income definition. Several variants of this most extensive version of integration, known as a negative income tax, are called for in a few submissions.

A more moderate form of integration could entail a unified policy basis and delivery of entitlements and liabilities for target groups, such as retired people. It could also entail delivery of family assistance entirely through the tax system or, alternatively, through the transfer system with a closer mirroring of the income and assets tests and assessment periods applying to income support.

An alternative approach to reducing churn would be to seek greater separation of the tax and transfer systems. There are a number of ways in which this might be done. One approach would be to align policy settings so that people only deal with one or other system in a given period. Another approach would be to redesign elements such as family assistance and means-tested tax offsets, which currently incorporate elements associated with both the tax and transfer systems.

Questions about churn ultimately go to how precisely the system is designed to target its incentives, and how it trades off precision of targeting with simplicity or other goals.

Consultation question

Q4.15 Given the competing demands of targeting assistance to people when they need it and minimising unnecessary transactions, what changes could be made to existing tax and transfer policies?

The unit of assessment

As noted in Section 2.2, the personal income tax system is primarily based on individual assessment. Earnings in the form of salary and wages are clearly taxed on an individual basis. Unearned income from sources such as investment may, however, relate to an individual or to a couple or family. Individual assessment also applies to some offsets and other policy settings, including the LITO, mature age worker tax offset (MAWTO) and government co-contribution for superannuation. However, certain other offsets have couple or family aspects to them, such as the SATO, the dependency offsets and spouse superannuation offsets. By contrast, all elements of the Australian Government's transfer payment system use a couple or family based income test.

A number of submissions raise issues relating to the unit of taxation. Some support some form of family unit taxation, for example, joint filing or income splitting. Others support maintaining an individual unit for tax purposes, although in many cases people see a continuing role for couple or family assessment of income for transfer purposes.

Submissions identify several reasons for supporting family unit taxation. The key argument is that couples or families form a single economic unit and should be taxed as such. Family unit taxation arrangements exist in several OECD countries, notably the United States and France. The United Kingdom moved from family to individual unit taxation in 1990. Another argument raised in favour of family unit taxation is that many couples and families achieve an equivalent arrangement through the use of trusts or companies, and it would improve equity to make such an arrangement available to all.

A key argument in submissions supporting an individual unit of taxation is that people engage with the labour market and to some extent with other taxable activities as individuals, and accordingly it is inequitable for those in couple or family relationships to have their tax schedule determined by the income of their partner. A second argument is that unpaid domestic work is currently untaxed, which makes it relatively attractive in comparison with paid employment. Individual unit taxation avoids strengthening this existing tax advantage.

An important efficiency implication of these arguments is that those most affected by the choice of tax unit are women in couple families, particularly mothers, who tend to be responsive to financial incentives. They face fewer disincentives to paid employment in an individually based tax system. Family unit taxation would also change the distribution of tax within couples – with higher tax being paid by the lower income earner, though lower tax would be paid by the couple. Practical considerations associated with a family tax unit include defining families in a way that is accepted by the community and developing ways of assessing people whose family circumstances change during a tax period.

Consultation question

- Q4. 16 Should the different bases of assessment for tax and transfers be reconsidered (including the unit of assessment, income definitions, period of assessment and assets treatment)?

Box 4.2: Forms of taxes and transfers

Governments provide assistance and impose liabilities in various ways. Assistance in the form of transfers could potentially be provided as a tax concession or refundable tax offset. The reverse is also true.

Whilst the final outcome of a cash transfer or reduction in tax liability may be the same in terms of income, the way in which assistance is provided is important. Delivery mechanisms determine the level of complexity that people face, particularly where compliance requirements vary. The delivery mechanism is also important because it affects the timeliness of a payment or collection of a tax liability and timeliness affects incentives to work. The mechanism can also be important where there is a question of coherence. For example, payments may interact in ways that are unintended, anomalous or create disincentives to work.

In addition (or as an alternative) to providing cash transfer payments or a reduction in tax, government can provide 'in kind' assistance which is either linked to income (means tested) or universally available.

Cash and in kind transfers in Australia

In Australia, cash transfers are the principal means of providing income support to individuals and families. Some means tested assistance is also provided through the tax system.

Most cash transfers are untied. Untied cash benefits allow recipients to spend the money as best they see fit. A recent change has been the introduction of a tied element to income support and family payments through income management, which limits what can be purchased by recipients in certain circumstances.

Some cash transfers, while being untied, are earmarked for meeting the costs of particular circumstances or needs. Examples include the Baby Bonus and Utilities Allowance.

Other payments are tied in some way. Providing some support in the form of tied cash benefits can allow increased support to be provided to individuals who face specific costs. For instance, Telephone Allowance is paid to those income support recipients and holders of a Commonwealth Seniors' Health Card who are telephone subscribers, with a higher rate being paid to home internet subscribers. The medical expenses tax offset and Private Health Insurance Rebate are subsidies that are provided in reimbursement of certain costs. Child Care Benefit is paid in proportion to the amount of eligible child care used by a family, while the Child Care Tax Rebate provides a benefit proportional to out-of-pocket child care costs, up to a cap.

Box 4.2: Forms of taxes and transfers (continued)**Cash and in kind transfers in Australia (continued)**

A number of payments and entitlements are paid on the basis of a person being entitled to some other benefit. Families who receive FTB Part A can also claim the Teen Dental Plan subsidy and the Education Tax Refund, in respect of eligible expenditure. Bonuses for seniors and carers in recent years have been paid on the basis of entitlement to Age and other pensions. Residential aged care has a fee structure that imposes lower fees on maximum rate pensioners than on others.

Providing assistance in this way can create a discontinuity at the edge of payment thresholds if there is no taper applying to the supplement or bonus. Where a taper does apply to a supplement or bonus, this leads to higher effective tax rates across some ranges of income.

Where the payment is made as a lump sum, it may be difficult to target effectively. For example, people who became eligible for a payment after the lump sum entitlement date may miss out on the lump sum. However, lump sum payments have the advantage that they can assist with 'lumpy' costs in the absence of effective credit markets.

Both Australian and state governments, as well as private providers, provide lower cost goods and services to holders of Australian government concession cards. These cards are available not only to income support recipients but also to self funded retirees and low income families. The benefit they provide can vary greatly from one person to another.

The Australian and state governments also provide support to individuals and families through the direct provision of goods and services. In some cases they are linked to income, such as public housing. In other cases they are made available irrespective of income – for example, education and health services.

In kind benefits provide a mechanism to target assistance. For example, in the case of disability support recipients, some individuals will face greater costs of disability than others. Offering in kind benefits that are generally only of value to those who need such assistance allows a degree of self selection in a way that would otherwise be difficult to achieve.

In kind benefits may also be provided with the intention of constraining the behaviour of the recipient where society, through government, determines that the recipient should be directed in the goods and services they receive. The provision of public education (and the requirement that children attend school or an approved substitute), is an example.

Box 4.2: Forms of taxes and transfers (continued)

Incidence

With each of the transfers described above, the recipient may not be the sole beneficiary. The ultimate impact, or the incidence, may lie partly or wholly elsewhere.

Untied cash transfers are unlikely to influence overall price levels. This means the recipients of these transfers are likely to receive most of the benefit. An exception to this may occur where the recipient is unlikely to spend the transfer themselves. For example, it may be that the Age Pension benefits not only the pensioner, but also, through allowing them to maintain the value of their estate, their heirs.

Payments that are tied to particular consumption items and in kind benefits are more likely to have flow on impacts on prices. This can result in some of the benefit flowing to the provider of the good or service. For example, some of the benefit of government child care assistance is likely to flow to child care providers.

Subsidisation of specific goods and services and payments that reduce the cost of a good or service are likely to increase their utilisation. This may be an objective of policies such as subsidies for child care and private health insurance. However, reducing the cost of particular goods and services can encourage people to over use those goods and services, and possibly under use alternative goods and services. For example, subsidised provision of energy may encourage people to spend more on heating, and less on insulation than they otherwise might.

The method of providing assistance also has equity implications. Linking assistance to particular consumption items can be a way of targeting assistance at particular groups. For example, subsidising health services is a way of providing additional support to people who are sick compared to those who are well.

5 The retirement income system

The Treasurer wrote to the Panel on 4 November 2008 asking it to bring forward its consideration of the retirement income system. This is to allow the Government to consider the issues facing the retirement income system in conjunction with those arising from the Pension Review, due in February 2009.

In meeting the Treasurer's request to bring forward its consideration of the retirement income system the Panel has released a separate consultation paper.

The Panel is to report to the Government on its findings on the retirement income system by the end of March 2009. The Panel is seeking community input to help develop its report. The Panel is inviting written submissions from the public by 27 February 2009. The Panel may initiate meetings with representative organisations for further discussions on the retirement income system.

Overview

Australia has a three pillar retirement income system:

- a government-provided Age Pension;
- compulsory savings enforced through the superannuation guarantee (SG); and
- voluntary savings (both through superannuation and other sources).

The Age Pension provides a guaranteed income based on means, while the income generated from the second and third pillars depends on the amount invested and returns on these investments.

The retirement income system has developed over time. The SG pillar will not mature until 2037 when employees retire after a full working life (35 years) of compulsory superannuation contributions of 9 per cent.

Submissions to the Panel support the structure of the retirement income system. Common themes in the submissions concern the current rate of the SG and the level of concessions provided to encourage additional saving. Other themes relate to how the system should deal with individuals outliving their savings and the way the system treats individuals with different circumstances.

Key considerations about the retirement income system are whether it is broad and adequate, acceptable, robust, simple and approachable, and sustainable.

Another aspect to be considered is the role of the retirement income system in providing health and aged care services.

Consultation questions

- Q5.1 In considering the future of Australia's retirement income system, which objectives are relevant in setting retirement income policy? Does the current system of the Age Pension and compulsory and voluntary savings meet these objectives? If not, how should the system be changed to meet these objectives?
- Q5.2 As the SG system matures, it will become a greater part of an employee's retirement income. What are the implications for individuals partially or fully excluded from the mature SG system (the self-employed, individuals with broken work patterns such as carers, women and migrants), and how can the retirement income system best accommodate these groups?
- Q5.3 Noting that the adequacy of the Age Pension is being considered by the Pension Review, what is an appropriate concept of adequacy for the retirement income system? Should it be to ensure there is a minimum level of income in retirement, to replace a proportion of income earned prior to retirement, or some other alternative?
- Q5.4 What should the role of the government be in assisting individuals to meet their retirement income expectations in relation to the support provided by the Age Pension, the level of compulsory savings and incentives to make additional savings? Should the role of government change as an individual's income increases over their working life?
- Q5.5 Do the settings of the retirement income system, such as the level of SG and access to concessions, adequately consider the needs and preferences of individuals both before and after retirement?
- Q5.6 Is the current level of superannuation income tax concessions appropriate and sustainable into the future? Are the current concessions properly targeted and, if not, how should they be reformed?
- Q5.7 At what age should an individual be able to access their superannuation and at what age should they become eligible for the Age Pension?
- Q5.8 What is the role of individuals in dealing with investment and longevity risk in accumulating and drawing down their retirement income? Do financial markets provide the means to deal with these risks? If not, is there a role for government to address these shortcomings?
- Q5.9 In what ways does the retirement income system impose undue complexity and cost on retirees and workers? How could this complexity be reduced?
- Q5.10 The Age Pension serves two roles, as a safety-net for individuals who are unable to sufficiently save for their retirement and as an income supplement for many individuals who do save. What should be the role for the Age Pension and means testing in a future retirement income system and what impact does this have on its sustainability into the future?

Consultation questions (continued)

- Q5.11 In what ways does retirement income policy affect workforce participation decisions and what, if any, changes might reduce disincentives to work? Does the sustainability and cost of the retirement income system affect the workforce decisions of younger generations of workers?
- Q5.12 What impact could financial intermediation have on the effectiveness of retirement income policy?
- Q5.13 The cost of providing health and aged care to older Australians is currently met by government through the health sector. Should retirement income policy take into account projected increases in health costs for older Australians? If so, what would be the most effective mechanism and how might the transition to such a system be achieved?

The future role of the retirement income system

The Panel is also reviewing the personal tax arrangements of retirees and the taxation of non-superannuation savings as part of its broader consideration of the tax-transfer system. The Panel may suggest possible changes in these areas, which may have implications for retirement income policy. These implications will be dealt with at the time of the Panel's final report at the end of 2009.

One aspect to be considered as part of the broader paper is the role of the retirement income system in providing health and aged care services.

In retirement, the type of products and services people consume will change as they age. In particular, as a person gets older they are likely to require more health and aged care services. A significant part of this care is paid by the government.

The *2007 Intergenerational Report* (Australian Government 2007) projects health spending as a proportion of GDP to increase from 3.8 per cent in 2006-07 to 7.3 per cent in 2046-47. While a significant amount of this increase is due to technological change, including the development of new drugs and treatments, the affect of an older population is also considerable. Historical data show that average per person spending on pharmaceutical subsidies for those aged over 65 years is around four times greater than on the general population.

A question is whether arrangements should be introduced now so that current generations of workers save for these costs. One option would be to pre-fund this expenditure as an individual account similar to superannuation, or as part of an insurance arrangement. This would have an effect on the pre-retirement standard of living of individuals. However, as it is difficult to predict future health costs because of unknown future diseases and health technologies, other possible responses might include changing current policy on co-payments and health concessions.

Consultation questions

The Panel has asked 12 questions in its *Retirement income consultation paper*. The following question is specific to this section.

- Q5.13 The cost of providing health and aged care to older Australians is currently met by government through the health sector. Should retirement income policy take into account projected increases in health costs for older Australians? If so, what would be the most effective mechanism and how might the transition to such a system be achieved?

6 Taxing business and investment

Overview

The tax system needs to evolve to respond to the opportunities, as well as challenges, arising from globalisation. Attracting investment to Australia, directed to activities with the greatest national return, will improve the returns to Australians from working and saving.

An internationally competitive business environment is necessary to attract investment and international businesses, consistent with an objective of increasing national income. Achieving an internationally competitive business environment depends, in part, on getting the right balance of tax bases and rates.

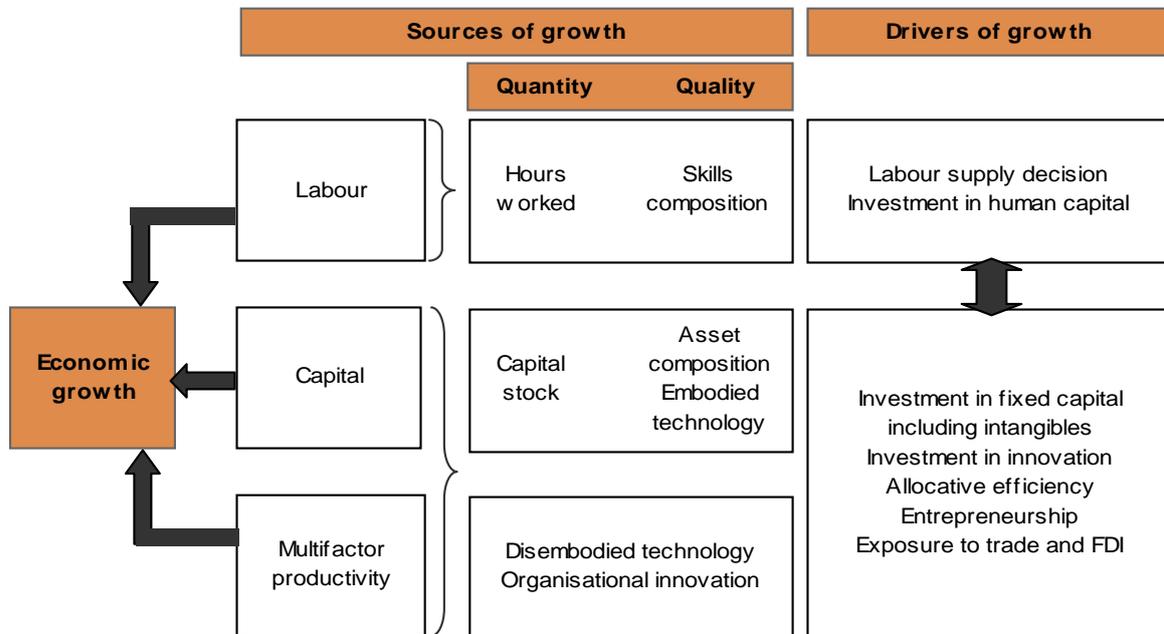
The quality of investment is equally important. Improving the allocation of resources and investments, not discouraging risk taking, and removing tax biases that negatively affect business and household investment decisions, offers the potential to increase productivity and Australia's long-term prospects for economic growth.

Consultation questions

- Q6.1 Can the tax system be structured to better attract investment to Australia in a way that increases national income, and if so how? For any given revenue outcome, what are the relative merits of broader base/lower rate (comprehensive income tax) or narrower base/higher rate (a narrow income tax or an expenditure tax) approaches?
- Q6.2 What changes, if any, to the tax system would improve the ability of Australian companies to operate internationally orientated businesses? How should the tax treatment of companies and shareholders be integrated in an open economy?
- Q6.3 Can the tax system be restructured to improve resource allocation within the economy and minimise operating costs, and if so, how? What changes would reduce distortions to risk taking and encourage entrepreneurial activity?
- Q6.4 What principal goals should inform the taxation of capital gains in Australia, and what, if any, changes should be made to capital gains tax as a result?
- Q6.5 Should the tax system provide a more neutral treatment of different financing arrangements (debt, equity and retained earnings), and if so, how? What principles should inform approaches to entity taxation?
- Q6.6 Should the tax system be structured to cater for the specific circumstances of small business, and if so, how?
- Q6.7 Should the tax system be restructured to deliver a more neutral tax treatment for the different forms of return on household savings and investments, and if so, how?

The living standards of Australians are linked to Australia's economic performance. That performance is affected by the level and productivity of investment in Australia, which significantly affect the level of economic output. In the long-run, productivity growth drives per capita economic growth and determines the improvements in the welfare of Australians. Chart 6.1 provides a summary of the sources and drivers of economic growth.

Chart 6.1 Economic growth — sources and drivers



Source: Adapted from OECD (2007b).

Taxes on investments in Australia and, to a lesser degree domestic savings, can affect many of the drivers of economic growth. Taxes affect investment in fixed (including intangible) capital, innovation, allocative efficiency, entrepreneurship, labour productivity and exposure to trade and foreign direct investment (FDI). Recent studies suggest that the impacts on the economy are potentially large (see Schweltnus and Arnold (2008) and Johansson et al (2008)).

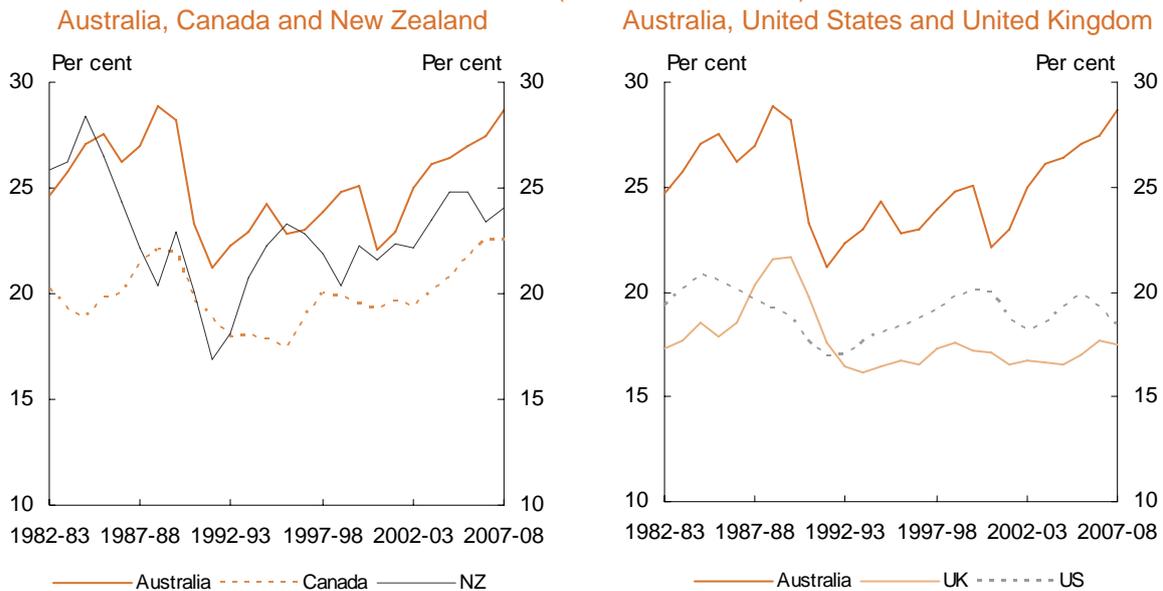
For a given revenue objective, structuring the tax system to maximise Australia's global share of investment and business (the focus of Sections 6.1 to 6.3) and to improve business and investment choices (the focus of Sections 6.4 to 6.7) can result in higher economic growth and national income.

6.1 International tax competitiveness and domestic investment

Australia relies on domestic and foreign savings to fund domestic investment. Taxing the returns on investment can reduce the willingness of domestic and international investors to invest in Australia. Reduced investment in plant and equipment, software, innovation and other intangibles involves forgoing the higher labour productivity arising from 'capital deepening' – where there is more capital available for each worker.

However, Australia has achieved a high level of investment compared to other developed countries (Chart 6.2).

Chart 6.2: Gross national investment
Per cent of GDP (1982-83 to 2007-08)



Source: ABS (2008a), IMF (2008), Statistics New Zealand (2008).

Summary of key messages from submissions

Most business submissions indicate that globalisation offers major opportunities for Australia. However, they also note the disadvantages arising from Australia's remoteness from world markets, our relatively small economy and geographically dispersed population.

Many submissions comment on the international trend towards less tax on capital income, citing reductions in company tax rates among OECD and neighbouring countries. These reforms are generally seen as providing countries with a competitive edge in global markets and enhancing their ability to attract globally mobile investment.

There are also concerns that over-reliance on capital income taxes, especially corporate income taxes, is not conducive to maintaining a stable and robust revenue base.

Many submissions indicate that Australia's tax arrangements, particularly taxes on corporate income, are internationally uncompetitive. This is said to adversely impact on Australia's productivity and potential for economic growth.

Submissions supporting lower capital income taxes argue it will ultimately benefit many Australians, reflecting a view that the incidence of high effective corporate income taxes falls on labour in the long-run.

Organisations that represent small and medium enterprises generally view reducing the company tax rate as secondary to reducing personal tax rates. Such organisations prioritise aligning the top personal tax rate with the company tax rate.

Summary of key messages from submissions (continued)

Some non-business organisations contest the need to cut capital income taxes to maintain competitiveness. Such submissions view equity considerations as being of greater importance, reflecting a view that the incidence of corporate income tax largely falls on shareholders.

There is also a concern that any reduction in company tax rates could result in an increase in taxes on labour, with the increased burden of labour taxes largely falling on low to middle income earners.

International tax trends and comparisons

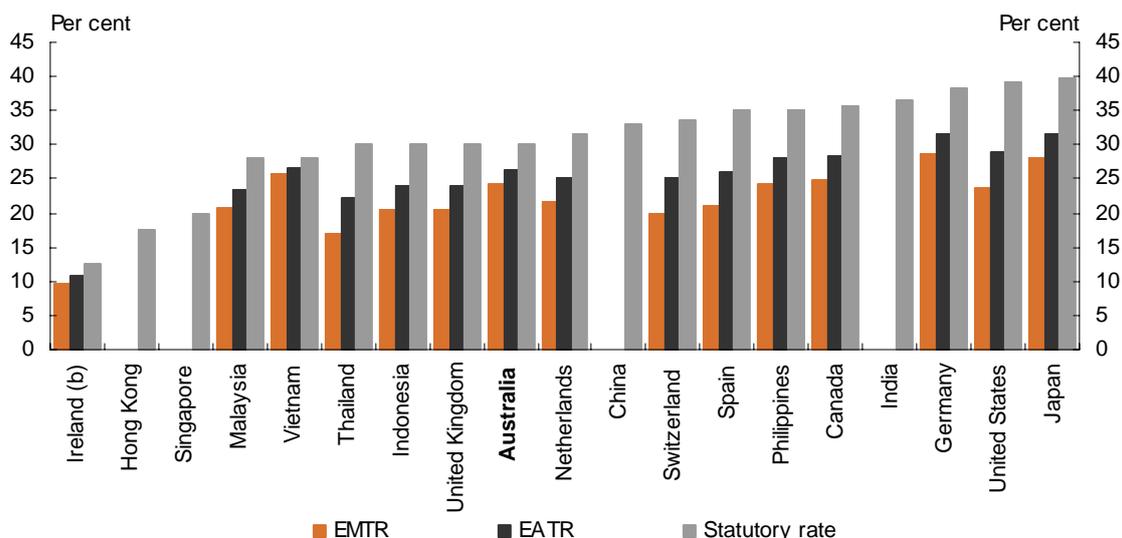
Statutory and effective company tax rates

International tax competition occurs where countries reduce taxes in an attempt to increase their share of global investment, generally or in specific sectors. Competition may also exist between countries in terms of where businesses report or allocate their profits.

The decline in international company tax rates observed in Chart 1.1 is the most significant indication of international tax competition. While the decline in company tax rates has generally been accompanied by a broadening of the company tax base, measures of effective tax rates – which take into account the statutory rate as well as significant elements of the tax base – have also generally declined (OECD 2007a).

Chart 6.3 below shows how Australia compared with other OECD and regional countries across several indicators of tax competitiveness in 2005.

Chart 6.3: Comparison of statutory and effective company tax rates^(a)
Selected countries (2005)



(a) Effective marginal tax rates (EMTRs) on investment measure the effect of taxation on the return to a marginal investment. Effective average tax rates (EATRs) measure the tax burden on projects that generate above normal returns. See the *Architecture paper*, page 189.

(b) The company tax rates shown for Ireland apply to active income of new operations. Different statutory company tax rates apply to other activities.

Source: For Singapore, Hong Kong, China and India, KPMG (2008). For all else, Botman et al (2008) (The EATRs shown are those calculated for a project that generates a pre-tax profit of 20 per cent).

Chart 6.3 indicates that Australia's statutory company tax rate is higher than some neighbouring economies (in particular, Singapore and Hong Kong). However, reflecting Australia's relatively broad company tax base, the effective marginal tax rate (EMTR) and effective average tax rate (EATR) for Australia were higher than for many countries, including some with higher statutory rates.

To achieve international competitiveness, many submissions in effect propose matching overseas' tax rates and bases. Such submissions typically assume but do not explain how this would be of net benefit to Australia.

It may be the case that as the gap between a country's tax rate and those of other countries increases, foreign investment may become more responsive to a rate change, increasing the potential benefits of a reduction. There is some evidence that foreign investment becomes more sensitive to tax where a country's tax rate is significantly above average. Conversely, where a country's tax rate is around or below average, the response to a change in the rate may be reduced (Bénassy-Quéré et al 2003).

Where foreign countries have foreign tax credit regimes, the impact of rate differentials is unclear. In theory, where a country operates a foreign tax credit system, investment in Australia will be deterred only if Australian rates are above those in the foreign country. However, empirical evidence for this is not strong, suggesting multinationals undertake significant tax planning (for example, defer repatriation of foreign income) that limits how foreign tax credit systems operate in practice (OECD 2008b). In 2008, around half of the stock of Australia's inbound FDI was from countries with a foreign tax credit system.

Differences between the Australian and overseas statutory rates can influence the degree and direction of profit shifting. Reasonably strong empirical evidence shows that tax differences between countries can induce profits to be shifted (Griffith et al 2008).

Other aspects of international tax competition

There are a number of other international tax competition trends.

- Declining withholding tax rates on dividend, interest and royalty payments to non-residents. In part, this reflects the influence of the OECD Model Treaty (the basis for most of the world's bilateral tax treaties).
- A move away from dividend imputation, with most European countries abolishing imputation systems for other forms of shareholder relief (generally for European Union specific reasons).
 - However, there has been no general trend away from providing relief to shareholders in recognition of company tax paid. For example, the United States has recently moved to provide dividend tax relief (by applying a lower rate of personal tax to dividend income taxed at the company level).
- A move away from taxing the worldwide equity income of resident companies with a credit for foreign tax paid, towards exempting dividends received from foreign affiliates. Some large capital-exporting countries (in gross terms) that still run credit systems (the United States and Japan) have been considering moving to dividend

exemption regimes. The United Kingdom has recently announced its intention to introduce a dividend exemption regime for large and medium sized businesses.

- Consistent with the movement to dividend exemption systems, a broader trend of not taxing foreign source income of non-residents derived through resident entities ('conduit income').

International tax coordination efforts

Accompanying international tax competition has been a trend towards international tax coordination or cooperation. It has been in part motivated by fears of declining company or capital income tax revenue arising from a 'race to the bottom' in company tax rates or of capital flight.

Such cooperation has had more success in addressing 'harmful' tax competition by improving information exchange between countries' tax authorities, including countering bank secrecy in tax havens and moving to abolish or amend 'harmful' preferential tax regimes. Efforts to cooperate on tax bases and rates have been less successful, possibly because even if there is a potential overall net gain for countries in cooperating, some countries would lose out relative to their current position.

The incidence of taxes on investments

As discussed in Sections 1 and 2, the economic incidence of a tax is particularly important when considering the efficiency and distributional consequences of a more internationally competitive tax system. Submissions supporting lower capital income taxes argue it will ultimately benefit many Australians, reflecting a view that the incidence of high effective corporate income taxes falls on labour in the long-run. This view is contested by non-business organisations, which consider the incidence of company income tax to largely fall on shareholders.

Increasing taxes on investment can affect the returns to other factors, in particular labour. It reduces the capital stock in the economy, which reduces marginal labour productivity and thus wages. Box 6.1 describes how this tax increase can reduce investment but not affect after-tax returns from domestic savings.

An increase in a tax on investment can also affect wages through wage bargaining. Where there are economic rents (for example, arising from imperfect competition), a tax increase could reduce the labour share of the rent through reducing the overall size of the rents or by improving the bargaining power of firms. Economic rents are defined in Box 6.2.

However, a range of factors complicate this analysis.

In reality, capital stock reallocations would be expected to occur over time, not immediately. While the real economy adjusts over time, the capital markets respond quickly through asset price revaluations. Thus, in the short-run, some of the economic incidence of the investment tax increase is likely to fall on the owners of existing investments. In the long-run, the extent to which the domestic investment owners can pass on that tax burden also depends on factors such as the substitutability between labour and capital, the relationship between domestic and foreign capital, product substitutability and the responsiveness of labour supply to taxes.

A number of overseas studies have attempted to estimate the incidence of corporate income tax. Gravelle and Smetters (2006) and Randolph (2006), using general equilibrium models, estimate that, in the United States, domestic labour bears around 70 per cent of the corporate tax burden – with foreign labour being the main beneficiary of capital outflows. Randolph also predicts that for smaller open economies, like Australia, domestic labour would bear even more, and domestic capital even less, of the corporate tax burden. However, those models make simplifying assumptions including perfect capital mobility. Other overseas studies, using a variety of empirical approaches, consistently indicate that a large proportion of the burden of a corporate tax increase falls on wages. See for example Felix (2007), Hassett and Mathur (2006), and Arulampalam et al (2007).

Given the importance of incidence for the efficiency and distributional consequences of company income tax and other investment taxes, the Review Panel is commissioning further work in this area.

Factors driving cross-border investments

Foreign investment between countries takes different forms. Broadly, it can be segmented into FDI which confers ownership and control on the foreign investor, and portfolio investment where the foreign investor does not have control over the project or firm.

The level and composition of cross-border investments can depend on factors such as investors' desire for liquidity and risk diversification, as well as the institutional frameworks of the country in which the investment is made.

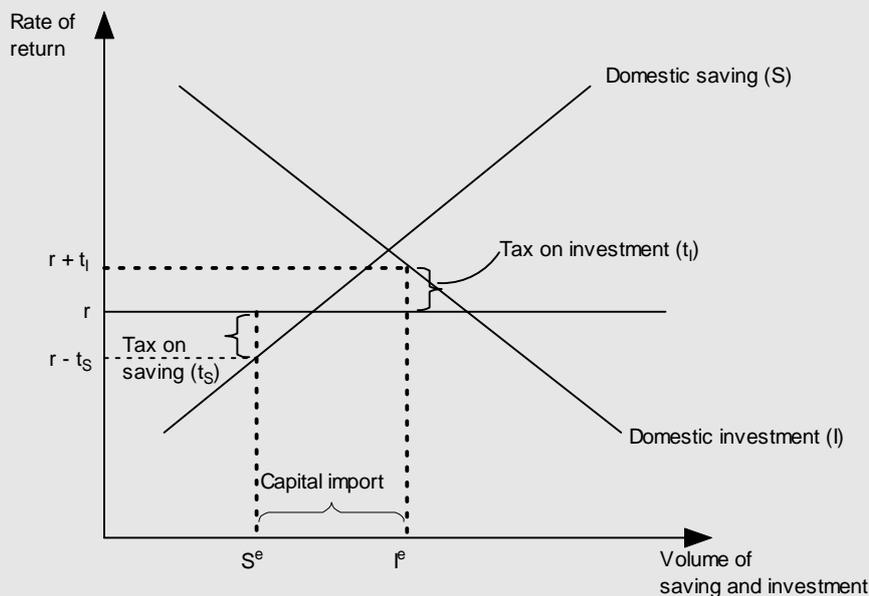
- FDI tends to be more long-term. Hence, foreign investors with lower liquidity needs (large, mature firms) tend to undertake FDI, while investors with higher liquidity needs (for example, managed funds) undertake portfolio investment.
- Portfolio investment offers risk diversification opportunities. In spite of this, there is significant evidence that investors' portfolio holdings exhibit 'domestic bias' (overinvestment in the investor's domestic market) and/or 'foreign bias' (under or overweighting between different foreign markets).
- Portfolio investment tends to be more sensitive to market openness and development as well as the existence of quality economic, political and regulatory institutions. Where these features are not present, any foreign investment into a country will more likely be in the form of FDI.

Box 6.1: Savings and investment in an open economy

In the case of a small, open economy with efficient capital markets, the after-tax return to foreign investors and the pre-tax rate of return to domestic savers are determined in the international capital market. A tax imposed on the savings of resident individuals will not affect the pre-tax rate of return available. A tax imposed on investment in Australia will increase the pre-tax rate of return required by foreigners from investments in Australia to provide the international after-tax rate of return.

Chart 6.4 illustrates this disjunction between savings and investment. A tax on domestic savings does not affect the total level of investment in an open economy, which is determined by the supply of foreign capital. As domestic savings fall (to S^e), they are offset by an increase in imported capital. In contrast, a tax on investment decreases the total level of investment in the economy but, of itself, does not reduce returns to domestic savings (which remain at $r - t_s$) nor the returns to foreigners (r , the cost of capital globally).

Chart 6.4: Taxes on savings versus taxes on investment in a small open economy



Source: Adapted from Sørensen (2006).

Foreign direct investment

There are a number of theories about the geographic pattern of FDI. The new economic geography theory focuses on the impact that economies of scale and concentration of firms (agglomeration) can have on firms' location decisions.

As trade costs decline, more foreign firms are likely to enter the domestic market, particularly where that market is large. It is expected that the subsequent concentration of firms will bring about economies of scale, which increase the scope for economic rents. Beyond a certain point, there will be forces favouring geographic dispersion. These 'dispersion effects' come about as the increased competition that accompanies co-location results in less potential for economic rents.

From a taxation perspective, new economic geography theory suggests there is not a smooth relationship between taxation and firms' location decisions. Where agglomeration benefits are strong, firms should be less responsive to higher levels of tax. However, as agglomeration economies weaken, investment becomes more responsive to tax.

Another perspective offered by international trade theory suggests that firms will undertake FDI (for example, locate production overseas rather than service the foreign market via exports) where some combination of the following benefits is present:

- ownership advantage – the firm has some knowledge capital (for example, a superior production process) that it can exploit in the foreign market;
- location advantage – there are certain benefits available in the foreign market that induce the firm to produce or headquarter there (for example, lower factor costs); or
- internalisation advantage – the firm chooses to exploit its knowledge capital, rather than license it to an agent, to prevent dissipation of the knowledge.

This model provides a useful framework for understanding how tax affects the decisions that must be made by a firm considering locating production overseas.

Where there are location advantages, taxes imposed by the host country on any location-specific rents may have a minimal impact on the decision to invest. In the absence of location-specific advantages or rents, different business and investment choices can be related to different tax rate measures:

- the effective average tax rate (the EATR) on the total return (the sum of the normal return to capital and firm-specific rents, similar to ownership advantages) affects the location of the investment;
- once location is determined, the effective rate of tax on the marginal cost of capital (the EMTR) affects the scale of investment – where the EMTR is zero, tax will not affect the marginal investment; and
- the statutory tax rate affects the (artificial) allocation of profit between countries.

Box 6.2: Economic rents

Economic rent can be defined as the difference between the return to a factor of production in its current use and what it would be paid in its next best use.

One property associated with an economic rent is that the supply of the relevant factor of production is invariant to a change in its price. Land and natural resources are commonly cited as giving rise to economic rents. However, rent may also arise from a firm's superior technologies or management techniques, as well as from barriers to entry of new firms.

In the short-run, certain resources may also exhibit qualities of an economic rent where the supply cannot be readily altered in response to a change in price. A country's highly-skilled workforce may be an example of this. In time, increases in the supply of the factor would be expected to dissipate the rent.

Rents are sometimes categorised as being either 'location-specific' or 'firm-specific'. A location-specific rent arises where firms can only generate a rent from investing in a specific geographic location, as is the case with natural resources and land. A 'firm-specific' rent is not tied to a specific geographic location. It is commonly associated with a firm's intangibles, such as product brand or management know-how. In practice, location-specific and firm-specific rents may not be always readily distinguishable.

Portfolio investments

Portfolio investment can be in the form of debt or equity. The effects of tax differ between the two forms. Portfolio equity investors are generally subject to company income tax or (less frequently) dividend withholding tax. They can share in a firm's rent, provided these rents have not already been capitalised in the firm's share price at the time of purchase. Portfolio debt investors do not share in the rents of a business and are subject to tax on debt, such as interest withholding tax (IWT).

A number of submissions propose reductions in IWT. The trend in Australia and other countries has been to reduce IWT, lowering EMTRs on this highly mobile source of financing for investments. There are a number of IWT exemptions, including for publicly offered debentures and syndicated loans, and (in certain tax treaties) lending by financial institutions. Submissions consider these to be too narrow and of less relevance, with implementation through tax treaties seen as too slow. Submissions argue that improved exemptions would enhance liquidity and provide access to alternative sources of financing.

Royalty withholding tax (RWT) is also relevant to the treatment of investment in Australia. Royalties include payments to non-residents for the use of copyrights or patents, or technical or industrial knowledge. Royalties are related to a firm's intangible assets. Submissions propose that existing reductions in RWT provided in tax treaties be expanded to other major trading partners, preferably through domestic law.

Revenue raised by the withholding taxes applying to dividends, interest and royalties paid to non-residents are low compared to associated income flows. It is also low compared to company income tax and other business taxes directly or indirectly paid by non-resident investors (see Box 6.3).

Box 6.3: Revenue from non-resident investment in Australia

Non-residents are potentially liable to a number of withholding taxes on the payment of returns from investments in Australia. However, given the range of exemptions provided (for example, dividends with imputation credits are exempt) the level of taxes collected is relatively low compared to the associated income stream (Table 6.1).

Table 6.1: Non-resident withholding tax revenues and income flows (2006-07)

Type of tax	Estimated revenue for 2006-07 (\$ billion) ^(a)	Investment income flow (\$ billion)
Dividend withholding tax	0.2	20.4 ^(b)
Interest withholding tax	1.3	36.6 ^(c)
Royalty withholding tax	0.3	3.2

(a) Withholding tax revenue estimates should be used with caution as collections for specific withholding taxes have not been separately identified in tax returns since 2000-01.

(b) Assumes 60 per cent of portfolio equity investment income is distributed.

(c) Includes income from other investment liabilities.

Source: for revenue, Australian Treasury estimates; for investment income flows, ABS (2008e).

Non-residents are also subject to company income tax either directly (where investment in Australia is through a branch) or indirectly (through their shareholding in an Australian company). Given that non-residents own around 30 per cent of equity in Australian companies and around 50 per cent of equity in the mining sector, in 2006-07 indicatively \$21 billion in company income tax and resource taxes and royalties may be attributed to non-resident investors.

6.2 Achieving international tax competitiveness

Many countries are examining their capital income and company tax arrangements in light of the increasing mobility of capital and of globalisation generally. As businesses have increased choice as to where they locate their investments and source and structure the related finance, the economic costs to a country of unilaterally trying to tax such investments has increased. Structuring tax arrangements in the face of international tax competition is the focus of this section.

Company tax and other business tax arrangements cannot necessarily be set by referring to international competitiveness alone. For example, company income tax also functions as a withholding tax on the company income of resident shareholders, and so its design and rate have implications for how resident individuals are taxed on their savings (a focus of Section 3.2) and labour income, and shareholder relief mechanisms. Changes made for competitiveness reasons also need to take into account potential implications for allocative efficiency and productivity, including compliance costs, discussed below.

Summary of key messages from submissions

Business submissions strongly advocate a more internationally competitive tax system. Most submissions support both reducing the company tax rate and narrowing the company tax base. Submissions proposing lower company tax rates generally suggest reductions of 5 or 10 percentage points.

A number of submissions suggest that the current treatment of tangible and intangible assets is inappropriate and uncompetitive compared with other countries. They say that more generous write-offs for depreciable assets and other tax base arrangements are needed.

Many submissions support retaining and enhancing the imputation system because it is well understood and liked by Australian investors. Such submissions say a compelling case for abolishing imputation has not been made.

Some other submissions remain open to winding back imputation or to introducing alternative means of relieving the double taxation of resident shareholders, but note that any significant changes would require careful consideration.

A number of submissions propose reductions in withholding taxes, particularly IWT. It is claimed the existing IWT exemptions are too narrow and that expansion of existing exemptions (preferably through domestic law rather than tax treaties) would provide Australian firms with access to alternative forms of financing.

There is some interest in considering alternative approaches to taxing capital income, including providing an allowance for corporate equity (ACE) or otherwise taxing economic rents, or moving to a dual income tax system.

General approaches to achieving international competitiveness

Two broad approaches to improving international competitiveness through tax measures are to reduce statutory tax rates or to narrow the tax base.

The first approach would involve retaining a broad income tax base and lowering the company tax rate. More radically, it could involve limiting interest deductions either fully, as under the 'comprehensive business income tax' (CBIT) proposal by the United States Treasury in 1992, or in part, as done recently in Germany.

The second approach would involve narrowing the company tax base in preference to reducing the existing company tax rate. A narrower base could be achieved by adjustments to the current income tax base (for example, through more concessional write-off arrangements) or, more radically, by moving to a business level expenditure tax, such as a cash-flow tax or an ACE. Box 6.4 provides an overview of these taxes, while Appendix E provides further detail.

Many submissions propose reducing the statutory company tax rate by around 5 or 10 percentage points. They also indicate the current treatment of both tangible and intangible assets (particularly goodwill) is inappropriate and unsatisfactory when compared with other countries (Section 6.4 discusses the treatment of depreciating assets). Hence, most

submissions advocate a hybrid approach, with few discussing the priority or relative merits of each.

For a given level of revenue, the two approaches have differing implications for the statutory rate adopted and the EMTRs and EATRs that arise from the combination of the chosen base and rate. As such they have different strengths and weaknesses (see Table 6.2). One complication to the analysis below is that Australia's tax system alone will not fully determine the investor's EMTR or EATR if they are subject to tax in their home country or a third country.

Table 6.2: Comparing alternative approaches to international competitiveness

Type of return (relevant tax metric)	Effect on type of return	
	Lower statutory rate	Narrower base
Normal returns (EMTRs)	Taxed more	Taxed less
Location-specific rents (EATRs)	Taxed less	Taxed more
Firm-specific rents (EATRs)	Taxed less	Taxed more
Profit-shifting (statutory rate)	Less incentive to shift profit	More incentive to shift profit

Reducing the statutory rate of tax on capital has the advantages (relative to a narrower base) of increasing competitiveness with respect to investments that earn high firm-specific rents and of reducing incentives to shift profits offshore. However, adopting a narrower base (rather than a lower statutory rate) has the advantages of increasing competitiveness in respect of marginal investments and increasing tax on location-specific rents (an immobile base).

In theory at least, the potential disadvantages of the narrower base approach (higher taxation of firm-specific rents and increased incentives to shift profits) could be avoided by implementing a 'destination-based' expenditure tax, which would exclude export sales from gross receipts and exclude expenses relating to imports (similar to the approach of the GST). Such an approach was proposed by Auerbach et al (2008) as part of the Mirrlees Review, but the full implications and practical feasibility of such an approach are unclear.

Not shown in Table 6.2 is that reducing the statutory rate would reduce tax on existing investments. This can be seen as a transitional cost or as an ongoing loss of revenue on what would be a relatively efficient tax. Moving to a narrower base can avoid this problem.

Company income tax is not the sole means by which investments are taxed. Trade-offs between the base and rate need to be seen in this broader context. Some natural resource rents are subject to tax through the petroleum resource rent tax (PRRT) and a range of specific taxes and non-tax revenue arrangements (see Section 14).

For withholding taxes, abolishing or reducing IWT, by broadening the current exemptions, would be consistent with the second approach of adopting a narrower base (that is, by effectively excluding returns to debt from the investment tax base). However, the current role that IWT plays in limiting the gains to profit shifting through the thin capitalisation of Australian investments needs to be taken into account.

To the extent that RWT is imposed on payments to the firm in respect of firm-specific rents, it may deter investment in Australia. On the other hand, it is arguable that, particularly in the non-traded sector, returns to firms even where they have significant intangibles include elements of location-specific rents. In such cases, RWT is a way of taxing such rents. RWT also acts as a back-stop against firms using intra-firm pricing (particularly of intangibles) to avoid corporate income taxes.

Box 6.4: Business level expenditure taxes

Business level expenditure taxes, in effect, only tax the above normal returns of investments, whether financed by debt or equity. As they involve a narrower business tax base, a higher rate of tax will be required to achieve a given revenue objective. While they have attracted considerable interest among tax policy specialists, they have only been implemented in a few countries and so the practical consequences are not fully understood.

Expenditure taxes can be either based on cash flows or on providing an allowance for the return on equity (or ACE). Cash-flow taxes have been implemented in Estonia and in Australia (the PRRT). Belgium recently adopted an ACE, Brazil and Italy had variants, and Croatia had an ACE for several years.

A business cash-flow tax provides a deduction in full for new investment at the time of acquisition. Income and expenses are recorded at the time the cash comes in or goes out, making income and expense recognition and depreciation rules unnecessary. The treatment of debt and equity is also made more neutral. The nature of transactions included in the tax base depends on which variant of the cash-flow tax is implemented.

An ACE operates by allowing a deduction equal to the imputed ('normal') return to equity. By providing a deduction for an imputed return on equity, the ACE can provide more neutral treatment between debt and equity. It operates within the existing income tax framework (existing timing and depreciation rules continue to be specified). Hence, while easier to implement, the ACE does not offer some of the 'cut-through' simplicity potentially offered by a cash-flow tax.

Expenditure taxes have implications for how the tax treatment of owners is integrated with that of the business. Transitional issues and interactions with the tax system in general (including integrity rules) may also need to be considered as part of any move to a business level expenditure tax.

Further information on expenditure taxes is provided in Appendix E.

Shareholder taxation and international competitiveness

More controversial is how the tax treatment of dividends and capital gains accruing to the underlying shareholders of firms affects firms' investment decisions.

One view is that as financial capital is highly mobile, the cost of capital for an Australian company is set internationally and shareholder tax arrangements therefore do not affect the investment decisions of firms. The economic literature that addresses issues of international tax competitiveness and cross-country comparisons typically makes this assumption.

Under this view, increasing tax at the resident shareholder level (for example, by abolishing dividend imputation as proposed in CEDA (2006)) to fund a reduction in company level tax will reduce the cost of capital for Australian firms and help attract foreign investment. This argument pre-supposes that if dividend imputation were abolished no other form of shareholder tax relief would be provided. Submissions open to reconsidering dividend imputation generally suggest alternative relief be considered.

An alternative view is that since capital is not fully mobile, resident shareholder tax treatment affects the cost of capital of Australian firms and, hence, investment decisions. Submissions that support retaining imputation argue that imputation credits are valued by the market and by firms (which would be unlikely if non-residents set the cost of capital) and so lower the cost of capital for Australian firms. There is some limited, though mixed, evidence that imputation credits have a market value and so affect the cost of capital.

Submissions supporting imputation also point to other advantages, such as the integrity benefits of providing incentives to pay Australian, rather than foreign, company tax and reduced incentives to avoid tax. Another advantage claimed is imputation provides a more neutral tax treatment between debt and equity finance, though (as discussed in Section 6.5) this also depends on an assumption about the mobility of capital.

The impact of more internationally competitive taxes on investment returns

Significant reform of taxes on investment returns, designed to make Australia a more internationally competitive location for investment and to reduce distortions between different investments, could have significant structural and macroeconomic impacts on the Australian economy.

Firstly, the intended increase in post-tax returns could result in increased investment in Australia, whether funded by domestic or foreign capital, leading to an increase in the capital stock (capital deepening). Secondly, reducing distortions between different investments could lead to a more efficient allocation of capital across the economy. These impacts would increase the productivity of labour, leading to higher real wages and increasing the wellbeing of Australians.

Such reform would result in structural adjustment, with resources reallocated across the economy to more productive uses. During the transition, increased demand for resources, including land, labour and other inputs may lead to increases in prices and wages increasing the cost of investment projects and offsetting the increase in the expected post-tax return. However, this latter effect would be ameliorated to the extent that higher demand is met from foreign sources. For instance imports could rise, as potentially could net migration.

To the extent there is an increase in investment this would be matched by an increase in net capital inflow and the current account deficit, unless there were offsetting increases in domestic savings. Net foreign liabilities would also rise as a proportion of GDP (at least initially). Associated exchange rate movements and the lift in real wages would mean that not all sectors of the economy would experience equal improvement in overall competitiveness.

Australia has arguably experienced effects of this type over recent decades. Australia's strong terms of trade and other economic settings, in part driven by economic reform, has meant Australia has been a favourable place to invest. The level of investment in Australia in recent years has represented a much higher share of GDP than the OECD average. The high level of capital inflow to finance that spending has matched a high current account deficit. Real wages have increased strongly, and net migration has increased strongly as well.

Where reductions in the tax on capital income are offset by increases in other taxes (for revenue neutrality), changes in these other taxes will also have implications for structural adjustment and may reduce some of the benefits discussed above. Impacts will vary depending on which taxes are adjusted. Higher labour taxes may lead to a reduction in labour supply and consumption. Higher consumption taxes would be likely to have a smaller effect on labour supply decisions as part of the burden will fall on existing holders of capital and on rents.

Consultation question

- Q6.1 Can the tax system be structured to better attract investment to Australia in a way that increases national income, and if so how? For any given revenue outcome, what are the relative merits of broader base/lower rate (comprehensive income tax) or narrower base/higher rate (a narrow income tax or an expenditure tax) approaches?

6.3 Australia as a location for international businesses

Investments overseas by Australian firms or financial intermediaries raise additional issues relating to Australia's attractiveness as a place from which to manage global or regional businesses or export financial services.

Many non-tax and tax factors are relevant to Australia's attractiveness as a location for international business, such as access to skilled labour and tax system simplicity. The focus in this section is on the taxation of returns to Australian-based multinationals from foreign investment, at the business level and the level of underlying investors (either resident or non-resident), and certain issues relevant to financial service providers.

Summary of key messages from submissions

A number of submissions propose allowing imputation or other credits for taxes paid on foreign income, to lower the cost of capital for Australian firms seeking to invest offshore and thereby address a bias against offshore investment. For similar reasons, some submissions also support the streaming of foreign source income to non-resident shareholders.

A number of submissions support mutual recognition of imputation credits with New Zealand on the basis it will progress the development of a single economic market and increase efficiency in trans-Tasman investment.

Submissions support recent reviews by the Board of Taxation into Australia's anti-tax-deferral rules and taxation of managed investment trusts, on the basis these would improve the treatment of outbound investment and further Australia's development as a financial services centre. Submissions indicate that recommendations from the Board of Taxation's reviews should be progressed independently of the Australia's future tax system review.

A number of submissions note there is strong competition from regional financial services centres, such as Singapore. They propose expanding concessional tax arrangements for regional financial services businesses, possibly through expanding the offshore banking unit concessions. Some submissions also raise concerns with other taxes on financial services, including withholding taxes and input-taxing of financial services.

Some non-business organisations suggest that tax concessions for business, such as the offshore banking unit concessions, should be limited.

International competitiveness of Australian-based multinationals

The *Architecture paper* provided an overview (at page 267) of the efficiency benchmarks that guide policy on the tax treatment of outbound investment. Traditionally, capital export neutrality (CEN) was thought to be the most appropriate benchmark for maximising global efficiency. However, there has been a trend away from CEN towards capital ownership neutrality (CON), which allows the most productive firms to manage investments. This trend is reflected in the adoption of dividend exemption regimes.⁸

Countries that have adopted exemption regimes, such as Australia, typically only do so in respect of their resident companies' active (business or trading) income, and continue to tax the foreign passive income of resident companies (such as interest and dividends on portfolio investments) with credits for foreign taxes. Such a policy aims to strike a balance between competing objectives. It allows resident firms to attract foreign capital – that is, engage in the business of managing international capital. At the same time, it protects the home country's ability to tax the savings of its residents.

⁸ A tax system reflects CEN where all investments by residents of a country are taxed the same regardless of the location of the investment. It can be achieved by taxing residents on all their income from offshore investments as they accrue with a full credit for foreign taxes paid. A tax system reflects CON where the cross country ownership of assets is not distorted by tax considerations. One way of achieving CON is to not tax the offshore income of resident companies (Griffith et al 2008).

Dividend imputation and offshore investments

Many submissions support dividend imputation, indicating it is well understood by Australian investors, generally avoids the double taxation of company profits and lowers the cost of funding for Australian firms. However, submissions suggest there is scope to review aspects of the imputation system to improve how it operates for Australian firms investing offshore.

A number of submissions argue that the denial of imputation credits for foreign taxes paid on foreign income distributed to resident shareholders limits their ability to access capital for offshore investment. This impairs their international competitiveness. In effect, under the imputation system, resident shareholders are provided with a deduction, rather than a credit, for foreign taxes paid by the company. To redress this situation, submissions propose a credit or some recognition for foreign tax paid.

However, paying foreign tax does not benefit Australians, whereas Australian tax funds public services. The absence of a foreign tax credit then aligns an investor's private return from investing overseas with the national return and provides a counter-balance to incentives for Australian companies to shift investments to low-tax countries. This view is consistent with maximising Australian (rather than global) welfare, but assumes no spillover benefits from offshore investment and disregards any costs of biasing the saving portfolio choices of residents (see Section 6.7). Providing a credit for foreign tax paid might also reduce the integrity benefits associated with imputation.

A number of submissions propose the mutual recognition of imputation credits between Australia and New Zealand. This would see imputation credits being provided for foreign taxes on a reciprocal rather than unilateral basis. Mutual recognition is said to lead to greater efficiency in trans-Tasman investment and help develop a single economic market. These benefits would need to be balanced against potential distortions to the location decisions of Australian companies with a choice between investing in New Zealand or a third country.

The above arguments for and against providing imputation credits to resident shareholders for foreign tax assume that shareholder-level taxation is relevant to companies' investment decisions. An alternative view is that shareholder-level taxation is not relevant (see Section 6.2) as non-resident investors are the marginal source of financing.

On this alternative view, providing a credit to resident shareholders for foreign taxes paid is unlikely to affect the offshore investment decisions of Australian companies. However, as one business submission notes, dividend imputation may still increase the cost of capital in these cases. This is because raising equity from non-residents to fund an offshore investment will see those non-residents claiming a share of any imputation credits the company generates from domestic investments. The availability of imputation credits for resident shareholders would therefore fall.

To address the bias arising from the loss of credits, or the more general bias against offshore investments, a number of submissions propose that dividend streaming be allowed to maximise the use of imputation credits. In particular, they favour streaming of (unfranked) foreign income to non-resident shareholders. This would require a change from the current policy of trying to prevent streaming on the basis that it is inconsistent with the integrated treatment of shareholders and companies upon which imputation is premised.

Dividend streaming raises issues beyond the treatment of foreign income earned by Australian companies. Dividend streaming is arguably already achievable in certain ways, for example, through dual listed company structures or share buy-backs. Submissions note that existing anti-streaming rules add considerable complexity to the tax system and increase business compliance costs – including for those that are fully foreign-owned.

Dividend streaming proposals can also have different objectives. For example, foreign multinationals with a secondary listing on the Australian Stock Exchange could be allowed to ‘pay’ franked dividends to Australian shareholders in those multinationals (out of credits generated by their Australian subsidiaries). The rationale for this alternative would be to improve Australian capital markets and provide an incentive for foreign multinationals to pay Australian tax.

Competitiveness of Australian-based managed funds and other financial service providers

For Australian-based managed funds and other financial services providers, taxing the foreign source income from the investment of funds provided by non-resident investors could disadvantage them relative to overseas funds. Providing targeted concessions to remove or reduce tax on such conduit income may still give rise to higher operating costs. However, if exemptions are broader, it may be more difficult to maintain the ability to tax resident investors on these funds and non-residents on Australian investments.

The Australian Government has asked the Panel to consider tax settings that would assist in positioning Australia as a financial services centre in the region. The Government hosted, in conjunction with the NSW Government, a financial services hub summit in July 2008. Following the summit, the Australian Government announced the establishment of an Australian Financial Centre Forum to further Australia’s development as a regional financial services centre.

Participants at the summit identified tax, regulatory and other impediments. Participants cited the complexity, uncertainty and inflexibility in the administration of tax law as deterrents to foreign investment. They proposed lower taxes on inbound investment through reductions in withholding taxes, expansion of the offshore banking unit concessions, and a reduction in the company tax rate. Matters related to these issues are discussed in Sections 6.1 to 6.2, and Section 8. A further issue, raised in submissions, is discussed below.

Input taxing of financial service providers

Financial services providers in Australia, as in many other countries, are input taxed on financial supplies under the GST. Taxing inputs into a production process is generally considered to be inefficient, as it distorts production as well as (once the input taxes are passed on) consumption choices.

This results in what submissions described as an ‘embedded’ cost, which increases the provider’s cost structure and that can cascade through the prices of other goods and services in the economy, contrary to the basic intention of a GST. It can also give rise to additional complexity (rules relating to reduced input tax credits are required) and increase compliance costs. For highly mobile financial services, input taxing may reduce international competitiveness.

Financial services give rise to technical problems under the invoice-credit-style GST because the tax is applied to the expected profit margin for each transaction. This is problematic for many financial services as implicit fees are typically charged by adjusting interest rates, with millions of transactions occurring daily.

Submissions suggest adopting alternative approaches to taxing financial services, such as New Zealand's approach to taxing financial services, to mitigate some of these effects. Alternatively, there are some variants of business cash-flow taxes (discussed in Appendix E), which could potentially address issues around taxing implicit fees. Changes would need to balance the potential benefits of removing taxes on business inputs with the implications for the treatment of household consumption of financial services.

Consultation question

Q6.2 What changes, if any, to the tax system would improve the ability of Australian companies to operate internationally orientated businesses? How should the tax treatment of companies and shareholders be integrated in an open economy?

6.4 Investment and risk-taking biases

Effective tax rates on investments in Australia vary considerably depending on the investment and associated risks. This variation reflects the different tax treatments of various assets, of net losses compared to net gains, and a range of specific rules, concessions and exemptions.

Through altering relative prices, these tax biases can affect the efficient allocation of resources within the economy by potentially diverting inputs and outputs from their most valued use to lower valued uses, discouraging some productive investment and reducing the overall productivity of the economy. These tax arrangements are also among the more complex parts of the tax system, resulting in a system that is difficult for government to maintain and for business and households to understand and comply with.

Summary of key messages from submissions

Many submissions express concern that current allowances for depreciation or the amortisation of certain tangible and intangible assets are inadequate and reduce international competitiveness. In particular, there are concerns about the limited recognition for certain business intangibles, such as acquired goodwill.

A number of submissions support stepped rates for capital gains tax (CGT), with rates declining the longer an asset is held, to encourage more long-term investments. However, some express concern over disincentives to sell assets ('lock-in').

A number of other specific changes are suggested, including providing additional roll-overs, clarifying the revenue/capital distinction, and providing for managed fund assets to fall only within the CGT provisions.

Summary of key messages from submissions (continued)

Submissions note that the treatment of losses is asymmetric and negatively affects risk taking and international competitiveness. A number of changes were suggested, most commonly to allow the carry-back of losses.

A number of submissions suggest that the tax treatment of research and development should be made more generous. The recommendations of the Innovation Review (2008) are also supported. Submissions also propose providing tax incentives for a range of other activities or sectors, including those relating to small business, shipping, the environment, technology and infrastructure.

Submissions suggest that the compliance costs and risks imposed on taxpayers arising from the business tax system – its administration, complexity and uncertainty – should be reduced.

Measuring business profits and losses

Australia notionally operates an income tax base at the company or business level. While some countries' tax systems deal with the challenges of implementing an income tax better than others, taxing investments on an income basis inevitably gives rise to distortions and significant complexity due to inherent difficulties in measuring and recognising gains and losses.

The difficulties inherent in a comprehensive income tax include adjusting for inflation, measuring changes in asset values and accounting for the timing of inflows and outflows. The current tax system also measures investment gains and losses differently depending on the form of investment, the type of investment or industry in which it occurs, and the entity or entities involved. Even when annual income is measured accurately, the tax system treats measured net gains and losses asymmetrically.

Most of these biases and complexities could potentially be addressed under an expenditure tax system, though the treatment of net losses would remain an issue. Box 6.4 and Appendix E outline the principal types of business expenditure taxes: a cash-flow tax or an ACE system.

Broad reform approaches are to either improve on current income tax arrangements (either by adopting a broader base or, as submissions suggest, a narrower base) or move to a business level expenditure tax. Under either approach, the treatment of losses may need to be further considered. Some of the issues involved in adjusting arrangements in an income tax framework are discussed in more detail below.

Taxing returns that compensate for inflation

As discussed in Section 3.2, the income tax system generally taxes the full nominal return on an investment, rather than the real return which excludes the inflation premium. This means the effective tax rate on the real return to investment can be higher than the statutory tax rate.

There is a trade-off between the efficiency gains from reducing distortions by trying to accurately adjust for inflation and the efficiency losses from the increased operating costs that would result. Given that price stability is a key objective of monetary policy, the case for comprehensive adjustments for inflation appears weaker now than it was in the past.

The measurement of declines in asset values

Australia moved to effective life depreciation in 1999. More recently, the diminishing value rate for depreciation deductions was increased from 150 per cent to 200 per cent (commonly referred to as 'double declining balance' depreciation). These changes were made to better reflect the underlying pattern of economic depreciation for most assets and so improve the neutrality of investment decisions in an income tax framework.

Some submissions express the view that some effective lives do not currently reflect experience in the market, discourage investment and create biases against certain investments (including long-lived assets). Submissions also express the view that capital allowance rules for both tangible and intangible assets should be brought into line with other countries to improve international competitiveness (consistent with an approach of narrowing the tax base, as discussed in Section 6.2). In particular, there are concerns there is no recognition for the decline in value of acquired goodwill.

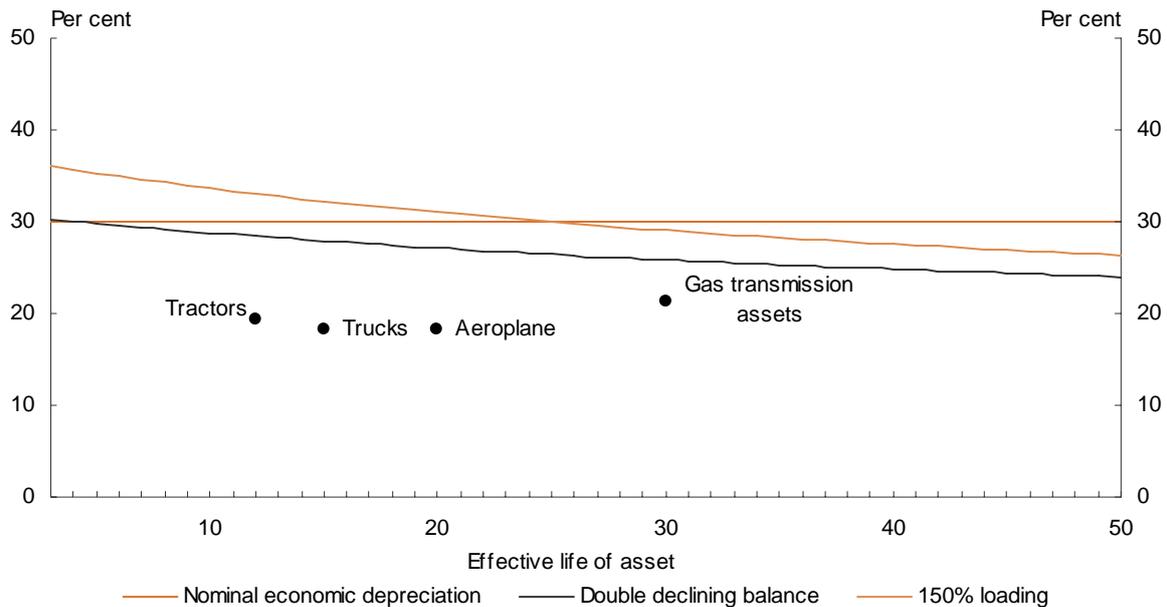
However, more generous arrangements could increase efficiency costs arising from distorting investment choices.

Tax depreciation affects the effective tax rate and the after-tax profitability of an investment project. Even where the effective life of an asset is accurately assessed, tax depreciation allowance schedules represent approximations of the actual pattern of economic depreciation. True economic depreciation, which is the real decline in the value of assets as they age in use, is likely to vary significantly across different types and uses of depreciating assets.

A number of exceptions allow tax depreciation rates to diverge from those based on effective life. A significant exception is the building depreciation provisions, which provide deduction rates of either 2.5 per cent per annum or 4 per cent per annum. Also significant are the statutory life caps that have been placed on the effective life of certain assets, providing accelerated depreciation. Another example is immediate deductions for expenditures, such as certain repairs and maintenance expenses, even where the expenditure is consumed over time – providing an incentive to extend the life of existing assets rather than replace them.

Chart 6.5 compares the EMTRs of various tangible assets depending on tax depreciation regime and asset effective life. All investments that are immediately expensed face an EMTR of zero. This is because immediate expensing effectively exempts normal returns. Where tax allowances equal the economic depreciation, the EMTR is equal to the statutory tax rate as the normal returns are fully taxed. Where tax allowances are underprovided, the EMTR faced would be above the statutory tax rate. The downward sloping nature of the EMTR schedules reflects capital allowances based on historical cost rather than current cost.

Chart 6.5: Comparison of nominal EMTRs of equity financed investments by depreciation arrangement and effective life



Note: Assumes a nominal interest rate of 6 per cent, inflation of 2.5 per cent and statutory tax rate of 30 per cent. Depreciation allowances under 'double declining balance' and '150% loading' are calculated based on effective life and diminishing value method at historical cost. Under the 'economic depreciation' method, capital allowances equal economic depreciation at current cost. The capital allowances for tractors, trucks, aeroplanes and gas transmission assets are calculated based on their statutory effective life caps. The effective lives for these assets as determined by the Commissioner of Taxation are 12, 15, 20 and 30 years respectively (ATO Tax Ruling 2008/4).
Source: Australian Treasury estimates.

Intangible assets pose even greater difficulties in estimating appropriate rates of economic depreciation (or in many cases, appreciation). The value of these assets, and how values change over time, can be inherently difficult to ascertain as intangibles exhibit different rates of economic depreciation (or appreciation). As discussed in Box 6.5, the treatment of intangibles can vary markedly.

The measurement of gains in asset values

Appreciating assets are generally subject to CGT. CGT was introduced in 1985 partly to enhance the neutrality of treatment for assets that generate gains via increases in their value (such as land and some financial assets) compared to assets that generate gains via cash flows (such as interest-bearing accounts). For businesses and certain other taxpayers, appreciating assets may also be taxed on revenue account or under accruals-like rules.

Submissions raise several concerns with the current CGT system. A number of submissions also raise concerns about the clarity of the revenue/capital divide while others seek a CGT treatment.

Box 6.5: Intangible assets and goodwill

Intangible assets and goodwill form a large part of the book value of listed Australian firms. The concentration of reported intangible assets is likely to vary depending on industry sector and firm type. PricewaterhouseCoopers (2006) found that in their 2005 year-end financial statements, ASX 200 companies reported around \$112 billion in intangible assets. (The market capitalisation for the ASX 200 as reported by Standard & Poors (2008) was around \$800 billion on 30 June 2005). Of these intangibles, goodwill represented 58 per cent, contract-related assets (such as franchise agreements) 24 per cent, marketing-related assets (such as brands and mastheads) 9 per cent and customer-related assets (such as customer lists) 1 per cent.

Some intangibles, such as patents and in-house software, are currently treated as depreciating assets for tax purposes. For other intangibles, such as acquired goodwill, there are no provisions to allow taxpayers to deduct or amortise these amounts. The sale and acquisition of goodwill, for example, falls within the CGT provisions. To the extent that acquired goodwill and other intangible assets are depreciable assets with finite effective lives (accounting standards prohibit the amortisation of intangibles with an indefinite effective life), an income tax system should recognise real declines in value.

However, in other respects the tax system provides for a more generous treatment of intangibles than appropriate when measured against an income tax benchmark. In particular, expenditures incurred to build goodwill and certain other intangibles are immediately expensed, without the value of the asset generated being recognised. The taxation of the cash flow arising from the sale of these intangibles plus the immediate expensing means that this form of investment is (when equity funded) afforded expenditure tax-like treatment, with a zero EMTR. When debt funded, the EMTR is negative.

Where acquired goodwill declines in value, the expenditures required to maintain goodwill are typically immediately deductible. The deductions for expenditure sufficient to maintain the level of goodwill means that the investment in acquired goodwill has access to deductions equivalent to allowing write-off based on economic depreciation.

Biases arising from the CGT treatment of appreciating assets

Levying CGT on realisation (when an asset is disposed) results in tax deferral, which creates two biases.

- It results in a falling effective rate of CGT the longer an asset is held. Thus, the effective rate of CGT is lower than that applied to a comparable asset that generates cash returns (see Box 6.6).
- Asset owners may be discouraged from selling their assets, even when a potential buyer values them more highly (the 'lock-in' effect).

The decline in the effective rate of CGT the longer an asset is held is avoided under current asset test arrangements in the transfer system that deem a return to capital assets, effectively proxying the accruing gain.

While the extent to which lock-in is a problem in practice is unclear, the current law contains a large number of roll-over provisions that address potential lock-in where taxpayers are particularly sensitive to realising a liability. Some submissions propose further specific roll-overs, such as to allow superannuation funds to merge or for the transfer of intellectual property to a spin-off company.

Improving the CGT system

To improve incentives to invest and to encourage long-term investment, some submissions propose introducing stepped CGT rates, with the rate of tax declining the longer an asset is held. Such stepped-rate approaches have been a feature of CGT arrangements in some other countries. However, adopting stepped rates would have potential downsides. Short-term investments are not necessarily less productive than long-term investments. A yet more favourable CGT regime could further distort investment choices and exacerbate lock-in.

An alternative approach suggested in academic literature would be to continue to assess capital gains and losses when they are realised but to provide an uplift to realised gains, with symmetrical treatment for realised losses. This is equivalent to accrual-based taxation. However, it could exacerbate problems arising from the lumpiness of realised capital gains when assessed against progressive tax rates, and could increase complexity.

Submissions also place emphasis on reducing the complexity and operating costs associated with current CGT arrangements. In particular, some submissions propose CGT exemptions for assets held beyond five or 10 years on the basis it would simplify record-keeping requirements. The CGT regime is complex and costly to operate. General reasons for this include:

- the provisions have a broad reach and there are numerous concessions;
- they have also been drafted in a highly prescriptive way and have become outdated;
- the CGT rules can interact with other parts of the tax and general (equity, property and contract) law in complex ways; and
- changes to the provisions can be ad hoc.

The four small business CGT concessions are also a major area of increasing complexity.

Box 6.6: CGT tax deferral benefits

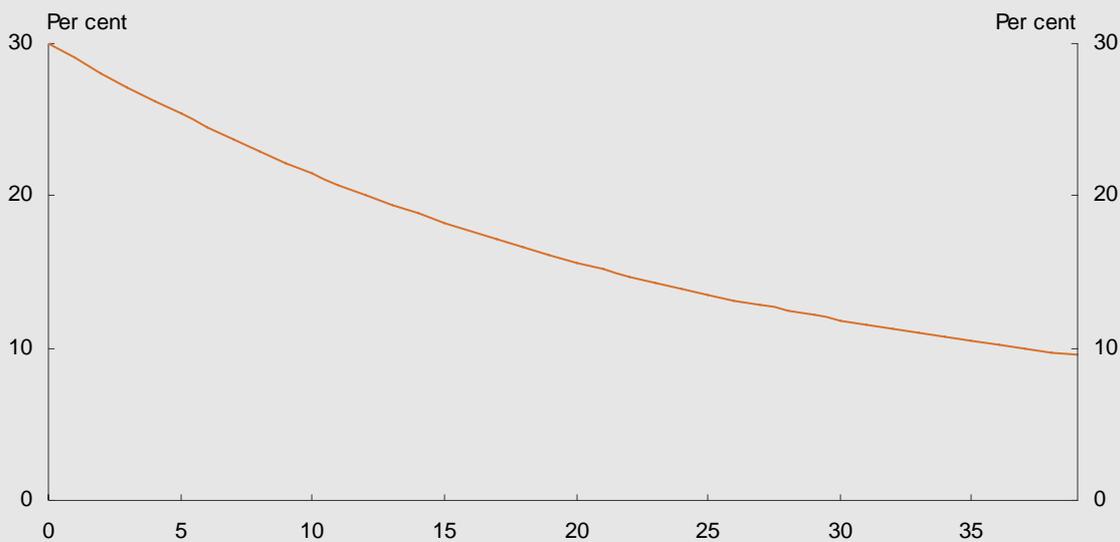
This example compares two assets held by a taxpayer facing a 30 per cent tax rate: a bank account paying 10 per cent interest taxed on an annual receipts basis (when net interest accumulates), and a piece of land which appreciates in value at 10 per cent a year, but which is taxed on disposal. The land owner will have more post-tax cash available than the bank account holder, even in the absence of a CGT discount.

Table 6.3: Example of the CGT deferral benefit

	Bank account					Appreciating land				
	Pre-tax interest	Tax	Post-tax interest	End period balance	Net cash flow	Appreciation	End period value	Tax on sale	Net cash flow	
Year 0				\$10,000	-\$10,000		\$10,000		-\$10,000	
Year 1	\$1,000	\$300	\$700	\$10,700		\$1,000	\$11,000			
Year 2	\$1,070	\$321	\$749	\$11,449		\$1,100	\$12,100			
Year 3	\$1,145	\$343	\$801	\$12,250		\$1,210	\$13,310			
Year 4	\$1,225	\$368	\$858	\$13,108		\$1,331	\$14,641			
Year 5	\$1,311	\$393	\$918	\$14,026		\$1,464	\$16,105			
Year 6	\$1,403	\$421	\$982	\$15,007	\$15,007	\$1,611	\$17,716	\$2,315	\$15,401	
Internal rate of return						7.000%				7.463%
EMTR						30%				25%

Although there is a large tax liability for the land in the final year when it is sold, the deferral benefit means the effective tax rate is significantly lower than the interest-bearing investment. The land owner has the benefit of tax-free accumulation in the preceding years. The tax deferral benefit means that the effective tax rate under CGT declines the longer the asset is held (Chart 6.6).

Chart 6.6: Nominal EMTR on a CGT asset
By holding period (in years)



Source: Australian Treasury estimates.

Risk taking

Entrepreneurial activity can make an important contribution to economic growth. New entrants in a market can introduce more highly valued products, new production methods and processes, and organisational innovations. These in turn can provide spillover benefits to existing firms. Potential entrepreneurs typically face a choice between returns from risky entrepreneurial projects and a more stable income from the current use of production factors.

As identified in a number of submissions, an important structural element in the tax system that can affect risk taking is the extent to which the treatment of net losses matches (is symmetrical to) the treatment of net income or gains. Submissions argue the current asymmetric treatment of losses, described in the *Architecture paper*, inhibits Australia's international competitiveness.

The treatment of losses and risk taking

A proportional (flat rate) income tax with full loss offset can be expected to share risk and returns between an investor and government. Thus, the tax has little effect on investors' risk taking. This is because investors can increase the proportion of risky assets in their portfolios so the after-tax risk is unchanged. In a full loss offset case, government is effectively a 'silent partner' in the investment, by taking a share of the risky return if it succeeds, and providing a full offset if it fails. Broadly, the tax imposed on the risky project reduces the rewards of success and the losses from failure.

Partial loss offsets, as in Australia, can distort risk taking in either direction, depending on the size and direction of income and substitution effects (IMF 1995). If the project is part of a large entity, such as a consolidated group, that has profits against which to offset a loss, the entity will receive full value for the loss. If a business does not have other profits against which to offset a loss, and it cannot pass the loss to the individual investor, it must carry forward the loss to be offset against future income. Losses carried forward lose value over time, and tax law can also limit access to current and carried forward losses. These effects can create a tax bias in favour of large companies and less risky investments.

The income tax system can also distort risk-taking behaviour where tax is not levied proportionately, for example where there are progressive income tax rates as may apply to a sole trader or partners in a partnership. Where gains are assessed against a higher tax rate than the rate at which losses are assessed, progressive personal rates effectively tax success more than they subsidise failure. This effect can be further exacerbated by progressive credits such as the entrepreneurs' tax offset, which reduces the tax liability for entrepreneurs whose income is lower than a specific threshold.

Providing a more neutral treatment of losses

If the economic costs of the current treatment of losses are considered sufficient to justify moving to a more symmetrical treatment, or full loss offset position, a range of approaches could be considered.

To improve the treatment of losses, submissions generally support allowing loss carry back, against (time-limited) past tax payments. Suggestions as to the period within which losses can be carried back range from one to three years. Another approach could be to index losses carried forward using a risk-free rate of return, with an adjustment to compensate investors for the risk that the loss will never be utilised.

Other options similar to full loss offset include providing refunds proportionate to the losses, allowing losses to be offset against a firm's other tax payments, and allowing losses to be traded. These offsets would address loss issues for projects with uncertain overall returns. However, integrity issues would be significant. Tax collections would also likely become more variable and cyclical.

Loss offset could also be improved by allowing losses to pass from an entity to the underlying owners. This is part of the proposal to provide a flow-through treatment to small business and is a specific objective of proposals to provide flow-through treatment for certain exploration companies (see Box 6.7).

The merits of such proposals depend in part on: how they interact with other aspects of the tax system, such as dividend imputation and CGT; long-standing integrity concerns around artificially generated losses; and the net impact on operating costs. It also becomes more important to prevent tax losses arising from timing misalignments, such as for negatively-gearred rental properties. Further, any move to a more generous treatment also needs to consider the treatment of existing accumulated losses.

Box 6.7: Flow-through for exploration companies

Loss offset could be improved by allowing losses to pass from an entity to the underlying owners, as currently happens for sole traders and partnerships, by using flow-through share schemes. This type of scheme has been proposed for junior exploration companies.

Broadly, a flow-through share scheme encourages investment in exploration in preference to other investment options, by allowing deductions (or equivalent tax credits) generated from exploration expenditure to 'flow-through' from the exploration company to its shareholders. An exploration company generates losses as it incurs exploration expenditure with, generally, little income to offset that expenditure. While the losses are able to be carried forward, the risk that they will not be absorbed is predictably high, given the risky nature of exploration.

Reforms to the treatment of losses incurred by exploration companies need to be considered in the context of any broader reforms to the treatment of losses and entities across the business tax system.

Other business concessions

Submissions call for a range of new tax concessions or improvements to existing exemptions for small business.

Like other countries, the business tax system in Australia provides specific tax concessions for particular types of investments. The major business tax concessions currently available in Australia include research and development (R&D) concessions, statutory caps on the effective lives of some depreciable assets, accelerated write-offs for certain capital expenditures, film investment incentives, and small business concessions. There is also a range of non-tax sector-specific industry assistance including measures for primary production (such as relief for exceptional circumstances, including interest rate subsidies) and for the automobile sector (structural adjustment payments and the Green Car Innovation Fund).

A rationale for certain business concessions is that they can help productivity growth by providing incentives for particular activities that may be underprovided by the market. For example, incentives to undertake R&D are usually justified on the basis there are spillover benefits to the rest of the economy. However, business tax concessions alter the allocation of resources in the economy by changing the relative prices of inputs and outputs. These price distortions can result in an inefficient allocation of resources within the economy, reducing productivity.

Another rationale for some concessions (also advanced in a number of submissions) is international tax competition, with concessions proposed to achieve comparative outcomes with other countries for investments that could be undertaken elsewhere. Such proposals need to be considered from the broader perspective of the overall competitiveness of the tax regime (as discussed in Section 6.1), while also taking into account the potential misallocation of domestic investments they create.

Consultation questions

- Q6.3 Can the tax system be restructured to improve resource allocation within the economy and minimise operating costs, and if so, how? What changes would reduce distortions to risk taking and encourage entrepreneurial activity?
- Q6.4 What principal goals should inform the taxation of capital gains in Australia, and what, if any, changes should be made to capital gains tax as a result?

6.5 Biases affecting commercial decisions

As well as affecting the investment choices of businesses, the tax system can also affect other commercial choices, such as financing and the distribution of profits to owners, and the choice of business structure.

Summary of key messages from submissions

Submissions support dividend imputation because it provides a neutral treatment of debt and equity for resident investors by addressing the double taxation of corporate profits. Most submissions consider that the imputation system generally lowers the cost of capital.

A number of submissions propose flow-through treatment for companies and, possibly, other entities either in general or in particular cases (including for small businesses, indigenous ventures or venture capital).

Some non-business organisations express concern over the tax advantages arising from the use of certain business entities, particularly discretionary trusts.

There are a few other concerns about the current entity arrangements. One is the potential for managed funds to be taxed as companies.

Sources of finance: debt and equity

Firms can raise capital to finance investments in a number of ways. Firms can issue equity or debt or finance investment from retained earnings.⁹ Nominal interest payments are deductible from Australia's company income tax base but total corporate profits (or returns on equity) are taxed. This can provide a tax incentive for firms to finance investment out of debt rather than equity.

The different treatments of debt and equity are a major source of complexity in the income tax system. For example, they necessitate complex rules to classify instruments as debt or equity and require 'thin capitalisation' rules to prevent profits being shifted from Australian firms to firms in low-tax jurisdictions. A number of submissions express concerns around Australia's thin capitalisation rules, citing their complexity and potential interactions with the transfer pricing rules.

To the extent capital is not perfectly mobile, as may be the case particularly for small unlisted domestic firms, financing decisions may be influenced by taxes on capital income (dividends, capital gains, interest) at the personal level. Even with dividend imputation, investments financed by retained earnings can be favoured over new equity, due to the concessional treatment of capital gains. The tax system may therefore provide a tax advantage to more mature firms and discourage the entry of new firms. Distortions to firms' payout policies may also arise (Jones 2008).

However, where the marginal source of finance is the international capital market, interest deductibility coupled with a lack of credit for Australian company taxes may bias the capital structure of the firm towards higher levels of debt. This bias might then affect other factors driving the firms' choice of capital structure such as liquidity, the ability to match asset/liability durations and to adapt to changing economic conditions.

Providing a more neutral treatment of debt and equity

There are other approaches to address distortions arising from the debt/equity distinction at the business level apart from dividend imputation, which becomes less effective as the economy becomes more open and capital more mobile.

Business level expenditure taxes, such as an ACE or business cash-flow tax, could provide a more neutral treatment of debt and equity at the business level. As discussed in Box 6.4, an ACE system allows a deduction for company equity at an interest-equivalent rate. Under a cash-flow tax, the immediate expensing of investment means that the normal return on equity is not taxed, thereby providing neutral treatment between debt and equity.

Another approach, the CBIT proposed by the United States Treasury in 1992, would be to include debt interest payments in the company income tax base by removing interest deductibility. However, under this approach, the cost of debt financed from foreign investors would increase. The extent to which debt-equity neutrality is achieved also depends on the tax treatment of capital income in the foreign investor's country of residence. As noted in

⁹ In practice, the distinction between debt and equity can be blurred for hybrid instruments that combine debt and equity features, such as non-cumulative preference capital.

Section 6.2, while the CBIT has not been formally adopted by any country, there have been partial steps taken in some countries (for example, Germany) to limit interest deductibility.

Choice of business organisation

Businesses and investors can use a variety of organisational forms, with considerable variation in the income tax treatment of the entity type and the underlying owners. As discussed in the *Architecture paper*, this sets up the potential for inefficient outcomes that can affect overall business productivity. A potential inefficiency is that businesses will be conducted through multiple entities or a sub-optimal entity structure.

The different tax treatments applying to different entity types largely revolve around the degree of integration between the firm and the investor. For example, partnerships reflect full integration, while companies are taxed separately from their shareholders with dividend imputation providing partial integration.

In the past, proposals have been made for uniform treatment across most entity types, such as company tax style treatment. The intention was to achieve consistency and so reduce distortions and complexity. However, doing so can introduce complexities of its own, imposing higher tax operating costs on many businesses. An alternative viewpoint is reflected in Auerbach et al (2008), who argue that allowing for heterogeneity in organisational form is a means by which to accommodate the different circumstances of firms and owners.

Another approach would be to move away from taxing entities separately from their underlying owners, by looking through the entity – ‘flow-through’ treatment. This is the reform path favoured in submissions, generally on an optional or elective basis. Such an approach would allow for a more integrated, partnership-like, treatment of companies and, possibly, other entities. In the United States, ‘S-corporation’ rules provide for such an outcome and ‘check the box’ rules (also proposed in a submission) allow entities to elect for flow-through treatment.

A flow-through approach would potentially make tax affairs simpler for small businesses by allowing business income to be taxed in the individual’s hands, rather than at the company level. This would avoid the need to comply with complex company tax provisions. It could also reduce the cost of capital for small startups, as losses could be more readily utilised. A specific flow-through proposal for small business is discussed further in Section 6.6.

Possible disadvantages include additional complexity arising from two distinct company tax treatments. The choices facing business could also increase, particularly if flow-through was optional. While the United States’ experience demonstrates the practicality of flow-through options, its rules were developed as a means of addressing the double taxation of company profits under the classical system and, hence, had a stronger rationale. In Australia, imputation is the primary means of addressing this. The United States has also experienced integrity issues with its ‘check the box’ approach.

Another possible approach is to set key elements of the overall system, including business and personal income tax rates, to allow for a simpler set of rules to align the tax treatment of entities and owners. An example is the combination ACE tax system at the business level and a dual income tax system at the personal level, as advocated in Griffith et al (2008). The

authors propose setting business and personal income tax rates so that the combined taxes on capital income are equal to the top tax rate on labour income. This is said to avoid the need for crediting provisions and remove incentives to characterise labour income as capital income.

Consultation question

Q6.5 Should the tax system provide a more neutral treatment of different financing arrangements (debt, equity and retained earnings), and if so, how? What principles should inform approaches to entity taxation?

6.6 The treatment of small business

A range of specific provisions intended to assist small business activity, or reduce tax operating costs, are contained in the income tax system, as well as other taxes such as payroll tax. These provisions may temper the relatively high operating costs facing small business, but can add to the overall complexity of tax law and affect resource allocation in the economy.

Summary of key messages from submissions

Several submissions indicate that tax concessions for small business are justified, given the inherent disadvantages faced by small business. These submissions consider that small business makes important contributions to employment and economic growth.

Some submissions propose further rationalisation of existing small business concessions to minimise operating costs. Other submissions are more critical of existing small business concessions and indicate that separate arrangements (such as a separate tax code) for small business are required, possibly with more concessional arrangements and exemptions from state taxes and duties.

Some submissions claim that existing concessions for small business cannot be justified on efficiency or equity grounds. These submissions argue for more neutral treatment of small business, with the abolition or reduction of current concessions, such as the CGT and payroll tax concessions.

Rationales for small business specific rules

The tax system provides a range of concessions or separate rules for small business.

One rationale for these arrangements is the contribution small business makes to the overall economy, through product differentiation, entrepreneurship, job creation and increased competition. A number of submissions call for lower income taxes for small business, generally based on such a rationale. Thresholds exempting small businesses from payroll taxes are also often supported on this basis, as well as to reduce operating costs.

A second rationale is to counter the inherent disadvantages of being small, including high tax operating costs and potentially less ability to offset net business losses against other

income streams. Submissions acknowledge current tax concessions are designed to address some of these problems, but there is a view that they have not succeeded in their purpose. Some submissions propose the development of alternative small business arrangements that could provide for increased upfront write-off of capital expenditure and more extensive exemptions from state taxes and duties.

Small businesses are inherently more closely aligned with the individuals or family that own the business. The profits of a small business represent a return to work (labour income) and invested capital. The small business CGT retirement concessions reflect this relationship, as do various integrity measures. Also reflecting this alignment, submissions with a small business focus support reducing the top personal income tax rates before reducing the company tax rate.

Some submissions express concerns about the robustness of the underlying rationale for providing specific concessions for small business. Such submissions take the view that existing concessions cannot be justified on either efficiency or equity grounds. Recent work also suggests that small business incentives have no discernible impact on economic growth (Johansson et al 2008). The discussion of small business issues in the Mirrlees Review (Crawford and Freedman 2008) provides a critical perspective on whether concessions are appropriate and whether the benefits outweigh the costs.

Entity flow-through taxation

The Australian Government has asked the Panel to consider a proposal for an optional entity flow-through arrangement, which is also raised in a number of submissions. The proposal would allow small businesses to operate formally within a limited liability entity, typically a company, while effectively treating the business as a partnership for tax purposes.

Broadly, the deemed partnership would calculate its taxable income or tax loss and allocate it to individuals based on their interest in the entity. Allocated profits and losses would be assessed at the individual investor's personal tax rates. In the case of a taxable income distribution, the outcome would be the same as currently provided through dividend imputation. In the tax loss situation, to the extent the investors have other taxable personal income it would allow losses to be used in the year they are generated.

Partnership-like treatment also means a number of rules associated with companies are not required, including rules on payments to associated entities, franking accounts and the carry forward of losses.

However, as noted in the discussion of business structures, a disadvantage of such an approach is that it could give rise to additional complexity. Hence, the impacts of entity flow-through on tax system operating costs would need to be carefully considered. Entity flow-through may also offer an opportunity to simplify other parts of the tax-transfer system, such as the small business CGT concessions, or to simplify the arrangements for all small business structures on a more uniform basis.

Consultation question

Q6.6 Should the tax system be structured to cater for the specific circumstances of small business, and if so, how?

6.7 Biases in the personal investments of residents

As well as affecting the overall level of savings of a household (discussed in Section 3), the tax-transfer system also affects the way households allocate their savings between different financial and real investments.

This section provides an overview of issues regarding household savings. The discussion in previous sections around dividend imputation, capital gains, the treatment of different entities, and of losses and risk taking, is also relevant to household choices. The discussion of housing in Section 10, of retirement savings in Section 5 and the separate retirement incomes paper, are also of particular relevance in light of the share of housing and superannuation in total household assets.

Summary of key messages from submission

Submissions note that interest-bearing accounts and assets are taxed heavily compared to other investments, with implications for incentives to save and for equity. These submissions suggest a variety of means of providing more favourable treatment for interest income such as through exemption, taxation at a low flat rate or tax preferred savings accounts.

Some submissions suggest moving to a 30 per cent capped rate on capital income or considering a low flat rate tax on capital income (a dual income tax).

A number of submissions raise concerns regarding the 50 per cent discount available for individuals (particularly for rental properties) and the CGT exemption for principal residences. These submissions are concerned that the concessions favour the wealthy or increase house prices.

Reflecting concern over negative gearing, some submissions also propose capping the level of deductible interest to income generated by the investment, with excess deductions carried forward.

Other submissions take an alternative view of the 50 per cent CGT discount, negative gearing and the general availability of interest deductions, citing their role in encouraging the supply of housing and rental properties and referring to similar arrangements overseas.

The treatment of household savings

The principal assets of Australian households are the houses they own and live in (44 per cent of household assets), other property including rental properties (16 per cent), superannuation (13 per cent), shares and interests in trusts (12 per cent), personal use assets (11 per cent), and bank accounts and bonds (4 per cent).

There is considerable variation in the treatment of different household assets and investments.

Owner-occupied housing receives a treatment close to that of an expenditure tax, reflecting the non-taxation of imputed rent and a CGT exemption. While a number of state taxes apply to residential land and housing, including rates, land tax and stamp duty, they only provide a limited shift towards an outcome consistent with an income tax benchmark. In addition, some of these taxes will have been capitalised in the purchase price and so do not affect marginal returns.

For rental properties, although rental income and capital gains are subject to tax, interest and depreciation expenses are fully deductible, while capital gains are only partially taxed on realisation. A number of submissions express concern over the treatment of negative gearing, which is discussed further in Box 6.8. Investments in shares also fall below an income tax benchmark, principally due to the availability of the CGT discount.

The ability to invest in superannuation out of pre-tax income through SG contributions or salary sacrifice arrangements can provide a tax treatment more favourable than under an expenditure tax for individuals on higher personal rates. Individuals on lower personal tax rates do not receive such favourable treatment, though they may benefit from superannuation co-contributions.

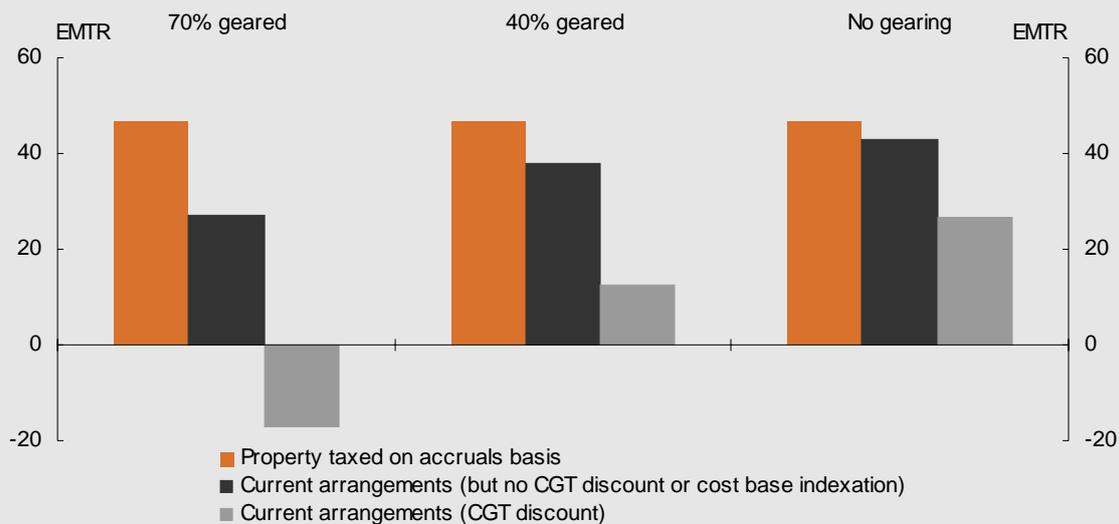
The entire nominal return on interest-bearing bank deposits and bonds in the hands of a resident investor are taxed on an annual receipts basis at the full personal income tax rate. This difference increases when inflation is taken into account. Submissions express concern that, relative to the other types of savings, term deposits are taxed unfavourably. One submission notes that the total value of financial assets of households held in the form of deposits has fallen from 30 per cent in 1990 to 18.5 per cent in mid-2007. However, where bank deposits are held for transaction purposes, the full return may not be taxed under the income benchmark. Most financial institutions offer cheque and transaction account products with free or reduced price transaction services in exchange for lower interest yields on deposits.

Box 6.8: Negatively geared property

Submissions raise a number of concerns about the concessional treatment for negatively geared investment properties. For an individual investor, the tax treatment of a negatively geared property would typically involve: the full taxation of rental income; a 50 per cent CGT discount on disposal of the property (with the building and land sharing a joint cost base); annual building depreciation allowances; full loss offset where losses can be offset against other income; as well as payment of land tax, rates and any stamp duty on conveyancing.

As demonstrated in Chart 6.7, ignoring state taxes, this tax treatment results in a significant deviation from the income tax benchmark because the individual is able to deduct annual interest and depreciation deductions with a full loss offset, while the capital gains from the property are taxed on realisation and – most importantly – at a 50 per cent discount. In addition, the 2.5 per cent annual depreciation allowance available in relation to the building component of an investment property represents another deviation from the income tax benchmark.

Chart 6.7: EMTR of equity investment in property by gearing ratio and tax treatment
Individual taxpayer on top marginal rate



Source: Australian Treasury estimates.

If the gains from the property were taxed without discount, investment properties would be taxed closer to the nominal income tax benchmark with full loss offset. The existing treatment of property losses and capital gains for individual investors potentially crowds out housing investment by companies, which do not receive a CGT discount, and superannuation funds, which are unable to borrow.

Not shown in the chart is that the realisation basis for taxing capital gains may enable the owner to time the sale of the property so that they pay tax on the capital gain at a marginal rate below that at which the net losses were claimed. For example, a negatively geared property could be acquired before retirement when the tax value of the net deductions is high, and sold after retirement when income is low (ignoring means and assets testing).

Approaches to reducing distortions

The preceding discussion points to some ways that the various biases affecting household investment choices, such as inflation, capital gains lock-in, the accessibility of losses and the favouring of domestic equity over foreign equity investments could be addressed.

With respect to the unfavourable treatment of interest income, submissions point out a number of approaches, including taxing only real interest returns, following the lead of countries such as the United Kingdom by allowing tax-preferred bank accounts (the most commonly suggested approach) or moving to a dual income tax system.

In contrast, where submissions see the current tax treatment as too favourable, the suggestion is to remove or limit the perceived favourable treatment. This is the case for the CGT discounts or exemptions and negative gearing.

In general, while submissions point to solutions specific to a given problem, they broadly suggest two approaches can be adopted to provide for more neutral treatment of household investment choices. One is to remove or limit concessions and move closer to an income tax benchmark. The other is to move away from an income tax benchmark for all assets, either through discrete adjustments (as for interest income), or, more radically, by adopting a dual income tax. The relative merits of either approach depend in part on the efficiency and equity arguments surrounding the taxation of savings (as discussed in Section 3.2).

Consultation question

Q6.7 Should the tax system be restructured to deliver a more neutral tax treatment for the different forms of return on household savings and investments, and if so, how?

7 Not-for-profit organisations

Overview

Not-for-profit (NFP) organisations perform a valuable role in Australian society. They are eligible for a range of tax concessions and receive direct government funding in support of their philanthropic and community-based activities.

The tax concessions for the NFP sector are complex and applied unevenly.

Gifts are an important source of funding for NFP organisations. The current gift deductibility arrangements impose compliance costs on individuals and provide higher income donors with a greater taxation benefit than lower income donors.

Consultation questions

- Q7.1 What is the appropriate tax treatment for NFP organisations, including compliance obligations?
- Q7.2 Given the impact of the tax concessions for NFP organisations on competition, compliance costs and equity, would alternative arrangements (such as the provision of direct funding) be a more efficient way of assisting these organisations to further their philanthropic and community-based activities?

This section considers the main tax concessions available to NFP organisations. It does not canvass issues that are the subject of separate inquiries, including accountability and disclosure, the contribution of the NFP sector to the economy, and proposals to improve the integrity of prescribed private funds.

Overview of tax concessions

Australia applies a range of tax concessions to different types of NFP organisations (see Table 7.1). These concessions include: income tax exemptions; a higher GST registration threshold; the ability to make supplies GST-free in certain circumstances; GST input credits; capped exemptions from (or rebates of) fringe benefits tax (FBT); and the ability to receive tax deductible gifts. Box 7.3, at the end of this section, describes these concessions.

The concessions available to various NFP organisations are listed in the Australian Treasury's *2007 Tax Expenditures Statement* (Australian Treasury 2007). Among these are tax deductions for gifts to approved donees, which are estimated to cost \$950 million in 2008-09, and FBT concessions which are estimated to cost \$880 million in 2008-09. There is insufficient data to quantify the cost of income tax exemptions because many NFP organisations are not required to lodge income tax returns. Similarly, it is not possible to estimate the value of GST concessions as a significant proportion of the NFP sector is not required to register for the GST.

The complexity of the current arrangements was highlighted in the 2001 *Report of the Inquiry into the Definition of Charities and Related Organisations* (Australian Government 2001), which noted that 'much of the confusion in the sector is related to what tax or other concessions attach to what type of entities'. This complexity can impose administrative and compliance costs for NFP organisations and donors.

In addition to complexity, the uneven application of tax concessions is a long-standing source of concern within the NFP sector. These concerns were articulated in RSPCA Australia's submission (RSPCA Australia 2008) to the Senate Economics Committee 2008 inquiry into the disclosure regimes for charities and NFP organisations. The submission indicated that the current arrangements 'infer that some charitable purposes are more worthy than others'.

Internationally, a range of models are used to provide government support for NFP organisations, including direct funding and simplified tax concessions. In the case of direct funding, some models provide government contributions independent of public contributions, while others match government contributions with public contributions.

Table 7.1: Summary of main tax concessions for major types of NFP organisations^(a)

	Charities	Public benevolent institutions and health promotion charities	Deductible gift recipients	NFP and public hospitals, and public ambulance services
Income tax exemption (b)	Yes	Yes	-	Yes
GST concessions	Yes	Yes	Yes	Yes
FBT exemption (\$17,000)	-	-	-	Yes
FBT exemption (\$30,000)	-	Yes	-	-
FBT rebate (c)	Charitable institutions only	-	-	-
Deductible gifts	-	Yes	Yes	Yes

(a) Entities may have more than one status (for example, a charity could also be a deductible gift recipient).

(b) Many NFP organisations are taxable, but may be entitled to special rules for calculating taxable income and lodging income tax returns and may be able to access special rates of tax.

(c) Certain non-government NFP organisations are eligible for this concession.

Summary of key messages from submissions

Many submissions express concern over the number of NFP organisations establishing business ventures, suggesting that these tax concessions unfairly disadvantage competing taxable entities. Several submissions note that NFP organisations are servicing commercial markets unrelated to their philanthropic activities, including: turf supplies; insurance; music sales; pizza shops; and breakfast and health foods. However, others suggest that commercial pursuits simply provide these charities with more funds for their philanthropic and community-based activities.

Several submissions recommend the extension of the mutuality principle to provide a complete tax exemption for member-based organisations to provide clarity and certainty.

Summary of key messages from submissions (continued)

Submissions on the appropriateness of the FBT concessions for NFP organisations present mixed views. While some favour the abolition of these concessions, others suggest eligibility should be broadened. One submission notes that the value of FBT concessions has been eroded over time.

Submissions note that the gift deductibility arrangements impose compliance costs on individuals, and express concern that the rewards for charitable giving vary depending on the income of the contributor (the higher their applicable marginal tax rate, the greater the benefit).

Competitive neutrality

Income tax

If an entity's purpose is solely charitable, it can undertake other activities that are *incidental* to, and in advancement of, its charitable purpose. These may include commercial activities. While such activities are not in themselves charitable, they are generally used to raise funds to further charitable purposes (and thus often attract the same tax concessions). Moreover, some of the practices of businesses operated by charities may also provide a public benefit, such as training and employing homeless youths. Entities that do not have a sole charitable purpose are not considered charitable. These issues were recently considered by the High Court (see Box 7.1).

In recent years, several inquiries have considered the appropriateness of the income tax exemptions for charities operating commercial enterprises.

For example, the 2001 *Report of the Inquiry into the Definition of Charities and Related Organisations* (Australian Government 2001) recommended that commercial purposes should not be denied charitable status where they further, or are in aid of, a dominant charitable purpose, or where they are incidental or ancillary to a dominant charitable purpose. It acknowledged that charities operating commercial enterprises may become involved in activities that have no obvious connection with their charitable purpose and noted that the public may be concerned with such activities. The inquiry concluded that 'prohibiting charities from engaging in commercial enterprises would be an unnecessarily heavy-handed way to address these concerns'.

In 1995 the Industry Commission (forerunner to the Productivity Commission) released a report, *Charitable Organisations in Australia* (Industry Commission 1995) that, among other things, addressed the issue of competition between for-profit organisations and community social welfare organisations. The Commission concluded that:

... the income tax exemption does not compromise competitive neutrality between organisations. All organisations which, regardless of their taxation status, aim to maximise their surplus (profit) are unaffected in their business decisions by their tax or tax exempt status.

Box 7.1: Commissioner of Taxation v Word Investments Limited [2008] HCA 55

In May 2008, the High Court granted the Commissioner of Taxation special leave to appeal against the decision of the Full Federal Court in *Commissioner of Taxation v Word Investments Limited*, which was handed down on 14 November 2007. The Full Federal Court's decision was upheld by the High Court on 3 December 2008.

Under the High Court's decision, a commercial business may be a charity if its profits are required by its constitution to be given to a charity.

Another result of this decision is that a charitable institution which raises money to distribute to an organisation which, although located in Australia, pursues its objectives overseas may be endorsed as tax exempt.

The full implications of the decision are not yet clear.

Mutual receipts

The receipts that NFP member-based organisations (for example, licensed clubs) collect from dealing with their members are generally treated as non-assessable, non-exempt income (mutual receipts). These entities are subject to income tax on profits from transactions with non-members and on some transactions with their members.

Several submissions call for the extension of mutuality to provide a full tax exemption for NFP member-based organisations. Such an extension would enhance any competitive advantage these organisations hold relative to fully taxable businesses offering similar services.

Submissions also call for mutuality to be legislated (like other features of the concept of 'income', reliance is currently placed on the common law and ATO rulings). While legislating mutuality may provide increased certainty for NFP member-based organisations, it would add to the complexity of the tax law.

Fringe benefits tax

The FBT concessions provided to the NFP sector (see Box 7.3) can provide NFP organisations with a cost advantage for the recruitment and retention of staff. The concessions are capped to prevent over-use and limit the impact on competitive neutrality. This is a particularly significant concession for hospitals, given that the NFP health sector constitutes a large share of the health industry and competes directly with the private health sector for qualified staff. Some ineligible charitable and community organisations have criticised the concessions on the grounds that they have led to staff losses (through the inability to match market salaries for qualified staff) and resulted in a greater proportion of their funds being directed into salaries.

Similar issues in respect of competitive neutrality arise in relation to the treatment of 'rebateable' employers, which are eligible for a rebate of 48 per cent of the amount of FBT that would otherwise be payable. The rebate applies up to \$30,000 per employee and reflects the fact that these employers do not benefit from the tax deductibility of FBT costs.

The FBT concessions provided to NFP organisations may result in a greater proportion of income being provided to employees as fringe benefits, rather than as cash. In turn, this could exacerbate the issues related to transfer payments discussed in Section 4.2.

As noted in Section 4.2, the Government has asked the Panel to examine the complexity of the existing FBT arrangements for the NFP sector and make recommendations to improve equity and simplicity for the long term.

Goods and services tax

Certain NFP organisations are able to treat some or all of their separately identifiable branches as separate GST entities. As a consequence, one or more sub-entities may fall below the \$150,000 GST registration threshold for NFP organisations, when the complete entity would exceed the registration threshold. This is intended to reduce the compliance costs of NFP organisations and may result in a reduced GST liability for some NFP organisations.

The GST concessions for charitable organisations would not be expected to impact on competitive neutrality. Unlike income tax exemptions, the activities of charitable organisations are taxable under the GST legislation, unless an explicit concession applies. Since the commercial activities of charitable organisations would not be expected to qualify for these GST concessions, this is unlikely to lead to competitive neutrality concerns.

Gift deductibility

Gift deductibility allows donors to eligible charities to claim a tax deduction for donations over \$2.

Deductions are provided as a mechanism for distributing government funds to charitable organisations, on the assumption that they will increase the size of charitable donations. However, the degree to which this is the case is unclear.

Broadly, deductible gift recipient (DGR) status is extended to those organisations whose activities provide a benefit to the public or a significant group within the public. The general DGR categories include public benevolent institutions, public universities, public hospitals, approved research institutes, arts and cultural organisations, environmental organisations, school building funds and overseas aid funds.

These general categories restrict DGR status to a closely targeted set of organisations. While these categories have been created to reflect community demand and government priorities for the sector, some submissions indicate that they should be redefined as community activities and priorities change.

Compliance and equity

A number of submissions suggest that the compliance costs of the gift deductibility arrangements should be reduced, and express concern over the perceived vertical inequity of gift deductibility. Suggestions to address these issues range from abolishing deductions to enabling DGRs to collect and store tax file numbers, allowing donation information to be pre-filled on tax returns.

An alternative approach could involve the provision of a flat rebate for donors. While this approach would promote vertical equity, it would not reduce the compliance burden of the current arrangements as individuals would still be required to retain and report evidence of their donations to claim a rebate.

The United Kingdom's (UK's) Gift Aid scheme, which involves the payment of the tax benefit directly to the charity instead of the individual, may provide another potential model for consideration (see Box 7.2). While the scheme has been successful in the UK (HM Treasury 2008), its application in Australia may not address perceived vertical inequity (as donors who do not pay tax are not able to participate) and may increase compliance costs for charities.

Box 7.2: Gift Aid in the United Kingdom

Gift Aid was introduced in the UK in 1990, and is designed to enable the provision of tax-effective charitable donations to UK charities. The scheme originally applied to cash gifts of £600 or more. However, this limit was abolished in 2000.

Under the scheme, individuals subject to UK income tax can make a declaration to a charity (either orally or in writing) to enable their donation to be treated as a Gift Aid donation. The declaration must identify both the donor and the charity. The charity is then able to reclaim the basic rate of income tax paid on the gift from the government. Charities must maintain clear and auditable records of declarations to demonstrate that each donor has made an appropriate declaration.

The scheme enables higher-rate taxpayers to claim income tax relief above and beyond the amount claimed directly by the charities. Individuals who do not pay income tax are unable to use Gift Aid.

Consultation questions

- Q7.1 What is the appropriate tax treatment for NFP organisations, including compliance obligations?
- Q7.2 Given the impact of the tax concessions for NFP organisations on competition, compliance costs and equity, would alternative arrangements (such as the provision of direct funding) be a more efficient way of assisting these organisations to further their philanthropic and community-based activities?

Box 7.3: Further detail on the tax concessions provided to NFP organisations

Income tax

Income tax exemptions are provided to NFP organisations whose purposes are broadly beneficial to the wider Australian community, such as charitable, religious, scientific and public educational institutions.

Charities and income tax exempt funds within the NFP sector must be endorsed by the ATO to be exempt from income tax. Other categories of organisation can self-assess their exemption – such organisations include cultural, community service and sporting organisations.

NFP organisations, with income below \$416 a year, that are not otherwise income tax exempt receive an income tax exemption. The concession is intended to ensure small organisations do not have to incur the compliance costs associated with managing their tax affairs, such as lodging annual income tax returns.

Mutual receipts

Receipts from members of clubs (including member subscriptions and trading income relating to members) are not included in the assessable income of NFP clubs, societies or associations. Other income received (for example, interest and profits from trading with non-members) is taxable.

Fringe benefits tax

Public benevolent institutions and health promotion charities are provided with a \$30,000 capped exemption from FBT per employee, and public and NFP hospitals and public ambulance services are provided with a capped exemption of \$17,000 per employee. These caps are not indexed.

The caps do not limit the amount of other FBT-exempt benefits (for example, superannuation contributions, work-related mobile phones and other miscellaneous benefits).

Goods and services tax

Not-for-profit organisations

NFP organisations, including charities, have a GST registration threshold of \$150,000 a year compared with the general registration threshold of \$75,000 a year.

Where an organisation is not registered for GST, it does not pay GST on its supplies and is not entitled to input tax credits for the GST paid on its inputs. NFP entities with a turnover below the threshold can choose to be registered. Registered entities pay GST on the taxable supplies they make and are entitled to input tax credits for the GST paid for their creditable acquisitions.

Donations to a NFP organisation (including charities) that are made voluntarily and for no material benefit are not subject to GST.

Box 7.3: Further detail on the tax concessions provided to NFP organisations (continued)

Concessions for charities, DGRs and government schools

Charities, DGRs and government schools receive a range of GST concessions including the ability to make supplies GST-free in certain circumstances, the ability to make supplies of second hand goods GST-free, and the ability to treat certain fundraising events as input-taxed.

Gift deductibility

Gift deductibility is provided to individuals who donate gifts of \$2 or more in cash or gifts of property (subject to certain rules) to the organisations endorsed as DGRs. DGRs under the general categories must meet the relevant eligibility requirements and be endorsed by the ATO to receive their concessional status.

Prescribed private funds

Since 2001, individuals, families and businesses have been able to establish their own DGRs, known as prescribed private funds (PPFs). PPFs can receive donations for distribution to other DGRs (not PPFs).

Since their inception, PPFs have received donations of over \$1.3 billion and made distributions of over \$300 million.

Other tax concessions and grants

At the state level, many charitable institutions are exempt from municipal rates, stamp duty, land tax and payroll tax. At the federal level, exemptions from customs duty apply, as well as certain fuel tax concessions.

Many NFP organisations also receive grants from different levels of government, including block funding to cover some or part of their operational costs.

8 Complexity — cost, risk and transparency

Overview

The tax-transfer system is very complex. To a degree this reflects the reality of the modern world. Some complexity is unavoidable in a system that also has equity and efficiency objectives. However, complexity adds cost and risk to day-to-day business and personal activities. It affects the choices individuals make to work, save and consume. The time and resources individuals and businesses spend understanding and complying with the tax-transfer system could be devoted to more productive or satisfying activities. Complexity also makes the system more costly to administer. These costs impact on Australia's international competitiveness and the efficient allocation of society's resources.

Complexity also reduces transparency — that is, the extent to which people understand how the system works and what it is trying to achieve. This can impact on people's attitudes to the system, including its perceived legitimacy and people's willingness to voluntarily comply.

Sources of complexity include the large number of taxes and transfers, detailed rules associated with each, the interaction between them, different jurisdictions applying similar taxes or transfers in different ways, and the way taxes and transfers are administered.

Accordingly, reducing complexity may demand: reconsideration of the range of complex policies and objectives embodied in the system; integration and streamlining its currently fragmented administration; and greater certainty, transparency and public engagement in the overall management of the system.

Consultation questions

- Q8.1 Which taxes or transfers are the most complex and impose the greatest costs? How should these costs be reduced (by abolishing the taxes or transfers or by making the rules applying to them simpler)?
- Q8.2 In what ways might the administration of Australia's tax-transfer system be changed to better meet the needs of individuals and businesses? How might the process of personal income tax returns be simplified, including by removing the requirement for some taxpayers to lodge returns? Should the administration of the system be more integrated (across taxes and transfers and between jurisdictions)? How might advances in technology assist?
- Q8.3 To what extent might policy objectives be traded off to achieve a simpler system? In what areas should efficiency, equity or choice be traded off for simplicity?
- Q8.4 How could the governance of the tax-transfer system be reformed to reduce complexity, uncertainty and cost, and to improve transparency, understanding and support for the system?

This section considers the complexity of the tax-transfer system from three perspectives:

- the range of complex policies and objectives embodied in the system;
- the burden of complexity; and
- the governance of the system.

8.1 Complex policies and objectives

A significant reason for complexity in the tax-transfer system is that it has not been developed as a system. Rather, it consists of a large number of separate sophisticated elements, developed at different times, to meet different objectives and often in an uncoordinated way.

There are at least 125 different Australian taxes. Many of these are levied on essentially similar transactions by different Australian governments, with relatively little harmonisation across jurisdictions. There are also around 40 cash transfer payments paid by the Australian Government to Australians, with numerous other Australian, state and local government concessions available. In addition, there is a broad range of tax concessions, known as tax expenditures, which add complexity to the system because they complicate the law, create additional choices for people and create opportunities for tax planning. In some cases eligibility for these concessions also depends on characteristics and information that are not otherwise required for tax purposes.

Approximately 300 tax concessions were identified in the *2007 Tax Expenditures Statement* (Australian Treasury 2007). Around 100 new tax expenditures have been added over the past decade.

Summary of key messages from submissions

Many submissions identify complexity as a major problem with the tax-transfer system. While most acknowledge the system will always contain some complexity, they suggest simplification should be a high priority for reform.

In particular, a large number of submissions raise concerns that there are too many taxes (including taxes imposed by different governments), which are trying to achieve too many objectives. Many submissions focus on the difficulties of making sound decisions in an uncertain environment, and suggest eliminating a range of taxes, mostly state taxes, which they perceive to be the least efficient.

In relation to individual taxpayers, submissions raise as a concern Australia's very high reliance on tax agents to complete annual tax returns. Record keeping and retention is also seen to have a high cost. Submissions provide examples of where complexity in the tax-transfer system is leading people to miss out on benefits and entitlements, due to difficulty in accessing appropriate information or poor record keeping of receipts needed for claims.

Summary of key messages from submissions (continued)

Business taxpayers strongly support reducing the number of different taxes imposed by all levels of government. A number of business groups also note that businesses which operate across states often have trouble dealing with differences in the application of essentially similar taxes, such as payroll tax. This adds to compliance costs.

Submissions from certain large business stakeholders and a number of business groups support moves to align more closely the business income tax system with accounting profit, as determined for the purpose of company financial reporting.

For small to medium businesses, there is particular concern about the detail, volume and complexity of the tax law relating to specific transactions.

Complexity in the tax-transfer system is partially a reflection of complexity in the modern world and a certain level of complexity and operating costs is inevitable to implement the tax-transfer system in a manner that is both efficient and equitable. For example, means testing is intended to ensure that transfers are targeted to those in need of assistance. However, at some point, equity or efficiency (or both) are likely to be compromised by increasing levels of complexity.

Complexity reduces the system's transparency, making it harder for people to understand their obligations and entitlements, increasing the risk of non-compliance and hindering properly informed decisions. It creates uncertainty and risk. Individuals spend time and money dealing with this uncertainty. Some individuals may arrange their affairs to minimise the complexity they have to deal with even if it means they pay more tax than necessary or do not claim transfer payments to which they are entitled. Others pay for professional advice to understand how the system applies to their circumstances.

Complexity for individuals

The complexity of the personal tax system is evidenced by the use of tax agents to lodge over 70 per cent of all individuals' tax returns. Submissions indicate that many taxpayers feel they are unable to appropriately assess their eligibility for deductions and offsets and therefore use a tax agent to ensure they are both claiming every deduction or offset available to them and not claiming deductions and offsets they are not eligible for. An example of a deduction for which individuals feel unable to assess their eligibility is self-education expenses. To be deductible these expenses must have a sufficient connection to an individual's current employment by maintaining or improving specific skills or knowledge required in the individual's current employment or being likely to result in an increase in income from the individual's current employment.

The complexity of the personal tax-transfer system also emanates from the different approaches that the tax and transfer systems take with respect to income, assets, the period of assessment, the unit of assessment and the way that categorical support is provided or liabilities imposed. Some of these differences reflect the different objectives of the two systems. These differences are described in Section 2.2.

For example, complexity has arisen because the personal tax-transfer system measures income in different ways in the pursuit of their different objectives. Section 2.2 outlines the

differences in measures used to assess an individual's income tax liability versus their entitlement to transfer payments. 'Taxable income' follows the general principle that the costs incurred in producing income should not be included in the tax base, and therefore it allows for a broad range of deductions, including work-related expenses and certain superannuation contributions. In addition, some tax offsets are calculated on different income measures. In contrast, the measure of income generally used to determine entitlement to transfers such as income support payments uses a broader definition of income and is only reducible by losses and deductions in limited circumstances.

Submissions highlight that different transfer payments may apply in very similar circumstances. This can make it difficult for an individual to find out which rules apply to them, and what they mean for their choices (particularly to work or increase working hours). For example, when a child turns 16, the maximum rate of FTB Part A falls substantially and Youth Allowance becomes available for some families. Almost all low to middle-income families experience a reduction in assistance and many are faced with a choice as to which payment to claim.

Complexity for businesses

A number of areas of the tax law for businesses could be considered to be complex due to (amongst other things) the intricate types of transactions involved, the precise drafting used in the tax law to achieve intended outcomes and the length of the relevant segments of the law. Examples of such complexity defined in this way are the provisions relating to the taxation of trusts, consolidated company groups, the taxation of financial arrangements, small business tax concessions, the company loss rules and the capital gains tax provisions.

It should be noted that not all of this 'complex' tax law applies to every type of business. Some applies based on the election of the entity and other aspects apply only to certain business structures or transactions. As such, whether these provisions translate into complexity for a business will depend on its business activities.

A number of submissions suggest ways in which business income tax could be simplified. One specific proposal raised in a number of submissions is to more closely align the business income tax system with accounting profit, as determined for the purpose of company financial reporting/statements.

Most business taxpayers work out their taxable income by making a series of adjustments to their accounting profit. This reconciliation is needed because accounting profit takes into account different amounts to those relevant in working out taxable income. Some submissions note that this process can represent a significant compliance cost.

Some parts of the current income tax law recognise elements of accounting standards (for example, in the consolidation and thin capitalisation rules). A more general use of financial reports for tax purposes would raise a number of issues. For instance, it is often suggested that because taxes need to meet the revenue needs of government they cannot be as flexible as accounting standards. Accounting standards allow more subjectivity in the recognition and measurement of income (such as in the application of the accounting concept of materiality) than is currently available under income tax law. As taxpayers have an incentive to minimise their taxes, there is an argument for prescribing the measurement of income in

ways that are not required for accounting purposes. Counter balancing this is an incentive for publicly listed companies to record a profit that satisfies shareholders.

Another issue with greater alignment is the concern that either financial reporting or tax outcomes would be inappropriately distorted as a result. For instance, the interpretation of accounting standards would become subject to judicial review, affecting their flexibility and possibly leading to different accounting rules between jurisdictions. Other considerations are that accounting standards may not treat the same transaction in the same way for all entities and that not all entities observe accounting standards, though for certain classes of entity adherence to accounting standards is mandatory.

Notwithstanding these issues, the greater use of accounting concepts may hold some promise for improving certainty and reducing compliance costs for those businesses that produce financial reports according to the accounting standards.

Consultation questions

- Q8.1 Which taxes or transfers are the most complex and impose the greatest costs? How should these costs be reduced (by abolishing the taxes or transfers or by making the rules applying to them simpler)?

8.2 Simpler interaction with the system — who should bear the burden of complexity?

If some complexity is inevitable in the tax-transfer system, a key question is how the burden of that complexity should be allocated between the government (as administration costs) and businesses and individuals (as compliance costs).

Summary of key messages from submissions

Submissions highlight the regressive nature of compliance costs (that is, the burden of complexity may fall disproportionately on those least able, or with the least resources, to deal with it). Some call for this to be acknowledged by placing greater emphasis on simplifying taxes on small business and individuals.

Businesses operating across state boundaries express concerns about the complexity of dealing with multiple revenue authorities. Some submissions suggest transferring some or all of revenue collection responsibilities of the state revenue authorities to the Australian Taxation Office (ATO).

Some submissions suggest the level of uncertainty in Australia's tax system is creating excessive compliance risks, which are damaging our international competitiveness and inhibiting domestic business decisions. In particular, submissions argue that the need for timely, consistent and reliable advice is not always met by the ATO. These submissions consider this to be a problem of culture, focus and governance of the ATO. They propose changes in the tax administration arrangements for Australia, including the establishment of a board of directors to oversee the operation of the ATO.

Summary of key messages from submissions (continued)

A spectrum of possible approaches to improving the personal tax-transfer system is identified by submissions. At one end of this spectrum are measures to streamline or simplify existing taxes and transfers. At the other end are more radical approaches to simplifying and integrating the system.

Allocating operating costs between the administration and taxpayers

Administration costs and compliance costs can be substitutes for one another. In some cases there may be economies of scale from moving more of the revenue collection responsibility to the tax administration, which would spread the costs over all taxpayers. However, shielding taxpayers from the direct costs imposed by complexity could increase incentives to seek more complex tax arrangements and, as a result, could lead to higher overall operating costs than might otherwise be the case.

One specific issue often raised is the cost to business of withholding taxes from salary or wages paid to an employee. Collecting taxes from businesses rather than employees can save both administrative and compliance costs because of the inherent economies of scale and because businesses typically have accounting systems in place that facilitate tax reporting.

From one perspective this compliance burden is a cost of doing business, that is, it is a cost that business incurs on behalf of employees as part of the employment relationship. An alternative view is that employers are performing a collection function on behalf of the tax administration, based on them being best positioned to do so at least cost. Few countries provide explicit compensation for these collection costs, but business benefits from the time lag between when taxes are withheld and when they are remitted to the ATO. In the absence of the withholding requirement, the employees would receive their wages in full at the end of the pay period.

A specific concern of business is the extent to which it bears the burden of complexity of differences between taxes across jurisdictions. Section 9.4 considers potential approaches to streamlining the administration of the tax-transfer system across the federation.

Allocating compliance costs between businesses and individuals

When choosing how compliance costs should be allocated among different classes of taxpayers and transfer payment recipients, it is important to consider who is best placed to face these costs. In particular, an important question is how those costs are to be distributed fairly and efficiently.

It is often desirable to allocate compliance costs to businesses rather than individuals, such as in the withholding example outlined earlier. While businesses face these costs it is important to remember they are ultimately borne by the individual owners, employees or customers of the business. In most cases, the financial costs incurred in complying with tax obligations are also deductible, and so are shared with the broader community.

While businesses generally have greater capacity to deal with compliance costs than individuals, there are some circumstances in which employees are better placed to

understand and meet their tax-transfer obligations. For instance, while employers withhold taxes as part of the payroll function, they are not similarly involved in the transfer payments made by government to employees. One reason for this is that determining an individual's entitlement for transfer payments requires considerably more information about an individual than would normally be available to the business.

Section 4.2 examines the issue of taxing fringe benefits in the hands of the employee, rather than the employer.

Given the regressive nature of compliance costs, some submissions propose, a separate and less complex tax system for small business. To some extent, the current tax system already treats individuals, small and large businesses differently. For instance, a range of concessional and simplified tax arrangements exist for small businesses. Some have suggested that these arrangements should be revisited to ensure compliance costs are better targeted to those who are best placed to deal with them.

Traditionally, it has been thought that individuals and small businesses have relatively simple affairs which warrant a simpler tax system than big business. However, increasingly the affairs of these taxpayers are becoming more complex. For instance, many small businesses now trade nationally and internationally and more Australians are investors, either directly or through managed funds.

There is a risk that further complexity is created by applying different types of rules to different types of taxpayers. Care needs to be taken to ensure separate sets of rules actually reduce compliance costs. For example, giving small businesses the option of calculating their liability against a 'simplified' system may encourage them to work out their liability under each of the alternative systems, and so increase their compliance costs (Shaw et al 2008).

Responsive administration

The implementation of policy by administrators can have a significant bearing on the complexity experienced by taxpayers and transfer payment recipients. In particular, there is an important role for administrators to provide certainty in the application of laws to particular circumstances. In a recent report, the Inspector-General of Taxation found that the complexity of the tax system is a significant challenge for the ATO and one reason for delays in dealing with a number of issues (IGOT 2008).

Some submissions suggest that the level of uncertainty in Australia's tax system is creating excessive compliance risks, which are damaging our international competitiveness and inhibiting domestic business decisions. In particular, submissions argue that the need for timely, consistent and reliable advice has not always been met by the ATO. These submissions suggest there is a problem with the governance of the ATO. They propose changes in the tax administration arrangements for Australia, including the establishment of a board of directors to oversee the operation of the ATO. Submissions point out that revenue authorities in the United States, Canada and the United Kingdom are overseen by boards which include external representatives from a range of different backgrounds. The submissions argue that these arrangements would ensure the ATO has a better appreciation of the need to provide certainty to taxpayers, particularly where commercial decisions rest in the balance.

Client-centred tax-transfer administration

Australia's system of self-assessment for income tax relies heavily on taxpayers (or their advisers) having a good understanding of their tax obligations and voluntarily complying with them. For example, all but \$4.2 billion of \$214.9 billion received by the ATO in 2004-05 was paid voluntarily.

However, taxes and transfers are administered by multiple government agencies at the Australian, state and local government levels, reflecting the process by which policy has been developed and Australia's federal system of government. These arrangements can be complex for individuals who have to deal with the different approaches used by the various government agencies.

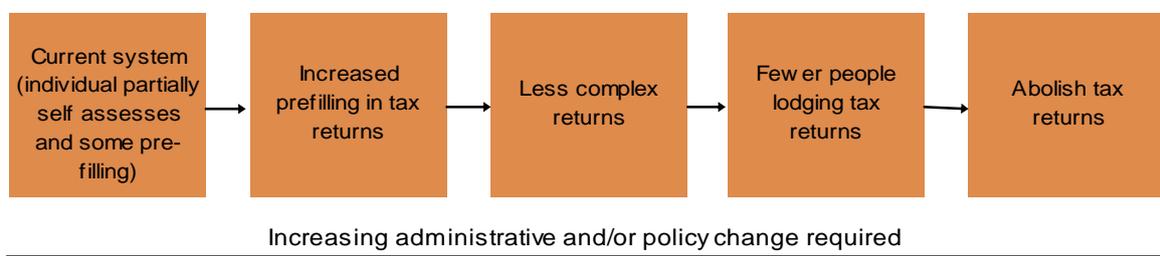
The proportion of individual taxpayers seeking professional assistance to complete their tax returns has risen from approximately 20 per cent in 1980 to around 74 per cent in 2007. This is considerably higher than in other countries which require individuals to lodge returns. For instance, only 56 per cent of individuals in the United States complete their tax returns with professional assistance (OECD 2005). The lower use of tax agents in other OECD countries may reflect efforts in those countries to reduce the information individuals with straightforward tax affairs need to put into their returns, or efforts to remove such individuals from the tax system altogether. In Australia, one of the motivations for the increases in the low income tax offset and the introduction, and subsequent increases in the senior Australians tax offset, was to reduce the number of people with low incomes who need to lodge returns.

A more client-centred approach to tax-transfer administration would place greater weight on simplifying the experience for individual taxpayers and transfer payment recipients, making it easier for them to understand and comply with their obligations and entitlements. Improvements in information technology may create opportunities and expectations for a radically improved client interface.

Simplifying the system of personal income tax returns

There is a spectrum of changes to the personal tax system that could potentially simplify tax administration and reduce compliance costs borne by individual taxpayers (Chart 8.1).

Chart 8.1: Simplifying personal income tax returns



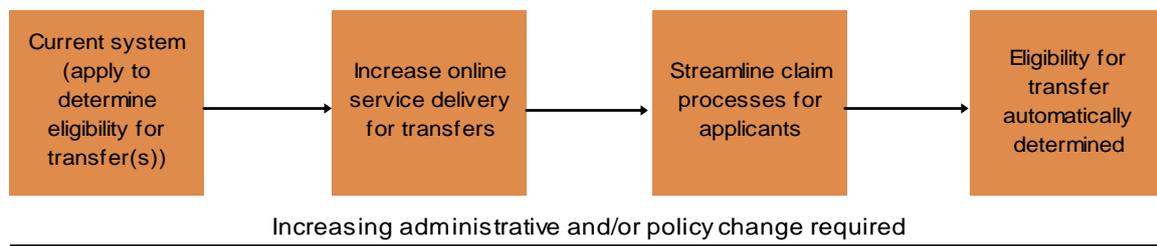
The ATO currently pre-fills some data into individual's electronic income tax returns, making it easier for many individuals to complete their returns. With appropriate policy changes it may be possible to increase the amount of pre-filled data.

For example, introducing a standard tax deduction in place of work-related expenses and replacing the tax deductions for eligible gifts with a co-contribution to gift recipients would potentially mean that some individuals would need only to confirm the data in their pre-filled tax return at the end of an income year. Greater at-source withholding, complemented by policy settings that obviate the need for further assessment of tax, might further reduce the need for individuals to lodge returns.

Improving access to transfers

There is also a spectrum of changes that could potentially simplify the administration of the transfer payment system (Chart 8.2).

Chart 8.2: Simplifying administration of the transfer system



It can be costly for individuals to access transfer payments. In particular, determining and fulfilling the requirements for eligibility (such as filling in application forms, providing the required information, or physically attending a transfer agency) can be a time consuming and inconvenient process. Greater use of online service delivery could improve client focus, building on current work being undertaken by transfer agencies.

As is the case with the tax system, the transfer system could be further simplified through changes to policy settings. For instance, policy changes may make it possible for application forms to be better tailored to gather only the information needed to assess an individual's entitlements. This may be supported by the transfer agency accessing information from tax and other transfer agencies. This would save clients' time and improve convenience.

Finally, it may be possible for improved technology, in conjunction with additional policy refinement, to enhance information exchange between tax and transfer agencies, so that a client could have their eligibility for some transfer payments automatically determined. Clients would not need to apply for or even know about the transfer, to receive their entitlements. However, this approach could raise issues about the transparency of the transfer system.

Streamlining tax-transfer administration

Ongoing improvements in information technology, and changing attitudes to engaging with technology and the holding and use of personal information, mean that the future administration of the tax-transfer system need not be constrained by present information management practices or systems limitations.

Improvements in data-processing, data-matching and information technology systems design, coupled with the rapid uptake of new technologies by Australians, may create

opportunities and expectations for a radically different client interface for a future tax-transfer system (Box 8.1).

Box 8.1 A single client interface with the tax-transfer system

A more client centred tax-transfer system could potentially involve a single interface with individuals. Under this approach, individuals might deal with government through just one organisation. This could effectively shield individuals from much of the complexity of the tax-transfer system, minimising their compliance costs.

This approach might consist of a single government agency that would administer all taxes and transfers that are relevant to individuals. Alternatively, the single interface might be a public or private institution, which intermediates between individuals and several government agencies responsible for administering different taxes and transfers. The single interface might support a single account for each individual, through which all taxes and transfer payments are administered.

The individual, their employer and other third parties could provide all relevant information to a central agency, which would determine the individual's tax liabilities and/or entitlement to transfer payments. This might be done by way of an internet-based interface with other support for people less familiar with such technology. The benefits of this approach, including policy transparency, may be further extended by linking other features to the account, such as tax and transfer calculators and financial planning tools.

The potential benefit derived from such an approach may depend on the acceptance of policy changes required to streamline and simplify the relationship between individuals and governments. A further consideration is the community acceptance of a single agency holding significant information about its clients, and whether it is possible for one agency to administer such a broad area of responsibility while maintaining service standards.

Consultation questions

- Q8.2 In what ways might the administration of Australia's tax-transfer system be changed to better meet the needs of individuals and businesses? How might the process of personal income tax returns be simplified, including by removing the requirement for some taxpayers to lodge returns? Should the administration of the system be more integrated (across taxes and transfers and between jurisdictions)? How might advances in technology assist?
- Q8.3 To what extent might policy objectives be traded off to achieve a simpler system? In what areas should efficiency, equity or choice be traded off for simplicity?

8.3 Certainty and transparency in the running of the system

The governance of the design, maintenance and administration of the tax-transfer system influences the priority given to simplicity relative to other objectives and can protect the system from the gradual erosion of the benefits of reform. Submissions raise a range of factors likely to support sound governance of the system.

Summary of key messages from submissions

A common theme in submissions is the need for the tax policy process to be more open and transparent, particularly around the trade-offs between efficiency, equity and simplicity. In expressing these views, submissions welcome the recent government announcement to engage the private sector earlier in the policy and legislative design process.

Submissions identify the lack of a guiding plan with clearly articulated objectives as one of the chief contributors of tax system complexity. The absence of a plan leads to ad hoc and uncoordinated changes, increasing the risk of unintended consequences, including imposing complexity and compliance costs. In doing so, submissions point to the need for the institutions and processes of the tax-transfer system to exhibit transparency, stability, accountability and certainty.

Some submissions note there has been considerable investment by many in understanding and applying the current system, that changes to the system can involve significant upheaval, and that these costs need to be taken into account. Some propose that more explicit consideration be given to the costs imposed by change at the policy design stage. Other submissions propose the amount of change to the system be limited, so minimising uncertainty.

Further, a number of submissions call for a greater commitment to identifying and monitoring tax compliance costs. Certain submissions call for these costs to be estimated, reported, monitored and reduced.

A few submissions also consider the current large number and type of tax expenditures to be adding to tax system complexity and reducing transparency. Submissions put forward solutions including reviewing, reducing or abolishing the tax expenditures.

Transparency and community engagement

The making of a sound tax-transfer system relies on a well-informed community that can hold governments to account. The current complexity of the tax-transfer system makes it hard for people to understand the way it operates and to think about the way it should. At the same time, there is a limit to how well-informed the general community can be and should be, as it is costly to gain this information when complexity is inevitable.

Policy development can benefit from a broad consultative approach, which helps to ensure that a range of perspectives are brought to an issue, thereby reducing the potential for policy to be developed without the benefit of knowing its broader impact. Such transparency has the potential to reduce the complexity of the system by ensuring that compliance costs are taken into account and that other practical ramifications of a policy are understood before it is implemented. However, consultation is not a panacea for complexity in policy design, and can result in increased complexity.

In August 2008, the Australian Government announced that consultation would occur throughout the tax design process, including before the Government announces its decision to legislate. These changes aim to improve the contribution that the private sector can make to the development of tax policy and legislation. Submissions have welcomed this approach,

but some note that the complexity of the system means that consultation is unlikely to guarantee that all implications of a new policy are identified before it is put into operation.

Taking a whole-of-system view

Rather than thinking of tax-transfer policy in an integrated way, we have become accustomed to considering elements of the system separately. The complexity of the system forces a compartmentalised approach to policy, that is, it is difficult to consider the myriad of interactions across all the different dimensions of the system. While it is important to understand the effect of individual policies, it is the combined effects of all tax-transfer policies that matter when trying to strike the right balance between simplicity and other objectives.

From time to time, attempts have been made to reduce the complexity and operating costs of the system. These have tended to focus on refining existing elements of the system, rather than looking to fundamentally reshape the system. That is, many attempts to reduce complexity have concentrated on identifying excessive compliance burdens that could be reduced without considering the basic policy design. Periodic, whole-of-system review creates opportunities to explore reforms that could offer more equitable and efficient outcomes at the same time as reducing complexity. It also presents a chance to take a systemic view of any trade-offs between simplicity, equity and efficiency, to ensure the right balance is achieved.

The frequency and impact of change

Uncertainty can be compounded by the rate of change in the tax-transfer system. The higher the rate of change, the more difficult and time consuming it can be for people to understand their obligations and entitlements under the system. This instability in the tax-transfer system may also reduce efficiency by affecting the expected payoffs to long-term investment decisions, such as investment in education, retirement products, long-lived productive assets or choice of business structure.

Some submissions note there has been considerable investment by many in understanding and applying the current system. Changing the system can involve significant upheaval and these costs need to be taken into account. However, what ultimately matters is how the system can be improved for the benefit of the whole community, including future participants of the tax-transfer system, not just for those who have established an understanding of the existing system. Nevertheless, when considering proposals for change it is important to consider the relationship between the short-term costs of change and the long term benefits of reform.

Monitoring compliance costs

Traditionally, compliance costs have not received the same attention as the equity and efficiency implications of tax and transfer policies. Some submissions call for a greater commitment to identifying and monitoring compliance costs. The *Architecture paper* notes that there are no reliable estimates of the complexity or operating costs of the tax-transfer system. Some submissions call for these costs to be estimated, reported, monitored and reduced.

Reporting of the compliance cost impact of new tax legislation began in 1996. Regulation impact assessment has since been mandatory for any regulatory proposal affecting business. In 2006, the Taskforce on Reducing Regulatory Burdens on Business reported that the requirements had often been circumvented or treated as an afterthought, and so had not realised their potential to improve the quality of regulation. Following recommendations of the Taskforce, the Australian Government strengthened requirements for regulatory assessments, especially at the time that policy is being decided (Office of Best Practice Regulation Handbook, 2007).

Recently, a number of state governments have adopted specific targets to reduce the total burden of their regulation. The Australian Government has focused on specific reform projects, rather than pursue a general target. It has, however, endorsed a 'one in one out' principle to address the cumulative burden of increasing regulation.

Review of tax expenditures

Australia, like many OECD countries, reports tax expenditures annually. The publication of tax expenditures can facilitate their review and assessment, and help to determine whether their objectives are being met at a reasonable cost and in the interests of the community in general.

A more direct approach to ensure that tax expenditures are regularly reviewed could be to subject them to a sunset clause, after which they would automatically lapse unless a decision is taken to renew them. Currently sunset clauses apply in relation to most delegated legislation, but not in relation to Acts of Parliament where most tax expenditures arise. Sunset clauses may reduce complexity by ensuring that tax expenditures remain in the system only as long as they are actively justified. This would provide a useful housekeeping mechanism for rationalising unnecessary concessions. However, it might not be appropriate for significant and longstanding elements of the tax system to be subject to a sunset. This could introduce considerable uncertainty into the system, with costs that exceed the benefits.

Some submissions suggest that to simplify the tax system, tax expenditures that lack strong public policy justification should be abolished. Another approach to reduce the number of tax expenditures would be to replace them with equivalent government outlay programs. This would improve the tax system, but it may not reduce the overall level of complexity and operating costs imposed by government. In some cases, the tax system is a more efficient means of delivering policy than an equivalent expenditure program.

Key issue/policy directions for consultation

Q8.4 How could the governance of the tax-transfer system be reformed to reduce complexity, uncertainty and cost, and to improve transparency, understanding and support for the system?

9 State and local taxes and transfers

Overview

A well functioning federal tax-transfer system is necessary if Australia is to meet the challenges of the coming century and make the most of future opportunities. Through a lack of coordination in policy and administration, the federation's tax-transfer system has become disjointed and complex, imposing unnecessary costs on all Australians.

Reforms which enhance the accountabilities, integration and efficiency of the federation's tax-transfer system can improve the functioning of the federation by reducing costs, removing complexity and improving resource allocation.

There are many issues that need to be taken into account when considering possible reforms to the way the tax-transfer system operates across the federation. Central to this is the trade-off that may occur in relation to the accountability (and other benefits) of State governments for raising their own revenue and the complexity and efficiency of the federal system. In addition, having different transfer policies in different States as well as multiple administering agencies for both taxes and transfers is a source of further complexity and possible inequities.

Consultation questions

- Q9.1 Noting the overall structure of Australia's federal financial arrangements, what changes, if any, should be made to the assignment of revenue raising powers and intergovernmental transfers in Australia?
- Q9.2 Given the widely held view in submissions that the current state tax arrangements need to be reformed, what changes should be made to state and local government own source revenue instruments? What scope is there for greater use of user charging to bring social, environmental or economic benefits?
- Q9.3 What is the appropriate allocation of the roles of the Australian and state governments in income redistribution?
- Q9.4 What opportunities could be pursued to deliver more seamless administrative arrangements of the tax-transfer system across the federation?

9.1 Funding expenditure responsibilities in the federation

Australia's fiscal relations between the Australian government and the states is characterised by a high level of vertical fiscal imbalance (VFI). That is, the States' own revenue sources are insufficient to fund their expenditure responsibilities, while the Australian government's revenue sources are greater than required to meet its expenditure responsibilities. This imbalance, and the mechanisms used to transfer funds to the states, can have implications for

the fiscal accountability of the Australian government and the states, and the overall effectiveness of the tax-transfer system.

In 2006-07, the own source revenue of the states comprised around 55 per cent of their total revenue, with the remaining 45 per cent made up of specific purpose payments and distribution of GST revenue. Australia's level of VFI is higher than in comparable federations, such as Canada and the United States, although less than in some others.

The continuation of current federal financial arrangements is likely to have implications for the level of VFI in the future. For example, the Productivity Commission (2005) noted that in the context of an ageing population, under current taxing powers and expenditure responsibilities, the States' taxation sources would be relatively stable as a percentage of GDP, but expenditure pressures would increase. The States would therefore be more reliant on transfers from the Australian government.

Summary of key messages from submissions

Many submissions note the complexity that arises from multiple levels of government being involved in the tax system. They also note that the mix of taxes currently levied by the States (and, to a lesser extent, local government) is inefficient and inequitable.

A number of submissions recommend abolishing some state and local taxes and compensating the States and local government by increasing the level of grants from the Australian government, thereby increasing VFI.

Other submissions note that the current level of VFI leads to weakened accountability for spending decisions, particularly at the state level. There is a view that this could be addressed by a review of the existing distribution of expenditure functions between levels of government. That is, some functions could be transferred from the States to the Australian government.

Submissions that propose addressing VFI through increases in States' own source revenues note that any new revenue source needs to be of better quality than the existing taxes imposed by the States. Some submissions raise the possibility of the States having access to the income tax base (that is, sharing the base with the Australian government).

In terms of intergovernmental transfers, some submissions note that the current arrangements, including specific purpose payments and the distribution of GST revenue, are in need of reform to make payments between levels of government more transparent.

Submissions by local government note the importance of Australian government funding in equalising the fiscal capacities of local councils across the federation.

Implications of the structure of funding

For a given allocation of expenditure responsibilities in a federal system there are a number of different ways that the expenditure responsibilities of governments at each level can be funded. The two extreme approaches are:

- one level of government (the national government) raises all revenue in the federation and distributes an appropriate amount to each sub-national government so they can meet their expenditure responsibilities (complete VFI); and
- each level of government raises enough revenue to fund its own expenditure (zero VFI).

The first approach allows tax system centralisation with only one level of government involved in the policy, administration and collection of taxes. This provides the opportunity for a less complex and more efficient tax system. The main disadvantage of this approach is with accountability. Sub-national governments may be able to shift the blame for inadequate service provision to the national government, by claiming that insufficient funding is provided by the national government. Equally, the national government can blame poor outcomes on poor administration or a misallocation of funding by sub-national governments. The accountability issue can be further complicated if the national government imposes conditions on how the sub-national government spends its funding. This can reduce the transparency of revenue and expenditure decisions, thereby reducing the accountability of governments to their citizens.

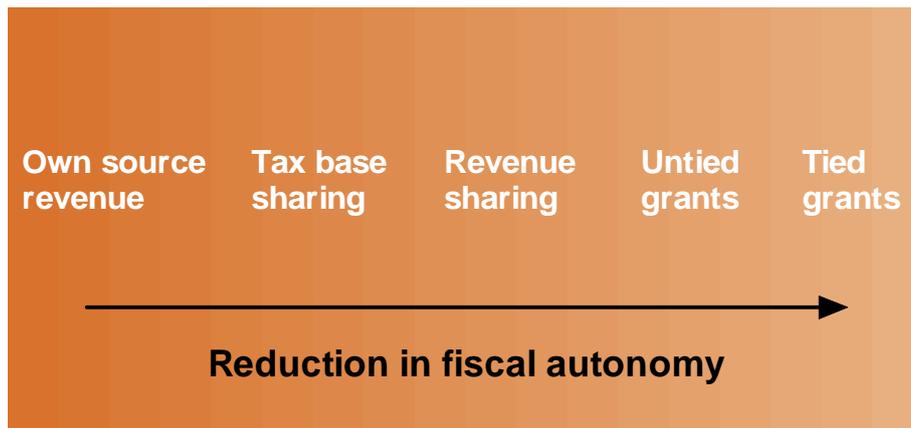
The second approach reduces the opportunity for blame shifting to other levels of government. However, with governments at each level raising revenue independently, there is a greater risk of the tax system becoming more complex, particularly for individuals and businesses operating across more than one jurisdiction.

In practice, federations do not operate at either of the two extremes, but at some point in between. The *Architecture paper* showed how Australia's level of VFI compares to other federations and how the level of VFI in Australia has changed over time. It also outlined costs and benefits of VFI. The extent to which the current and future level of VFI is seen as a problem depends upon how these costs and benefits are viewed, in particular the trade-off between efficiency and accountability. Of those submissions that address VFI, most suggest there should be a better alignment of revenue raising capacity and expenditure responsibilities.

Alternative methods of funding sub-national governments

The level of VFI is not the only important issue for a federation. A further important issue is the way in which government's expenditure responsibilities are funded – that is, the type of taxes levied and the grants received. Chart 9.1 provides a summary of the alternative ways the expenditure responsibilities of sub-national governments can be financed.

Chart 9.1: Funding sub-national governments in a federal system



With own source revenue, sub-national governments are able to determine how they raise and spend their revenue. With tied grants they may have little or no control over how these funds are raised and how they can be spent. Funding from own revenue sources may, however, not provide sub-national governments with sustainable fiscal autonomy if the revenue raising instruments are of poor quality. Tax base sharing or revenue sharing arrangements may provide sub-national governments with a better capacity to manage their fiscal position compared to taxes that are subject to base erosion or that are highly unpopular.

Own source revenue

Own source revenue refers primarily to revenue from taxes and other sources, such as royalties and user charges, that are levied independently by sub-national governments. For example, the States in Australia levy a range of taxes, including payroll tax, conveyance duty, land tax and gambling taxes. Other revenue sources are user charges for services provided by government, regulatory fees, dividends (including property income and tax equivalent revenue), interest income and fines (Section 9.2 examines state taxes).

With own source taxation, sub-national governments have the ability to modify the bases and rates in accordance with their individual circumstances. The trade-off to this, as a number of submissions highlight, is that it can increase the complexity of the tax system, particularly for those dealing in multiple jurisdictions. To reduce this concern, sub-national governments may choose to cooperate and agree on uniform tax rates and/or bases. Submissions support recent steps to harmonise the payroll tax arrangements across the States.

Some taxes are better levied by certain levels of government. Submissions note that land-based taxes are more appropriate for lower levels of government because of their immobile base. Box 9.1 further discusses the theory of tax assignment in a federal system.

Box 9.1: The theory of tax assignment

There is a great diversity of federal arrangements worldwide and so there is no universally applicable theory of tax assignment. However, some experts have identified useful principles that may apply in many, although not necessarily all, cases.

In his article ‘Who Should Tax, Where, and What?’ Richard Musgrave (1983) outlined a set of principles for the assignment of taxes between different levels of government in a federal system. These principles are:

- middle and especially lower-level jurisdictions should tax those bases which have low inter-jurisdictional mobility;
- personal taxes with progressive rates should be used by those jurisdictions within which a global base can be implemented most efficiently (that is, consideration needs to be given to how easily a government can tax the income of its residents if it has been earned in another jurisdiction);
- progressive taxation designed to secure redistributive objectives should be primarily central;
- taxes suitable for purposes of stabilisation policy should be central, while lower-level taxes should be cyclically stable;
- tax bases that are distributed highly unequally among sub-jurisdictions should be used centrally; and
- benefit taxes and user charges are appropriate at all levels (although the significance of these instruments at each level of government depends on the nature of public services provided at that level of government).

Tax base sharing

Tax base sharing is where two (or more) levels of government tax the same, or roughly the same, base. Tax base sharing generally requires greater coordination and harmonisation of the tax base and can involve lower compliance costs than if separate levels of government utilise the same tax base independently. Each jurisdiction can set its own rate and receive the revenues raised in, or derived from, that jurisdiction. Further, the collection of revenue can be undertaken centrally or by each individual jurisdiction.

Tax base sharing arrangements are not currently in use in Australia but are used in other federal systems. For example, Canada applies tax base sharing across major tax bases (Box 9.2). A few submissions raise the possibility of introducing a tax base sharing arrangement between the Australian government and the states, using the income tax base.

Box 9.2: Tax base sharing in Canada

There are a number of tax base sharing arrangements that operate in Canada, where both the federal government and provincial governments apply taxes to the same base. Tax base sharing arrangements are in place for personal income tax and corporate taxes in most provinces, as well as sales taxes for some provinces. For example, with the exception of Quebec which administers its own personal income tax, all provinces have a base sharing agreement with the federal government for personal income tax. The provinces can set their own rates and thresholds, which apply in addition to the federal rates and thresholds. British Columbia currently has a progressive five rate income tax scale, while Alberta levies a single 10 per cent rate on taxable income.

Federal taxes are collected by the Canada Revenue Agency (CRA). Tax collection agreements enable provincial governments to levy taxes which are administered by the CRA and remitted to the provinces. For personal income tax, this means individuals only file one set of tax forms each year covering both their federal and provincial tax.

Revenue sharing

Revenue sharing is where one level of government has access to a specific share of revenues collected by another level of government. This usually involves the national government setting a uniform tax rate and base, being responsible for administration and collection, and distributing a share of the revenue to sub-national governments.

The proportion of revenue that each level of government receives from revenue sharing may influence the operation of a revenue sharing agreement. If sub-national governments receive the greater share of revenue, it might provide them with a greater sense of 'ownership' of the tax. This may increase accountability if citizens associate the tax with the level of government receiving the revenue. However, the lower the share of the revenue that the collecting government keeps, the less concerned it may be about the integrity and sustainability of the tax base.

Untied grants

Untied grants are provided by the national government to sub-national governments without conditions on how the money is to be spent. Untied grants can either be an arbitrary amount of money or set by a formula which, depending on institutional arrangements, may be subject to unilateral change. Given there are no attached conditions to their receipt, untied grants can be administratively simple to deliver. However, as it is more difficult for citizens to explicitly link paying a tax with untied grants, sub-national governments that receive untied grants may have diminished accountability to the public.

Some submissions suggest that issues with federal financial relations could best be addressed by funding the abolition of a number of state taxes using untied grants. These submissions generally acknowledge VFI as a problem, but consider the efficiency, equity and simplicity of the tax system to be more important.

Tied grants

Tied grants from the national government to sub-national governments come with conditions on how the money is to be spent. Tied grants may be an efficient way to address externalities or spillovers across the borders of sub-national jurisdictions (such as in the Murray-Darling basin where the actions of one State affects the wellbeing of another).

Where tied grants are used for purposes other than addressing externalities, they can create efficiency and accountability problems. If the conditions on service delivery are different to the preferences of the sub-national government, citizens may hold the sub-national government responsible for the services provided, even though it is unable to provide them in its preferred way. Further, tying grants may increase administration costs, for example due to the need to monitor the conditions of the grant. By determining the amount of funding to be spent on the delivery of a particular service, tied grants can also reduce the incentive for the service provider to pursue efficiency in service delivery.

An alternative approach to tied grants is for the national government to provide funding to any service provider that can deliver a specific outcome. Under this approach the national government would tender for service provision. Sub-national governments would have the option of applying to be a service provider and, if successful, would receive the necessary funding (along with any other successful tenderers) to deliver the specified outcomes. For example, if the national government wanted people with low incomes to be able to access particular services charged on a user pays basis – the loss in revenue to service providers from this concession could be funded by the national government (see Section 9.3 for further discussion of this issue).

A few submissions note the possibility of the Australian government contracting service delivery, with one suggesting that the Australian government purchase services from the States on a per unit basis, with the unit price linked to quality and reliability performance criteria.

The choice of funding approaches

In most federal systems, sub-national governments are financed from a combination of the approaches in Chart 9.1. The extent to which each of these methods of funding is used is partly dependent on how the trade-off between the benefits of a centralised tax system and its effects on the accountability of governments is viewed. It is also dependent on a number of other factors such as:

- the constitutional framework of the federation;
- the extent to which the equalisation of fiscal capacities of sub-national governments is viewed as important, as this will influence the choice of taxes assigned to sub-national governments and the need for revenue sharing or untied grants to more easily implement fiscal equalisation;
- the existence of externalities across the borders of sub-national governments; and
- the capacity for sub-national governments to raise revenue from their own sources in a sustainable way.

Consultation question

- Q9.1 Noting the overall structure of Australia's federal financial arrangements, what changes, if any, should be made to the assignment of revenue raising powers and intergovernmental transfers in Australia?

9.2 State and local taxes and other own-source revenue

The States currently have access to a range of tax bases and other revenue sources. These taxes could be reformed independently of changes to the way the States are funded (outlined in Section 9.1). However, changes to funding arrangements may provide greater flexibility for state tax reform.

Summary of key messages from submissions

Of those submissions which consider state and local taxes, many raise concerns with the imposition of one or more of these taxes, noting issues of inefficiency and equity. Many highlight the need to rationalise the number of taxes.

A number of business groups note the complexity and compliance costs arising from the different structure and administration of taxes across States.

Many submissions propose the abolition of a number of state taxes. Few submissions identify ways the States could fund the abolition of these taxes, but those that do propose improving the application of some existing taxes (or introducing new ones).

Many submissions call for the abolition of payroll tax. However, several recent efficiency analyses of state taxes indicate that payroll tax is one of the more efficient state taxes (see Charts 9.2 and 9.3). Many submissions suggest that, if payroll tax is to be maintained, the current exemptions and thresholds should be removed and that the tax be harmonised across the States. An option put forward is to apply a uniform system with the Australian Taxation Office (ATO) collecting the payroll tax on behalf of the States.

Several submissions propose that insurance duty and the fire services levy imposed on insurers be abolished. They argue that these levies result in multiple taxation of insurance products and highlight the risks associated with non-insurance or underinsurance.

Submissions canvass a range of changes in relation to land taxes — from complete abolition to broadening by removing exemptions and concessions. A few submissions consider that land tax should be harmonised across the States, or that it should be a federal tax. Some submissions propose abolishing local government rates, while others suggest it is an appropriate tax base for local governments.

There is general agreement in submissions that stamp duty on conveyances should be abolished, with a number of submissions noting the inequity of this tax.

Several submissions express concerns about the impact that property taxes and charges (for example, stamp duty on conveyances and land taxes) have on housing prices.

Summary of key messages from submissions (continued)

Many submissions propose changes to state motor vehicle taxes, where the rate of tax depends on the carbon emitted from the car. One notes that such an approach would require tax to be based on fuel usage rather than annual vehicle charges.

One submission argues that gambling should be taxed the same as other industries.

One submission suggests that the States should make more use of user charging.

Some submissions express concern that not all taxes identified for abolition under the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* have been abolished. Some suggest all state taxes could be replaced by the GST.

Issues with state and local taxes

In considering alternatives to the current mix of state taxes, a number of factors need to be taken into account. The ability to reform state taxes will depend upon:

- the revenue raised by broadening the base of efficient taxes and any revenue forgone if tax rates are lowered as part of these reforms;
- the revenue lost due to the abolition (or reduction) of inefficient taxes;
- any changes to revenue sources of state governments;
- the constitutional restrictions on the states levying some taxes; and
- the scope to raise additional revenue from user charging.

Insurance taxes

Submissions note that stamp duty on insurance may encourage people to either under insure or to not insure at all by increasing the cost of insurance products relative to other goods. While this in itself is inefficient, it may also lead to an increase in government expenditure if assistance is provided to the uninsured in the event of a disaster. Further, the fire services levy – which is levied on insurance companies to partly fund fire brigades – can exacerbate the effects of the stamp duty on insurance.

Payroll tax

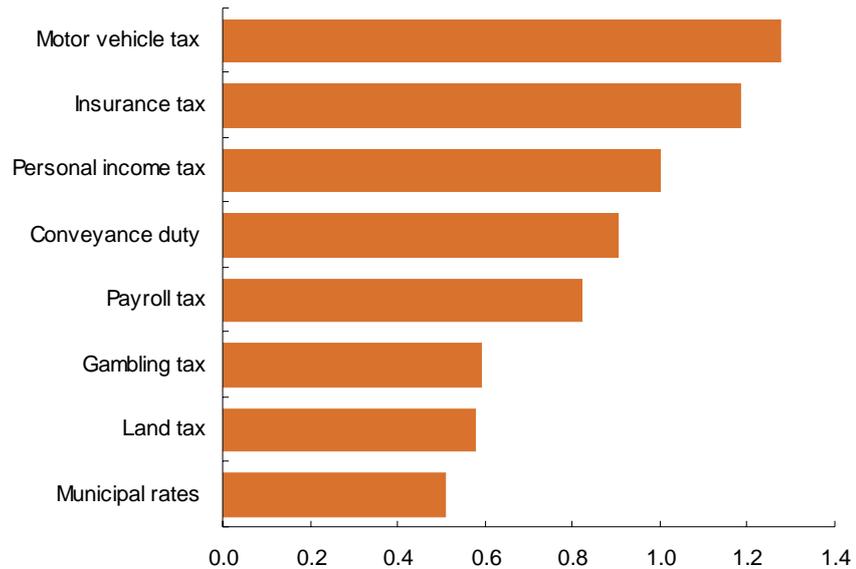
As noted in the *Architecture paper*, it is difficult to determine the precise economic incidence of a tax. Many submissions are concerned that payroll tax acts as a disincentive to businesses to hire workers. However, a recent review by the NSW Independent Pricing and Regulatory Tribunal (IPART) found that the economic effect of a broadly based payroll tax is similar to a broad consumption tax or a flat-rate income tax, concluding that the view that payroll tax is a tax on employment is not supported by the evidence (IPART 2008).

This reflects the generally accepted view that the economic incidence of a comprehensive payroll tax is likely to fall on labour, either directly through lower after tax wages or indirectly through higher prices for goods and services. However, in the short run it is possible that, due to certain market conditions, businesses which pay the tax are not able to

pass it on through prices or wages, and this in turn could affect business investment decisions.

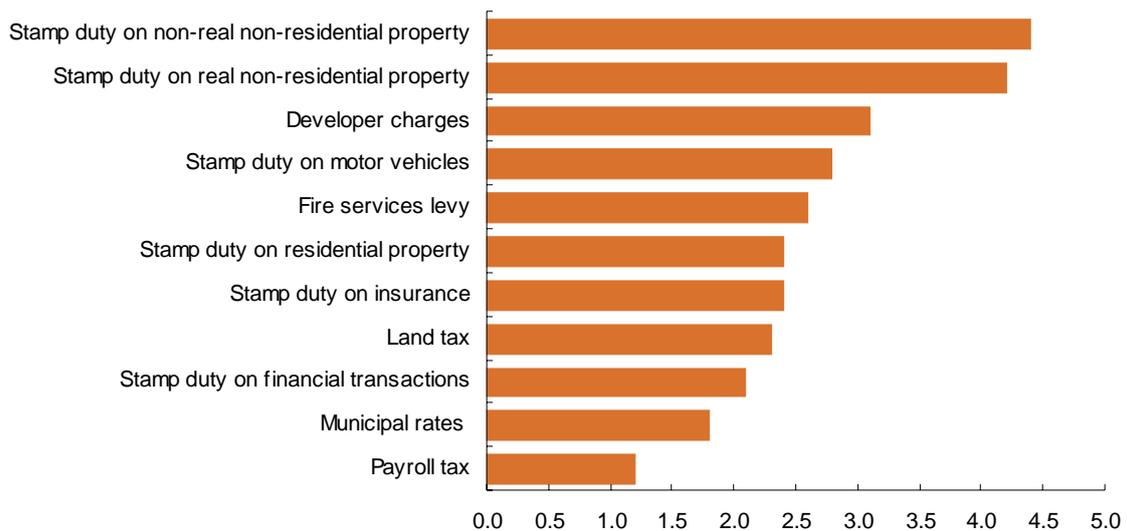
Charts 9.2 and 9.3 (from the submissions) suggest payroll tax is a relatively efficient tax, notwithstanding its narrow base. While payroll tax is shown to be relatively efficient, the efficiency rankings of taxes vary considerably. The Review Panel has commissioned work on the efficiency of Australia's main taxes.

Chart 9.2: Australia-wide ranking of state/federal taxes
 % change in consumption / % change in tax revenue (relative to personal income tax)



Source: Investment and Financial Services Association submission (2008).

Chart 9.3: Inefficiency ranking of selected taxes
 Impact on output relative to benchmark tax set at 1.0



Source: Property Council of Australia submission (2008).

While the payroll tax threshold may make it less efficient, this outcome needs to be balanced with the compliance costs that would be faced by small business if there were no threshold.

However, the tax threshold means that a higher rate is needed to raise an equivalent amount of revenue.

Land taxes

Many submissions consider land tax an efficient and under utilised tax base. It is generally accepted that a broad-based land tax is relatively efficient, as landowners cannot reduce the supply of land to avoid the tax. As supply is unable to respond to the tax, its primary impact is to reduce the current after-tax price of land so that the future after-tax earnings on the asset reflect the return on equivalent assets.

However, where there are exemptions in the state land tax base, as currently exist for owner-occupied housing and land used for primary production, there is scope to move some land from a taxable to a non-taxable use. This opens the possibility that the supply of taxable land can decrease, resulting in at least part of the tax being passed to users of land. Thus the exemptions from land tax can create an efficiency cost by distorting the use of the land.

Exemptions for owner-occupied housing mean that home owners do not face a land tax liability, which could potentially represent a significant proportion of their income depending on the value of the land on which their home is located. Removing exemptions may mean it is necessary to ensure there are sufficient mechanisms to ameliorate potential cash flow problems for such people, such as reverse mortgages or personal loans, or tax deferment arrangements. Removing exemptions would also mean that the same amount of revenue could be raised with lower rates of land tax. However, it could be argued that the land tax exemption for owner-occupied housing creates room for local governments to apply rates.

While a few submissions consider the exemptions necessary for equity reasons (with reference to income not asset value), exemptions may be seen as inequitable (due to wealthy and/or high income home owners being exempt from the tax) and this may reduce the community's acceptance of the tax. In this context, Carling (2008) notes the relative acceptance of local government rates, which are primarily land taxes applied on a uniform basis.

Gambling taxes

Unlike most other activities, the States restrict the supply of gambling providers in an attempt to reduce social problems associated with some gambling. These restrictions generate 'rents' to gambling operators, as they are able to earn higher profits without the fear of competitors entering the market. As a tax on rents, gambling taxes have the potential to be efficient and redistribute above normal returns to the community at large.

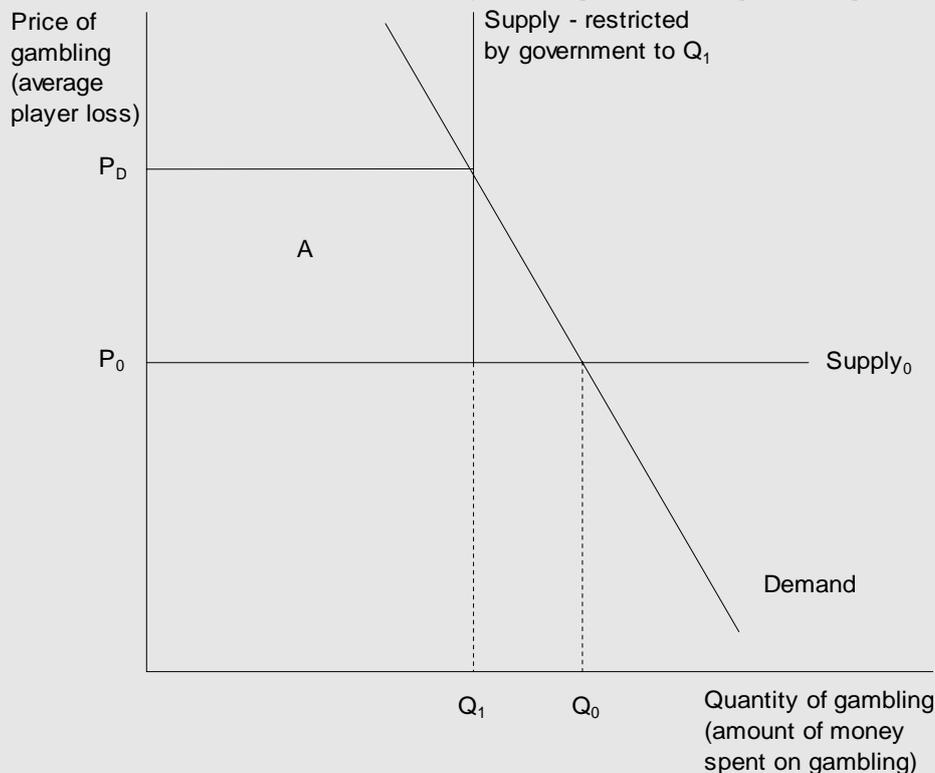
If gambling taxes do no more than recoup the increased profits accruing to gambling operators from the restrictions on gambling supply, they will have no impact on the overall level of gambling or on the return to the gambler (see Box 9.3).

Effective taxation of rents would imply taxing more restricted segments of the market more heavily than less restricted segments. However, this could be difficult to do in practice. While the States have differing tax rates on different forms of gambling (for example, lotto compared to horse racing) there is no clearly articulated reason for these differences. If the States are not taxing differing rents, or levying taxes to address different social costs

associated with different forms of gambling, there may be an argument to tax gambling at a uniform rate. This would ensure that the type of gambling activity reflects the benefit to the gambler of the activity, rather than the rate of tax.

Box 9.3: Gambling taxes — collecting the rents created by regulation

Chart 9.4: Rents created by the regulation of gambling



In an unregulated gambling market the amount of gambling is determined by supply and demand. State governments may choose to regulate the amount of gambling, for example by placing a cap on the number of poker machine licences. This restriction in the supply of gambling provides an advantage to those operators who remain in the market: they are able to charge a higher price to gamblers (a higher player loss, P_D). The restriction in supply means these gambling providers yield additional profits (area A). If the government taxes away this increased profit, it is effectively recouping the benefit that it created through the restriction in supply.

User charging

As noted in Section 3.4, the essence of user charging is that a program is funded not from general tax revenue, but rather by charging those who access the program. As the user charge is generally collected by the entity that provides the service (which will usually have the best information about who is using the service and the cost of providing it) and State governments provide the majority of services to the Australian public, the potential for them to apply user charging appears greater than for the Australian government. One submission highlights that States are able to generate own source revenue from user charging.

Currently, the States charge for a wide range of activities including transport, education and environmental services. Technology is improving the ability of governments to measure and charge individuals for what are essentially publicly provided private goods (for example,

roads). While this can produce efficient outcomes, governments may also choose to under-price the provision of the good or service to pursue social policy goals (although often such goals can be achieved through other mechanisms, such as the transfer system).

Other taxes

Many submissions call for a rationalisation of the number of taxes in the federation. The States raise a number of taxes which are levied on narrow bases and raise relatively small amounts of revenue. For example, NSW and the ACT impose a levy on health insurance (known as the ambulance services levy in the ACT), while NSW, Victoria and WA impose a parking space levy. The small amounts of revenue that come from these taxes may mean that the costs of administering them are high relative to the revenue raised. However, each may have favourable efficiency implications which support their continued use.

Consultation question

Q9.2 Given the widely held view in submissions that the current state tax arrangements need to be reformed, what changes should be made to state and local government own source revenue instruments? What scope is there for greater use of user charging to bring social, environmental or economic benefits?

9.3 Redistribution in the federation

In Australia, redistribution of income among households is primarily a function of the Australian government, which is responsible for the policy and administration of a range of payments to individuals and families. State and local governments are also involved in redistribution, mainly through indirect transfers in the form of concessions and exemptions for certain groups in respect of some taxes and services. With multiple levels of government involved in redistribution, there are potential issues with the complexity that individuals face and the compatibility of different redistributive policies.

Summary of key messages from submissions

Some submissions note the interaction between transfers provided by the Australian government and concessions provided by state and local governments for services (such as public transport) and taxes (most notably, local government rates). The link between transfer payments and concessions can create stronger attachment to (means-tested) payments and this can have implications for workforce participation.

Some submissions highlight the equity concerns of existing state and local government taxes and propose that the Australian government take over a number of state and local taxes. Other submissions see an ongoing role for state and local taxes, but the Australian government, given its capacity to achieve equity across the country, should be the only government involved in redistribution. This may also improve the capacity for state and local governments to raise revenue more efficiently from their own taxes.

Submissions proposing an income tax base sharing arrangement note that consideration would need to be given to how this would affect the ability of the Australian government to coordinate redistribution.

Alternative methods of redistribution

Section 4 notes that the redistributive function is applied mainly at the Australian government level. In 2006-07 the Australian government provided around \$70 billion in cash transfers to individuals and families. State and local governments do not have a system of general income support but provide transfers to individuals in a number of ways, including:

- through services directed to assist low income people, such as public housing schemes to provide affordable accommodation;
- subsidised services, such as electricity, water and public transport; and
- tax concessions, such as motor vehicle registration and local government rates concessions, and stamp duty concessions to eligible first home buyers.

Tables 2.27 to 2.34 of the *Architecture paper* show the range of concessions available to people in each of the States and some of the interactions between these concessions and eligibility for certain Australian government programs (such as the Pensioner Concession Card and the Commonwealth Seniors Health Card). The tables illustrate considerable variation in the concessions provided.

Some submissions note that the interaction between eligibility for transfer payments and eligibility for concessions can affect the incentives for workforce participation. As the eligibility for some of these concessions can be withdrawn in a 'sudden-death' nature, this can create a disincentive for people to earn extra income and move off transfer payments, particularly those facing high effective marginal tax rates.

A number of submissions note that the Australian government is in the best position to coordinate redistribution. Wellisch (2000) suggests that in federal systems the redistribution function is best assigned to the national government because competition between sub-national governments can lead to a sub-optimal level of income redistribution. For example, if one jurisdiction had higher rates of payment (financed by higher taxes), it may attract non-workers, and repel workers, from other jurisdictions increasing the tax burden on its citizens relative to those in other jurisdictions. There could therefore be an incentive for sub-national governments to reduce redistribution. As migration responses can be expected to be lower at the national level, these distortions would be lower where the national government is in charge of redistribution.

However, sub-national governments are often in a better position to provide public services. This stems from their comparative advantage in being able to vary levels of service provision based on localised information and the preferences of their constituents. State and local governments in Australia provide a wide range of services and generally set the policy for the provision of those services, although some are provided within agreed frameworks between the Australian government and the States.

The concessions provided by the States can be used for services which are operated by state and local governments or by private enterprises. A number of problems arise with this approach:

- the administration of concessions can be complex;

- there can be different equity outcomes in different parts of the country depending on the accessibility and need to use particular services;
- redistribution and equity outcomes can become dependent on consumption choices;
- concessions for specific services can dampen the effect of price signals; and
- concessions might provide a subsidy to particular businesses.

Submissions from local government note that concessions to certain groups weaken the local government tax base (although the cost of these concessions may be met by state governments) and the redistributive function should ideally be addressed by the Australian government. Such an approach could also reduce vertical fiscal imbalance, as the cost of providing concessions for services and taxes would be moved from state and local governments to the Australian government.

If a nationally consistent approach to redistribution is desirable, this could be done in two ways. State and local government concessions could be removed, with the Australian government focusing on the capacity of individuals to use services and pay taxes. This could be done through the Australian government providing vouchers to eligible people to use certain types of services, or through increases to existing Australian government transfer payments. State and local governments would continue to be service providers (competing against private businesses in some sectors). Alternatively, the states could harmonise their concessions to achieve a similar outcome. Again, if considered appropriate, the value of the concessions could be provided in a transfer payment rather than concessions.

An issue requiring further consideration under this approach is the appropriate cost and value of the services and concessions for which certain groups are currently eligible. Another issue is how changes to transfer payments might affect workforce participation decisions.

In another respect, applying the principle that redistribution is a national government responsibility may reduce the extent to which the states can use certain tax bases. For example, submissions that raise the possibility of introducing an income tax base sharing arrangement between the Australian government and the states note that an important consideration is the ability for the Australian government to coordinate redistribution (given the interaction between personal income tax and the transfer system).

Consultation question

Q9.3 What is the appropriate allocation of the roles of the Australian and state governments in income redistribution?

9.4 Streamlining tax-transfer administration in the federation

Section 2.1 highlights the complexity of the federation's tax-transfer system and the duplication of administration arrangements. At present, an individual may have to deal with several different agencies at an Australian government, state and local levels to understand the taxes that they have to pay and the transfers that they may be entitled to receive.

Duplication in administrative structures may lead to unnecessary costs. There may be scope

to streamline the administration of the tax-transfer system to reduce the complexity that individuals face and reduce operating costs.

Summary of key messages from submissions

Submissions consider that greater efficiency and simplicity of the tax system could be achieved by having a central agency (such as the ATO) administer either individual state taxes (such as payroll tax) or the States' entire tax system. The administration and legislation of these taxes should be harmonised.

Alternative approaches for administrative reform

Streamlining the administration of the tax-transfer system in the federation may yield two broad types of benefit. First it may reduce the cost of administration. Second, members of the community may face less 'red tape' in accessing their benefits and more certainty with regard to the taxes they need to pay and the transfers they are entitled to receive.

Streamlined administration could be a by-product of tax-base sharing arrangements described in Section 9.1. Beyond this, consideration could also be given to three broad kinds of administrative reform.

First, improved sharing of information provided by individuals to tax authorities could reduce the number of interactions people need to have with different levels of the system. This could be implemented along similar lines to the Standard Business Reporting model where the goal is for businesses to provide reports, used by tax and regulatory authorities across jurisdictions, using standardised definitions and a single secure channel, with business software automatically pre-filling forms to satisfy their reporting obligations and regulatory compliance. State revenue offices are already participating in the Standard Business Reporting project as one way of reducing red tape.

Second, some or all of the actual collection of state taxes (and payment of state transfers) could be undertaken by centralised agencies. An individual would still be paying (receiving) local, state and Australian government taxes (transfers), but would only have relationships with the centralised agencies (for example, the ATO and Centrelink). A further extension of this approach, discussed in Section 8.2, would be to have only one agency at the Australian government level with which individuals would interact regarding both taxes and transfers.

A third approach would be to retain the existing administrative architecture across jurisdictions (including state revenue offices) but overlay it with an intermediary function that would provide a 'one-stop' interface for individuals. That is, administering the taxes and transfers would remain with several institutions but citizens would only interact with the one body.

While reducing the number of agencies involved in the administration of the tax-transfer system may reduce the complexity and costs for individuals interacting with the system, there may be a loss of transparency for citizens and a risk that the information sharing arrangements may be inadequate. The extent to which the administration of the tax-transfer system can be integrated and centralised will also depend on the degree to which

jurisdictions are prepared to give up distinguishing features of their systems in order to harmonise relevant taxes and transfers.

Consultation question

Q9.4 What opportunities could be pursued to deliver more seamless administrative arrangements of the tax-transfer system across the federation?

9.5 Other issues

Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations

Some submissions express concern that taxes listed for abolition in the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (the IGA) have not been abolished. Under the IGA, wholesale sales tax and accommodation taxes were abolished on 1 July 2000, financial institutions duty and stamp duty on quoted marketable securities were abolished on 1 July 2001, and bank account debits tax was abolished in all states by 1 July 2005.

The IGA also provided that the Ministerial Council for Commonwealth-State Financial Relations would, by 2005, review the need to retain stamp duty on: non-residential conveyances; non-quotable marketable securities; leases; mortgages, bonds, debentures and other loan securities; credit arrangements, instalment purchase arrangements and rental arrangements; and cheques, bills of exchange and promissory notes. With the exception of the real property component of non-residential conveyance duty (that is, conveyance duty on real business property), the Australian government agreed timetables for the abolition of these taxes with each of the States.

Some submissions suggest that the abolition of other taxes (that is, those not listed in the IGA) should be funded by the GST. However, there was no specific commitment in the IGA to abolish taxes other than those noted above. It was the intent of the IGA to improve the financial position of the States over time, rather than have the additional revenue provided by the GST being fully offset by reductions in other taxes.

Horizontal fiscal equalisation

Several submissions express a concern that the current horizontal fiscal equalisation (HFE) process affects the incentives for states to undertake economic reforms. As agreed by all the States in the IGA, GST payments are distributed among the States in accordance with the principle of HFE and having regard to the recommendations of the Commonwealth Grants Commission. The panel considers that HFE is beyond the scope of its terms of reference.

10 Tax and transfer impacts on housing

Overview

Housing plays an integral role in Australian society. It provides a source of shelter and a base for people to participate in communities and the workforce. It is the largest store of the nation's wealth and a major source of retirement savings for home owners.

The tax-transfer system affects the housing market through a range of taxes, concessions and transfers, which in some cases are targeted at certain housing tenures or income levels. These aspects of the system influence the type of homes people live in, the way they save and invest, including for their retirement, and the affordability of housing. Through its treatment of housing, the tax-transfer system also delivers significant assistance to particular groups of Australians, which affects the overall equity of the tax-transfer system.

Consultation questions

- Q10.1 What should be the objective of the tax-transfer system in respect of housing? Should there be assistance for housing over other assets or services? Should assistance be based on housing tenures? Should assistance be focused on people on low incomes? Should assistance differ between public and private tenants?
- Q10.2 What role, if any, should the tax-transfer system play in respect of housing affordability? Should the tax-transfer system be used to influence housing supply and/or demand to improve housing affordability? What changes, if any, should be made to housing-related transfers that assist disadvantaged households to find housing?
- Q10.3 Recognising the influence that some taxes and transfers have on the use of housing and residential land, what changes, if any, should be made to ensure the housing stock and residential land are used efficiently?

This section considers the impact of the tax-transfer system on housing. It outlines the taxes and transfers affecting housing and discusses their distributional effects by tenure type and income level. The impact of the tax-transfer system on housing affordability and the efficient use of the housing stock are then discussed.

10.1 Housing taxes and transfers

A wide range of taxes and transfers affect housing. While some of these reflect revenue raising objectives, many are designed to achieve social policy objectives, such as access to affordable housing, adequate retirement incomes or equity concerns.

It is difficult to discern the overall distributional outcomes of the tax-transfer system in relation to housing. This partly reflects the range of objectives for the system. It also reflects the complex ways in which tax-transfer policies interact with the housing market. In light of this complexity, the panel has commissioned new research on the impact of the tax-transfer system on housing.

Summary of key messages from submissions

Some submissions say that the tax-transfer system should tax housing concessionally in light of its social benefits and place in Australian society. Others take an alternative view, arguing on equity grounds that housing should be taxed more like other assets. Submissions emphasise the role the tax-transfer system plays in supporting access to affordable housing for low-income Australians.

The submissions contain mixed views about whether property owners are paying a 'fair share' of tax. Several submissions note that property is subject to many taxes across all levels of government and claim that this results in the sector being over taxed. Others claim that housing is treated favourably as an asset class within the income tax system.

The exemption of the principal residence from capital gains tax (CGT) is raised as an issue in a number of submissions. Many argue that the exemption encourages excess investment in housing. Similarly, a number of submissions question the land tax exemption for the family home, noting the significant narrowing of the potential tax base that the exemption creates and expressing concern about equity between owner-occupiers and renters.

Other submissions claim that private rental investment is advantaged relative to owner-occupiers due to interest deductibility and 'negative gearing'.

In terms of the transfer system, a number of submissions suggest that pensioners who own their own house are more favourably treated than people who do not. Several submissions argue that low-income renters receive payments that are too low and do not keep pace with growth in rents.

Some submissions suggest that 'negative gearing' for investors and the exemption from CGT for owner-occupiers benefit high-income Australians. Others argue that negative gearing supports the provision of affordable rental housing.

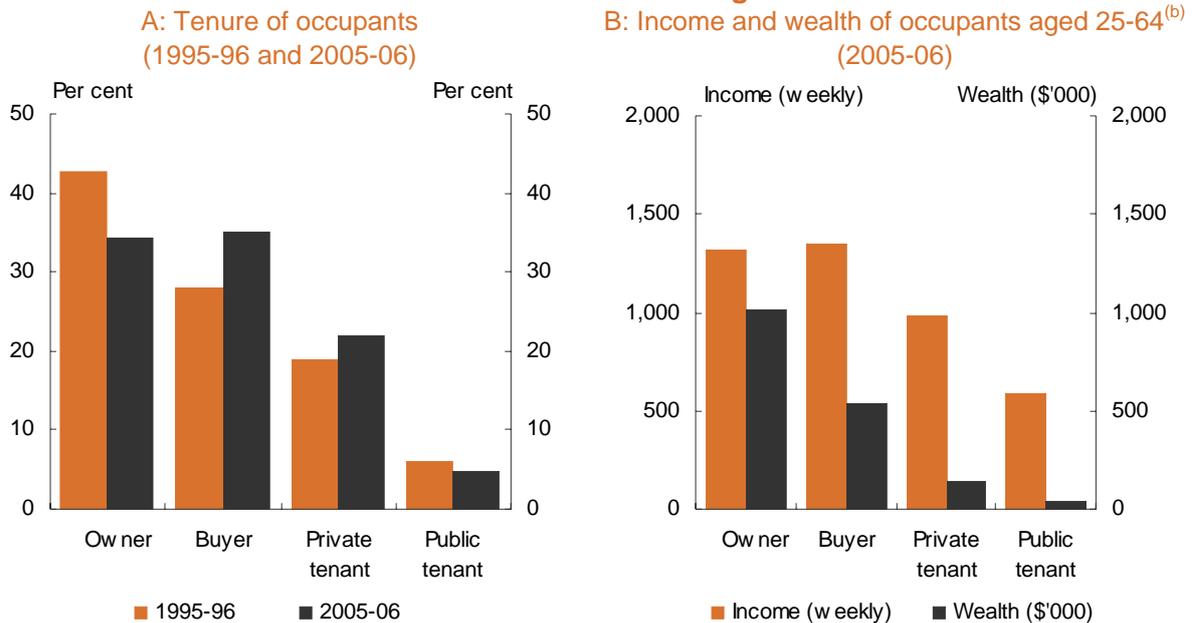
Size and distribution of housing taxes, subsidies and transfers

Snapshot of the housing market

In 2005-06, around 70 per cent of households lived in their own homes (Chart 10.1A). The rate of home ownership has remained stable over the past 40 years and is one of the highest in the OECD. Between 1995-96 and 2005-06, the proportion of owner-occupiers who owned their home outright declined.

Owners and buyers aged between 25 and 64 years have the highest incomes and are the wealthiest Australians, their wealth being six times higher than non-homeowners. Tenants of public housing have the lowest wealth and incomes (Chart 10.1B).

Chart 10.1: Overview of housing market^(a)



Source: ABS (2007c).

Source: ABS (2007d).

(a) Owner refers to a household that owns the home outright. Buyer refers to a household with a mortgage.

(b) Older Australians are excluded from the comparison in Chart 10.1B to remove the influence of demographics. Older Australians are over-represented in the outright owner category. Similar to the results in the chart, older Australians who are home owners or home buyers have higher average wealth and incomes than non home owners.

The major taxes and transfers affecting housing are outlined in Table 10.1. Specific taxes on housing, such as stamp duty and land tax, are levied by the states. Local government rates affect both owner-occupied housing and private rental properties.

Owner-occupied housing is not subject to Australian government income tax, whereas private rental properties are subject to income tax as they are an income-generating asset. A range of transfers are provided by all levels of government.

Table 11.1: Major taxes and transfers relating to housing

	Owner-occupied	Private landlord	Private renter	Public tenant
Taxes				
Income tax (Australian Government)	Exempt.	Taxable. 50 per cent discount on capital gain. Costs deductible.	n/a	n/a
Stamp duty (All States)	Taxable at progressive rates based on property value (some first home buyers exempt).	Taxable at progressive rates based on property value.	n/a	n/a
Land tax (All States except Northern Territory)	Exempt.	Taxable based on land values. Deductible from income tax. Thresholds exclude many small-scale holdings.	n/a	n/a
Rates (local governments)	Taxable, based on land values. Some exemptions.	Taxable based on land values.	n/a	n/a
Transfers				
Income support assets tests (Australian Government)	House value not counted toward total assets. Home-owning couple subject to maximum rate threshold of \$243,500.	Property value counted toward total assets.	Non-home-owning couple subject to maximum rate threshold of \$368,000.	Non-home-owning couple subject to maximum rate threshold of \$368,000.
Rent Assistance (Australian Government)	n/a	n/a	Eligibility determined by access to other payments. Payment rate determined by rent (capped) and family circumstances.	Not eligible.
First Home Saver Accounts (Australian Government)	Savings of first home buyers receive Government contributions and preferred tax rates.	Existing property owners ineligible.	Savings of first home buyers receive Government contributions and preferred tax rates.	Savings of first home buyers receive Government contributions and preferred tax rates.
First Home Owners Grant (Australian and state governments, administered by States)	Until 30 June 2009, \$14,000 grant for first home purchased — \$21,000 if a newly constructed home. To revert to \$7,000 from 1 July 2009.	Not eligible.	n/a	n/a
Public housing (Australian and State governments)	n/a	n/a	n/a	Eligibility determined by income and other criteria indicating disadvantage. Recipients pay a rent, usually around 25 per cent of their income.
National Rental Affordability Scheme (Australian and State governments)	n/a	Eligible institutional investors receive \$8,000 per dwelling rented to eligible tenants.	Low to moderate income renters access a home at rent 20 per cent below market rates.	n/a
Home purchase assistance (State governments)	Includes direct lending, deposit and mortgage subsidies. Generally means-tested by income.	n/a	n/a	n/a
Private rental assistance (State governments)	n/a	n/a	Payments to help meet ongoing, bond or other rental costs. Generally means-tested by income.	n/a

Owner-occupied housing

Owner-occupied housing is taxed more like a private good than an investment asset. That is, returns to owner-occupied housing, such as a capital gain or imputed rent (see Box 10.1) are not taxable and the holding costs (interest or maintenance) are not deductible. This tax treatment makes an investment in owner-occupied housing more favourable than other housing options. The *Architecture paper* suggests that the effective rate of tax on owner-occupied housing is also lower than the rate on bank deposits and ungeared share investments.

The taxation treatment of owner-occupied housing can affect two key decisions of individuals or households:

- Their investment allocation decision. The closer the alignment in the taxation of owner-occupied housing and other investments, the smaller is the tax distortion when allocating capital.
- Their retirement savings decision. An owner-occupied home is a way to save for retirement, as it reduces housing costs in retirement. Aligning the taxation of owner-occupied housing with superannuation will reduce tax distortions from the retirement savings decision.

Many studies have tried to measure the size of the net subsidy (or tax) conferred on owner-occupied housing by its tax treatment. A common approach in Australian studies is to determine the amount of tax that households would pay if owner-occupied houses were taxed like investment properties. Using this approach, the Productivity Commission (2004) estimated an annual implicit subsidy for owner-occupied housing of \$25 billion in 2003, reflecting the combined effects of the exemption from CGT (\$10 billion), the non-taxation of imputed rent net of interest and other costs (\$8 billion), and exemptions from land taxes (\$7 billion). This equates to roughly \$4,600 per dwelling per year. This estimate is similar to the results of Yates (2003), who found a \$13 billion benefit from the exemption from capital gains and a \$8 billion benefit from the non-taxation of imputed rents (net of other expenses).¹⁰

10 The estimates of tax advantage in the paragraph are not necessarily indicative of revenue raised from the hypothetical alternative tax settings. This is because the alternative settings would likely lead to significant behavioural responses by tax payers, which are not accounted for in the estimates.

Box 10.1: What is imputed rent?

Imputed rent is the value housing provides to an owner-occupier and can be thought of as the benefit from not having to pay rent to reside in that dwelling. Imputed rent is not included as part of a person's assessable income for tax purposes.

Excluding imputed rent from income tax can be considered to be a tax expenditure (or subsidy) that provides an incentive to owner-occupation. If a person were to move out of their home into rental accommodation and let out their property at the same rental rate, their tax bill would increase even though their assets and income (after housing costs) are unchanged. This is because rental income is taxed, while imputed rental income is not.

The Australian Bureau of Statistics (ABS) estimates gross imputed rent for owner-occupied property as the amount that would be received if it were rented privately. Net imputed rent is derived as gross imputed rent less holding costs such as interest and maintenance. The 2005-06 results show that even though outright owners have lower cash income on average than home-buyers, their income is higher once adjusted for net imputed rent.

Table 10.2: ABS estimates of imputed rent (\$ per week) (2005-06)

	Mean disposable income(a)	Mean gross imputed rent	Mean net imputed rent	Mean disposable income (including net imputed rent)(a)
Home owners				
Outright	625	236	172	731
With mortgage	716	245	5	718
Renter				
From market	603	0	7	608
From state authority	356	183	83	404

(a) Household equivalised incomes. Equivalised incomes take account of different household sizes and structures by identifying the amount needed to provide an equivalent standard of living to that of a single person.
Source: ABS (2008g).

A number of submissions suggest that not taxing owner-occupied housing benefits high-income Australians. Yates (2003) also analysed the distribution of the tax subsidy to owner occupied housing, as shown in Table 10.3. People on higher incomes benefit most from tax exemptions as they have high marginal tax rates and generally have more expensive houses, with higher imputed rents and larger capital gains. Low-income earners on a zero marginal rate may receive no benefit. As mortgage payments and other expenses are not deductible, the current system favours home owners more than home buyers. Apart from people in the 'lower middle' income quintile, the subsidy was found to be mildly regressive as it increases proportionally more than income.

Table 10.3: Tax benefit to owner-occupiers by income quintile (1999)^(a)

	Income quintiles				
	Bottom	Lower middle	Middle	Upper middle	Top
Outright owners					
Tax benefit (\$)	0	2,100	2,500	4,600	8,800
as % of income	0	9	6	7	7
Home buyers					
Tax benefit (\$)	0	400	100	500	2,100
as % of income	0	2	0	1	2

(a) The tax benefit was calculated as the sum of the tax that would otherwise be payable on imputed rent and the annual capital gain less interest costs. The personal tax rates used in the calculation were determined using half of the household income (before net income from the owner-occupied property).

Source: Yates (2003). The study uses Housing Survey data from ABS (2000).

As not all Australians are financially able to participate in owner-occupation, there is a further equity dimension arising from the tax exemption for owner-occupied housing. Unlike investments in other assets, such as shares or a bank deposit, it is not possible to buy a \$1,000 stake in an owner-occupied house. The 15 to 20 per cent of people that never purchase a home tend to be much poorer than other Australians.

As outlined in Table 10.1, a range of other government programs provide direct assistance to owner-occupiers through grants or tax exemptions. First home buyers are the major recipients of this assistance. In 2006-07 this group received the majority of the \$1.7 billion in exemptions from stamp duty and received around \$1.0 billion through First Home Owners Grants. From 2008-09, they have access to First Home Savers Accounts, which will confer a transfer of \$625 million over four years. These transfers are not targeted, other than the case of stamp duty reductions that are restricted through house values. In 2005-06, state governments provided home purchase assistance, of which \$30 million was through interest rate assistance and other subsidies and \$969 million was repayable direct lending. This assistance is generally means tested by income.

A number of submissions note that owner-occupiers who receive pensions or allowances benefit through concessional treatment in assets tests. Assets tests reduce payments once assets exceed a certain threshold. Pensions are reduced by \$1.50 for every \$1,000 above the threshold, while allowances are stopped once assets exceed the threshold. For home owners the threshold is \$124,500 lower than the threshold facing non-home owners. This provides a concessional treatment for home owners whose home is worth more than \$124,500, with the extent of concessionality increasing in line with the home's value.

Private rental housing

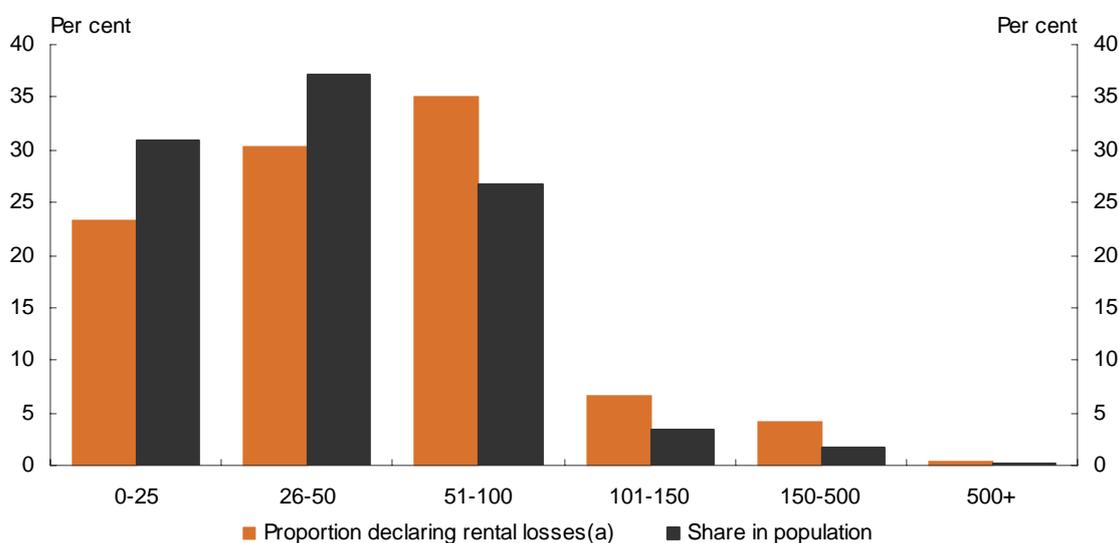
Unlike owner-occupied housing, investment in residential property is taxed in the same way as other assets. However, as shown in Section 8 of the *Architecture paper*, the current system treats some types of returns (for example, capital gains) more favourably than others (for example, interest), and this effect can be accentuated through gearing.

The features of the tax system argued by many submissions to favour property investment – such as the interaction of 'negative gearing' with the CGT discount (see Box 6.8) – are available for other investments. However, these favourable features may be more prevalent for housing than other assets. For example, properties tend to be more highly geared than share investments, which may reflect the lower volatility of house prices.

The size of this tax benefit has not been studied as comprehensively for rental investment as for owner-occupied property. Abelson and Joyeux (2007) calculated the tax benefit to housing by netting tax paid from direct and implicit subsidies. They found that the net subsidy accruing to private rental housing was \$400 million in 2004, compared to \$6 billion for owner-occupied housing.¹¹

Tax data provide some insights into the size and distribution of tax benefits for private rental investments. In 2005-06, total deductions exceeded rental income by \$5 billion. Chart 10.2 shows that the majority of rental property investors who declare losses have a total income of less than \$50,000.¹² However, high-income earners who declare losses are over-represented compared to their share of the overall income distribution. Investors whose total income is below \$50,000 have an average deduction of around \$7,000, about half the deduction of investors who have a total income above \$100,000. The distribution of tax benefits between investors and renters is considered in the following section.

Chart 10.2: Proportion of individuals with rental losses
By total income (\$'000) (2005-06)



(a) The 'Proportion declaring rental losses' is the proportion of people declaring losses whose income falls within the given range. 'Share in population' is the proportion of people who submit tax returns and whose income falls in the given range. Source: ATO (2008).

Publicly-assisted housing

Some equity concerns for housing access are directly addressed by the tax-transfer system through programs such as Rent Assistance, the provision of public housing and the National Rental Affordability Scheme (NRAS).

Rent Assistance is a non-taxable income supplement paid by the Australian government. In 2007-08, around \$2.3 billion was paid to 940,000 low to moderate income individuals and families who rent in the private rental market. Public housing is funded jointly by the Australian and state governments, at a cost of around \$1.6 billion in 2006-07. The proportion

¹¹ This study used the income benchmark to measure their subsidy, which differs from the approach used by the Productivity Commission (2004) and Yates (2003).

¹² Total income is the sum of all assessable income, but does not include any deductions.

of people in public housing has fallen from 6 per cent in 1995-96 to 5 per cent in 2005-06. From 2008-09 to 2011-12, the NRAS is expected to encourage the construction of 50,000 new rental properties that will be rented to low income and moderate income households at rates at least 20 per cent below market levels.

Housing related transfers are more tightly targeted than tax incentives. Around 76 per cent of public housing recipients are in the bottom 40 per cent of the income distribution. Eligibility for Rent Assistance is determined by access to income support or eligibility for more than the base rate of FTB Part A, both of which are means-tested. Reflecting the different means tests applied across the eligible payment types, the incomes of Rent Assistance recipients can vary significantly. As shown in Table 6.2, Rent Assistance will cease when a family with one child receiving FTB Part A has an income of \$72,854, compared to \$47,655 for a single pensioner and \$26,762 for a single Newstart allowance recipient.

The targeting of housing assistance according to recipient's income and housing costs differs between public housing and Rent Assistance. For recipients of public housing, the payment made by a tenant is generally fixed at 25 per cent of their income and is not affected by the value of the property. This means the effective subsidy paid by the government is higher for higher priced homes and is lower for recipients on higher incomes. For the 71 per cent of recipients who receive the maximum amount of Rent Assistance, their subsidy remains flat when rents increase.

Consultation question

Q10.1 What should be the objective of the tax-transfer system in respect of housing? Should there be assistance for housing over other assets or services? Should assistance be based on housing tenures? Should assistance be focused on people on low incomes? Should assistance differ between public and private tenants?

10.2 Impact on housing affordability

Access to affordable housing is a long-standing issue for the community and policy makers. Recent growth in housing prices has resulted in significant wealth gains for owners of residential property, but has also led to widespread concerns about falling affordability for home buyers and renters.

Summary of key messages from submissions

Submissions from developers and the construction industry argue that taxes are an important contributor to high housing prices in Australia. GST, developer charges and stamp duties are claimed to have contributed to price growth over the past 10 years. One submission argues that 35 per cent of the cost of broad-acre development in north-west Sydney is attributable to these taxes and charges. Developers express concern about a lack of transparency in the way they have been derived. Local government bodies argue that developer charges are consistent with the beneficiary principle of equity and encourage the efficient consumption of goods and the efficient use of resources.

Other submissions suggest that tax plays relatively little role, arguing that recent low affordability is attributable to economic fundamentals which have raised demand, and institutional arrangements which have constrained supply.

A number of submissions claim that 'negative gearing' has reduced housing affordability by causing speculation in the housing market. Several submissions propose restricting negative gearing or directing it so that it promotes the supply of affordable housing. The housing industry argues for the retention of negative gearing on the grounds, among others, that the temporary removal of negative gearing lead to an increase in rents in 1987.

Some submissions take the view that investors have enjoyed systemic tax advantages and that this has decreased affordability for owner-occupiers.

A range of submissions also stress the impact of stamp duty on the up-front costs of home-buyers.

Submissions raise concerns about housing affordability for low-income renters, citing the level of Rent Assistance compared to the costs of renting and the variation in rents experienced by people in different parts of the country.

What is housing affordability?

There is significant community concern about the affordability of housing. This reflects the importance of adequate housing in enabling people to participate in the workforce, raise a family and engage in a local community. At its most basic level, affordable housing involves access to an adequate level of housing for Australians, regardless of their means.

There are many other objectives for housing affordability, reflected in the range of ways it is measured. Some measures record the residual disposable income of households after deducting their housing costs. This can indicate if a household enters housing poverty, whether through rising housing costs or falling income. Some measures indicate the ease of access to owner-occupied housing, often focusing on first home buyers. These include the 'deposit gap', which records the difference between typical house prices and the maximum mortgage available on a typical household income. Other measures suggest housing becomes unaffordable when housing costs exceed a certain proportion of income, with 30 per cent of income frequently cited.

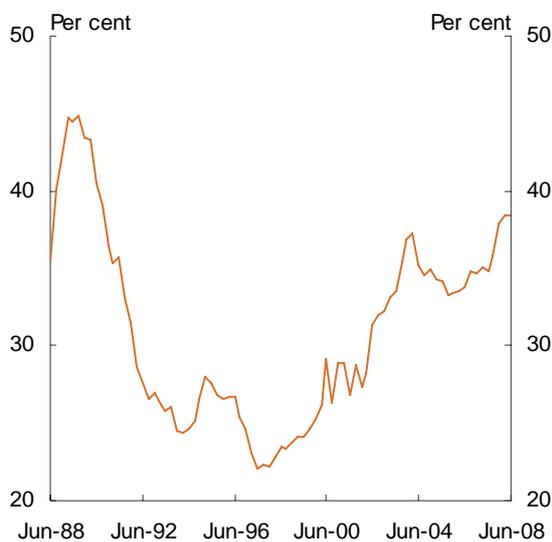
Using measures of housing affordability to make comparisons between people or over time can be problematic. For example, high-income earners may be able to spend more than

30 per cent of their income on housing costs and still be able to achieve a level of consumption regarded as adequate.¹³ Comparisons of housing costs between renters and mortgage payers is difficult because all rent is an expense, but part of a mortgage repayment represents saving (through principal repayment). Increasing real incomes over time also confound comparisons. A household devoting 47 per cent of their income to housing costs in 2007 could afford the same level of non-housing consumption as a household in 1996 devoting 30 per cent of their income to housing costs.

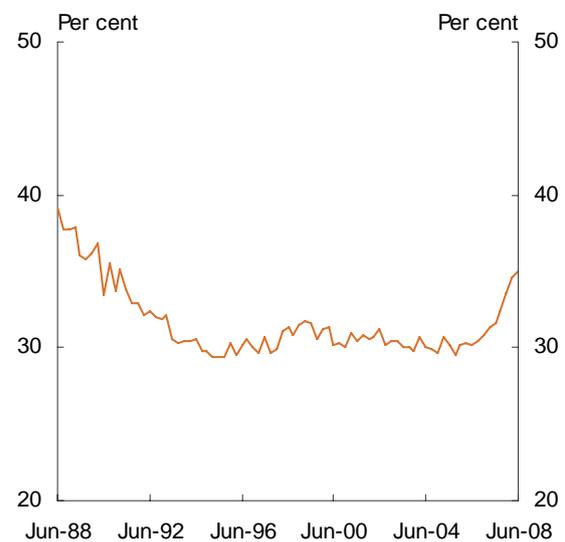
Chart 10.3 shows income-share measures of housing affordability for home buyers and renters. These have been falling and are at their lowest level since 1990-91. The decline in housing affordability for home buyers reflects strong growth in house prices and increases in interest rates from their lows of 2001. Chart 10.3 does not reflect the significant reductions in interest rates and slight falls in house prices that have occurred since June 2008.

Chart 10.3: Changes in housing affordability (1988 to 2008)

A: Repayments on the median house as a share of household income **B: Rents as a share of average weekly earnings**



Source: RBA (unpublished).



Source: Real Estate Institute of Australia (2008) and ABS (2008c).

House prices have increased by 54 per cent in real terms since 2000. Though real rental growth over the same period has been lower (17 per cent), rents are now growing strongly. Strong rental or price growth in a market is a sign that demand is outstripping supply.

¹³ For this reason, some measures focus only on housing costs for households in the bottom 40 per cent of the income distribution.

Housing affordability — major drivers of recent trends

In its review of first home ownership, the Productivity Commission (2004) considered that demand factors were the 'dominant' source of widespread price growth. Increased access to housing credit had been an important factor fuelling demand, reflecting:

- the long-run implications of financial market deregulation, which has reduced constraints on borrowing and, through competition among lenders, led to smaller interest rate spreads on lending; and
- lower and more stable inflation over the past 15 years, which has meant that interest rates have been both lower and more predictable than over the previous 20 years.

Both of these factors allow households to borrow larger amounts.

Household income growth has also supported housing price growth. Real household incomes have grown by around 40 per cent over the past 15 years, having been essentially flat over the previous 15 years. General employment growth has also played a role, with the unemployment rate around a 30 year low.

Among other demand factors, immigration has recently grown strongly in response to skill shortages in the economy, which has contributed significantly to housing demand.

In contrast, the national supply of new housing has fallen since 2004-05. The reduction has been driven largely by the Sydney market, with supply stable across the rest of Australia. However, the fact that the national rental vacancy rate in 2007 was at its lowest level since data first became available in 1980, indicates that supply is not responding sufficiently to meet strong demand. Factors influencing the level of housing supply may include delays in approval processes, land release and zoning policies, and infrastructure charges levied on developers.

The increase in the price of housing also reflects an improvement in the quality of the housing stock. The average size of a newly constructed house has increased from 130 square metres in 1970-71 to 240 square metres in 2006-07.

Impact of tax and transfers

Recent policy changes

The most significant changes to tax and transfer settings for housing include the changes to CGT in 1999; increased infrastructure charges; the introduction of the GST on housing and the First Home Owners Scheme; as well as changes in rates, land taxes and stamp duty conveyancing.

The introduction of the 50 per cent discount for capital gains in 1999 is more favourable for assets that experience strong capital growth than the indexation system it replaced. Tax settings that favourably treat capital gains can magnify cyclical price volatility by encouraging investment targeted at capital gains rather than income flows. In its report on First Home Ownership, the Productivity Commission (2004) states that 'these changes have almost certainly contributed to the surge in investment in rental housing in the past few

years'. Since 2004, the share of investment activity in the overall housing market has returned to the average level of the 1990s.

Several submissions by property developers cite increasing infrastructure charges as a driver of declining housing affordability. Infrastructure charges are the payments made by property developers for the various services that local and state governments provide to land sold for residential property. These charges vary considerably by jurisdiction and can include payment for access to types of economic and social infrastructure – such as roads, water, sewerage and community centres.

Section 3.4 notes that a role of user charges is to facilitate efficient allocation of goods and services by ensuring that the cost of providing them is passed to the user. In the case of infrastructure charges, this would encourage development in areas where it is most valued and at least cost. However, excessive infrastructure charges can act like a tax on development and reduce the supply of dwellings. There is mixed evidence about the significance of infrastructure charges. The Productivity Commission (2008a) showed local infrastructure charges at the aggregate level increasing at around one per cent per annum in real terms in NSW between 2000-06. The Housing Industry Association (in Productivity Commission (2008a)) showed local infrastructure charges in Sydney more than doubling in real terms to \$50,000 from the mid-1990s to 2007.

The GST was introduced on 1 July 2000 and is levied on new housing through input taxation. The Australian Treasury (Productivity Commission 2004) estimated that the introduction of the GST increased house prices by 5.5 per cent. Changes to stamp duty and land tax have been relatively small in comparison to the overall increase in house prices. As noted in several submissions, stamp duty can affect affordability by significantly increasing the up-front cost for purchasers who have small deposits. However, as noted in the *Architecture paper*, stamp duties are likely to push down house prices received by sellers, an effect that would be reversed if they were removed.

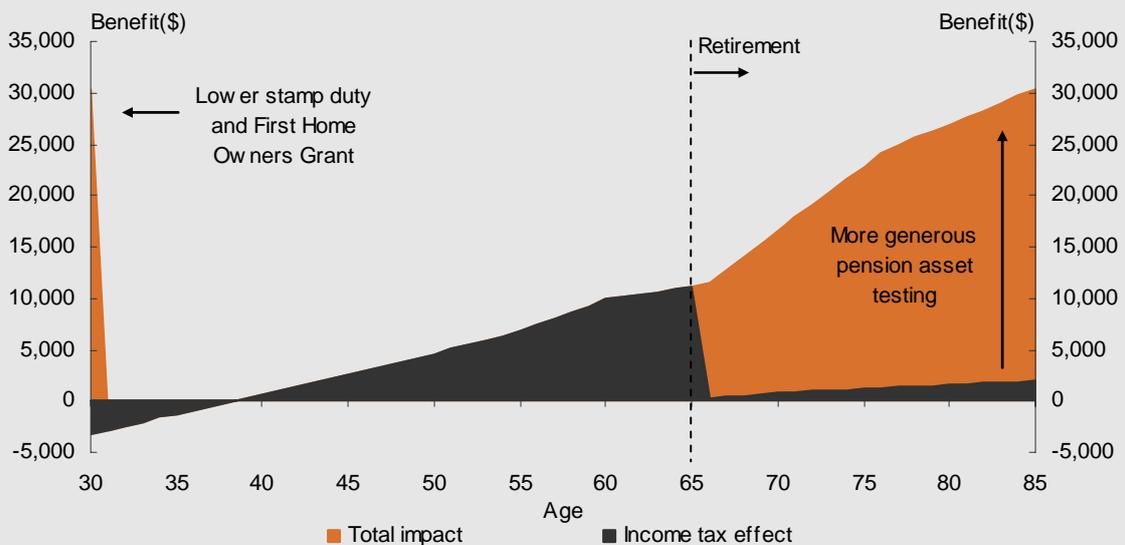
Ongoing tax and transfer impacts

The tax treatment of owner-occupied housing has a variable effect on affordability over a person's lifecycle (Box 10.2). For owners with low equity, cash costs of purchasing a house are higher than they would be under an investment-style tax as interest payments are not deductible for owner-occupied housing. However, as principal repayments are made and houses increase in value, the tax treatment of owner-occupied housing becomes more favourable. For retired people with low or no private income, excluding housing-related earnings from income tax may not provide a concession as they may not otherwise pay tax. However, Age Pension recipients who own their own house benefit from the preferential treatment that owner-occupied housing confers through the asset test for the pension. Owner-occupied housing also reduces financial risk in retirement as it provides insurance against movements in rental prices to which private renters are exposed.

Box 10.2: Treatment of owner-occupied housing over a lifecycle

Owner-occupied housing is treated differently to private rental housing for the calculation of income tax, stamp duty and land tax, and assets test of the Age Pension. Chart 10.4 illustrates the impact of the different treatment over a lifecycle, by comparing owner-occupied treatment to private rental property treatment for these taxes and transfers. A positive amount indicates owner-occupied housing receives a more favourable treatment (less tax and/or a larger transfer payment) at that point in the person's life.

Chart 10.4: Tax-transfer treatment of owner-occupied housing compared to investment housing over a lifecycle
Real annual benefit (or cost) by age of owner



Note: Assumes: a 30 year old purchases a new home with a price of \$380,000. The mortgage is 80 per cent of the home's value, with an interest rate of 8 per cent and a 30 year repayment period. Initial income is \$65,000, which increases at 4 per cent per year until retirement at age 65 years. The home's value is assumed to increase at 4 per cent per year in line with wage growth. Imputed rent is equal to 4.5 per cent of the value of the home. Schedules from NSW are used for the calculation of stamp duty and land tax. In retirement, the person's only assets are their home and their superannuation. Their superannuation is saved through compulsory 9 per cent contributions, with earnings of 7 per cent per year. All payments and schedules that are currently indexed to inflation, such as pension asset test thresholds, increase by 2.5 per cent. The Age Pension and income tax schedules increase in line with wage growth at 4 per cent. The house is not sold, so a capital gain event is not triggered. Were a sale to occur at age 85 years, for example, the additional benefit to the home owner of the CGT exemption would be around \$215,000 (in 2008 dollars).

Source: Australian Treasury estimates.

As noted by several submissions, housing subsidies have the potential to adversely affect affordability if they increase prices. If housing supply is not fully responsive, concessional treatment of both owner-occupied and private rental investment can lead to higher prices. Several Australian studies find the responsiveness of supply to housing prices to be relatively low (Berger-Thomson and Ellis 2004), which suggests that a generous tax treatment is likely to cause higher prices than would otherwise be the case.

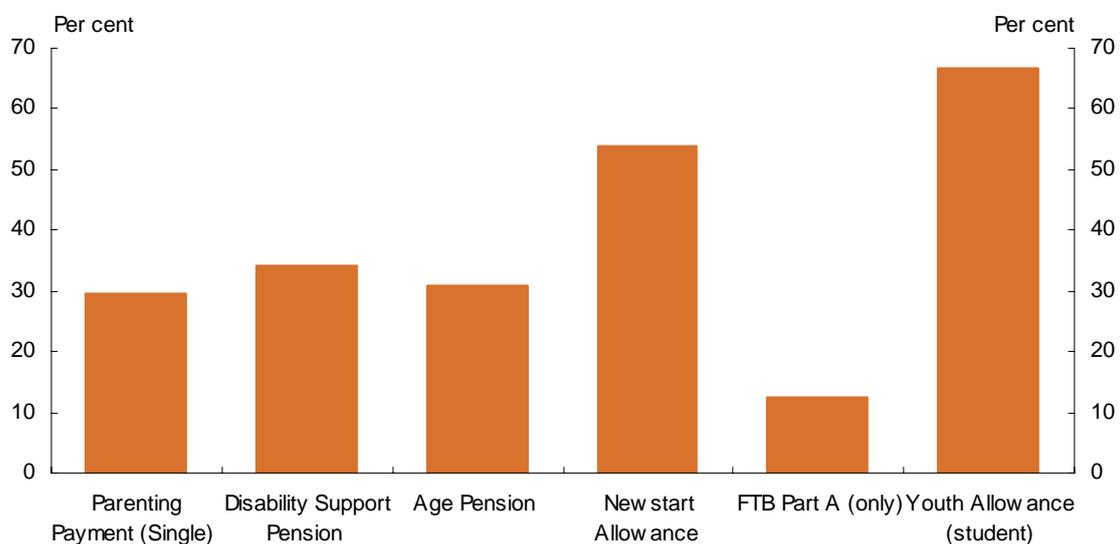
A number of submissions suggest that tax advantages for private rental investment lead to higher house prices. In the long-run, their potential effect on house prices depends on the extent of tax-advantaged investment relative to the total market. A significant and growing number of investors engage in 'negative gearing'. However, around half of investors are likely to receive limited tax advantage due to low levels of gearing and low personal tax rates. Further, the share of private investors in the overall property market (around 22 per cent) constrains their capacity to influence prices in the long term.

To the extent that any tax advantages to private investors are shared with their tenants through lower rents, this could improve housing affordability. The potential gain to a particular tenant would depend on the size of a landlord's tax advantage, which will be higher for landlords with higher incomes. Wood and Watson (2001) showed that higher income investors tend to own more expensive rental properties, and that the rental yield for the most valuable 10 per cent of properties was 5.9 per cent, compared to 9 per cent on the cheapest 10 per cent of properties. This suggests that the scope for sharing of any tax advantages to boost housing affordability is greatest for those who rent more expensive properties.

Similarly, the imposition of land tax on investors is likely to be shared with tenants through higher rents. If land tax were levied on all residential properties, it would tend to reduce the price level of housing. However, as owner-occupiers are exempt, their property valuations would be largely unaffected, which is likely to support the price level (though perhaps less so for housing types dominated by investors). If house prices are not affected, rents have to be higher than otherwise to maintain the after-tax return to investment. In this way, a majority of the impact of land tax on investors is likely to be borne by tenants.

The housing affordability outcomes for transfer recipients can differ significantly depending on how assistance is delivered. As public housing tenants' rental payments are determined in proportion to their income, less than one per cent have housing costs that exceed the 30 per cent of income affordability benchmark. For Rent Assistance recipients, around 36 per cent have rental payments that exceed 30 per cent of their income. Chart 10.5 shows that this varies considerably depending on which payment they receive.

Chart 10.5: Proportion of Rent Assistance recipients with rents exceeding 30 per cent of their income (June 2008)



Source: FaHCSIA estimates.

Several submissions note that the value of public housing and Rent Assistance transfers can vary significantly by time and location. Public housing tenants are insulated from the effect of house price movements. However, as their assistance is generally tied to a specific dwelling, they may be exposed to significantly higher costs if they need to move. In contrast, Rent Assistance is indexed to CPI, so housing affordability for recipients decreases when growth in rent outpaces general inflation. Over the past five years, rents have increased by

around 7.3 per cent per year, compared to CPI growth of 3.1 per cent per year. Further, the contribution of Rent Assistance to housing affordability outcomes is affected by the significant regional variation of rental costs. For example, the maximum Rent Assistance payment represents 24 per cent of the median rent in Adelaide but only 13 per cent of the median rent in Darwin.

Consultation question

Q10.2 What role, if any, should the tax-transfer system play in respect of housing affordability? Should the tax-transfer system be used to influence housing supply and/or demand to improve housing affordability? What changes, if any, should be made to housing-related transfers that assist disadvantaged households to find housing?

10.3 Impact of specific taxes and transfers on the efficient use of the housing stock and residential land

Several taxes and transfers affect the way people live or invest in housing. There may be scope to modify these taxes to encourage more effective use of the existing housing stock.

Summary of key messages from submissions

A number of submissions express a view that the exemptions from land tax, including for owner-occupied housing, result in an unfair distribution of the tax burden and make the tax base less efficient than it otherwise could be.

Many submissions highlight that stamp duty discourages people from relocating and argue that it is unfair and inefficient. Several submissions, estimating the efficiency costs of different state taxes identify stamp duty as one of the least efficient taxes and land tax among the most efficient. Many submissions propose abolishing stamp duty, with some proposing to replace it with a modified land tax.

Several submissions argue that some tax settings have adverse behavioural outcomes in the housing sector. A number of submissions suggest that land tax encourages high-value commercial development of land. One argues that the tax-free status of owner-occupied housing encourages habitual renovation.

Efficiency impact of different taxes and transfers

The *Architecture paper* notes that stamp duty, land tax and the concessional treatment of owner-occupied housing in means tests for income support can affect the use of the housing stock. Stamp duties may encourage people to live in one house when they would prefer to live in another, by discouraging transactions and relocation. Stamp duties may also lead to over investment in large dwellings, by encouraging people to renovate and discouraging downsizing.

The concessional treatment of owner-occupied housing in the assets test for income support can also create this type of 'lock-in' effect and encourage people to store their wealth in housing. The assets testing of owner-occupied housing effectively values a person's home at \$124,500, irrespective of its actual value. It encourages people to store wealth in their house to access income support. The assessability of capital withdrawn from the home through relocation to a lower value property (or by way of a reverse mortgage) also discourages downsizing.

Several features of the tax system can lead to a tax advantaged treatment of certain classes of investors. Most states levying land tax use progressive schedules, which discourage larger holdings of land. This may discourage participation in the market by institutional investors. In addition, as argued by several submissions, 'negative gearing' and the favourable treatment of capital gains are likely to lead to lower rental returns than would otherwise be the case. These tax advantages are not available to all investors, such as superannuation funds, which cannot borrow and companies which are not eligible for the CGT discount (see Box 6.8). Faced with lower rents, such investors may be discouraged from investing in the housing market.

In its final report, *Review of State Taxation*, IPART (2008) suggests that one long term reform option for property tax is to reduce reliance on stamp duty and increase the use of land tax. It notes that such reform would need to address the potential impact on different taxpayers, as land tax can adversely affect people who have high property values but low incomes.

Consultation question

Q10.3 Recognising the influence that some taxes and transfers have on the use of housing and residential land, what changes, if any, should be made to ensure the housing stock and residential land are used efficiently?

11 Taxes on specific goods and services

Overview

In addition to the broad-based GST, there is also a range of consumption or other indirect taxes levied on narrow bases, including excise collected by the Australian Government, and other taxes collected by the States. Products subject to these narrow-base taxes, are taxed relatively more heavily than other consumption goods.

The decision whether to tax some consumption goods more highly than others, and the optimal design of a particular tax, depends on the policy objective it is trying to achieve.

The current tax arrangements for beer, wine, spirits, tobacco and luxury cars reflect a range of competing policy goals. They exist in the context of other forms of regulation and the broader tax-transfer system.

Consultation questions

- Q11.1 Is it appropriate to use taxes on specific goods or services to influence individual consumption choices, and if so, what principles can be applied in designing the structure and rates of such taxes?
- Q11.2 Can the competing potential objectives of alcohol taxation, including revenue raising, health policy and industry assistance, be resolved? What does this mean for the decision to tax alcohol more than other commodities?
- Q11.3 What is the appropriate specific goal of taxing tobacco? Is it necessary to change the structure or rate of tobacco taxes?
- Q11.4 If health and other social costs represent the principal rationale for specific taxes on alcohol and tobacco, is any purpose served in retaining duty free concessions for passenger importation of these items?
- Q11.5 Are taxes on specific 'luxury' goods an effective way of making the tax system more progressive? If so, what principles should apply to the design and coverage of these taxes?
- Q11.6 Should the tax system have a role in influencing the relative prices of different types of cars, including luxury cars and higher polluting cars, and if so on what basis? What does this mean for taxes on the purchase price of motor vehicles?

In addition to the GST, there are other taxes that affect goods and services. The Australian government imposes additional taxes on beer, wine, spirits, tobacco, luxury cars, and motor vehicle fuel. State governments also impose taxes on particular services, including taxes related to motor vehicles (see Section 12.1), insurance services and gambling (see Section 9.2). Governments also levy smaller taxes and levies on other goods for notional cost recovery or resource allocation purposes – these are not discussed here.

As discussed in Section 3.3, there may be sound policy rationales for taxing some goods and services more heavily than others. The potential policy objectives for a specific consumption tax – such as efficient revenue raising, reflecting social costs, discouraging consumption, indirectly charging for government services, or meeting other objectives – affect the structure, design and size of the tax. For example, a tax designed to raise revenue efficiently would be set independently of any associated social costs. A tax imposed for cost-recovery purposes would be designed differently again.

This section examines some of the potential justifications for existing taxes on alcohol, tobacco and luxury cars.

11.1 Taxes on alcohol

Alcohol produced commercially for human consumption in Australia is subject to specific taxes through a number of different regimes. Beer and spirits are subject to excise at eight different rates. Wine is subject to the wine equalisation tax, which is based on the value of the wine. Rebates are available to small producers.

The result is that very different amounts of tax are payable on a standard drink depending on beverage type, alcohol concentration, container size, size of producer and the pre-tax price of the product.

Summary of key messages from submissions

Many submissions are concerned with the complexity of the existing tax structure. They argue that current arrangements reflect historical compromises between a range of policy objectives – raising revenue, protecting domestic industry and improving public health.

Many submissions note the existing structure of alcohol taxation contains many arbitrary elements and is unnecessarily complex. As examples, submissions state that beer supplied in containers larger than 48 litres is more lightly taxed than other beer; a 1.15 per cent excise-free threshold applies to beer, but not spirit-based beverages; some imported spirits are subject to a 5 per cent customs tariff; and wine is taxed on value, rather than alcohol content, with small producers paying no wine tax.

Industry submissions note that the tax structure has different effects on different industries. One submission from the wine industry supports the status quo, noting that because of the wine equalisation tax (WET) rebate, 96 per cent of wineries do not bear any WET impost – the submission argues that this is justified due to external economic benefits smaller wineries provide for regional development.

Other submissions argue that the tax system should be neutral between the beer, wine and spirits industries – some submissions argue that small wineries receive favourable treatment relative to microbreweries.

Some submissions, particularly from the health sector, suggest replacing separate tax treatment of beer, wine and spirits-based beverages with a tax based on alcohol content given the significant health problems associated with alcohol abuse, and that alcohol taxation is an effective way to reduce aggregate consumption.

Summary of key messages from submissions (continued)

Other submissions argue that alcohol taxation has only a limited role in addressing public health concerns. Some submissions stress that the harms from alcohol depend on the context in which alcohol is consumed, arguing that intervention programs targeted at specific groups or behaviours are a better way to address alcohol-related harm.

Under a system of 'volumetric taxation' proposed by some submissions, tax would be determined entirely by the volume of alcohol, regardless of what the product is made from, where it is consumed or how it is packaged. In addition, one public health advocate suggests a 'floor price' for alcohol sales. Some submissions further argue that high alcohol concentration is riskier than low-alcohol products, and therefore high alcohol products should be taxed disproportionately.

Modelling presented by some industry groups suggests that a revenue-neutral shift to volumetric taxation would decrease the price of spirits and increase the price of cheap wine. Some submissions oppose the introduction of volumetric taxation, on the basis that some beverages should be taxed differently, for different reasons, irrespective of alcohol content. Some submissions also argue that volumetric taxation would create opportunities for new products or risky drinking patterns that could not be addressed through the tax system.

Raising revenue efficiently

One rationale for imposing specific taxes on alcohol is that it is a relatively efficient way of raising revenue. This reflects one theory of taxation that those commodities that are less responsive to price should be taxed more heavily, because this minimises the distortion that taxes have on economic decisions (Ramsey 1927). Taxing alcohol – and also other consumption items such as 'necessities' for which consumption does not vary greatly with price – is relatively more efficient than taxing specific commodities that are highly responsive to price. An Australian estimate found that a 10 per cent increase in the price of alcohol would reduce consumption by around 6 per cent (Selvanathan and Selvanathan 2004).

Although this principle might be used to justify additional taxation of alcohol as a whole, it has not been followed for setting rates for specific alcohol products. Recent Australian estimates suggest that both beer and wine are less responsive to price than spirits.¹⁴ However, spirits are taxed more highly than beer and most wines.

Benefits and costs of alcohol consumption to the consumer

Around five in six Australian adults drink alcohol. Australian survey data shows an association between daily consumption of small amounts of alcohol and high reported levels of wellbeing (Cummins 2008).

¹⁴ The own-price elasticity of beer has been estimated at -0.3 per cent, wine at -0.4 per cent and spirits at -1.3 per cent (Selvanathan and Selvanathan 2004).

On the other hand, submissions from the health sector stress alcohol use, particularly binge drinking or sustained heavy drinking, can harm the consumer. This can be both in an immediate sense (including road traffic accidents and other injuries) and over the long term (including cancer, cirrhosis of the liver and other diseases).

Survey results indicate that 35 per cent of people drink at levels that place them at risk of short-term harm and 10 per cent of people drink at levels putting them at risk in the long term (Australian Institute of Health and Welfare 2008). These patterns of drinking led to an estimated 3,100 deaths and 72,000 hospitalisations per year from 1992-2001 (Chikritzhs et al 2003).

Submissions argue that taxing alcohol is an effective way of reducing harm from alcohol use. Tax is not the only way to do this. Other policies with the same aim include regulating the physical availability of alcohol (for example, through licensing restrictions), restricting advertising, providing information (for example, through labeling requirements and education), and policing (including random breath testing).

A threshold question underpinning taxation of potentially harmful activities is whether it is appropriate to use tax policy to minimise the costs that individuals impose only on themselves. For example, many individuals undertake other activities or use products that pose a risk to themselves. Sometimes these activities are regulated or even prohibited, but in most cases tax is not used. Moreover, where tax is effective in reducing demand for one product, an individual's alternative consumption choices may also have some risks.

Social costs of alcohol use

Alcohol use can impose costs on people other than the consumer. It sometimes harms others through road accidents, the cost to the health system and the cost of crime. Collins and Lapsley (2008) estimate these costs to be around \$2.2 billion, \$2.0 billion and \$1.4 billion, respectively.

Where the social cost per unit of alcohol can be reasonably estimated, tax might be used as an instrument to incorporate the costs imposed on others into the price of alcohol, and therefore to reduce consumption to a socially optimal level (see Box 11.1).

However, some submissions argue that alcohol taxes may not be an effective way to target social costs. A tax on the production or importation of alcohol does not discriminate between consumption that does and does not impose costs on others. The impact of tax-induced price changes also varies from individual to individual. An individual's consumption patterns are influenced by many factors other than price, including age, sex, income, alcohol availability, cultural setting, marketing, and the potential for alcohol dependence.

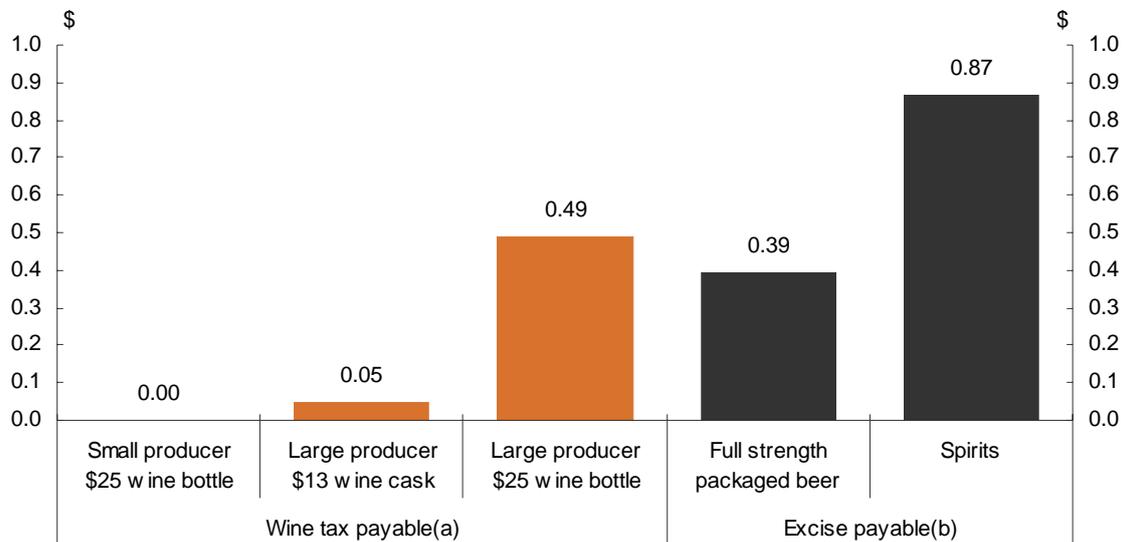
This means that while alcohol taxation does reduce the aggregate consumption of alcohol, and therefore some of the costs of alcohol abuse, it also reduces satisfaction of individuals whose consumption does not harm others.

Uniform taxation of alcohol

Many submissions suggest that a consistent tax applied to all alcohol, whether consumed in beer, wine or spirits based beverages, would be more coherent than the present

arrangements. Some submissions point out that under the current regime, the amount of tax (either excise or wine equalisation tax) payable per unit of alcohol varies significantly (see Chart 11.1).

Chart 11.1: Tax per standard drink (2008-09)



(a) Assumes 12.5 per cent alc/vol. wine, 750ml wine bottle. The wine equalisation tax (WET) payable is calculated using the half retail price method, with WET liability fully offset by producer rebate for small producers, and no effect of WET producer rebate for the large producer.

(b) Includes 1.15 per cent alc/vol concession for 5.0 per cent alc/vol beer. A standard drink is equal to 12.67ml or 10 grams of pure alcohol.

Source: Australian Treasury estimates.

Many submissions support the taxation of all alcoholic beverages, based on the volume of alcohol in the beverage. The major argument from a health perspective is that the ingredient responsible for alcohol-related harm (whether to self or others) is alcohol, and therefore it is this ingredient that should be taxed, regardless of how it is delivered. Some submissions argue an ideal alcohol tax should tax low-alcohol beverages disproportionately less than stronger products, on the basis that drinking low-alcohol products entails less risk.

As submissions note, adopting a volumetric approach to all alcohol would affect the relative prices of different beverages, particularly wine, which is currently taxed based on value. A volumetric tax on wine, for example, would increase the price of cheap wine relative to expensive wine.

From an efficiency perspective, applying the same rate of tax to different types of alcoholic beverages may make the tax system more neutral in influencing consumer preferences and industrial production.

Box 11.1: Taxing to control social costs

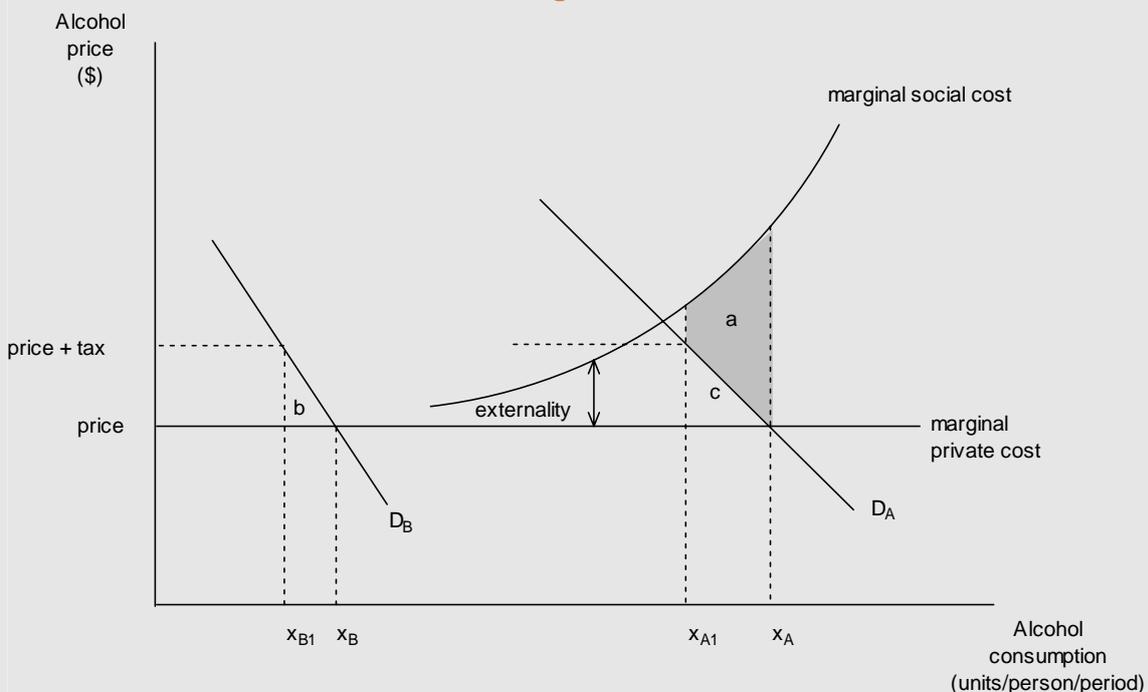
It is sometimes possible to improve overall welfare by taxing the consumption of particular commodities that cause social harm. The purpose of imposing such a tax is to ensure the price paid by a consumer reflects the cost consumption imposes on others. Individuals then face incentives (through higher prices) to reduce consumption to a socially optimal level.

However, the social cost of consuming an extra unit of alcohol varies from consumer to consumer. A person who consumes two light beers instead of one may not impose costs on others. An inebriated person in a risky environment who consumes an additional drink may impose significant additional social costs. Taxes on alcohol production do not discriminate between cases where the marginal social cost is high and cases where it is low.

These differences are illustrated in Chart 11.2, in which curve D_A reflects the demand for alcohol from a high-risk drinker (who imposes increasing costs on others per unit of drink), while curve D_B reflects the demand from a low-risk drinker, where the social costs are minimal. Imposing a tax on alcohol reduces the demand in both markets (from x_A to x_{A1} , and from x_B to x_{B1}).

Although this would reduce the satisfaction of high-risk drinkers (area c), this may be less than the reduction in harm caused to others (area a + c), in which case society as a whole benefits from the reduction in high-risk consumption. However, the tax would also reduce the satisfaction of those whose consumption is low-risk (area b), reducing the benefit from the tax.

Chart 11.2: Taxing to control social costs

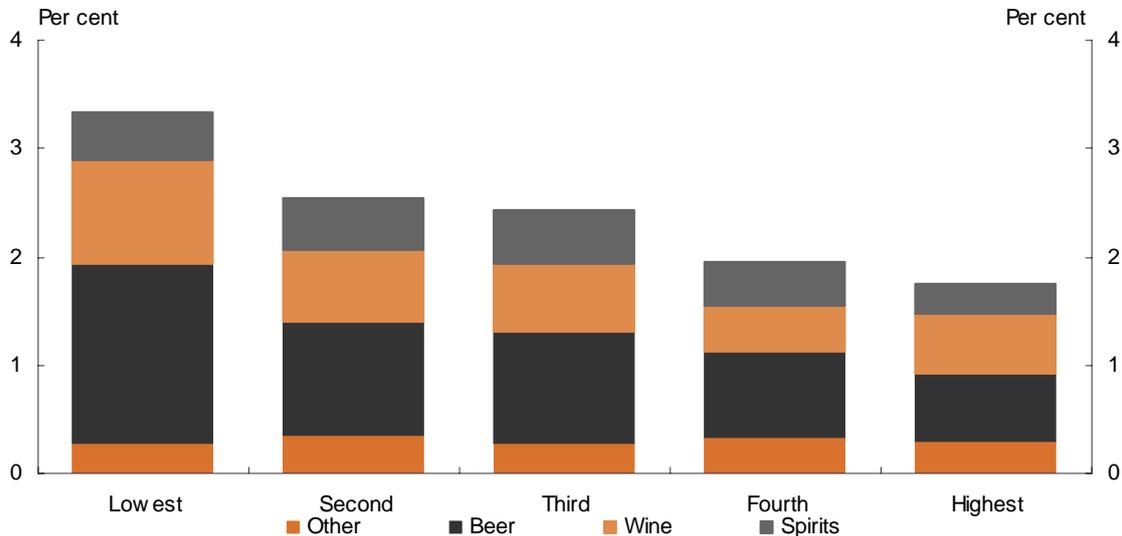


Note: Adapted from Pogue and Sgontz (1989).

Distributional issues

Different income groups have different tastes in alcohol and different levels of spending on alcohol in general (see Chart 11.3). Any change to the taxation of alcohol will therefore have distributional consequences, although consumer choices are likely to change over time.

Chart 11.3: Spending on alcohol as a percentage of gross household income
By gross income quintile (2003-04)



Source: ABS (2006a).

Consultation questions

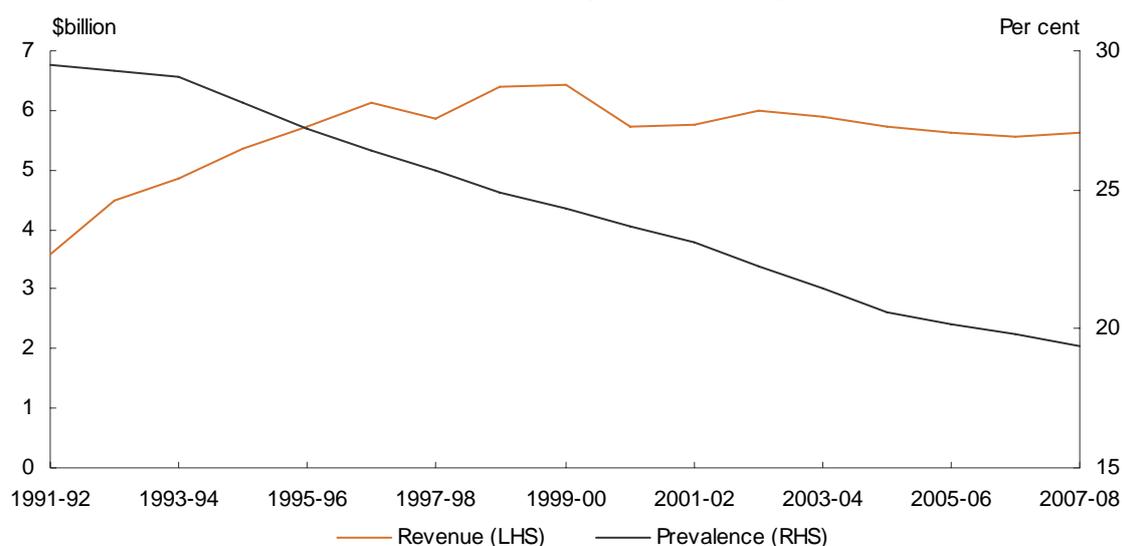
- Q11.1 Is it appropriate to use taxes on specific goods or services to influence individual consumption choices, and if so, what principles can be applied in designing the structure and rates of such taxes?
- Q11.2 Can the competing potential objectives of alcohol taxation, including revenue raising, health policy and industry assistance, be resolved? What does this mean for the decision to tax alcohol more than other commodities?

11.2 Taxes on tobacco

Cigarettes and cigars with up to 0.8 grams of tobacco per stick are taxed on a per stick basis. Rates are indexed twice a year in line with the consumer price index. The per stick excise is \$0.2545 or \$6.36 on a pack of 25 cigarettes. All other tobacco products, such as snuff and rolling tobacco, are subject to an equivalent excise rate of \$318.14 per kilogram. There are relatively few concessions or exemptions from tobacco excise. Inbound passengers to Australia enjoy access to limited quantities of duty-free tobacco and excise-free tobacco is available on certain Australian military sea vessels in Australian waters.

Smoking rates have been declining in Australia for many years. Revenue raised from tobacco excise has been flat in real terms over the part 10 years. Chart 11.4 compares smoking rates in Australia over the past 17 years with real revenue from tobacco excise.

Chart 11.4: Smoking prevalence and tobacco excise revenue
1991-92 to 2007-08 (2007-08 dollars)



Source: ABS (2008h); AIHW (2008); Australian Government (2008a).

In 2007, 19 per cent of adult Australians were smokers, of whom 86 per cent were regular daily smokers. Fifty-five per cent of adults had never smoked regularly, and the remaining 25 per cent were ex-smokers. More males than females smoked (21 per cent compared to 18 per cent). Smoking rates are also higher among people aged between 20 and 49 (Australian Institute of Health and Welfare 2008). Indigenous Australians also have higher smoking rates, with 50 per cent of adults identified as daily smokers in 2004-05 (ABS 2006c).

Summary of key messages from submissions

The health sector supports increasing taxes on tobacco (by roughly one third – around \$0.075 per stick) as an important means of reducing tobacco use and its associated health impacts. Some submissions also advocate the abolition of duty-free tobacco.

The tobacco industry argues the current regime of tobacco taxation provides certainty for industry, consumers and government, while helping to control tobacco use and providing government with a significant and stable revenue stream.

Both the health sector and the industry acknowledge higher taxes on tobacco would increase incentives for illicit trade in untaxed tobacco, by way of smuggled cigarettes and tobacco leaf, or 'counterfeit' cigarettes purporting to be legally produced and taxed. The health sector believes tighter regulation and enforcement would be necessary to control the illicit trade. The industry believes the risk of more illicit trade is an argument against increasing tobacco taxes.

Users of smokeless tobacco, snuff and related products, argue these products have less severe health impacts than smoking and should therefore be taxed at a lower rate.

Responsiveness of consumption to price

Compared with many other consumer goods, tobacco consumption is relatively unresponsive to price. Most estimates suggest that a 1 per cent increase in the price of cigarettes will reduce total consumption by 0.4 per cent. This suggests that taxing tobacco, like alcohol, provides a relatively efficient source of revenue.

This also implies that the scope to control consumption with tax is limited. However, the impact of tobacco taxes on different groups may vary, as some subgroups in the smoking population are more responsive to price than others. Data from the United Kingdom suggest women are more responsive to price than men, people in lower socioeconomic groups are more responsive than people in higher groups, and young people are more responsive than adults (Chaloupka 1999). Moreover, those who are already dependent on tobacco may respond differently to price changes than occasional or potential smokers.

Studies using individual level data suggest the prevalence of smoking is less responsive to price than overall consumption – a 1 per cent increase in the price of cigarettes will decrease the proportion of the population that smokes by around 0.25 per cent.

Health impacts on the smoker

The Australian Institute of Health and Welfare estimates that in 2003 tobacco smoking was responsible for about 8 per cent of the total burden of disease and injury for all Australians (Begg et al 2007). In particular, smoking is a leading cause of lung cancer and respiratory diseases such as emphysema and chronic bronchitis.

Costs imposed on others

Smoking can impose very heavy costs on the smoker but can also impose costs on non-smokers. For example, passive smoking can affect the health of non-smokers, and babies born to mothers who smoke are likely to experience worse than average health and developmental outcomes. These effects impose costs on the affected individuals and on the wider community through the health and education systems.

Some of the costs of ill health caused by smoking are borne by taxpayers through the public health system. However, the net impact of smoking on direct health and transfer costs is unclear. The direct costs of smoking-related disease may be offset by reductions in pensions and health expenditures due to reduced longevity. Collins and Lapsley (2008) estimate the net health-care cost from tobacco to be around \$320 million.

Dependence

Unlike most other legal commodities consumed in Australia, tobacco causes dependence in a large proportion of users. Some argue consumers take into account the chances and likely costs of dependency before beginning to consume an addictive substance. In some cases, such a consumer may still maximise their lifetime satisfaction, even allowing for the negative effects of dependence.

However, there is considerable evidence that consumers systematically misjudge the costs of smoking. In particular, young people tend to overestimate the risk of catastrophic health outcomes from smoking but markedly underestimate the risk of becoming dependent.

To the extent tobacco causes dependence, it means existing smokers are likely to be relatively unresponsive to price, and any increases in tax will increase the tax burden on them, with little change in behaviour. On the other hand, it is sometimes argued that an additional price signal through tax is necessary to deter potential consumers who are uninformed or unaware of the risk of dependence. That said the manufacture and sale of tobacco products is tightly regulated. Many of the information problems are targeted directly through public education campaigns and restrictions on tobacco advertising.

Consultation question

- Q11.3 What is the appropriate specific goal of taxing tobacco? Is it necessary to change the structure or rate of tobacco taxes?
- Q11.4 If health and other social costs represent the principal rationale for specific taxes on alcohol and tobacco, is any purpose served in retaining duty free concessions for passenger importation of these items?

11.3 Luxury car tax

Arising from the Parliamentary debate on amendments to the luxury car tax (LCT), the Treasurer has asked the Review Panel to consider phasing out the LCT and phasing in a tax on vehicle fuel inefficiency and consequent greenhouse gas emissions. The Treasurer has also asked the Panel to examine the fringe benefits tax arrangements for motor vehicles. This section considers the current LCT. Section 13.2 considers the environmental impact of fringe benefits tax (FBT).

LCT applies at a rate of 33 per cent on the GST-exclusive value of domestic or imported cars in excess of the threshold (currently \$57,180). LCT is estimated to have applied to roughly 10 per cent of new vehicles in 2007.

Amendments to LCT, which received Royal Assent on 3 October 2008, introduced a higher threshold of \$75,000 for cars meeting minimum fuel efficiency standards. Refunds are paid for certain four-wheel drive and all-wheel drive vehicles purchased by primary producers and some types of tourist operators.

Summary of key messages from submissions

Motor industry submissions generally call for the abolition of the LCT or argue that the LCT threshold should be increased to \$70,000 or more. Other industry submissions claim the increase in the LCT announced in the 2008-09 Budget will reduce sales of luxury cars and, therefore, LCT revenue.

Many submissions link the LCT with environmental concerns, arguing either that the tax has no real environmental benefits or it should be replaced with a tax on cars reflecting fuel efficiency.

Summary of key messages from submissions (continued)

Some submissions argue that the LCT should not be imposed on vehicles used for business purposes, such as stretch limousines or four-wheel drives used in the tourism industry. Other submissions argue detailed exemptions and amendments to the LCT make the law overly-complicated, thereby increasing compliance costs and expanding the scope for tax-avoidance.

Other submissions note the relatively narrow base of the LCT and, in particular, that no special tax is imposed on other luxury goods. Some see this as an argument for abolishing the LCT, others as an argument for extending the LCT to other luxuries.

Taxing luxuries

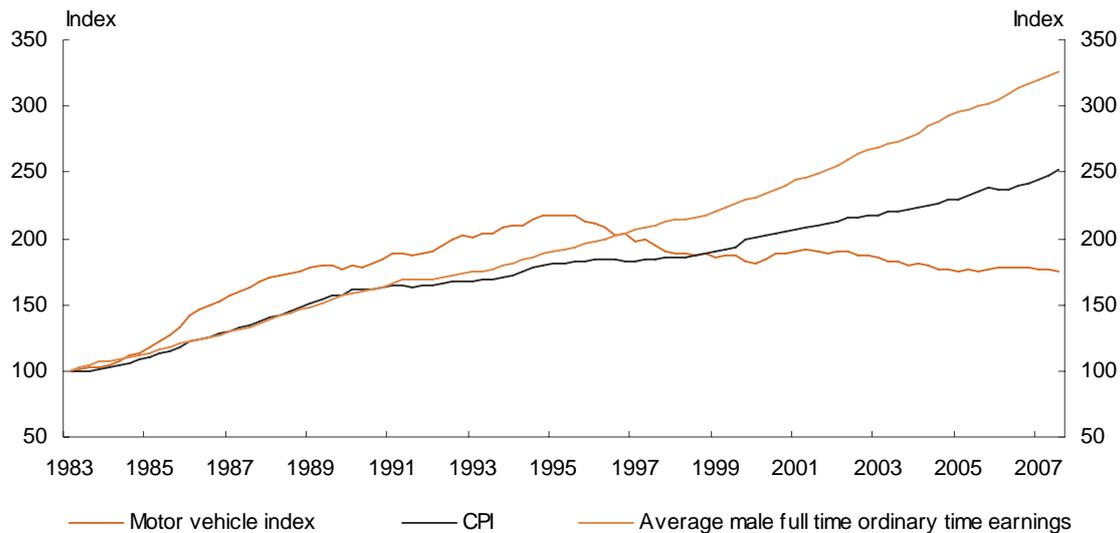
The LCT was originally imposed to ensure the price of luxury cars did not fall by relatively more than the price of non-luxury cars when the GST replaced the wholesale sales tax in 2000. However, the prices for other highly-taxed goods, such as furs and jewellery, were allowed to fall. One argument for the recent increase in LCT is it makes the tax system more progressive, on the basis that those individuals who can afford to buy a car subject to LCT have a greater capacity to pay tax than others.

While some goods are used more by high income households than lower income households, consumption patterns vary considerably within income and wealth ranges. Imposing a heavy tax on a specific luxury good tends to tax the rich more heavily than the poor, but will also penalise consumers of moderate means who happen to have strong preferences for the good in question. Taxing a single luxury good or a subset of such goods discriminates against people who have a taste for the taxed goods in favour of those who prefer other luxuries. In other cases, consumers who would have demanded goods taxed at the higher rate can escape the tax by choosing to consume another product.

For these reasons, redistribution through the tax-transfer system is usually based on an individual's annual income, rather than their consumption patterns. However, some people may have a substantial capacity to pay tax despite having a low taxable income. Taxes on luxury goods may help to ensure such people contribute in line with their capacity to pay and thus increase equity in the tax system.

As the purchasing power of Australians increases, cars priced above the LCT threshold may become accessible to more consumers. Currently, thresholds for the LCT are indexed to the motor vehicle purchase sub-group of the Consumer Price Index. Historically, this has changed at different rates to both wages and other consumer goods (see Chart 11.5).

Chart 11.5: Motor vehicle component of consumer price index
Index (December 1983 = 100)



Source: ABS (2008f) and ABS (2008d).

Industry effects

The European Commission's submission to the 2008 Review of the Australian Automotive Industry claimed the LCT acts as a non-tariff barrier to trade, arguing it falls mainly on imported vehicles. While many of the imported cars that are priced above the LCT threshold are European models, the origin of the vehicle is not a consideration in whether the tax applies, and there are also a number of Australian-manufactured models affected by the tax.

The LCT is unlikely to affect world production of cars, but it may influence the production decisions of Australian car manufacturers, encouraging production of vehicles that fall below the LCT threshold.

Fuel efficiency

The introduction of fuel-efficient vehicle standards to LCT does not aim to redistribute income or wealth, but to encourage consumers to choose more fuel-efficient high price cars, rather than less fuel-efficient high price cars.

As Section 12 notes, the Australian Government currently imposes tax on fuel use, and is also introducing the Carbon Pollution Reduction Scheme as a means of reducing Australia's greenhouse gas emissions. Across the life of a car, this increases the running costs of less fuel-efficient cars relative to more fuel-efficient cars. While many car purchasers take this into account, there is an argument some consumers do not consider long-term costs when making their purchasing decisions. This raises the general question as to whether less fuel-efficient vehicles in all price ranges should be subject to a special additional tax.

The design of any potential tax related to fuel-efficiency depends on the goal the tax is trying to achieve. For example, a tax designed from a greenhouse perspective would need to take into account the Carbon Pollution Reduction Scheme and might be based on carbon emissions directly rather than fuel consumption, as this approach avoids the complications caused by different fuel types. Alternatively, if the purpose of a fuel-efficiency based tax is to

conserve a non-renewable resource, then the use of non-renewable fuels in other applications would also need to be considered. Moreover, a tax on less fuel-efficient cars would not discriminate between different types of fuel.

One possible approach to encourage the purchase of more fuel-efficient vehicles is to implement a sliding-scale surcharge or rebate. Potential options are considered in the September 2008 public discussion paper of the Australian Transport Council and the Environment Protection and Heritage Council Vehicle Fuel Efficiency Working Group.

Consultation questions

- Q11.5 Are taxes on specific 'luxury' goods an effective way of making the tax system more progressive? If so, what principles should apply to the design and coverage of these taxes?
- Q11.6 Should the tax system have a role in influencing the relative prices of different types of cars, including luxury cars and higher polluting cars, and if so, on what basis? What does this mean for taxes on the purchase price of motor vehicles?

11.4 Other issues

Some submissions suggest that the taxation of products for health reasons be extended, notably to introduce higher rates of taxation on energy-dense, nutrient poor foods that contribute to obesity.

Tariffs

Submissions that address import tariffs are concerned with their effect on specific products (for example, motor vehicles and alcohol) rather than the general tariff as a revenue source. Of those that address the general tariff, one submission suggests that its existence provides leverage in international trade negotiations. Another considers that products should be made in Australia for the domestic market, even if cheaper imports are available.

Australian governments over the last 35 years have tended to reduce import tariff levels. The general tariff rate is currently 5 per cent of the value of the imported good. However, higher rates apply for passenger motor vehicles (and parts) and the textile, clothing and footwear industry. Further, goods may be imported at rates lower than their scheduled rate due to the application of tariff concession orders or through free trade agreements. Apart from the tariff, most imports are subject only to the same taxes, for example, the GST and excise-equivalent customs duties, that apply to domestically produced goods and services.

Tariffs assist some local firms by providing some protection from import competition. In effect, they enable local producers to increase the prices at which they can sell their goods on the Australian market and/or to increase the volume of their sales. Tariffs also impose costs on firms which use imported products that are subject to tariffs or use domestic products that are produced at a higher cost because of the tariff.

The Productivity Commission (2008b) estimated that tariffs on imports provided \$9.1 billion of assistance to Australian industry in 2006-07 but also cost Australian industry around

\$7.7 billion in higher input prices, leaving net assistance of \$1.4 billion. This net assistance comes at a cost to consumers who pay higher prices than in the absence of tariffs.

While the Review considers specific industry policies to be outside its terms of reference, it will need to consider the future revenue and other roles of general tariffs.

12 Fuel, roads and transport

Overview

The efficient movement of people and goods is an important contributor to productivity and wellbeing. Improving the structure of taxes and charges related to transport can improve efficiency.

Taxes on motor vehicle fuels provide a considerable share of revenue, but contribute little to reducing the location and time specific costs of motoring. Different tax treatments of alternative fuels may also further reduce the efficiency of fuel taxes. Different types of transport are also taxed in different ways, potentially altering economic behaviour.

There may be opportunities to replace existing taxes with more targeted taxes and charges that promote the efficient use of transport networks. In particular, emerging technologies may have a role in targeting the social costs of motoring such as air pollution, greenhouse gas emissions and damage to publicly funded roads.

Consultation questions

- Q12.1 How can motor vehicle related taxes and road funding arrangements be designed to improve the efficiency of transport of people and goods in Australia?
- Q12.2 What should be the role, if any, of fuel taxes? What does this mean for how fuels and their uses are taxed and the rates of tax applied?
- Q12.3 Do the existing tax arrangements lead people to make economically inefficient transport choices, and if so, how might they be improved?

12.1 Efficiency of motor vehicle-related taxes

Fuel tax is a major source of Australian government revenue. Liquid fuels are used widely by both households and businesses.

Under current arrangements, on-road fuel use in heavy vehicles and certain off-road uses of fuel are eligible for fuel tax credits. This reflects the principle that direct inputs to production should not be subject to general revenue-raising taxes, although not all fuel used in business is eligible for credits.

Although fuel tax is by far the largest tax on motoring, other taxes also affect the movement of people and goods in the economy.

Australian government taxes relating to motor vehicles include fringe benefits tax (Section 13.2), luxury car tax (Section 11.3) and tariffs. In addition, the States levy a range of taxes related to motor vehicles, including fees for registration, transfers and drivers' licences. As with Australian government taxes on motor vehicles, the primary impact of these taxes is

to increase the cost of owning a motor vehicle, with little impact on driving behaviour. Some States also charge parking levies in city areas. As well as raising revenue, these levies may make driving to the city and parking more expensive than public transport. State taxes and levies also recover some of the cost to state governments of some public infrastructure projects and externalities.

Summary of key messages from submissions

Many submissions note that motor vehicle taxes, particularly fuel tax, are a significant part of household consumption expenditure, and the purchase and use of motor vehicles is taxed disproportionately to other forms of consumption.

Submissions say the use of motor vehicles imposes costs on society, through greenhouse gas emissions, air pollution, noise pollution, urban congestion and road trauma. Some submissions identify fuel tax as a way of addressing these problems, though many see the proposed Carbon Pollution Reduction Scheme as a better instrument to address greenhouse gas emissions.

Some submissions support extending road user charging to light vehicles. They suggest the use of targeted taxes as a method of 'demand management' for transport. Other submissions consider that in many cases fuel tax is a good proxy for taxing the social costs associated with driving.

Other submissions propose replacing registration, insurance and fuel taxes with charges that reflect road usage. This would be based on vehicle mass, distance travelled and location of vehicle use and could involve converting fixed charges to charges that depend on the marginal cost of driving, or to distance-based fees. One suggestion is to apply charges to driving in inner-city areas at certain times of day.

Some submissions argue that stamp duty on the transfer of motor vehicles, and import tariffs on cars, are obstacles to upgrading to more fuel-efficient vehicles. Others suggest the design of taxes on the purchase of motor vehicles promotes fuel-efficiency.

Many submissions also raise the fringe benefits tax treatment of motor vehicles as a major contributor to the over-use of motor vehicles.

A few submissions propose that revenue raised from pricing on specific roads should be returned to the road network according to the road from which it is collected. Arguably, this would provide a method of allocating resources for the supply of road infrastructure. According to local government submissions, this may be an effective way to fund local roads, the majority of which are owned and maintained by local government.

Submissions also argue that the provision of fuel tax credits is an inappropriate subsidy for on-road use in heavy vehicles and off-road uses. Some submissions suggest the current tax system favours the use of cars over public transport.

Taxing transport

Transport services are generally not demanded for their own sake. The demand for transport is usually derived from the demand for other goods and services. Without efficient transport networks, the exchange of goods and services that underpins a modern economy could not take place.

Taxes related to transport, specifically the use of motor vehicles, have historically been designed to raise revenue, whether for general budget purposes or for the provision of transport infrastructure. Fuel tax, for example, is an administratively simple and relatively efficient way of raising revenue.

However, there may be opportunities to use taxes and charges to make transport networks more efficient. The Review Panel has commissioned research on the potential to replace the existing system of transport related taxes and charges with more efficient and targeted pricing systems as a way of reducing the social costs of motor vehicle use (see Chart 12.1). This is possible, in part, because of new technology.

Chart 12.1: Targeting the social costs of motor vehicle use

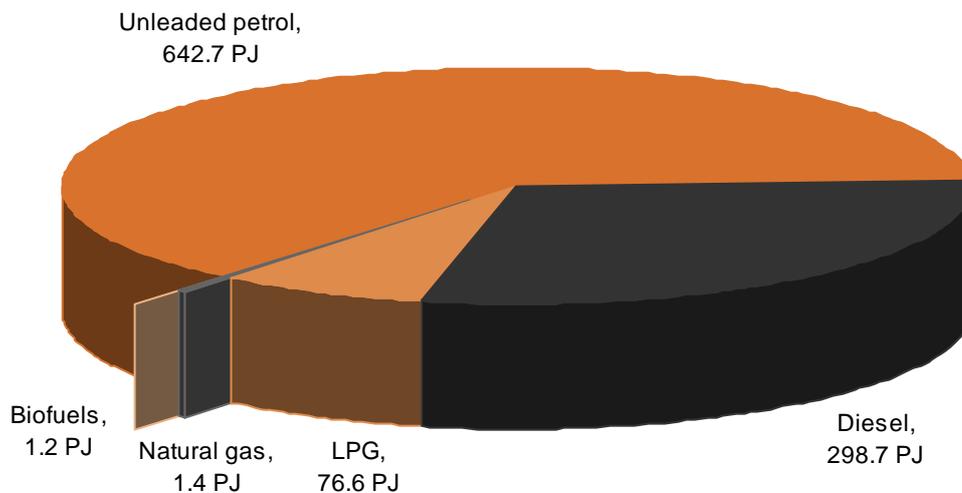
Current arrangements		Introduction of CPRS ^(a)		System based on targeted taxes and charges	
Target	Instrument	Target	Instrument	Target	Instrument
General revenue raising	Fuel taxes, state taxes on motor vehicles	Climate change	CPRS	Climate change	CPRS
		General revenue raising	Fuel taxes, state taxes on motor vehicles	Congestion	Location & time based charges
				Road usage	Mass, location and distance based charges
				Other social costs	Specific taxes, charges or regulations
Efficient revenue raising	Fuel tax, annual registration				

(a) CPRS refers to the Australian Government's Carbon Pollution Reduction Scheme.

General revenue raising

As Chart 12.2 shows, liquid fuels provide almost all energy used in Australian road transport. Given the absence of practical alternatives, due to limitations in current technology and distribution systems, the demand for transport fuels is relatively unresponsive to price. This is one reason why fuel taxes can be applied with a relatively small efficiency cost. Moreover, transport fuels are produced and imported by only a few producers, so output is easily monitored. This makes the administration of fuel tax relatively simple.

Chart 12.2 Energy use in Australian road transport by fuel type
In petajoules (2005-06)



Source: ABARE (2008).

However, in the long-term, behaviour changes in response to increases in fuel prices. This is because options to reduce fuel consumption increase with time, including switching modes of transport, substituting technology for travel (for example, videoconferencing and internet banking) or choosing more fuel-efficient vehicles.

To the extent that future technologies might make liquid fuels a less important energy source for transport (for example, if electricity becomes a more viable alternative), fuel tax is likely to become a less efficient way of raising revenue. This is because motorists would have an increased opportunity to avoid the tax by switching to untaxed energy sources.

Funding the cost of infrastructure

Funding roads from general tax revenue can be justified based on the 'public good' characteristics of roads. Because the cost of a motorist using a road is usually quite low, allowing free access to the road network encourages efficient short-run utilisation of the infrastructure.

In Australia, most capital expenditure on road infrastructure is funded out of general tax revenue, although in the past the Australian government has hypothecated fuel taxes to provide the States with grants for road construction and maintenance. Some submissions support this approach of using motor vehicle taxes to fund transport infrastructure, although there is no necessary link between the amount of tax collected and the required funding at a particular time.

For major projects such as bridges or highways, governments have used road tolls to finance the capital cost of the roads. However, while road tolls may lead to a better allocation of road resources — because the roads that are built are expected to cover their costs — recovering the capital cost in this way can reduce the efficiency of the network. Some potential road users, who would use it without imposing costs on others, may be deterred by the toll. This is particularly the case if tolls do not vary according to the time of day or vehicle type. As a result, there is a trade-off between using taxes to fund the long-term capital costs of infrastructure and the most efficient use of existing assets.

Heavy vehicles

Heavy road vehicles (with a gross vehicle mass exceeding 4.5 tonnes) are eligible for a partial fuel tax credit. This effectively reduces fuel tax to a road user charge intended to recover the costs of heavy vehicle damage to the transport network.

The National Transport Commission is involved in calculating the road user charge and recommends annual registration charges based on the configuration and weight of trucks, prime movers and buses.

The methodology for calculating the road user charge reflects historical average network-wide costs attributable to heavy vehicles. However, recovering costs in this way does not reflect the actual costs imposed by an individual truck on a particular route. This limits the extent to which existing road-user charging provides incentives for the efficient use of the road network. The Council of Australian Governments has committed to undertake feasibility studies into mass-distance-location charging for heavy vehicles in 2011.

Taxing to address social costs

Many submissions see motor vehicle taxes as a way of charging for the social costs of motor vehicle use. These costs include air pollution (including greenhouse gas emissions), damage to public roads, urban congestion, noise, and public health costs related to road accidents. The costs are significant. According to the Bureau of Transport and Regional Economics (2007), the avoidable cost of road congestion alone was approximately \$9.4 billion in 2005.

Fuel tax may be an indirect way to address some of these costs, by reducing overall demand for transport. However, the relatively unresponsive nature of fuel demand to the final price, and the inability to target particular locations and times through fuel tax, makes it ineffective in managing demand for transport. Further, it does not influence the behaviour of drivers in ways that prevent crashes, reduce congestion or lower noise. High fuel taxes also discourage motoring that imposes little or no social cost – for example, light vehicle use in rural areas.

Many of the social costs of motoring are addressed through non-tax policy tools. For example, fuel standards aim to minimise dangerous air pollution and compulsory insurance schemes give coverage for many of the personal injury costs of road accidents. Vehicle design standards also reduce pollution and noise from vehicles and set minimum safety standards.

Social and technological change means other mechanisms are emerging to address externalities associated with fuel. For example, the Carbon Pollution Reduction Scheme will apply to transport fuels and will directly target the cost of carbon emissions from motor vehicles.

Impact of technology on transport taxes and charges

Some major international cities have now adopted road pricing schemes that more accurately reflect the social cost of road travel.

For example, London, Stockholm and Singapore charge motorists a fee to enter the city centre during peak times (see Box 12.1). In New Zealand, global positioning system technology tracks the distance travelled by heavy vehicles for the purpose of direct road-user charging. However, the feasibility of applying specific technology also depends on the transport issues faced by particular cities.

In Australia, the NSW Government recently announced the introduction of time-of-day tolling on the Sydney Harbour Bridge and the Sydney Harbour Tunnel, after full electronic tolling comes into effect. This will see existing tolls of \$3 fall by 50 cents for off-peak times, and rise by \$1 during peak times.

Box 12.1 Congestion charging

Congestion charging in London, Stockholm and Singapore has reduced traffic, increased average speeds and decreased congestion in affected areas. Estimates suggest that the schemes in London and Stockholm have reduced traffic volumes entering the city centre by around 20 per cent, reduced traffic delays by between 30 and 50 per cent, and significantly shortened travel times.

Tolling specific roads at peak times is used as an instrument for managing demand for congested roads in Singapore and areas of the United States.

Source: Booz Allen Hamilton (2006).

Economic geography

Many taxes and charges relating to transport have geographic distribution and efficiency impacts. To the extent that many of the social costs of motoring are location-specific (for example, noise and air pollution), these costs may be reflected in lower land prices in affected areas.

Urban road congestion affects the desirability of living in certain parts of a city, relative to others with alternative transport options (for example, walking, cycling or public transport). Selective tolling increases the monetary cost to commuters of driving to work from certain areas, although this may be balanced by shorter commuting times.

From a macroeconomic perspective some evidence suggests that the large distances between markets in countries similar to Australia may constrain potential productivity and growth. To the extent that fuel taxes increase the cost of transport to firms, the effect of distance on productivity will be exacerbated. This may partly explain the finding in the *Architecture paper* that fuel taxes in the geographically largest OECD nations (Canada, the United States, Australia and Mexico) are significantly lower than the European average.

Other taxes on motor vehicles

The fees charged by the States for motor vehicle registration, transfers and drivers' licences are a combination of user charges and taxes.

To the extent that they cover the administrative costs incurred by government in providing a service (for example, producing a drivers’ licence or maintaining a register of motor vehicle ownership), they provide an appropriate price signal to potential vehicle owners and drivers.

However, where the amount charged is greater than cost it can distort economic decisions. Settings in the income tax law – including fringe benefits tax – also affect motor vehicle use (see Section 13.2).

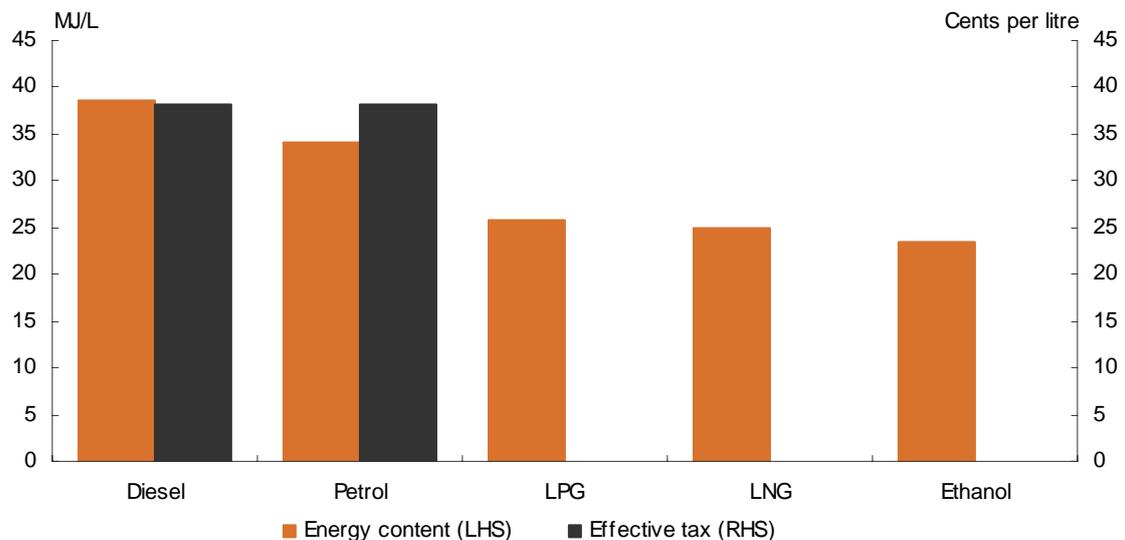
Consultation question

Q12.1 How can motor vehicle related taxes and road funding arrangements be designed to improve the efficiency of transport of people and goods in Australia?

12.2 Taxation of alternative fuels

Although the primary role of all transport fuels is to provide energy, both the energy content and tax treatment of fuels varies between different types (see Chart 12.3). Tax is one factor influencing the choice between petrol, diesel or alternative fuels. For example, liquefied petroleum gas (LPG) is currently not subject to fuel tax. Biodiesel and domestically produced fuel ethanol are also effectively tax-free through separate grant programs.

Chart 12.3: Energy content and current effective tax rate per litre of fuel (2008)^(a)



(a) Effective tax rate includes effects of programs that make biodiesel and domestically produced fuel ethanol effectively tax-free.

Source: ABARE (2008) and Australian Treasury (2008).

Summary of key messages from submissions

Some industry submissions argue that fuel tax should be reduced or removed on alternative fuels. They suggest that the use of alternative fuels should be promoted because of their purported environmental benefits, and note that under the Carbon Pollution Reduction Scheme there would be some price differential between conventional and alternative fuels.

Some submissions consider that tax assistance to biofuels (ethanol and biodiesel) is desirable to encourage investment in infant industries.

Other submissions argue that exemptions and concessions to fuel tax should be minimised to achieve greater market efficiency and to target the social costs of motor vehicle use through taxes. Some contributors suggest that a fuel tax system based on energy content would be an improvement over the current system.

Raising revenue efficiently

A revenue-raising tax is efficient to the extent that it does not distort economic activity by altering production or consumption decisions. This means that efficiency of fuel tax as a revenue-raising tax is diminished to the extent that untaxed substitutes for taxed fuels are adopted.

In the short run, different fuels are imperfect substitutes for one another — different fuels work in different types of engine, and have different storage and distribution mechanisms. However, the quality and price of different fuels affect longer term decisions about vehicle purchases — and therefore the long-term fuel mix.

Influencing production and consumption

As discussed in Section 3.3, specific product taxes are sometimes used to affect the price of goods, and therefore influence consumer and producer behaviour. While this may have limited effect on overall demand for transport energy, it does influence the fuel mix. For example, a higher level of tax on leaded petrol provided incentives to consumers to switch to unleaded petrol, as part of the phasing out of leaded petrol in Australia.

The tax-free status of LPG, and a subsidy for conversion to it, has encouraged motorists to adapt their vehicles despite its lower energy content. Many taxis use LPG even though the tanks reduce the available luggage space.

Similarly, arguments in some submissions in favour of the current concessional tax treatment for biofuels (including ethanol and biodiesel) characterise the biofuels industry as an infant industry which requires a subsidy until it is fully competitive with conventional fuels.

In some cases, the demand for alternative fuels is influenced by regulation. For example, NSW requires a minimum amount of ethanol be blended into the total volume of petrol sold there. The existence of this kind of legislative mandate interacts with tax concessions for alternative fuels.

To the extent that quantity demanded depends on regulations rather than price, the role of tax concessions in influencing decisions through price becomes irrelevant. Nevertheless, producers and consumers still receive the mandated fuel effectively tax-free, at a cost to the Australian Government budget.

Another perspective is that concessional rates of fuel tax are justified on the basis of the social costs of fuel use. If different types of fuel have different social costs it could be efficient to make allowance for this in the rate of tax charged. For example, if the social cost of carbon emissions of biofuels is less than for diesel, this could be reflected by charging a lower rate of tax on low-emission fuels.

However, as discussed earlier, there may be scope for external costs to be addressed through more targeted mechanisms. In the case of carbon emissions, the Carbon Pollution Reduction Scheme may provide a price signal that reflects differences in carbon emissions. Other significant social costs of motor vehicle use also depend on the time and location of driving, not the type of fuel used.

Consultation question

Q12.2 What should be the role, if any, of fuel taxes? What does this mean for how fuels and their uses are taxed and the rates of tax applied?

12.3 Different modes of transport

To the extent different modes of transport are substitutes for one another, specific tax arrangements that apply to some modes of transport, but not others, may influence the choice of which type of transport to use.

Summary of key messages from submissions

Some submissions consider that, because aviation fuel is taxed at a rate less than fuel used in road transport, air transport receives a subsidy from the tax system. Some submissions suggest that this is environmentally damaging because aviation is more energy intensive than other forms of transport. They also suggest that this favours more wealthy Australians who can afford air travel.

Many submissions raise the concern that the system of transport taxes distorts consumer decisions between public and private transport, as well as between road, rail and air travel. Other submissions note that governments earn 'rents' from issuing a limited number of taxi licences.

Some in the aviation sector are concerned that existing funding mechanisms for aviation (through taxes and user charges) do not provide appropriate price signals to different service providers and involve cross-subsidies. However, some carriers argue that the tax system should be used to subsidise air transport to regional areas.

International carriers object to the Passenger Movement Charge (levied on outbound passengers) on the basis that it overcharges for the services actually provided to passengers, and is therefore a tax rather than a user charge.

Summary of key messages from submissions (continued)

The shipping sector argues that Australia's tax system affects the Australian industry's domestic and international competitiveness. They advocate replacing the company tax for Australian shipping with a 'tonnage tax', and reforming the application of income tax to Australian seafarers. There is also concern that the tax treatment of fuel used for shipping favours foreign over domestic shipping in the Australian coastal market.

Aviation

Aviation gasoline and turbine fuel used for domestic trips are both subject to excise, although at a much lower rate per litre than automotive fuels. Here the policy rationale is to recover costs for funding the Civil Aviation Safety Authority, rather than for general revenue-raising.

The absence of taxation for general revenue purposes may reflect the principle that general revenue raising taxes cause least economic distortion when they are applied to consumer goods, rather than commodities that are predominantly used as business inputs.

Funding particular expenditure programs through an excise is an indirect way of recovering costs for the services they provide, in an administratively simple way. The impact of the excise may depend, in part, on the extent to which the cost of providing a service to a particular flight is directly correlated to the excisable fuel used on that trip. As with land based road user charging, there may be more direct methods for charging for services to aviation than through fuel excise.

Choices between transport types

Applying tax in some situations, but not others, can influence behaviour. The extent to which this diminishes efficiency depends on the degree to which different modes of transport are substitutes for one another. For example, imposing tax on fuel used for domestic air travel, but not international air travel, might bias against domestic journeys. Similarly, the choice between taking a journey by car or aeroplane might be influenced by the higher relative taxes on motor fuel compared to aviation fuel. The choice between a short trip in a car and using public transport will likewise be influenced by the taxes and subsidies that apply to each mode.

Many states raise tax revenue by restricting the number of taxi licences they issue. This cost is ultimately passed to users of taxis in the form of higher fares and more time spent waiting. This affects consumer decisions. For example, if taxis were more readily available and less expensive, individuals might rely more on taxis and less on private motor vehicles. There may be equity concerns. Individuals who are unable to drive private vehicles or access public transport may be reliant on taxis.

Consultation question

Q12.3 Do the existing tax arrangements lead people to make economically inefficient transport choices, and if so, how might they be improved?

12.4 Other issues

Interaction between fuel excise and GST

The Review Panel has been asked to consider the interaction of GST with the taxation of fuel.

The GST is charged at a uniform rate based on the market price of goods and services, including petrol. To the extent that any tax, fee or charge on business is passed to consumers in the price of a good, the imposition of the GST gives rise to 'tax on tax' for consumers. Business users can generally claim an input tax credit for GST paid. Removing the excise component of petrol prices from the GST would reduce GST revenue paid to the States.

Summary of key messages from submissions

Some submissions argue that because petroleum is a limited resource and fuel use has environmental impacts, reducing the price of fuel by cutting the GST would be counterproductive to long-term policy objectives.

Some submissions propose that fuel excise be automatically indexed to CPI so that the tax portion of fuel prices does not fall over time. Others consider that the 'tax on tax' or 'double taxation' is unfair, and that the GST or fuel excise should be removed.

The GST and other taxes

As noted in Section 3.3, the GST is a broad-based consumption tax covering roughly three quarters of household consumption expenditure. The key advantage of broad-based taxation is that the rate of tax has little influence on consumer choices between different taxable goods. In addition, a uniform rate of tax simplifies compliance by business, as they can apply the same tax treatment to most of their sales.

To the extent that any tax, fee or charge paid by business (including company tax, payroll tax, land tax, fuel excise, customs duties and other taxes) might be passed on to consumers in the GST inclusive price, there is a 'tax on tax' issue. In most cases these taxes are not apparent to consumers.

Where the GST applies to goods that are subject to excise, this effect is more obvious to consumers. Fuel tax is charged on a volumetric basis at a fixed rate of 38.143 cents per litre. The legal incidence falls on manufacturers and importers of fuel. Fuel excise is typically incorporated into the price of the fuel sold to service stations. Service stations then pass it to consumers in the pump price, on which they also charge GST. Consequently, approximately 3.8 cents GST per litre of fuel is attributable to excise.

Compensation for this 'tax on tax' effect was provided at the time the GST was introduced. Petrol excise was reduced by 6.7 cents per litre when the GST was introduced in July 2000. Fuel excise was further reduced by 1.5 cents per litre in March 2001. Since then, the excise rate has not been indexed to inflation. This means that the real excise rate has fallen over time.

13 Tax-transfer impacts on the environment

Overview

Australia faces significant environmental challenges in the 21st century, ranging from global issues, such as climate change, to local issues, such as water scarcity, land degradation and species loss. Economic development must be undertaken in an environmentally sustainable way, while also recognising that the environment itself has value.

Taxes may provide one means of improving environmental amenity. The tax-transfer system can also detract from environmental outcomes through the incentives it creates. Such incentives need to be carefully evaluated against other policy objectives.

Consultation questions

- Q13.1 Bearing in mind that tax is one of several possible instruments that can address environmental externalities, what opportunities exist to use specific environmental taxes to address Australia's environmental challenges?
- Q13.2 Noting that many submissions raise concerns over unintended environmental consequences of taxes and transfers, such as the fringe benefits tax concession for cars, are there features of the tax-transfer system which encourage poor environmental outcomes and how might such outcomes be addressed?
- Q13.3 Given the environmental challenges confronting Australian society, are there opportunities to shape tax-transfer policies which do not currently affect the environment in ways which could deliver better environmental outcomes?

Climate change is perhaps the most significant environmental risk to the future wellbeing of Australians. Left unaddressed, growth in worldwide carbon emissions is expected to have a severe and costly impact on agriculture, infrastructure, biodiversity and ecosystems in Australia (Garnaut 2008).

Climate change may also compound Australia's other environmental problems. While most environmental damage has resulted from agricultural development and the exploitation of native forests, most future damage is expected to occur around urban areas and water resources. Evidence suggests Australia's waterways are continuing to decline. In 2000, even before the current drought, about a quarter of Australia's surface water management areas were classed as highly used or overused, which may be contributing to the continued increase in the rate of threatened mammals and birds (ABS 2006b).

On the positive side, the amenity of some parts of the environment may not be declining as fast as in the past while other parts of the environment may actually be improving. For example, land clearing rates appear to be slowing and Australia's air remains relatively clean despite increases in motor vehicle usage (ABS 2006b). Indeed, technological developments

may allow some forms of environmental degradation to be reversed, such as by directly pricing road congestion and noise (see Section 12).

This section discusses the impact of the tax-transfer system on the environment and the potential role of taxation in managing environmental issues. Approaches to improving natural resource management are covered in Section 14.

13.1 Using the tax-transfer system to manage environmental issues

The scale of many environmental problems could be reduced if the costs of environmental damage caused by production and consumption of goods were incorporated into prices. Although such costs are often difficult to quantify, one potential solution is to impose a tax on the damaging activity to give people a price signal about the costs they are imposing on the environment.

The Australian tax-transfer system employs a number of environmental taxes. Some are intended to target specific environmental impacts (for example, the Aircraft Noise Levy), while others have impacts on the environment but primarily serve other purposes (for example, fuel excise discourages the consumption of taxed fuels but its primary purpose is to raise revenue).

The concept of an 'environmental tax' is imprecise. The OECD (1993) notes that the term may encompass:

- indirect taxes introduced with a specific environmental objective (for example, taxes on plastic bags in Italy and on fertilizers in Sweden);
- indirect taxes which have been introduced for non-environmental reasons, but for which environmental considerations are now taken into account in setting the level or structure of the tax (for example, taxes on energy in general or the balance between 'lump-sum' and 'use-related' taxes on motor vehicles);
- changes to the direct tax system introduced for environmental reasons (for example, favouring or discouraging certain activities such as farming, forestry, particular industrial processes or nuclear power); and
- charges, fees or levies used to provide direct control over certain environmentally damaging activities (for example, aircraft noise and waterway pollution).

There are other ways of categorising environmental taxes (for example, European Environment Agency 2000), but in general environmental taxes either impose a cost on some products or activities that are environmentally damaging, or give a benefit to some products or activities that are environmentally beneficial.

Corrective taxation is most efficient when the activity generating the external cost is taxed directly, for example, actual pollution emissions. However, this is not always administratively feasible. Accurate and cost effective monitoring may not be possible with existing technology. In such cases a key input (for example, a particular fuel) or output (for example, a particular manufactured product) associated with the activity may be a more practical means of imposing the corrective tax.

Some environmental strategies do not rely only on corrective taxes. For example, the Australian Government's product stewardship oil levy is an excise on motor oil and lubricants which raised \$23 million in 2006-07. Its objective is to help fund an expenditure program, worth \$32 million in 2006-07, which subsidises used oil recycling. This policy reflects a concern over the manner of disposal of used oil, rather than the production and consumption of oil itself. The environmental objective of the program could be achieved even in the absence of the associated levy.

In some cases tax policy can contribute to the management of environmental issues by changing the incentives faced by individuals, firms and other economic factors. However, in other cases non-tax policy responses may be more effective.

For example, the Carbon Pollution Reduction Scheme will set a limit on the nation's emissions of greenhouse gases by issuing a limited number of tradeable emission permits with effect from 2010. Similarly, reform of water entitlements and an improved balance between domestic, commercial and environmental water use is likely to see significant improvements to water management.

In some areas, land management issues may be better addressed through regulatory duty of care arrangements, allowing greater local involvement in land management than would be possible under a tax approach.

The choice of policy to manage a particular environmental issue will depend on the science of the issue, the incentives faced by the people involved and the information and technology available to government (see Box 13.1).

Summary of key messages from submissions

An important theme in submissions from environmental groups is that, given its central importance to economic decision making, the tax-transfer system needs to be consistent with achieving environmentally sustainable economic growth.

Some suggest that, in addition to a Carbon Pollution Reduction Scheme, tax concessions should be implemented to further reduce the carbon emissions of the Australian economy, by encouraging non-polluting transport modes, renewable energy generation and energy efficiency investments.

The potential costs of environmental protection are also a focus of attention, with a number of submissions arguing taxes relating to the Carbon Pollution Reduction Scheme should be designed to minimise the costs imposed on business.

Submissions also propose a range of tax concessions should be provided for activities and investments that address local environmental problems such as land remediation investments, water use efficiency and native species conservation. These could include incentives to promote the pursuit of conservation activities on private land, particularly farmland.

A large number of submissions indicate that state vehicle transfer and annual registration taxes should be concessional for more fuel-efficient vehicles.

Common arguments in favour of environmental taxes

The 'double dividend hypothesis' suggests that in addition to the reduction in environmental damage, environmental taxes provide a second dividend. The first dividend is that the environmental tax reduces environmental damage to a more sustainable level. The second dividend is that the environmental tax generates revenue which can be used to reduce the already existing distortions in the remainder of the tax system.

Bovenberg and Goulder (2002) note that the second dividend will generally depend on the environmental tax being more efficient than the tax its revenue is used to reduce. They also note that environmental taxes are often levied on narrow bases and hence the second dividend does not usually arise.

Consultation question

Q13.1 Bearing in mind that tax is one of several possible instruments that can address environmental externalities, what opportunities exist to use specific environmental taxes to address Australia's environmental challenges?

Box 13.1: Assessing whether environmental taxes are an appropriate policy option

Economic tools, such as taxes, may reduce the costs of achieving a given level of environmental protection. However, not all environmental problems are best addressed in this way. Regulation may be preferable in some cases (Fullerton et al 2008).

Economic tools include the use of taxes and property rights such as permits. Determining clear property rights to develop markets may be particularly effective where environmental problems are at least partly due to unclear or common property rights. For example, reform of water entitlements is likely to see significant structural improvements to water management as trade in permanent entitlements in the southern Murray Darling Basin increases (Peterson et al 2004).

In theory, with perfect information, the Government could design a tax or a pollution permit trading scheme for which the economic and environmental effects would be the same. However, in practice, it may be more appropriate to control the price (by using a tax) or the quantity (by using a trading scheme). For example, a trading scheme may be preferred where the costs to the environment increase steeply or are uncertain.

Australia's international climate change obligations are specified in terms of quantity of carbon dioxide equivalent emissions. The Government's proposed Carbon Pollution Reduction Scheme will set caps on emissions in line with these quantitative targets. However, the Carbon Pollution Reduction Scheme will also contain a price cap to limit extreme upside price risks (Australian Government 2008b).

Economic tools do not *prohibit* an environmentally damaging activity. They seek only to limit the level of damage to the point where the social cost of additional environmental damage exceeds the social value of the goods and services being produced, including by innovating and investing in alternative technologies through time.

Box 13.1: Assessing whether environmental taxes are an appropriate policy option (continued)

Government spending can also address environmental problems, especially where potential polluters have more information than governments. For example, spending to protect endangered species may sometimes be more effective than a corrective tax or regulatory penalty since the spending strategy gives people an incentive to ‘come forward’ with information about their actions. An example of such a strategy is the Environmental Stewardship Program, which allows landholders to bid for Australian Government funding to undertake endangered species conservation.

By contrast, under a ‘command and control’ regulatory approach, government not only identifies environmental targets but also specifies how these targets are to be achieved and, usually, by whom. For example, in order to control sulphur dioxide levels in populated areas, regulations may require specific power stations to install emission scrubbing devices. Such regulations raise prices for consumers in a non-transparent way and lead to a risk that polluters may develop influence over regulators.

Still, in some cases, command and control approaches may be more successful than economic tools, particularly where certain forms of pollution have significant social costs (such as the banning of leaded petrol). Where pollution damage varies depending on the location of the pollution, uniform pollution taxes may be relatively inefficient.

13.2 Environmental impacts of the current tax-transfer system

Since the tax-transfer system impacts on the everyday decisions of individuals and businesses, certain policies may create incentives that impact adversely on environmental outcomes. Reforms to such policies have the potential to improve both environmental outcomes and the efficiency of the tax-transfer system.

For example, most state governments provide energy concessions (such as electricity and gas) and vehicle registration discounts for pensioners, seniors and low income earners. While the objective of these policies is to assist these people in meeting the cost of essential services, lowering the relative prices of these goods inevitably increases their consumption, which increases greenhouse gas emissions. Providing direct financial assistance would help recipients to pay their energy bills without increasing their consumption of energy relative to other goods and services.

Summary of key messages from submissions

A large number of submissions collectively propose a range of tax concessions to encourage taxpayers to undertake environmentally beneficial activities, such as improving energy efficiency and rehabilitating degraded agricultural land.

Around a third of submissions expressing concern about the environment discuss the fringe benefits tax arrangements for motor vehicles. Most oppose a tax system that encourages people to drive more and contribute to noise and air pollution, greenhouse gas emissions and urban traffic congestion. While one submission suggests that the current fringe benefits tax arrangements do not encourage people to drive more to achieve tax savings, others provide anecdotal evidence to the contrary. Many submissions indicate they would like a tax system which offers some support to sustainable urban transport modes such as cycling, walking or using public transport, while recognising people outside urban areas have limited alternatives to private car travel.

Many submissions also propose that tax expenditures be reviewed to identify those with environmental consequences, and reformed to eliminate any negative impacts. For example, the fuel tax credits scheme, which refunds fuel excise used for business purposes, is seen by many as providing an incentive to generate carbon emissions.

Notwithstanding the proposed introduction of the Carbon Pollution Reduction Scheme, some submissions have argued that this alone will not be enough to achieve deep cuts in Australia's carbon emissions, and have proposed additional tax incentives such as accelerated depreciation for investments which reduce carbon emissions as an adjunct.

Submissions identify characteristics of the income tax system that discourage land owners from undertaking expenditure that would improve or protect ecological assets, unless there is a connection with a profit making enterprise.

The tax-transfer system affects every industry, region and demographic group in Australia and influences the allocation of resources in the economy, so there is a potentially wide range of tax-transfer settings that affect environmental outcomes. The Panel will commission research on the impact that the tax-transfer system has on the environment.

One example cited in submissions is the treatment of car fringe benefits (Box 13.3).

Box 13.3: Fringe benefits tax (FBT) treatment of car benefits

The statutory formula method for valuing car fringe benefits applies a declining taxable value the further the car is driven in a year. The original purpose of this policy was to apply tax to the private use of the vehicle, not its use for work purposes, and distance travelled was used as a proxy for the proportion of business travel. The value of the car for FBT purposes is its cost multiplied by a 'statutory fraction' which depends on how far the car is driven in the relevant tax year. The statutory fraction, and hence the taxable value of the car benefit, reduces as the number of kilometres driven increases (Table 13.1).

Table 13.1: Distance thresholds for the FBT statutory fraction

Number of kilometres driven	Statutory fraction
< 15,000	0.26
15,000 to 24,999	0.20
25,000 to 40,000	0.11
> 40,000	0.07

This valuation formula has two main impacts on incentives. It reduces the overall cost of car ownership and provides employees with an incentive to drive additional kilometres to reduce the amount of FBT payable. These incentives indirectly encourage increased greenhouse gas emissions, pollution and congestion through increased car use.

The Australian Treasury estimates the tax expenditure associated with this concession to be \$1.6 billion (Australian Treasury 2007).

There are also some elements of the current system designed to provide tax advantages to environmentally beneficial activities. For example, some states charge lower registration fees or transfer stamp duties for smaller-engine or hybrid vehicles.

There may be other opportunities to use the tax-transfer system to promote better environmental outcomes, although Box 13.1 cautions that tax-transfer approaches will not always be the most efficient way of pursuing environmental objectives.

Consultation questions

- Q13.2 Noting that many submissions raise concerns over unintended environmental consequences of taxes and transfers, such as the fringe benefits tax concession for cars, are there features of the tax-transfer system which encourage poor environmental outcomes and how might such outcomes be addressed?
- Q13.3 Given the environmental challenges confronting Australian society, are there opportunities to shape tax-transfer policies which do not currently affect the environment in ways which could deliver better environmental outcomes?

14 Natural resource charging

Overview

Natural resources are an essential input to Australia's productive capacity. The way in which Australia uses its natural resources is an important determinant of the level of economic growth. It also affects the environment now and into the future.

Ensuring the community obtains maximum value from the appropriate use of its natural resources is an important part of an efficient tax system. The tax system can influence the rate at which resources are extracted and the capacity of future generations to enjoy the benefits of natural resources. Issues which need to be taken into account in considering the taxation of natural resources include the size of the recoverable stock of the resource and how quickly (if at all) it is able to renew, the effect of taxes on investment decisions, which level of government taxes the resource, and the alternative uses of resources outside commodity markets.

Consultation questions

- Q14.1 When considering the appropriate return to the Australian community for the use of its non-renewable resources, what relative weight should be given to the determinants of that return?
- Q14.2 What is the most appropriate method of charging for Australia's non-renewable resources, given they are immobile but that Australia needs to compete globally for mining investment?
- Q14.3 What is the role of the tax system in ensuring that renewable resources are used both sustainably and efficiently?

Taxing natural resources

Australia is endowed with significant natural resources. For example, in the non-renewable sector Australia has the world's largest reserves of brown coal, lead, mineral sands (rutile and zircon), nickel, uranium and zinc and the second largest reserves of bauxite, copper, gold, iron ore (contained iron) and silver (Geoscience Australia 2008).

The Australian natural resources sector can be divided into the non-renewable sector (mining and fossil fuels consisting of oil, natural gas and coal)¹⁵ and the renewable sector (forestry, fisheries, water and renewable energy).

¹⁵ For ease of reference the non-renewable sector is referred to as the mining sector.

There are two significant justifications for taxing natural resources differently from other factors of production:

- they are assets that are taken to be owned by the community — taxation by government reflects one way of achieving a return for the community on its assets; and
- they can be sources of location-specific economic rent — taxing such rents is efficient and avoids the economic distortions arising from taxing other factors of production.

To achieve an appropriate return for the community, government charging for resource use has to balance the returns required by private firms to develop the resource with the community's valuation of the resource.

The community's valuation of a resource can be difficult to determine. At a minimum, it will be informed by the market price of the resource. Selling a resource to one buyer at a price that is lower than another would pay, now or in the future, wastes the community's resource. The amount of the market value of the resource that can be captured by the community depends on the costs and risks associated with developing the resource. A company developing the resource effectively acts as an agent for the community — resources will not be developed if agents are not able to earn a sufficient rate of return on the investment.

Communities may place a higher value on a resource than its market price. This higher value may reflect:

- Social benefits not reflected in the market price, such as the ecological value of fish stocks or the recreational value of native forests. These benefits can imply significantly different valuations to those in resource markets. For example, two forests may have identical market values for their timber, but one may be a sanctuary for an endangered species and hence be of much higher value to the community.
- Preservation benefits to future generations. Communities may also have a stronger desire to preserve resources for future use, compared to agents extracting the resource. It has been argued that the value future generations place on resources are not adequately reflected in market prices. This may reflect uncertainty surrounding the preferences and other opportunities of future generations. Where this is the case, market driven outcomes are likely to result in resources being overexploited.

Taxation represents only one way in which governments can derive a return for the use of community assets. Another approach is to charge for the right to explore or use an asset. The most effective way to assign rights will depend on the characteristics of the resource. For example, depending on the level of certainty regarding the value of a particular resource, a bid or auction process could be undertaken to assign rights. In addition, some community valuations may be more directly targeted through regulation (such as the establishment of nature reserves).

14.1 Non-renewable resources

Summary of key messages from submissions

Some submissions argue that there is potential to increase revenue from natural resources in the context of the overall tax mix.

Submissions from the mining sector argue that the sector's large capital expenditures and the long life of investments require stability in revenue arrangements. Consequently, any changes to mining sector revenue arrangements should only apply on a prospective basis. These submissions also state that consultation with industry prior to the introduction of any changes to existing resource pricing arrangements is critical.

One mining industry submission favours profit based arrangements over *ad valorem* arrangements.

Submissions from the mining sector also propose more generous tax depreciation arrangements.

Existing arrangements

The *Architecture paper* outlines the significant variation in resource charging arrangements in Australia. Different resource tax, royalties or payment arrangements are imposed on the same type of resource depending on its location.

Resource rent taxes are designed to tax the economic rent of a mineral resource. This economic rent is the excess of revenue over costs, where costs are in effect defined to include, the minimum rate of return required to hold capital in the activity ('normal profits').

Some general features of the petroleum resources rent tax (PRRT), Australia's only resource rent tax, are worth noting. The PRRT taxes profits (at a rate of 40 per cent) generated by petroleum projects located offshore, with the exception of the North West Shelf project area. The PRRT is assessed on a project basis and the liability to pay PRRT is imposed on a taxpayer in relation to its interest in the project. This liability is based on the project's receipts less expenditures.

Deductible expenditure not offset against project receipts in a financial year is compounded at varying rates, depending on the type of expenditure and time between the expenditure being incurred and deducted. Compounded expenditure is available as a deduction against project receipts in future years.¹⁶

16 In particular: for exploration expenditure incurred within five years before the commencement of the petroleum project, the compounding factor is the long term bond rate plus 15 percentage points; for exploration expenditure incurred more than five years prior to the commencement of the petroleum project, the compounding factor is the GDP implicit price deflator; for general project expenditure, the compounding factor is the long term bond rate plus 5 percentage points. Exploration expenditure can be transferred between petroleum projects provided there is common ownership over the period between when the expenditure is incurred and when the transfer occurs.

Design considerations

The overarching design issue with resource revenue arrangements is how to balance the competing objectives of enabling exploration and extraction, while ensuring the community receives the appropriate return on Australia's assets.

The recent cycle in resource prices, sustained increases followed by sharp decreases, serves to highlight the relative efficiency of the various revenue arrangements. The extended period of profitability in the mining sector resulted in an increase in revenues from company income tax and specific resource taxes, royalties and excises levied on mining, oil and gas resources (accounting for the major part of resource related revenues). However, the rate of increase does not appear to have been proportional to the growth in the operating profits of the mining sector (see Chart 8.12 of the *Architecture paper*).

The relatively slow growth in government revenues is partially explained by the prevalence of *ad valorem* royalties. *Ad valorem* royalty revenues do not vary in proportion with profits. A corollary is that in a period of lower operating profits for the mining sector total government revenues fall by less than operating profits. Indeed, a particular project may be in a loss making position but still be required to pay royalties. Royalty arrangements can therefore discourage higher risk projects. They can also impede the efficient development of otherwise marginally profitable reserves.

Resource rent taxes such as Australia's PRRT are designed to overcome these issues.

As resource prices rise, so does the portion of revenue that companies earn that can be considered 'super normal' profits. A resource rent tax increases the effective tax rate as the price of the resource increases, thereby capturing a component of the super normal profits. By excluding normal returns, it avoids discouraging marginal investments. Under other resource revenue arrangements (for example, an excise or royalty), while the total government revenue increases as prices rise, the effective tax rate falls and with it the taxation of super normal profits.

Some important design considerations for resource rent taxes include the need to set appropriate threshold rates of return before the tax applies (generally linked to the long term government bond rate), rates at which the tax is levied (sufficiently below 100 per cent to ensure that it does not seriously weaken efficiency incentives in the private sector) and carry forward loss rules. Issues also arise in determining the appropriate tax base in vertically integrated enterprises and identifying when one or more projects exist, given uncertainties in identifying the boundaries of deposits and discrete projects. Another design issue is the range of mineral commodities to be covered by any resource rent tax. For example, the case for imposing a resource rent tax on low value commodities (such as silica, limestone/lime, and construction materials) is not as strong as the case for high value commodities because of the lack of economic rent to be captured.

Another issue with a resource rent tax is the stability of the tax base compared with royalties. Resource rents tend to be more variable than the volume or value of the resource sold. While a tax based on rents may be more efficient than royalties, it is also likely to be a less predictable source of revenue. Tax base stability is an important consideration for state governments as they require a reliable revenue stream to fund their expenditure responsibilities. However, at the national level variability in resource revenue may be consistent with macroeconomic stabilisation objectives.

Resource specific taxes and charges need also to be considered in conjunction with the income tax system. Submissions from the mining sector focus on this issue. (Box 6.7 outlines a related proposal for flow-through treatment of shares in exploration companies). As income tax is also a tax on rents or above normal profits, changes in the company income tax base or rate may in turn require offsetting adjustments in resource tax arrangements. In this regard, it is notable that since the PRRT was introduced, the PRRT rate has remained constant at 40 per cent notwithstanding a decline in the company tax rate from 46 to 30 per cent. Consequently, the effective tax rate on above normal profits (or rents) from relevant projects has fallen from 67.6 per cent to 58 per cent.

One mining industry submission proposes a shift to profit based revenue arrangements away from *ad valorem* royalty arrangements, pointing to greater consistency with the proposition that resource discovery and extraction is a joint venture arrangement between the mining company and the government (on behalf of the community). The submission also argues that while resource revenue arrangements may have a different rationale to other taxes, they are a charge on the cost of doing business. This suggests that the capacity to pay might appropriately be struck as a share of profits.

Developments in other jurisdictions

Many factors affect investor decisions about where and how much investment to make in mines located in particular countries. These include such fundamental factors as the richness of the potential resource, law and order in the host country, the availability of supporting infrastructure such as roads, rail and ports, the availability of an appropriately skilled workforce and stable government. At the margin, taxation arrangements can also be important.

However, it is not easy to make international comparisons of tax regimes in the mining sector because of the complexity of aggregate tax arrangements. The relevant base for international comparisons is, therefore, not just the resource charge but the overall effective tax rate on companies, taking into account this charge and all other direct and indirect taxes.

Hogan (2008) details mineral taxation arrangements in various countries and, drawing on Otto et al (2006), discerns four current trends:

- a shift toward profit based royalties in developed economies;
- a shift toward lower rates and/or sliding scales under *ad valorem* royalties;
- increased application and coverage of mineral taxation arrangements; and
- increased emphasis on transparency of mineral taxation systems.

The allocation of charges and taxes between levels of government

Given the location specific nature of non-renewable resources, resource taxes are often considered to be appropriate taxes for sub-national governments in a federal system. However, if the value of natural resources is distributed unevenly across jurisdictions (in a per capita sense), this will affect the relative fiscal capacities of sub-national governments. A horizontal fiscal equalisation process, whereby the revenue raising capacities of sub-national

governments is equalised, may lessen this concern. Also, if the extraction of natural resources involves inter-jurisdictional externalities, some involvement from the national government may be warranted.

Consultation questions

- Q14.1 When considering the appropriate return to the Australian community for the use of its non-renewable resources, what relative weight should be given to the determinants of that return?
- Q14.2 What is the most appropriate method of charging for Australia's non-renewable resources, given they are immobile but that Australia needs to compete globally for mining investment?

14.2 Renewable resources

Summary of key messages from submissions

Submissions from environmental organisations argue that renewable resources are being used at a rate that does not take into account their full value and is, therefore, unsustainable.

Connected with this concern is a view that government involvement in the allocation and pricing of natural resources needs to be reviewed so that renewable resources are used more efficiently and in a way that improves environmental outcomes.

Pricing the value of renewable resources

In contrast to non-renewable resources, which have a limited supply and cannot be replaced once extracted, renewable resources can be used and replaced. Renewable resources are sustainable, provided the rate of replacement at least equals the rate at which they are depleted. While forestry, fisheries and water are often included in the renewable sector, the replacement rate for some of these resources may blur their classification as renewable resources. For example, the time taken to replace an old-growth forest is sufficiently long to class such forests as non-renewable. Although most water is considered a renewable resource, some underground water resources in Australia are non-renewable. Over-use of other resources, such as fisheries, can damage their renewal potential.

Submissions argue that correctly valuing natural resources is the most effective strategy in advancing economic and environmental outcomes. In determining the value of renewable resources, there is a need to consider:

- the cost to the community from the extraction of the resource and how quickly the resource can be regenerated; and
- the benefits that the resource can provide to the community beyond its value in commodity markets.

The valuation of some renewable resources also needs to take into account the fact that they may exist such that no one individual can have complete control. In these situations, the incentives to utilise the resource are greater than to preserve it, since no individual can capture the value of the resource as an asset. This can lead to the extraction of renewable resources at rates which are unsustainable, potentially leading to complete depletion.

Governments may intervene to ensure that renewable resources are used sustainably through the imposition of a royalty-type tax which seeks to align extraction levels with sustainable supply and takes into account the ecological value of resources. The imposition of such a tax and the resulting higher extraction cost reduces the risk of over-depletion. However, in practice there are difficulties in implementing this approach. For example, timber extracted from different parts of a native forest may have the same value as a commodity, but the externalities associated with their extraction (for example, loss of habitat for wildlife) can be vastly different. Different royalties may be charged based on the location from which trees are extracted, but there is a risk of such an arrangement becoming quite complex. Similarly, efficiently taxing the use of water to balance supply and demand may need to vary by location and over time.

One submission notes that institutional arrangements may also weaken the effect of taxes (and other instruments) as a means to correctly price renewable resources, in particular native forests. In Australia, native forests are in public ownership and managed by state forest agencies that are near monopoly suppliers of native forest timber. The conventional technique used to calculate a royalty for native timber in Australia is the residual value pricing method. This method estimates a derived demand curve for native timber for a timber mill by subtracting reasonable costs incurred by the sawmill from the prevailing market price, including an allowance for normal profit (similar to a resource rent tax). However, institutional arrangements may mean that the usual market incentives to minimise costs and seek an appropriate market return for timber are diminished. Under the residual value pricing method, no allowance is made for the costs incurred in supplying timber, as the price is determined by the market price for processed timber and the timber mill's production costs. This may also give timber mills an incentive to artificially inflate their costs so as to reduce the price they pay for logs. The underpricing of timber may increase the rate at which native forests are logged.

Governments may also impose a sustainable extraction limit on the available resource. The imposition of a limit can create rents for those who retain access. The value of the rents created by such restrictions can be returned to government by a number of means. This includes auctions or tenders for access to the resource (or a quota of the resource) on the basis that the value paid for access to the resource reflects the rent created. This can provide incentives for resources to be used efficiently.

Consultation question

Q14.3 What is the role of the tax system in ensuring that renewable resources are used both sustainably and efficiently?

Appendix A: Terms of reference

Australia's future tax system

Objectives and scope

1. The tax system serves an important role in funding the quality public services that benefit individual members of the community as well as the economy more broadly. Through its design it can have an important impact on the growth rate and allocation of resources in the economy.
2. Raising revenue should be done so as to do least harm to economic efficiency, provide equity (horizontal, vertical and intergenerational), and minimise complexity for taxpayers and the community.
3. The comprehensive review of Australia's tax system will examine and make recommendations to create a tax structure that will position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century and enhance Australia's economic and social outcomes. The review will consider:
 - 3.1. the appropriate balance between taxation of the returns from work, investment and savings, consumption (excluding the GST) and the role to be played by environmental taxes;
 - 3.2. improvements to the tax and transfer payment system for individuals and working families, including those for retirees;
 - 3.3. enhancing the taxation of savings, assets and investments, including the role and structure of company taxation;
 - 3.4. enhancing the taxation arrangements on consumption (including excise taxes), property (including housing), and other forms of taxation collected primarily by the States;
 - 3.5. simplifying the tax system, including consideration of appropriate administrative arrangements across the Australian Federation; and
 - 3.6. the interrelationships between these systems as well as the proposed emissions trading system.
4. The review should make coherent recommendations to enhance overall economic, social and environmental wellbeing, with a particular focus on ensuring there are appropriate incentives for:
 - 4.1. workforce participation and skill formation;

- 4.2. individuals to save and provide for their future, including access to affordable housing;
 - 4.3. investment and the promotion of efficient resource allocation to enhance productivity and international competitiveness; and
 - 4.4. reducing tax system complexity and compliance costs.
5. The review will reflect the Government's policy not to increase the rate or broaden the base of the GST; preserve tax-free superannuation payments for the over 60s; and the announced aspirational personal income tax goals.
 6. The review's recommendations should not presume a smaller general government sector and should be consistent with the Government's tax to GDP commitments.
 7. The review should take into account the relationships of the tax system with the transfer payments system and other social support payments, rules and concessions, with a view to improving incentives to work, reducing complexity and maintaining cohesion.
 8. The review should take into account recent international trends to lower headline rates of tax and apply them across a broader base, as well as domestic and global economic and social developments and their impact on the Australian economy.
 9. The review will also incorporate consideration of all relevant tax expenditures.

Composition and consultation

10. The Review Panel will be chaired by the Secretary to the Treasury, Dr Ken Henry AC and will also comprise Mr Greg Smith (Australian Catholic University); Dr Jeff Harmer (Secretary of the Department of Families, Housing, Community Services and Indigenous Affairs), Heather Ridout (Australian Industry Group), and Professor John Piggott (University of New South Wales).
11. The Review Panel will be supported by a working group from within the Treasury, with representation from the Department of Families, Housing, Community Services and Indigenous Affairs, and drawing on other Australian government and state agencies as appropriate.
12. The Chair may task members of the Review Panel to oversee programs of work related to their field of expertise.
13. The Review Panel will consult the public to allow for community and business input.
14. The review will also, where necessary, draw on external expertise and shall have the cooperation of state governments and their Treasuries as well as relevant COAG working groups.
15. The Minister for Families, Housing, Community Services and Indigenous Affairs will provide input on issues related to transfer payments, family assistance and retirement incomes.

Structure and timing

16. The review process will be conducted in several stages. These will follow the release of an initial discussion paper by Treasury on the architecture of the tax system and an examination of the existing tax rates and bases (excluding the GST). The paper will be released by the end of July 2008.

17. The Review Panel will provide a final report to the Treasurer by the end of 2009. The Government will respond in a timely way to the tax review's recommendations as they are released.

Appendix B: List of submissions

As at 14 November 2008, the Panel had received around 440 submissions from a wide cross-section of the community. The submissions contributed to the development of the *Consultation paper* and the separate *Retirement income consultation paper*.

Submissions are treated as public documents unless authors have specifically requested confidentiality. All authors of public submissions to the review (as at 14 November 2008) are listed in alphabetical order below. Authors who requested confidentiality, or whose submissions contain personal information, are not listed.

To read the public submissions, please visit the review website at www.taxreview.treasury.gov.au

Abacus Australian Mutuals	Australia Council for the Arts	Australian General Practice Network
Adam, Karin	Australia Council of Trade Unions	Australian Historic Motoring Association
Alexander, Bev	Australia Council of Wool Exporters and Processors	Australian Institute of Superannuation Trustees
Alexander, Trish	Australia ICOMOS	Australian Institute of Aboriginal and Torres Strait Islander Studies
Allan, Margaret	Australia New Zealand Leadership Forum	Australian Liquefied Petroleum Gas Association
Allatt, Craig	Australia New Zealand Secular Association	Australian Local Government Association
Allen, DCK	Australia Society of Authors	Australian Pensioners and Superannuants League WA Inc
ALP Adamstown Branch	Australian Automotive Association	Australian Petroleum Production & Exploration Association Limited
AMP	Australian Bankers Association	Australian Publishers Association
Anderson, Glenn	Australian Bicycle Council	Australia's Biotechnology Organisation
Andersson, Michael	Australian Charity for the Children of Vietnam	Aveling, Ben
Anglican Church Diocese of Sydney	Australian Communications and Media Authority	AXA Asia Pacific Holdings Ltd
Anglicare Australia	Australian Conservation Foundation	Ayres, Avinash
Arthur, David	Australian Council for the Arts	Baker, Ron
Ashcroft, Frank	Australian Council of National Trusts	Ball, Chris
Association for Good Government	Australian Council on Smoking Health	Batallion Legal
Association for Good Government ACT	Australian Employee Ownership Association	Batten, Peter
Association of Consulting Engineers	Australian Finance Conference	Biofuels Association of Australia
Association of Independent Retirees Limited	Australian Financial Markets Association	Bishop, Peter
Atheist Foundation of Australia	Australian Foundation Investment Company Limited	Blachard, RD
Ausbiotech		Blackburn, Jenny

Blows, Mark and Johanna	Community and Public Sector Union	Frazer, Murray
Blunt, Elspeth		Fullarton, AR
Board of Airline Representatives of Australia Inc	Condon, Thomas	Gale, Irene
Bob Such MP	Construction, Forestry, Mining and Energy Union of Australia	Gallagher, Anthony
Bond, Graham	Consumer Credit Legal Centre	Gasteen, G Peter
BP Australia Pty Ltd	Conyers, Anna	Gaunt, Ronald
BPW Australia	Corporate Tax Association and Ernst & Young	Georgist Education Association Inc
Brand Hoff	Corporate Taxpayers Group	Gifford, Elaine and John
Brisbane-Webb, Paul	Council of Single Mothers and their Children	GM Holden
British American Tobacco Australasia	Cox, Cathy	Goegan, Peter
Brons, Cornelis A	CPA Australia	Goodall, David
Brons, Ron	Cracknell, Ken	Goodwin, Ken
Brookes, John	Croke, Greg	Gordon, Tom
Brotherhood of St Laurence	Curtin, Michael	Grage, Poul
Brown, Timothy	Curtis, Chris	Graham, John
Buchler, Dan	Cycling Promotion Fund	Graham, Lorraine
Burke, Gary	Danila Dilba Health Service	Grant Thornton Australia Ltd
Business Coalition for Tax Reform	Davies, Thomas	Grant, Ian CF
Business Council of Australia	Dawes, Marc	Gray, Marion
Callinan, CJ	Dawson, Simon	Gray, Saide
Campbell, Wayne	Diment, Alex	Gulf Savannah Development
Cancer Council and National Heart Foundation	Distilled Spirits Industry Council of Australia	Hagstrom, Eva
Carlisle, John	Doherty, Matthew	Halacas, Chris
Carrad, Hudson	Duigu, Gabi	Hall, Christine
Carson, Anthony	Dunnill, Maggie	Hall, Michael and Joan
Cassidy, Rosemary	Dunsford, Geoff and Wickham, Darren	Hamilton, Ryan
Challenger Financial Services Group	Durney, Joanna	Hamilton, Stuart
Chamber of Commerce and Industry of Western Australia	Durnin, Judith	Haniszewski, Stan
Chapman, George	Edgerton, Dr Brett	Harris, Geoffrey
Cielinski, John	Evans, Dr Michael	Harrison, Steve
City of Mandurah	Evans, Rod	Hart, Richard G
Coca Cola Amatil	Fairhall, Lloyd	Hearn, Bill
Cole, Andy	Farthing, Annie	Henkel, Geoff
Collins, Anne	Financial Planning Association of Australia	Heritage Council of Victoria
Commerce Queensland	Flanagan, Anne	Hill, R.D. & E.M.
Commissioners for Children and Young People	Floyd, Stephen	Hobbs & Associates
Communications Electrical Plumbing Union Retired Members Association	Foresters ANA Mutual Society Ltd and Parent to Parent Association Queensland Inc	Hodgson, Patience
	Foresters Community Finance	Hogbin, Janne
		Holmes, Peter
		Hotel, Motel and Accommodation Association
		Housing Industry Association
		Howell, Roscoe
		Hurley, Steve

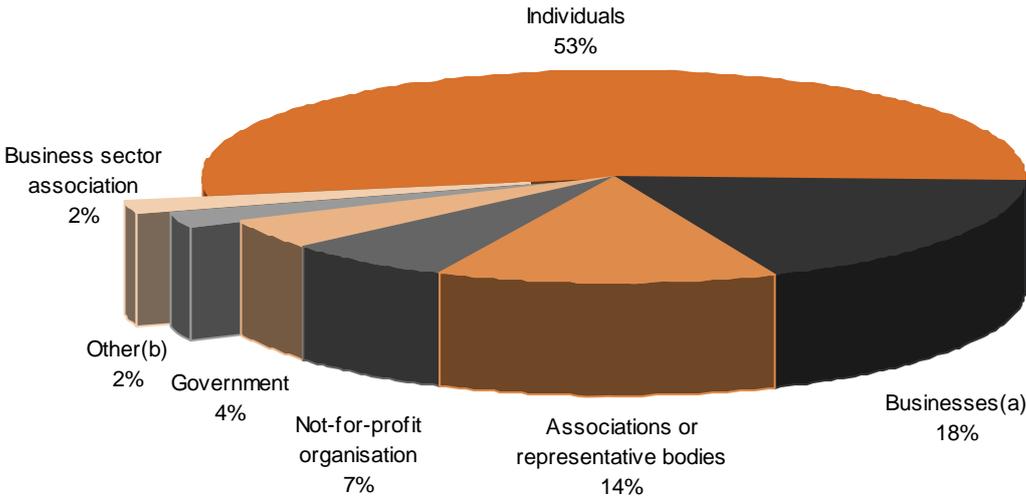
Hurley, Tim	Local Government Association of South Australia	Newman, Neil
Hutchings, Sharon	Lowcock, Michael	Noack, Jane
Independent Distillers Australia	MacDonald, Chloe	Nock, Trevor
Industry Super Network	Madell, Bob	Notholt, Paul
Infrastructure Partnerships Australia	Madigan, Richard	Nott, Alan E
ING Australia	Mannison, Mary	NSW Business Chamber
Institute of Actuaries of Australia	Maritime Union of Australia	O'Donnell, Carol O
Insurance Australia Group	Martin, P and Warren, K	Orams, Wendy
Insurance Council of Australia	Master Builders Australia	Ord, Michael
Investment and Financial Services Association Ltd	Matthews, Garry	Oxfam Australia
Ireland, David	Mawdsley, Anthony	Pace, Julie
Isakov, Milenko	McDowall, Kenneth Ian	Pacific Brands Limited
Isolated Childrens Parents Association	McEwen, Sandra	Parkes, Larry
Jackson, Robert	McGreevy, Stephen	Payne, Elsa
Jacobi, M	McIlroy, Keith	Peck, Chris
Johanson, AR	McIntyre, Clive	Pennington, Jane
Johnston, Adam	McKinna, Ian	People for Ecologically Sustainable Transport
Kavanagh, Bryan	McPherson, Margaret	Petersen, Barry
Keats, Reyn	Mercer Australia	Peterson, Tony
Kenrick, Robert	Metropolitan Transport Forum	Pfizer Australia
Kern, Lincoln	Meyer, Jake	Philps, Nicole
Killeen, Helen	Middleton, David	PKF Chartered Accountants and Business Advisers
King, GM	Mihaljevic, Marijana	Police Federation of Australia
Kit Fennessy	Minerals Council Australia	Pope, Jeff
Koci, Stephen	Mitchell, Donald	Portnoy, Alex
KPMG and the Institute of Chartered Accountants in Australia	Moffet, Russell L	PricewaterhouseCoopers
La Trobe University and RMIT	Moody, Tony	PricewaterhouseCoopers New Zealand
Lagarenne, Bernard	Moore, Christopher	Property Council of Australia
Land and Environment Planning	Moore, Justin	Prosper Australia
Land Values Research Group	Moreland City Council	Prout, Ross
Lang, Laurie	Moreton Bay Regional Council	Public Interest Advocacy Centre Ltd
Laris, Paul	Moss, Helen	Public Interest Law Clearing House
Law, Colin & Anne	National Disability Services	Public Transport Users Association
Lawrence, John	National Ethnic Disability Alliance	Qantas Airways Ltd and Virgin Blue Airlines Pty Ltd
Lefevre, Kay	National Farmers Federation	Rac, Meg
Legge, David	National Institute of Accountants	Raicu, Stefan
Lester, Richard	National Insurance Brokers Association	Rainbow, JG
Lester, Tom	National Transport Commission	Rationalist Society of Australia
Lim, Li Li	National Welfare Rights Network	
	New Internationalist Publications Pty Ltd	
	New Zealand Treasury and Inland Revenue	

Regional Aviation Association of Australia	Sporting Wheelies and Disabled Association	Walker-Roberts, Brett
Renton, Nick	Spry, Shae	Walker-Rolls, Anne
Revenue Review Foundation	St Vincent de Paul Society	Way, Melissa
Rheem Australia Pty Ltd	Stanford, Charles	Webster, Stewart
RiceWarner Actuaries	Stewart, Miranda and O'Connell, Ann	Weir, Olive
Richardson, Jim	Stoner, Arthur	Wells, Jessie
RL Lewis Pty Ltd	Summer, Beau	West-Newman, Steve and Lisa
Roberts, Andrew	Summers, Brian	Wheatley, Howard
Roberts, G.W.	Swainston, John	White, Ellen
Ronan, Nick	Tanner, Richard J	Whitton, Evan
Rose, Andrew	Tasmanian Association of Microbrewers	Wickham, Darren
Rose, Kathryn	Tasmanian Department of Environment, Parks, Heritage and the Arts	Wilden, John
Rowan, Peter	Tasmanian Heritage Council	Wilkes, Vikki
Rowland, Patrick	Taxation Institute of Australia	Wilkin-Smith, Tim
Royal Automobile Club of Queensland	Taylor, Brian	Wilkinson, Giselle
Russel-Stone, Christine	Telstra	Will, Noel
SA Superannuants	The Australian Taxation Reform Group Inc	Williams, Joe
Sach, Roy	The Tax Base Pty Limited	Williams, Neal
Saunders, Gillian	Thomas, George and Kay	Williams, Robert
Schaper, Peter	Thompson, Dianne	Williams, Stephen
Schlottmann, Eva	Thompson, Garry	Wilson, Raymond Henry
Schorel-Hlavka, Gerrit H	Thorp, David	Wilson, Richard
Schwab, Simon	Thorpe, Glenn	Winemaker's Federation Australia
Scolyer, David	Tieman, Dieter	Winthrop, Ronald Patrick
Secular Party of Australia	Tipping Point Institute Pty Ltd	Withers, Alison
SEDA Opals	Tomlinson, John	Women's Action Alliance
Sellar, Edward AM	Tourism Transport Forum	Woodside Energy
Seventh-day Adventist Church	Toyota Finance Australia Ltd	Woolworths Limited
Sigh Verick, Amarjit	Triumph Sports Owners Association of WA	YMCA Australia
Singer, David	Trotter, George	Young, Jill
Skipworth, Gail	Tuckerman, Philip	Zeitoun, Anthony
Smith, Derek	Uniting Church in Australia	
Smith, Jeanne	Urban Taskforce Australia	
Smith, Michele	Varley, Claire	
Smith, Rae	Victorian Farmers Federation	
Smith, Robert Lloyd	Victorian Land Tax Coalition	
Smith, Roland A	Walker, Caroline	
Smithers, Graham	Walker, Greg	
Smokeless Tobacco Action Group		
Snowball, Clare		
Spain, David		
Spakia Pty Ltd		

Appendix C: Analysis of submissions

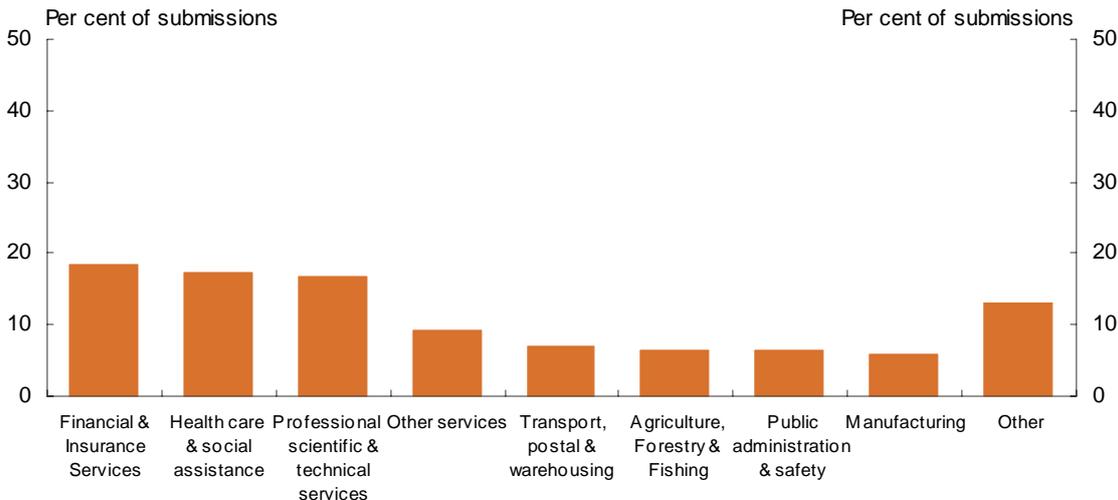
As at 14 November 2008, the Panel had received around 440 submissions from a wide cross-section of the community. A graphical analysis of the submissions by source and issues raised is presented below.

Chart C1: Composition of authors
All submissions



(a) Businesses includes corporate (12%) and non-corporate (6%).
 (b) Other includes academic or university (1.5%) with the balance made up of foreign persons, organisations or governments and submissions that could not be classified.

Chart C2: Submissions from organisations
Main sector of organisation^(a)



(a) Some organisations self-identified as belonging to more than one sector.

Chart C3: Policy issues raised — submissions from individuals

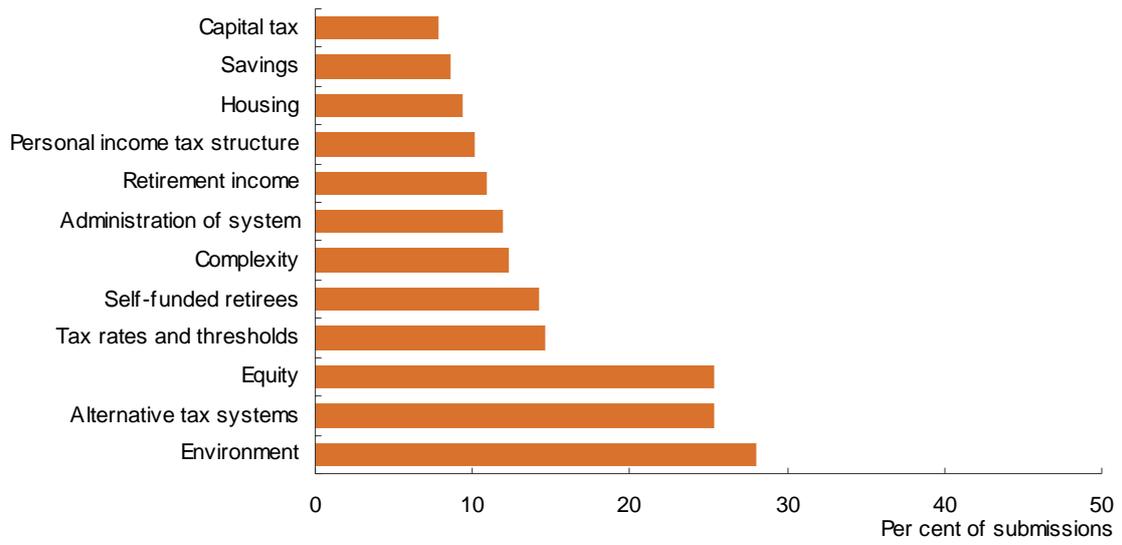


Chart C4: Policy issues raised — submissions from organisations

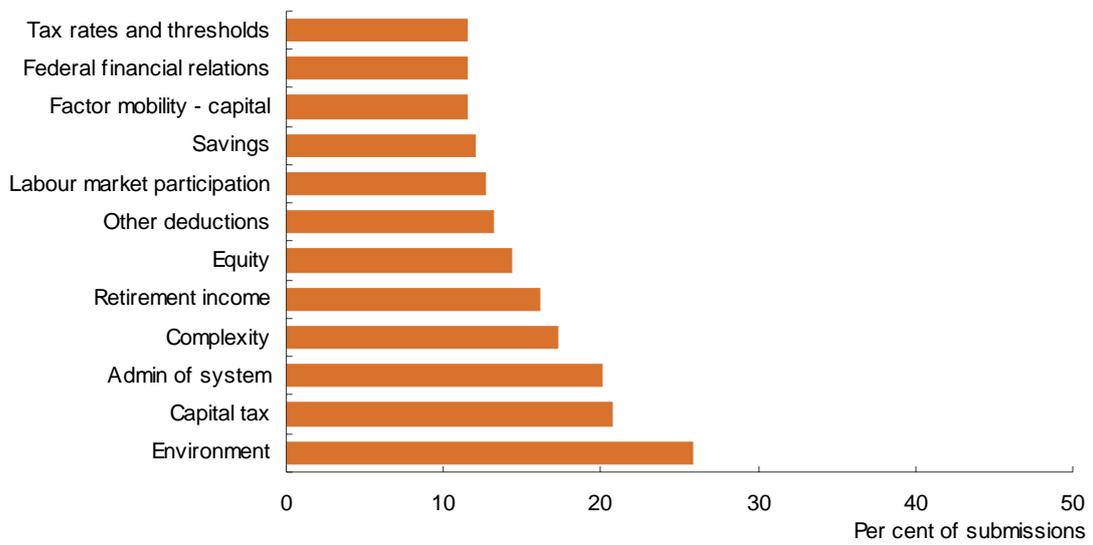


Chart C5: Issues raised in submissions
 Australian Government taxes, state government taxes and transfers

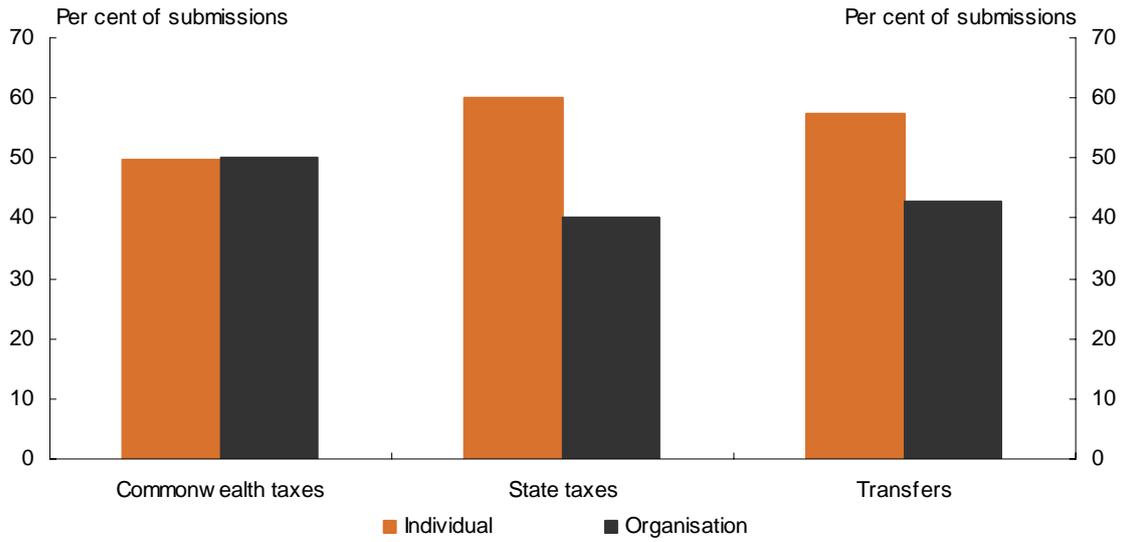


Chart C6: Issues raised in submissions — Australian Government taxes

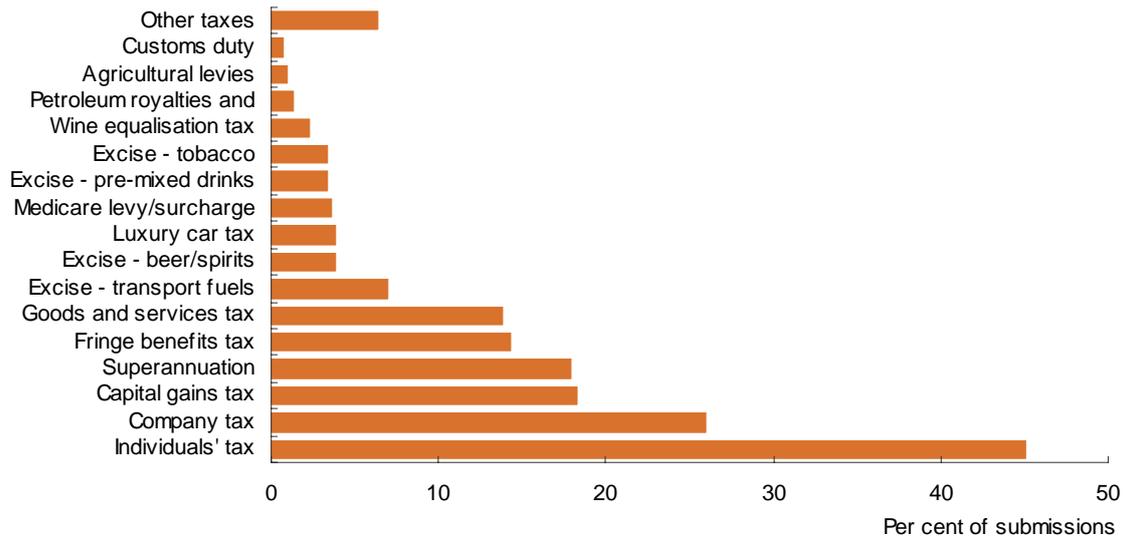


Chart C7: Issues raised in submissions — state government taxes

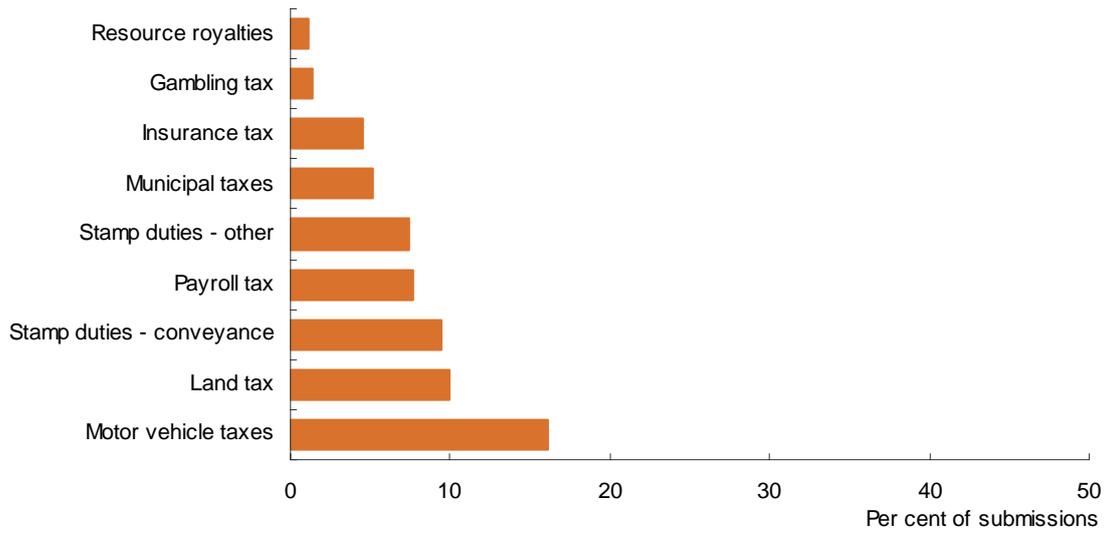
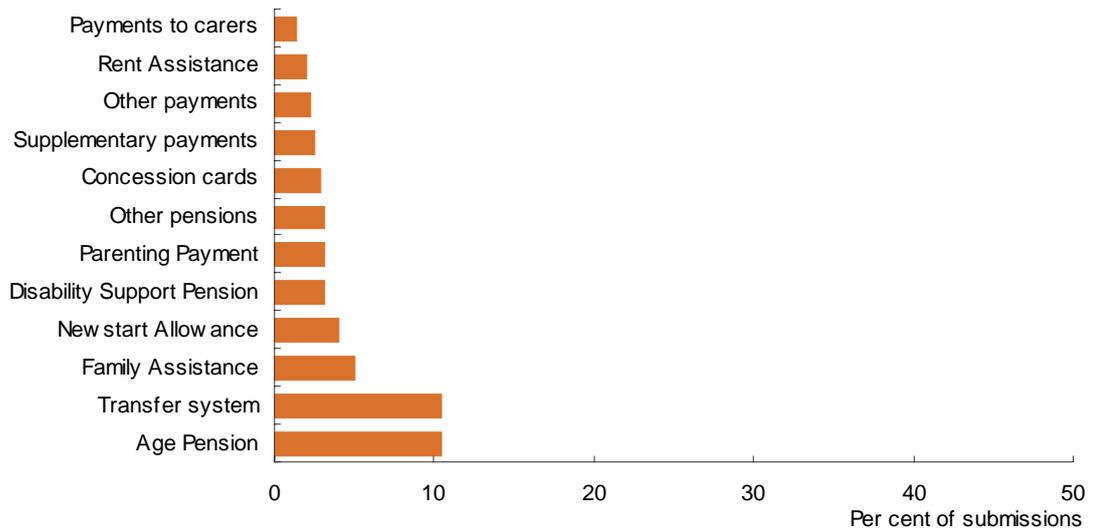


Chart C8: Issues raised in submissions — transfers



Appendix D: Research commissioned by the Review Panel

As noted earlier, the terms of reference for the review into Australia's future tax system are extremely broad. To help inform the Review Panel's deliberations, a wide range of opinions and expertise needs to be considered. The consultation process will help elicit some of this information. However, the Review Panel is conscious of the need to engage technical and academic expertise where required. As such the Review Panel has decided to commission research in a number of areas, some of which may be published by the review and/or presented to the tax conference planned for 2009.

The following outlines those research areas the Review Panel is considering or has requested at this point in time.

Roads and transport

This research aims to develop a conceptual framework for efficiently allocating private and social transport costs between users and service providers; consider the existing system of transport-related taxes and charges and its efficiency costs; if there are taxes and charges that more directly target the marginal private and social costs of transport; and consider current technological constraints to applying such charges, while taking into account new technology and international practice.

Tax and transfer compliance costs

This research aims to draw together and build on results from existing research in this area and attempt to identify a framework for calculating robust estimates of compliance costs in the future.

Housing

This research aims to estimate the net tax-transfer subsidy accruing to owners, investors and renters from the treatment of housing by the tax-transfer system (under different tax benchmarks); the economic incidence of the taxes or subsidies, their distribution by income and age and their effect on housing prices; the efficiency, equity and simplicity of specific taxes and transfers; potential reform options; and the impact of tax and transfer settings on housing affordability.

Natural resources

This research aims to develop an economic framework for the taxation of natural resources; current tax and royalty settings; alternative approaches proposed in the literature or used overseas; implications for federal fiscal relations; and the role of taxation as a mechanism to ensure optimal use of the resources.

Environmental taxation

This research aims to outline a framework for using tax-transfer measures to address environmental market failures, particularly in the context of other mechanisms available to deliver environmental outcomes (for example, regulation); outline inefficient elements of the existing tax-transfer system; and highlight the major environmental issues facing Australia and consider possible tax-transfer system policy responses.

Capital income and business taxation

This research aims to describe how Australia's tax-transfer systems tax capital income, both at the business and investment level (for both residents and non-residents); discuss the implications of those arrangements for the growth prospects and dynamism of the economy; consider distributional impacts; and outline broad reform choices and options.

A client-centred tax-transfer system

This research aims to consider system complexity from the perspective of the citizen; present a set of principles for testing alternative approaches; examine opportunities for improvement afforded by new technologies; explore developments in other countries and the private sector; describe linkages between administrative reforms and policy design.

Education and skills

This research aims to explore the incentives and disincentives for skills acquisition created by the tax-transfer system; examine the treatment of investment in human capital relative to other forms of capital; consider whether there are other, public, benefits to high levels of education; and review existing literature on the impact of tax-transfer incentives and assess the possible impact of demographic and structural change on incentives.

Lifecycle and the tax-transfer interface

This research aims to review the lifetime redistributive impact of the tax-transfer system, examining both interpersonal and intrapersonal distribution; and to consider the amount of redistribution to different cohorts under a range of different policy settings.

Efficiency of taxes

This research aims to assess the efficiency costs of the major taxes currently being levied in Australia (at the Australian, state and local government levels). The research will attempt to estimate the efficiency costs of the taxes now levied and any proposed changes.

Australian-state government taxation

This research aims to set out a framework for Australian-state government division of taxing responsibilities; consider the role and implications of vertical imbalance; undertake comparative analysis with other federations; and draw out some lessons and possible policy alternatives for Australia.

Consumption (including alcohol and tobacco)

This research aims to present a theoretical framework for excise in a modern tax system, looking particularly at the case of alcohol and tobacco, as well as luxury taxes and fuel taxes; and consider specific reform opportunities for taxes on specific goods and services taxes in Australia.

Development of tax-transfer theory

This research aims to provide a brief history of how tax and transfer theory has evolved over time, together with some insights on future directions and how this can be applied in a policy context. This will include some analysis on the impact that population ageing may have on tax policy design in the future.

Impact of the tax-transfer system on labour supply

This research aims to undertake modelling of the impacts of various, hypothetical, policy approaches (consisting of both tax and transfer changes) on labour supply decisions.

Appendix E: Business level expenditure tax designs

This appendix outlines and illustrates some of the main design, administrative, and transitional issues associated with commonly proposed business level expenditure tax options: the allowance for corporate equity (ACE) and cash-flow taxes.

It does not discuss issues in relation to business-shareholder interactions. Both the ACE and cash-flow taxes can be designed to accommodate different levels and forms of integration, including classical and dividend imputation systems.

Allowance for corporate equity

An ACE levies tax on business income as conventionally measured, but provides an additional deduction (allowance) equal to a return calculated on the equity invested in the business. This deduction parallels the deduction allowed for interest paid on a business' debt capital.

Under an ACE, the equity of the company is not calculated with reference to the market value of the equity but rather the book value (at historic cost) of accumulated equity as calculated for tax purposes. At each year end, the closing book value of equity could be calculated as follows (for a business operating solely domestically):

Opening value of equity
Add: Taxable profits in the previous period
Add: Dividends from other companies
Add: New equity issues
Less: Tax payable on taxable profits in the previous period
Less: Dividends paid and returns of equity
Less: Net new acquisitions of other companies
<hr/>
Closing value of equity = Opening value of equity for next year

The ACE allowance is calculated by multiplying the opening value of equity (for the relevant income year) by an imputed rate of return. Setting the imputed rate is one of the most challenging aspects of the ACE. The academic consensus is that where full loss offsets are available an appropriate imputed rate is the risk-free nominal interest rate, which can be approximated by the rate on government bonds.¹⁷

As for expenditure taxes generally, under an ACE the tax system should not affect the cost of capital of a firm, as the effective marginal tax rate (EMTR) is zero for an investment generating returns that just cover the cost of capital (that is, one that provides 'normal returns').

¹⁷ Belgium's imputed rate is calculated by taking an average of the monthly government bond rate of the year preceding the fiscal year by two years. The rate is capped at 6.5 per cent and cannot change by more than 1 percentage point from year to year (a separate higher rate applies to small and medium enterprises).

The design of the ACE is such that if too much (little) tax is paid in any one year — taxable income exceeds (is less than) economic income — it is compensated by a higher (reduced) allowance in future years. This approach automatically taxes real rather than nominal income (it does not tax the inflation component of returns) and causes deviations from accrual-based capital gains or economic depreciation, and other valuation or timing misalignments, to be less material other than for the timing of revenues. The ability of the ACE to accommodate the existing income tax framework (including associated income recognition rules) makes it relatively easy to introduce (compared to cash-flow taxes) though requiring an additional set of provisions.

For investments by a business in another country, where income generated by the foreign investment is exempt in principle, there should be a reduction in the book value of equity. This is on the basis that an allowance should not be provided against income that is exempt. Complications can arise where the foreign income is partially exempt (for example, it does not entirely consist of 'active' foreign income of a company) or where the investment occurs through a branch.

In the case of inbound investments by foreign businesses, under an ACE a domestic subsidiary or branch of a foreign firm would be treated in the same way as a domestic business. Based on the experiences of the ACE in Belgium and Croatia, it can reasonably be expected that domestic taxes paid under an ACE would be eligible for a foreign tax credit in the foreign firm's home jurisdiction.

The more symmetric treatment of debt and equity under an ACE mean that thin capitalisation rules (which guard against excess debt financing) should no longer be required. However, transfer pricing rules would still be required.

Cash-flow tax

A cash-flow tax taxes the difference between cash receipts and cash outgoings. Unlike income tax, there is no revenue/capital distinction and, hence, both current and capital expenditure receive the same treatment.

The nature of transactions included in the tax base depends on which variant of the cash-flow tax is implemented. Three variants include the following.

- The 'R' (real) base cash-flow tax: only real (not financial) cash flows are included in the base. Interest is neither taxable nor deductible. The petroleum resource rent tax is an example of an 'R' base cash-flow tax. Separate rules would be required if applied to financial service providers.
- The 'R+F' (real plus financial) base cash-flow tax: both real and non-equity financial cash flows (borrowing, lending and repayments of debt) are included in the tax base. Where an amount is borrowed, it will result in an increase in the tax base. Repayments of both principal and interest are deductible from the tax base.
- The 'S' (share) base cash-flow tax: the firm's net flows on equity is taxed (dividends paid plus purchases of shares less issues of new shares and receipt of dividends). It is essentially equivalent to an 'R+F' tax.

Like an ACE, the cash-flow tax gives rise to a zero effective tax rate on marginal investments. The immediate deduction for all expenditure means a cash-flow tax potentially: does not distort asset choices; taxes real returns only; and, as transactions are recognised at the time cash flows in or out of the business, does not require timing and valuation rules (for example, for depreciation). This offers significant simplification benefits.

International tax considerations raise similar issues as for an ACE. However, in the case of inbound investments there is a more open question as to whether other countries would be willing to provide a foreign tax credit for a cash-flow tax, given it is more radically different to an income tax than an ACE.¹⁸ As is the case with the ACE, thin capitalisation rules should be unnecessary as a bias towards debt financing should no longer exist.

The transition to a cash-flow tax is potentially complex given that existing assets and debts of firms would straddle the operation of both the original income tax and a replacement cash-flow tax.

It is also likely that revenue from a cash-flow tax would be pro-cyclical (as investment expenditure is typically pro-cyclical). This is in contrast to an ACE, which provides for 'smoother' revenue collections. This difference in the timing of revenues is reflected in the illustrative comparisons of income tax, ACE and cash-flow taxes below.

Comparison of corporate income tax, a business level cash-flow tax and an allowance for corporate equity

In each hypothetical case, a firm has initial capital of \$120. Its cost of capital is 10 per cent, which is equal to the return generated by the investment (a marginal investment). The tax rate is 30 per cent. Capital depreciates at a rate of \$40 per annum, which is assumed to be equal to depreciation for income tax purposes. The firm does not reinvest its gross returns, distributing these annually to shareholders.

Investment generates normal returns

Income tax

	Year 0	Year 1	Year 2	Year 3
Revenues		52	48	44
Less: tax depreciation		(40)	(40)	(40)
Taxable income		12	8	4
Tax		3.60	2.40	1.20
Effective average tax rate		30%		
Effective marginal tax rate		30%		

The income tax gives rise to a 'tax wedge' of 30 per cent, distorting the marginal investment decision.

¹⁸ It should be noted that the petroleum resource rent tax is recognised as a general income tax in some of Australia's tax treaties, while other treaties require it to be specifically identified in order to be creditable.

Allowance for corporate equity

	Year 0	Year 1	Year 2	Year 3
Revenues		52	48	44
Less: tax depreciation		(40)	(40)	(40)
Less: ACE(a)		(12)	(8)	(4)
Taxable income		0	0	0
Tax		0	0	0
Opening book value		120	80	40
EATR		0%		
EMTR		0%		

(a) Equal to 10 per cent of opening book value of equity for that year.

Under the ACE, where the correct imputed rate of return is selected (one that is equal to the normal return), no tax is payable on a marginal investment.

Cash-flow tax — 'R' and 'R+F' base

	Year 0	Year 1	Year 2	Year 3
Cash outlays	-120	0	0	0
Cash receipts	0	52	48	44
Tax	-36	15.6	14.4	13.2
EATR		0%		
EMTR		0%		

Under the 'R' and 'R+F' base cash-flow taxes, the present value of future tax payments is equal to the tax credit received in respect of the new capital expenditure. As with an ACE, the cash-flow tax does not distort the marginal investment. However, unlike an ACE it potentially requires the government to fund the tax credit in the first year (which would be subsequently recouped over later years).

Under an 'S' base cash-flow tax, a similar outcome is achieved, but the tax calculations instead focus on cash flows relating to the raising and return of shareholder equity and dividend payments.

Investment generating economic rents

In this case, the investment generates above-normal returns of 20 per cent. All other circumstances remain the same.

Income tax

	Year 0	Year 1	Year 2	Year 3
Revenues		64	56	48
Less: tax depreciation		(40)	(40)	(40)
Taxable income		24	16	8
Tax		7.20	4.80	2.40
EATR		30%		

Allowance for corporate equity

	Year 0	Year 1	Year 2	Year 3
Revenues		64	56	48
Less: tax depreciation		(40)	(40)	(40)
Less: ACE		(12)	(8)	(4)
Taxable income		12	8	4
Tax		3.60	2.40	1.20
Opening book value		120	80	40
EATR		15%		

Cash-flow tax — 'R' and 'R+F' base

	Year 0	Year 1	Year 2	Year 3
Cash outlays	-120	0	0	0
Cash receipts	0	64	56	48
Tax	-36	19.20	16.80	14.40
EATR		15%		

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