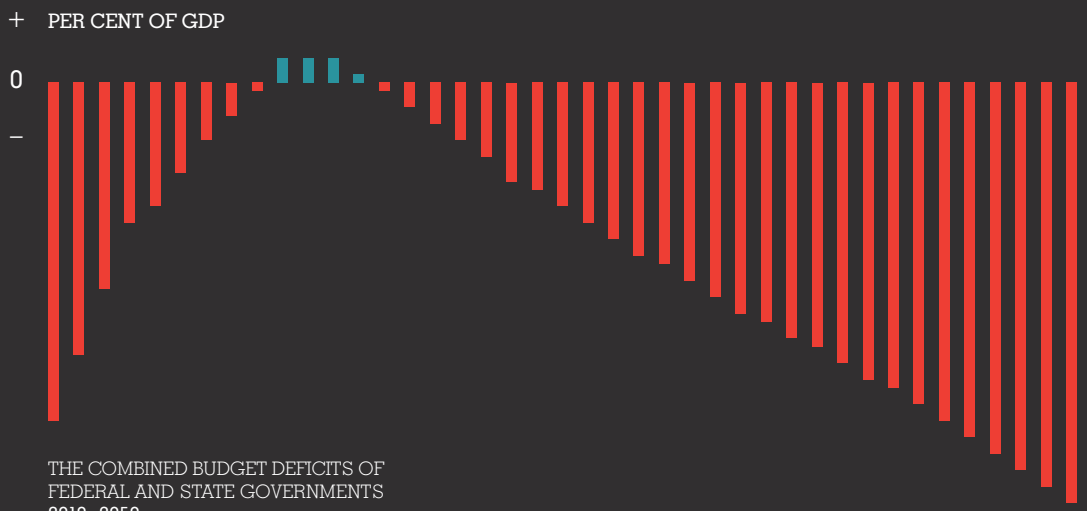
Preparing for a Better Future

Progressing Comprehensive Tax Reform in Australia

» SUBMISSION TO THE 2011 TAX FORUM



THE COMBINED BUDGET DEFICITS OF FEDERAL AND STATE GOVERNMENTS 2010–2050

Business Council of Australia

→ OVERVIEW AND EXECUTIVE SUMMARY

ABOUT THIS PUBLICATION

This is an overview and an executive summary of the Business Council of Australia's submission to the Australian Government's 2011 tax forum. The submission, which includes a report by Deloitte Access Economics titled 'An Intergenerational Report for the States', can be downloaded from **www.bca.com.au**.

While the submission has been written for the tax forum, its findings and recommendations stretch well beyond the scope of the forum.

ABOUT THE BUSINESS COUNCIL OF AUSTRALIA

Members of the Business Council of Australia (BCA) are the chief executives of 100 of Australia's largest and most successful businesses. They apply their skills and experience to develop, explain and promote policies for achieving economic, social and environmental goals that will benefit Australians now and into the future. Our aspiration is for Australia to become the best place in the world in which to live, learn, work and do business.

OVERVIEW

As part of its submission to the Australian Government's 2011 tax forum, the Business Council of Australia is calling for comprehensive changes to the tax system and a more efficient approach to government spending.

OVERVIEW CONTINUED

These changes are necessary because:

- Australia faces an unfolding fiscal challenge which, if not addressed, has the potential to bring on a severe fiscal crisis within the next 40 years. This will threaten the capacity of future Commonwealth and state governments to fund the services Australians will need.
  - » While the reality is that the Australian economy will continue to grow and the tax base will grow with it, actions can be taken to accelerate this growth and this will give Australia a better chance of meeting future challenges.
- The tax system is not as efficient as it could be and it is not keeping pace with the rest of the world. This undermines Australia's productivity and in turn, its competitiveness and its capacity to grow the economy.
- There are major problems with the way the finances are organised between the states and the Commonwealth, whereby the states have accountability for delivering high-demand services, but have little of their own revenue.
  - » This creates confusion but more importantly, forces the states to rely on their own relatively inefficient taxes. Some of these taxes, like stamp duties and insurance taxes, are among the worst and most productivity-damaging in the system.
- The tax system is too complicated for individuals, families and businesses to use. That complexity adds to business and household costs and impacts on our productivity.

If Australia is to remain competitive, prosperous and productive, the Australian Government and the Australian Parliament must embark on a 10-year reform of the tax system and improve the efficiency of government expenditure.

Fixing the tax system and improving the efficiency of government spending requires leadership and sound policy principles

This approach would involve four key actions:

- Improving the efficiency and sustainability of Australia's future government expenditure.
- Beginning a process of comprehensively overhauling the tax system, which could be staged over 10 years. This should begin with a focus on removing the most inefficient state taxes and identifying options for replacing that revenue. The other platform for improving the tax system is to improve the overall tax mix, rather than introduce new taxes. That tax mix should gradually reduce the reliance on direct taxes such as personal tax and company tax and increase the reliance on indirect taxes such as consumption tax and land tax.
- Action should be taken to resolve accountabilities for expenditure between the states and the Commonwealth, and consideration should be given to providing the states with a more predictable share of revenue (such as personal income tax) in return for a removal of the most inefficient state taxes.
- Action should be taken to immediately simplify the tax system, using the recommendations of the Henry review as a starting point.

The Business Council of Australia is calling for the government and the parliament to map out a process beyond the forum for well-managed, gradual improvements to the tax system and actions to improve the efficiency of state and Commonwealth spending.

We recognise that these are challenging and demanding issues that need to be resolved. The process will be assisted, however, through a program of reform with an emphasis on consultation and by building stronger institutional arrangements.

Consideration should be given to the potential role of independent bodies which may have a greater capacity for dealing with options and issues that are potentially 'off limits' for Australia's political parties. No option should be removed from debate or consideration.

This long-term approach to fixing the tax system and improving the efficiency of government spending requires leadership and adherence to sound policy principles, not political expediency.

Unless action is taken now to begin the process of properly changing the tax system, Australia will face declining productivity, reduced growth and an inability to pay for the vital services such as health, social security, education and infrastructure required by future generations.

EXECUTIVE SUMMARY

The Business Council of Australia is calling for a 10-year plan to bring comprehensive improvements to the tax system, coupled with a more efficient and accountable approach to government spending and to Commonwealth–state financial arrangements.

The process of improving the system will take 10 years to complete and it is essential we start that process now

This submission seeks to address the fundamental role of the tax system, which is to raise sufficient revenue to pay for the services properly expected from government. A good tax system must also be designed in a way that provides incentives for savings and investment and drives productivity and competitiveness in the economy.

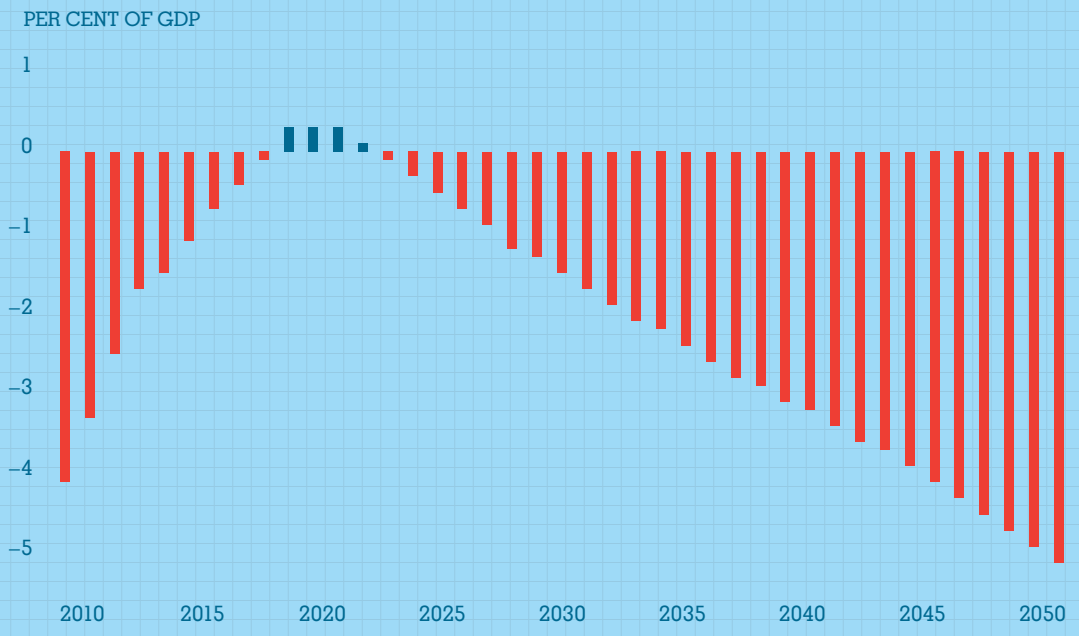
The sooner Australia gets its tax system right, the more likely we will be to generate the economic growth that will support the necessary revenue generation in the years ahead.

At the outset, however, we recognise that governments must ultimately have an overarching objective of improving the wellbeing of all Australians. This includes maintaining appropriate economic, environmental and social conditions including the provision of the acceptable social safety net on which the Australian social compact is predicated. It should continue to feature as a central element of the society we live in – but we need to make sure it is affordable and sustainable.

The capacity of future governments to improve the wellbeing of future generations will be hampered by the following factors.

Australia faces an unfolding fiscal crisis. In simple terms, the states and the Commonwealth Government will not have enough money over the next 40 years to pay for the services future Australians will need.

To assist in the consideration of issues around the fiscal challenges for Australia over the coming decades, the Business Council of Australia engaged Deloitte Access Economics to undertake an analysis of the long-term fiscal outlook and sustainability of government finances at the Commonwealth, state and territory levels. When the state and territory projected fiscal positions are added to the Commonwealth's, it is estimated that by 2050 Australia will face a combined fiscal deficit of 5 per cent of GDP. Today, a budget deficit of this size would be equivalent to around $70 billion. The current tax arrangements and the current approach to government spending will not be able to sustain deficits of this size.



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PROJECTED FISCAL BALANCE –
ALL GOVERNMENTS

SOURCE: DELOITTE ACCESS ECONOMICS,
'AN INTERGENERATIONAL REPORT FOR THE STATES'.

Unless we act to change this outlook, future governments will be forced to either reduce services – such as health and social security – or raise existing taxes significantly and thereby impose an unsustainable tax burden on companies, on individuals and on families.

The tax system is inefficient and uncompetitive. It does not sufficiently reward hard work or provide incentives for companies, individuals and families to save and invest. Nor does it create the right incentives for workforce participation for many citizens. Inefficient and uncompetitive taxes hurt our national productivity, damaging our long-term economic growth and improvements in real household incomes.

Government policies that best support productivity should focus on creating the right economic incentives. These include fostering competition and achieving the right balance of tax rates and tax structures.

In 2010, Australia's effective corporate tax rate on new investments was 26 per cent compared with an average among competitor countries of 18 per cent, making it one of the highest among relevant competitor nations. Our top marginal personal income tax rate is also uncompetitive within our region.

The tax system is overly complicated. A good tax system should be simple for companies and individuals to use. Few people would disagree that we need a smaller number of taxes. As the Henry review points out, 90 per cent of national revenue is raised through only 10 taxes, but there are 125 different taxes imposed across the federation.

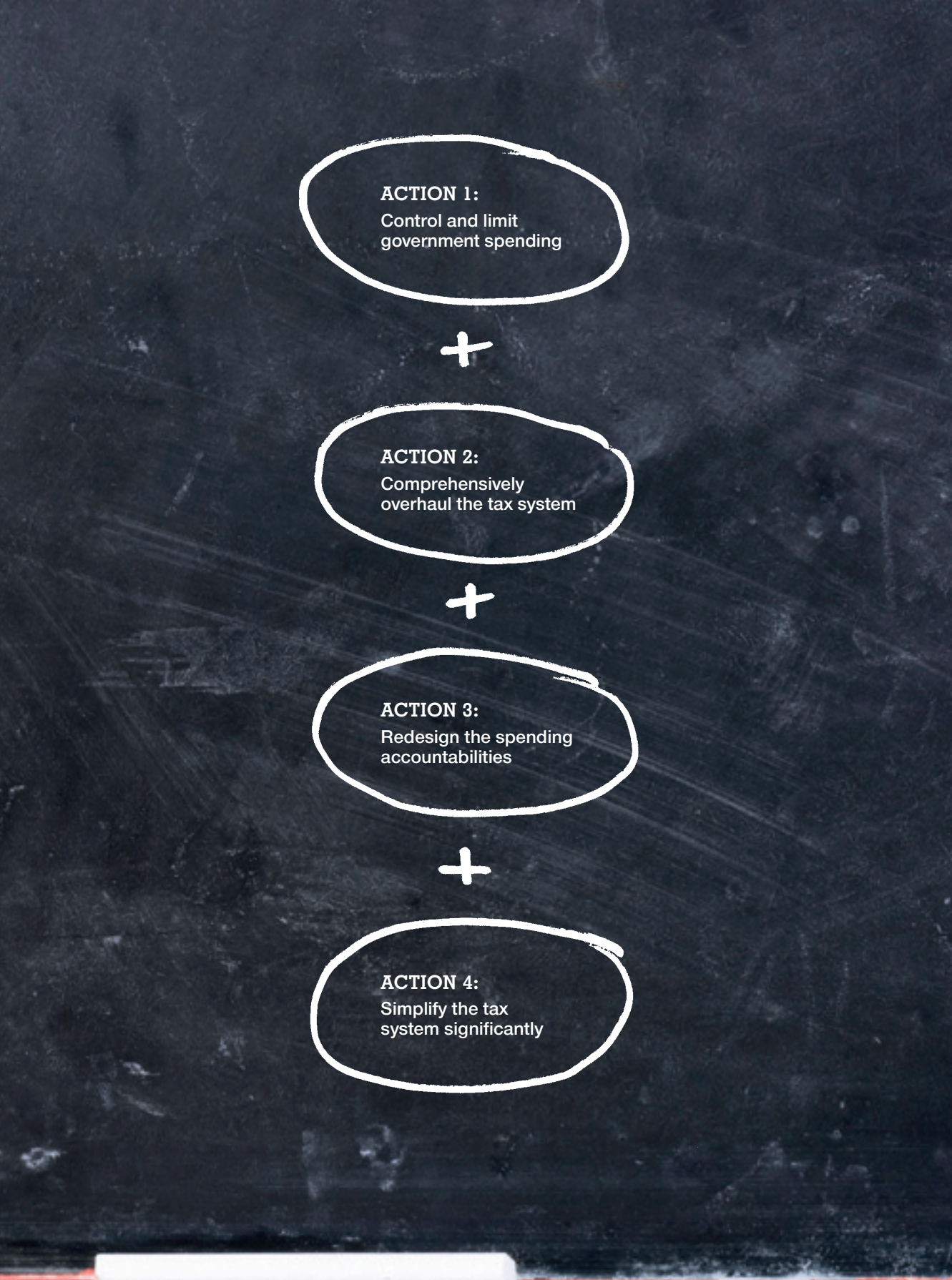
There is a mismatch between the service delivery responsibilities of the states and their revenue raising capacity. State governments are not able to raise sufficient revenue to meet the costs of the basic health, education and transport services they provide. In 2010–11, the states and territories were responsible for around $200 billion of spending. Barely half of this was funded through their own tax revenue sources and the GST. Yet, state governments must meet growing and more costly demands across all these areas. As a result, they have been forced to rely on a range of mostly inefficient taxes to raise revenue – taxes that hamper productivity and increase costs for households and businesses.

For all these reasons, Australia can no longer continue with a piecemeal and short-term approach to improving the tax system.

Australia cannot embark on improving the tax system without also examining the size and efficiency of government spending. Taxpayers – families, individuals and small and large businesses – cannot be expected to carry the burden of poorly planned, poorly targeted and inefficient government spending.

If Australia is to address lagging national productivity, create a better and fairer tax system, and position ourselves to become one of the more prosperous of nations, then four actions are essential.

Committed leadership is needed to start the process of improving the tax system and strengthening Australia's long-term budget position


ACTION 1:
Control and limit government spending
+
ACTION 2:
Comprehensively overhaul the tax system
+
ACTION 3:
Redesign the spending accountabilities
+
ACTION 4:
Simplify the tax system significantly

ACTION 1

Control and limit government spending

A first step must be for all levels of government to improve the efficiency and effectiveness of expenditure and stop committing to services and entitlement programs that cannot be afforded in the medium to long term.

The Business Council of Australia is calling for the establishment of a Commission of Budget Integrity to look at government activities and public sector performance to help inform the community about which programs are meeting their objectives and are delivering value for money. The commission would prepare regular independent reports on the sustainability of Australia's fiscal position, and look at longer-term budget pressures across all governments (including in areas that might otherwise be considered 'off limits') and ways of dealing with them.

A Commission of Budget Integrity would ensure the full and ongoing costs of new services and entitlement programs are independently reviewed. This would help Australia avoid the cumulative burden of future taxes and debts that now confront the governments of the United States and many states in Europe.

It could also progress analysis to identify the most intelligent options for improving the tax system in tandem with more efficient spending by all levels of government.

ACTION 2

Comprehensively overhaul the tax system

Comprehensive improvements to the tax system, while difficult, should be staged over 10 years to minimise the impact on families, individuals and businesses.

This overhaul should focus on abolishing the worst productivity-sapping taxes and improving the mix of taxes (rather than inventing new ones). Improving the tax mix would raise revenue, improve productivity and competitiveness and provide incentives for savings and investment back into the economy.

A first step towards a better tax system is the abolition of the most inefficient state taxes, beginning with stamp duties and insurance taxes, with revenues replaced from other, more efficient sources. These taxes are simply taxes on transactions, which limit the mobility of labour and capital and harm innovation and productivity.

Improving the total tax mix is also vital. Continuing to look at individual taxes in isolation (e.g. personal tax or business taxes) is not the best approach to improving the tax system.

Focusing on one set of taxes alone has the potential to create revenue shortfalls in other areas. It is critical that governments look at the tax mix as a whole.

A fundamental principle that should be used to guide tax policy formulation is to make the tax base as broad as possible in order to support lower tax rates.

Australia should aim to move progressively to a tax system less reliant on personal income tax and company tax (taxes on mobile factors) and more reliant on more efficient, less mobile, indirect taxes such as consumption and land tax. This will raise necessary revenue while supporting growth and investment.

Discussions about options to achieve a better tax mix across the four taxes could include personal tax, company tax, indirect taxes and social and environmental taxes.

Personal tax

We recognise the steps that the government has taken to address workforce disincentives that arise from the interaction of the tax and transfer system, particularly at lower income levels. The fact remains, however, that marginal personal income tax rates at middle and higher incomes are high and uncompetitive and risk discouraging work effort from those with relatively high skills and high productivity. That outcome is wrong at a time when we are striving to improve our national productivity performance.

Further steps are needed to simplify the personal tax system and improve the rate structure to improve incentives and competitiveness, including at higher incomes. This should be done in a way that retains an element of progressivity in the tax system.

Company tax

The growing mobility of investment and increasing sensitivity of capital flows to tax settings have important implications for Australia's long-term growth prospects. We strongly support the recommendation of the Henry review that company tax rates should be reduced to 25 per cent. But we need to recognise that a reduction of that magnitude will make us barely competitive within the region today. We should aim to reduce corporate tax even lower as and when we can.

There are some other important corporate tax reform directions set out in the Henry review, including around capital allowance arrangements and loss carry-backs. These issues warrant further consideration. However, they will need to be considered in the context of a goal of moving towards a simpler tax system, predicated on a broad tax base with lower rates.

Indirect taxes

The architecture of a reformed tax system should also recognise that a system freed from the most inefficient state taxes has the potential to deliver significant increases in productivity.

To abolish transaction taxes to improve efficiency and productivity, alternative revenue sources will be needed, ideally from more efficient taxes such as greater taxation of consumption, the taxation of land and potentially a more efficient payroll tax system.

We acknowledge that changes to consumption tax will be controversial. Modelling by many commentators for the tax forum shows that only modest increases in the GST rate, or changes aimed at broadening the GST base, could raise substantial revenue, allowing other taxes to be abolished.

Consistent with our view that Australia should increase reliance on indirect taxes and reduce reliance on personal and company taxes, it is important to set in place some principles for adjusting consumption taxes. Any future increases in GST should be applied solely to the reduction or removal of other taxes, not to raise more revenue. That is, there must be explicit offsets associated with any increase to the GST. Another critical principle is the need for a staged approach with transitional arrangements and appropriate compensation for vulnerable groups.

Increasing the GST is not the only possible solution. There is scope for the states to better utilise existing payroll or land taxes. Thought needs to be given to reconsidering land and payroll tax rates, thresholds, exemptions and concessions with a view to improving overall efficiency. A future tax system could incorporate a combination of revenue sources as a means of replacing existing inefficient state transactions taxes.

In order to improve the tax system, consideration of consumption tax issues should not be taken off the table.

Social and environmental taxes

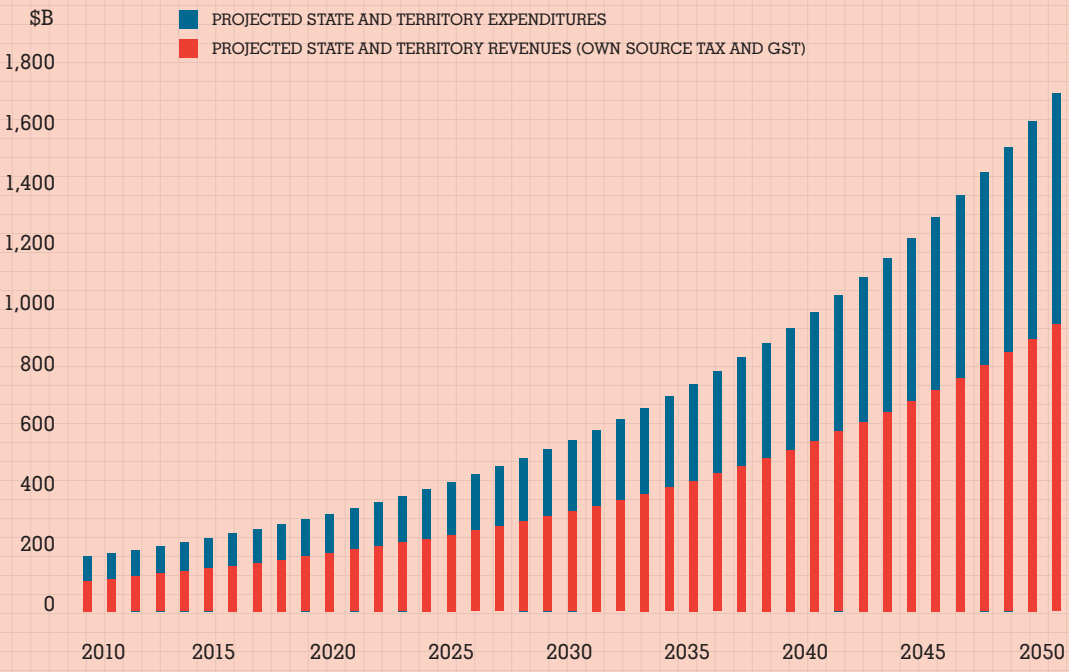
The social and environmental dimensions of human activity also have significant implications for future tax design and the application of tax principles. Narrowly based taxes specifically designed to change behaviour can have a legitimate role. In considering such taxes it is important to be explicit about their purpose. Taxes directed at addressing social and environmental issues need to bring about actual changes in behaviour. They should not have general revenue raising or income redistribution as their main objective.

ACTION 3

Redesign the spending accountabilities and revenue raising capacities of the states and the Commonwealth Government

If inefficient, unproductive state taxes are to be removed, then states will need to find other sources of revenue.

The states will bear a significant responsibility for delivering high-demand services, such as health care, and so they will need more predictable and growing sources of funding. While there are opportunities for the states to raise revenue more efficiently from their own taxes, consideration should also be given to sharing personal income tax revenue with the states.



The Commonwealth and the states must resolve these tensions over the next five years.

SOURCE: DELOITTE ACCESS ECONOMICS, 'AN INTERGENERATIONAL REPORT FOR THE STATES'.

ACTION 4

Simplify the tax system significantly

Reforms to reduce the cost and complexity of the community's interface with the tax system should also be a high priority. A commitment from government to implement administrative reforms recommended by the Henry review – including simplifying personal income tax returns and reducing paperwork for businesses – is an important first step.

A pathway for progressing reform

It is important that the 2011 tax forum not finish with one or two piecemeal changes.

Instead, it is essential that we start the process now of improving the system – a process that will take 10 years to complete.

The long-term program of tax reforms required in Australia will therefore need to be:

- progressed at all levels of government
- coordinated with broader government program developments
- linked to fiscal policy developments
- multi-disciplinary and multi-layered, addressing issues of policy, legislation, administration and compliance.

The key steps to do this would be as follows:

- The Commonwealth Government should, in conjunction with the states, set out the projected fiscal challenge by extending the Intergenerational Report-type analysis across all levels of government.
- The Commonwealth and states should prepare a prioritised list of inefficient state taxes and an approximate timetable for their removal, including identification of potential options to replace that revenue.
- The most useful way of dealing with such comprehensive change would be to progress analysis to identify the most intelligent options for improving the tax system in tandem with more efficient spending by all levels of government. Tax reform options would form the basis of an extensive consultation with the community. Such analysis would identify the impact of changes on families, individuals and companies, possible transitional and compensation arrangements and projected budget implications.
- The government should consider what is the best institutional arrangement to progress tax reform.

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It is important to note that our submission does not deal in detail with the so-called carbon tax and the Minerals Resource Rent Tax (MRRT). In respect of the Clean Energy Future Package and carbon price, if the legislation is passed after three years, this scheme will become an emissions trading scheme and will not form part of the tax system. Notwithstanding this, we remain of the view that the cumulative effect of the carbon price and MRRT will be to compromise the long-term competitiveness of our resources sectors. Given Australia's reliance on those sectors to underpin economic growth, actions taken by governments that impact on that competitiveness impede the strength of the very sectors that Australia needs to position it for long-term economic growth.

A principled way forward

Committed leadership is needed to start a process of improving the tax system and strengthening Australia's long-term budget position.

Australia should begin improving the tax system now, while the economy is in relatively good shape, rather than be forced to make major changes during more difficult economic circumstances, as is now the case with many other economies across the world (particularly in Europe and North America).

Changes to the tax system must be based on good public policy principles. No options should be taken off the table, even if they are politically difficult.

Inevitably, elements of a tax system will reflect political realities, but taking a principles-based approach can limit the potential for bad policy outcomes arising from short-term political expediency. We recommend a number of important principles in our submission.

Finally, and importantly, we must recognise that major changes in taxation will require a mandate from the Australian people. If Australia gets this wrong, or governments are prepared to make only piecemeal changes, it is inevitable that future growth and therefore tax revenue will be weaker, leaving a larger problem to future generations of Australians. Comprehensive, growth-oriented tax reform will, by contrast, support Australia's capacity to deliver on governments' social compact to improve the wellbeing of all Australians.

Australians deserve honest, bipartisan leadership on the challenges we face, on the options we have to create a better tax system and what a better system means for individuals and businesses.

More short-term fixes, more politically motivated tax changes and more promises that can't be kept are simply not in Australia's long-term national interest.

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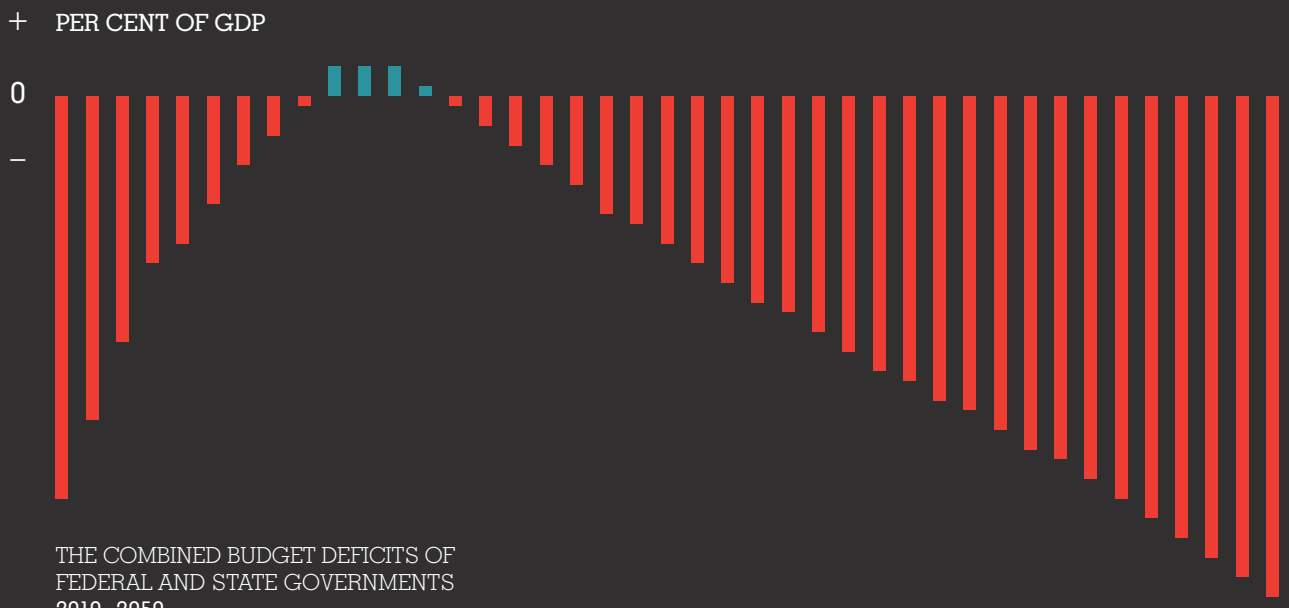

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Business Council of Australia

Acknowledgements

The preparation of this paper was overseen by the BCA's Business Reform Task Force comprising:

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Mr Rob McLeod – Ernst & Young Australia
Mr John O'Sullivan – Credit Suisse (Australia) Ltd
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Mr Andrew Reitzer – Metcash Limited
Ms Jennifer Westacott – Business Council of Australia

The Task Force was aided by an expert Tax Analysis Group, which was assembled to assist in generating ideas and informing the BCA's work for the tax forum. The Group comprised:

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The opinions contained in this report are those of the BCA and not necessarily those of the Tax Analysis Group or others who have assisted in its preparation.

OUR APPROACH TO IMPROVING THE TAX SYSTEM

The BCA has taken a very careful approach to thinking about the best way to improve the tax system. The Henry review provides much of the background work for future changes to the system. The Henry review properly diagnosed the shortcomings of the Australian tax system and provided detailed recommendations for how the system could be improved.

The Henry review had two critical shortcomings which were a product of the terms of reference rather than the work of the Review. The Henry review was not asked to examine the size of government which is a fundamental driver of what a good tax system should aim to achieve. The Review was also restricted from examining the full range of taxes, particularly the Goods and Services Tax (GST).

The BCA has taken the important work of the Henry review and built on it. Firstly, the BCA's report has examined the full cost of government for both the Commonwealth and state governments. If a fundamental part of any tax system is to pay for future services, then designing a new system guided only by the Intergenerational Report for the Commonwealth will mean that tax revenues will fall well short of the true cost of providing the services Australia needs.

Therefore, the BCA has prepared an intergenerational report for all state governments to augment that of the Commonwealth Government. This provides a better guide of the likely size of government into the future.

Secondly, the BCA has highlighted the need to improve the efficiency of government and address the difficulties between the Commonwealth and the states arising from the fact that the states have accountability for delivering the bulk of services, but only have a limited capacity to raise their own revenue.

The BCA has not set out detailed recommendations in this regard, as this is best left to governments. What this report is emphasising however, is that tax reform in isolation, from improving the way governments plan and spend taxpayers money, means that the tax system will simply be chasing poor spending decisions. The BCA believes there are very important questions to be answered about the long-term size of government, the capacity to support the growing costs of health and social security and to pay for the infrastructure Australia needs as our population grows, changes and ages.

This report strongly asserts that the best way of ensuring the tax system can both meet the cost of delivering services and be designed in a way that provides incentives for investment and promotes our productivity and competitiveness, is to focus on improving the mix of taxes, rather than trying to fill revenue gaps with new taxes.

It is important to state from the outset that this report does not deal in detail with the so-called carbon tax (Clean Energy Future Package) and the Minerals Resource Rent Tax (MRRT).

In respect of the Clean Energy Future Package and carbon price, if the legislation is passed after three years, this scheme will become an emissions trading scheme and will not form part of the tax system. The BCA has extensively documented the shortcomings of the Clean Energy Future Package and its risks to Australia's competitiveness.

However, the BCA remains of the view that the cumulative effect of the carbon price and the MRRT will be to compromise the long-term competitiveness of our resources sectors. Given Australia's reliance on those sectors to underpin economic growth, actions taken by governments which impact on that competitiveness impede the strength of the very sectors that Australia needs to position it for long term economic growth.

INTRODUCTION

In considering tax reform we must acknowledge the considerable economic uncertainty both domestically and more particularly with the global economy which is prevailing at present. Many developed nations are grappling with the consequences of large and unsustainable fiscal deficits.

In Australia there has been a decline in community confidence in the ability of governments to deliver programmes over recent years, and yet a sense that more and more will be expected of future governments as our population continues to grow and the population ages.

Dealing with these challenges will require bold actions around managing budgets, enhancing productivity and getting more efficiency out of government spending.

Reforming the tax system will play a fundamental role in this. However, tax policy must fit within responsible fiscal policy, requiring both spending discipline and a system that can raise enough revenue. The tax system itself must also support a productive and competitive national economy.

It is incontrovertible that further comprehensive reform of the tax system is needed in Australia. That is:

- the present system will not be capable of raising the revenue needed to fund the services the community expects from government in the decades ahead;

- the current system does not sufficiently reward productivity and distorts decisions about workforce participation, savings and investment;

- Australia's company tax rate is uncompetitive in our region and there are simply too many taxes that impose compliance burdens but collect limited revenue; and

- the tax system in Australia is too complex and it is costly for businesses and individuals to comply with all of its requirements.

The Henry review highlighted many of these points. It also highlighted the imperative of transitioning over time to a tax system that is robust and that is able to keep pace with emerging economic, social and technological trends as well as being able to adapt to ongoing processes of globalisation.

Comprehensive tax reform is essential if Australia is to meet its full potential in the twenty-first century. However, achieving the benefits that will flow from tax reform will only happen if reform is done properly.

We need to be prepared to put aside the current tax structure and search for the best system of raising revenue in a way that is fair but that also supports incentive and rewards productivity. We also need to recognise that the kind of comprehensive tax reform that Australia needs will take many years to achieve.

The approach to tax reform should not be piecemeal or involve tinkering or the imposition of new, one-off taxes. It would be wrong to consider that the combination of the carbon tax and the changes to the personal income tax and transfer system that went with this, to be representative of substantial tax reform.

The OECD[1] has noted that *'if piecemeal reforms are undertaken for the sake of reform and without any strategic vision to guide them, politicians might not understand or take into account the long-term implications of these measures, such as potentially negative impact on future tax revenues or the possibility that tax complexity might breed further tax complexity. This entails the risk of making the tax system more complex without tackling the underlying economic problems and tax issues in the most efficient way.'*

In seeking to progress tax reform it will be important that support is forthcoming from all sections of society. Engaging the whole community in a deliberate and thorough conversation about our tax system is the right course of action to take at this time.

This report is intended to provide helpful advice to all levels of government, to all politicians, to the community groups and to the broader community as they consider approaches to progressing tax reform in Australia.

PART 1: TAX POLICY WITHIN A RESPONSIBLE FISCAL FRAMEWORK

KEY POINTS

Our report has examined the financial pressures which will confront both the federal and state governments over the next forty years as a backdrop to addressing one of the fundamental challenges of any tax system: to meet the cost of future government outlays.

To date consideration of the fiscal pressures associated with an ageing population has tended to focus on spending pressures facing the Commonwealth Government. But it is important to recognise that the states and territories will also bear a considerable funding burden and that this will place their own budgets under stress.

Taking account of projected spending trends at a Commonwealth, state and territory level, it is apparent that without corrective action a national fiscal shortfall will open up from around 2020. Analysis commissioned by the BCA from Deloitte Access Economics finds that by 2050 this fiscal shortfall is projected to reach 5 per cent of GDP.

Unless we pull back government spending and change the tax system, successive governments will face an imperative of either cutting services or placing unsustainable tax burdens on key sectors of the economy and community.

A primary deficit of 5 per cent of GDP today would be equivalent to $70 billion. To rein in a deficit of that size through the existing tax system would require either:

- an increase in the company tax rate from 30 per cent to 67 per cent; or
- an increase in the GST from 10 per cent to 24 per cent; or
- an increase in all personal income tax rates from today's 15, 30, 37 and 45 cents in the dollar to 22, 43, 53 and 65 cents in the dollar respectively.

Governments would obviously pursue a mix of strategies to address such a deficit, but these illustrative examples underline the magnitude of the task.

Alternatively filling a $70 billion fiscal hole from the expenditure side would require cuts to around 70 per cent of all federal transfers to the states; or eliminating all payments for the aged pension and family benefits; or eliminating all federal payments for health and to the disabled.

Few if any of these options would be tenable. The most sensible approach would be one that seeks to maintain an acceptable and affordable social safety net, funded through a more efficient approach to government spending and by designing an improved tax system.

Dealing with these challenges requires action at both a Commonwealth and state level – recognising the difficulties that arise because state governments have expenditure responsibilities that far outweigh the size and strength of their tax bases. Simply increasing the rates of tax on existing state tax bases will not be a sustainable way of funding services in future.

The essential task of any tax system is to raise sufficient revenue to fund the services of government. Before we can answer the question of how this can best be achieved, however, it is necessary to examine the likely cost of government that Australia will face – at all levels – over the years ahead.

There is no avoiding the fact that the financial pressures that will confront both the federal and state and territory governments ('the states') will grow over the next forty years. This pressure will come from two key trends – an ageing population on one hand and relatively faster growth in health care costs on the other.

To date the majority of the work in this area has been the Commonwealth Treasury's Intergenerational Reports (IGRs) of 2002, 2007 and 2010. The reports have particular benefits in providing an indication of potential tax burdens on future generations of Australians.

To assist in the consideration of issues around the fiscal challenges for Australia over the coming decades, the BCA engaged Deloitte Access Economics to undertake analysis of the long-term fiscal outlook and sustainability of government finances. Recognising that the states will also bear a considerable load on the health care cost front, a focus of this work was the preparation of Intergenerational Report-type projections for state finances.

A discussion of the main features of the Deloitte Access Economics report is outlined below. A full copy of the Deloitte Access Economics material is included at Appendix D.

Once consideration is afforded to the spending pressures the states will face, it becomes apparent that the problems for Australian fiscal finances in coming decades will be greater than is usually realised. Moreover as Deloitte Access Economics has pointed out, there are additional complexities here:

- first, our federation has evolved into a system whereby the states spend more than they earn (and vice versa for the Commonwealth), leaving the national government providing subsidies to the states; and

- second, despite the relative efficiency of the GST (a federal tax distributed to the states) and the potential efficiency of payroll taxes (if they were not subject to the multiple exemptions that currently apply), state taxes as a group are rather less efficient than their Commonwealth counterparts.

That means the pressures on states – and the question that those pressures raise of 'who pays' – becomes worse in light of the small size of the state tax base and inefficient nature of many state taxes. In turn, as key trends add to spending needs at the Commonwealth and state levels, the tax system will need to be able to cope.

Moreover, the sooner we get our tax system right, the more likely we will be to generate the growth that will itself support revenue generation in the years ahead. However, if we get this wrong or are only prepared to make incremental changes then it is inevitable that growth and therefore revenue will be weaker which in turn will present a further layer of challenge. Growth-oriented tax reform will be fundamental to supporting Australia's fiscal challenge.

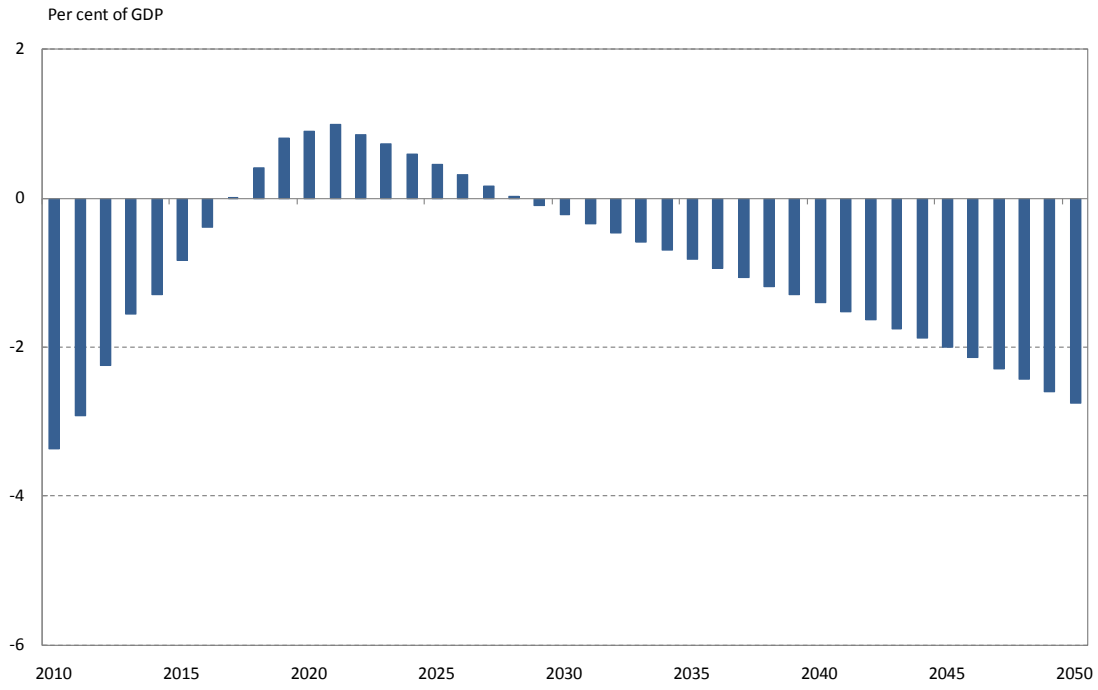
Commonwealth fiscal projections

At a Commonwealth level the most recent IGR was produced in early 2010. This report was based on the assumption of a stable tax to GDP ratio of 23.5 per cent as well as certain assumptions about population growth. It suggested that by 2050 total Commonwealth spending as a share of GDP would increase significantly, resulting in a projected primary fiscal gap (excluding interest payments) of around 2¾ per cent of GDP by that time.

It should be noted however that this result relies on the assumption that the government achieves its goal of constraining real spending growth to two per cent (in years where the economy is growing above trend until the budget is in surplus) and that this delivers permanent structural savings to the budget of around one percentage point of GDP from 2015-16.

Figure 1 below depicts the projected primary fiscal balance for the Commonwealth out to 2050.

Figure 1: Primary Fiscal Balance – Commonwealth Government



Source: Deloitte Access Economics, An Intergenerational Report for the States, Report for the Business Council of Australia

This figure shows that the Commonwealth is projected to run a string of budget surpluses through much of the second half of this decade and through the 2020s[i], although the size of the Commonwealth's primary balances worsens from about 2020 out to 2050.

It is worth noting however that there are necessarily considerable uncertainties surrounding the projections. For example, the Deloitte Access Economics analysis notes that the assumption of a constant tax to GDP ratio of 23.5 per cent may come under pressure from a long-term downtrend in the terms of trade from their recent highs. In particular, the 2010 IGR assumes that 'the boost to the company tax take as a share of GDP over the past decade was largely

[i] Deloitte Access Economics notes that these results are derived from long term models, and therefore do not match the announced forward estimates profiles of either the Commonwealth or the states. That may be seen, for example, in 2012-13, where the Commonwealth has budgeted a surplus.

permanent, rather than the essentially temporary result of the profound demand shock of the past decade which saw the demand for minerals leap ahead of the supply of them, sending prices [higher] and taking Australian government tax receipts with them. The latter view would see mining supply lift over the next decade, bringing down the terms of trade – and so tax receipts – more than the IGR assumes.'[2]

An associated risk is the extent to which the Budget has become significantly more exposed to the movements in commodity prices. This point has also been acknowledged by the government: "the historically high terms of trade and growth in the mining sector as a share of the economy have meant that the Budget is more sensitive to developments in commodity and currency markets than in the past. Given the continuing uncertainty around the growth prospects for many of the world's major economies, this is a potential source of volatility for Budget estimates."[3]

State fiscal projections

To date the Commonwealth's IGR's have focused on federal finances. However the most recent IGR has noted that while the Australian government provides over 40 per cent of the total health funding (and is the major source of public funds) the state and local governments fund around one quarter of the cost of health services, with non-government sources contributing around one third.

Indeed the Commonwealth has acknowledged that the states will face key cost pressures of their own. The NSW Treasury has estimated that spending on health will almost double as a share of the state's total Budget — from 30 per cent now to around 55 per cent in 2032-33.

Deloitte Access Economics has modelled state finances in a way that mirrors the approach taken in the Commonwealth IGR. States' own source revenues are assumed to be constant as a proportion of GDP, as are GST revenues. The projections include assumptions about the states having to continue to rely on grants from the Commonwealth and having to find revenue from other non-tax sources. The effect of these assumptions is that over the next four decades, states own source tax revenue continue to account for only around one third of states' total revenues.

On the expenditure side, the Deloitte Access Economics analysis notes that unlike the Commonwealth there is no matching assumption that there will be a notable period of expenditure savings from the states (i.e., no commitment to a 2 per cent real cap in spending) before the demographic and non-demographic spending pressures are applied.

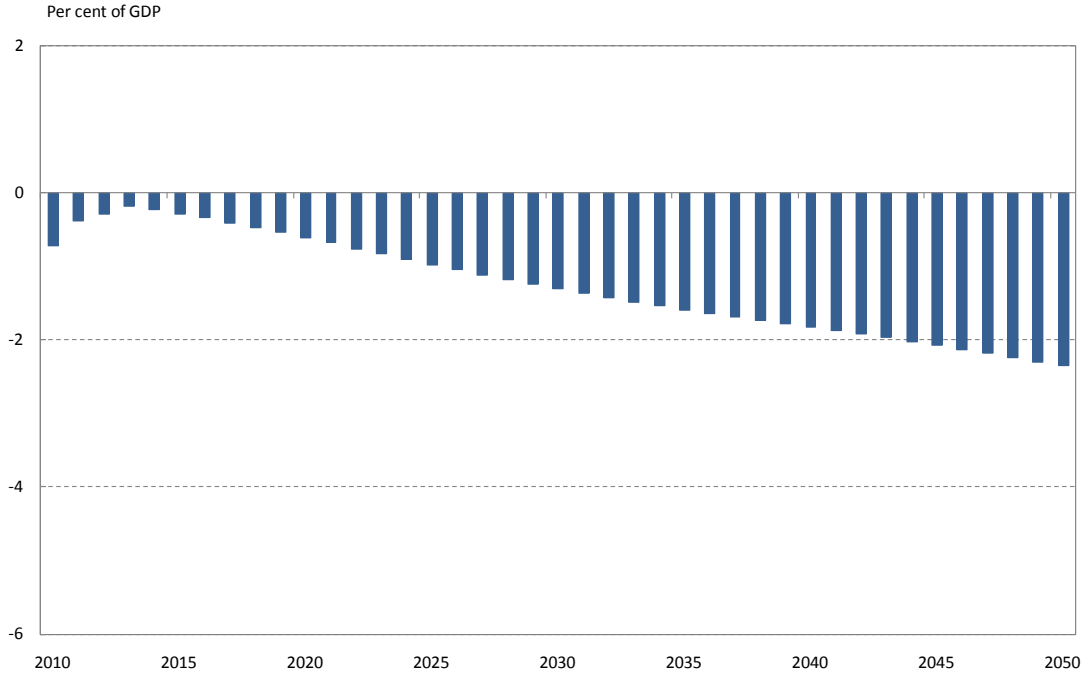
The results of Deloitte Access Economics' modelling show that although pressures on the states are not quite as notable as those on the Commonwealth Government, they are considerable – and have not been widely recognised. The states, for example, bear a considerable load on the health care cost front, even after allowing for recent proposed changes in state arrangements in this area.

Whereas the shortfall on primary balances for the Commonwealth is projected to reach 2¾ per cent of GDP by 2050, the Deloitte Access Economics modelling indicates that the states will see a shortfall of much the same size: almost 2½ per cent of GDP by 2050.

Deloitte Access Economics notes that that does not mean that the effects of pressures such as ageing and health care cost inflation are the same for the states as they are for the Commonwealth. Rather, that the end-point in 2050 is also affected by today's starting points, as well as by the federal assumption that spending restraint will occur over the next decade.

Figure 2 below depicts the projected primary fiscal balance for the states out to 2050.

Figure 2: Primary Fiscal Balance – Combined State Governments



Source: Deloitte Access Economics, An Intergenerational Report for the States, Report for the Business Council of Australia

Projected shortfalls in our national fiscal position

It is possible to combine the results of the fiscal modelling to obtain a sense of what the total shortfall in national fiscal finances could be by 2050.

When the states' position is added to that of the Commonwealth, Deloitte Access Economics finds that by 2050 the total shortfall reaches just over 5 per cent of GDP (excluding interest payments). Today a budget deficit of 5 per cent of GDP would be equivalent to around $70 billion.

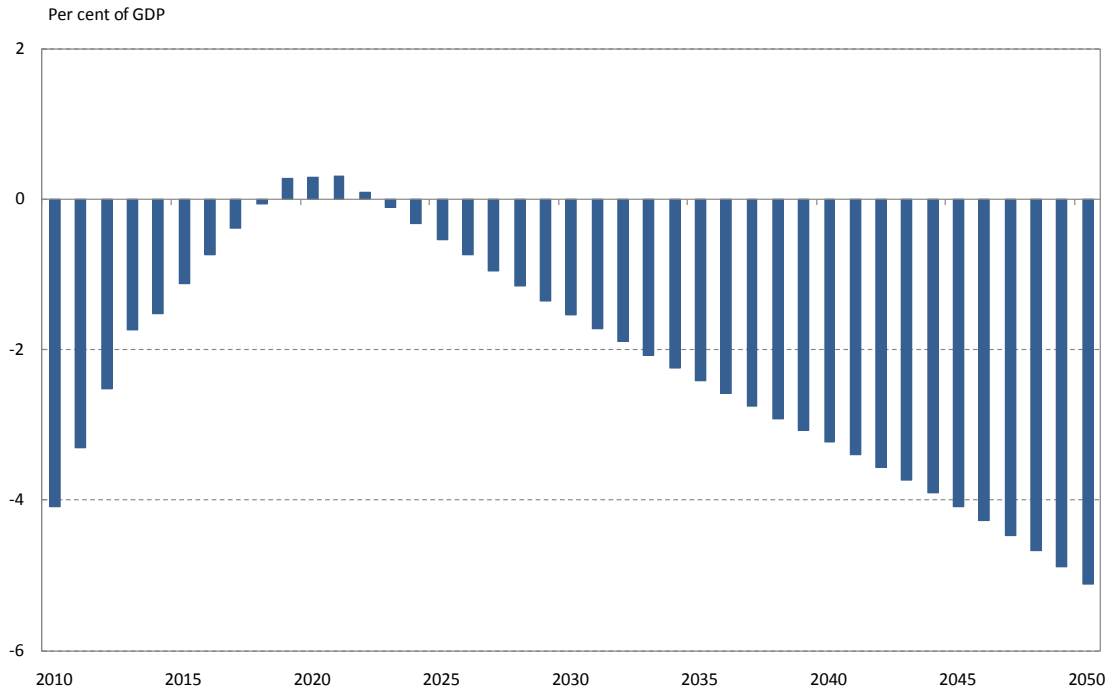
Such an outcome will present Australia with some stark choices and as a nation we will have to decide what we can do about this.

The option of doing nothing is not tenable. As noted by Deloitte Access Economics, compared with many countries around the world, Australia's governments have enviable fiscal positions. Indeed, our relative fiscal strengths served us well through the recent global financial crisis, leaving Australia better positioned to defend against the downturn through stimulus spending.

However, running rising fiscal deficits across four decades – the 'do nothing' outcome – would not be a viable option. Each year that governments run fiscal deficits requires borrowings and borrowing year in year out will mean that borrowings eventually blow out, taking the

government's balance sheet with it. Pursuing such a route would mean that Australia would inevitably lose its AAA credit rating.

Figure 3: Primary Fiscal Balance – All Governments



Source: Deloitte Access Economics, An Intergenerational Report for the States, Report for the Business Council of Australia

The national choice

If the do nothing option is not viable, then as a nation we need to think about the alternatives. At the outset however, we need to recognise that ultimately governments must have an overarching objective of improving the wellbeing of Australians. This includes by maintaining appropriate economic, environmental and social conditions including through the provision of an acceptable and affordable social safety net. The Australian social compact is predicated on this safety net and it should continue to feature as a central element of the society we live in.

In view of the funding challenge that lies before us, there are essentially three choices about what we can do. Either we:

1. try to fund the spending challenge by retaining the current tax system architecture, but scale it up to meet these costs. This would imply the need for significantly higher marginal tax rates on personal income and a high company tax rate (and even higher rates if we are not prepared as a nation to revisit the GST); or

2. retain the current tax architecture (with current tax rates and the like) but reduce entitlements through greater use of co-payments and user pays arrangements for health and aged care, provide less generous government pensions, and reduce other spending; or

3. maintain the safety net and major entitlements and have a reasonable redistribution of income, but fund this through a more efficient approach to government spending and by an improved, robust tax system architecture focused on a small number of broad revenue bases with competitive rates.

To obtain a sense of the task ahead and what might be required, Deloitte Access Economics has undertaken an exercise which illustrates what a primary deficit of 5 per cent of GDP would represent in terms of today's tax take.

To raise that money – the first funding option noted above – would require combined Commonwealth and state taxes to rise by $70 billion a year. To achieve that would require, for example[ii]:

- lifting the company tax rate to 67 per cent, rather than today's 30 per cent; or
- lifting the GST rate to 24 per cent, rather than leaving it at today's 10 per cent; or
- lifting all marginal personal income tax rates to 22, 43, 53 and 65 per cent (rather than today's 15, 30, 37 and 45 per cent rates).

Deloitte Access Economics notes that these illustrations do not attempt to account for second round effects. For example, as all taxes are inefficient to some degree, and become more so as rates increase, then higher taxes would result in a smaller economy and so smaller tax bases, meaning that there could be a negative spiral – taxes would need to go higher to raise the initial target amount, thereby hurting the economy more, and so on.

Similarly, some taxes are deductible or offsets are available against other taxes – hence, for example, higher company taxes would cut collections of personal income tax, also implying the need for higher taxes than suggested. That is, these illustrations are likely to be highly conservative.

On the other side of the ledger, to fill a $70 billion fiscal hole today from savings from lower spending – the second funding option noted above – would require, for example:

- cutting all federal payments to the states – payments for specific services plus general revenue assistance – by 73 cents in the dollar, along with the states then cutting their spending on services by the same amount; or
- eliminating all federal payments to the aged and to families – that is, eliminating both pensions and family benefits; or
- eliminating all federal payments for health and to the disabled; or
- eliminating all federal payments for education, defence and hospitals.

[ii] These examples highlight what is required if only one tax source is doing the work. An alternative would be to pursue a mix of tax sources.

Of the three options underpinning the national choice, clearly the most sensible approach would be to seek to maintain our social safety net and system of entitlements and fund this through a more efficient approach to government spending and by developing and implementing an improved, robust tax system architecture.

It is also worth noting that taking steps to make structural improvements to government spending and reform the tax system will be much easier to do in a time of economic growth.

As Deloitte Access Economics has noted, although much of the modelling underlying these numbers – and their implications – is already in the public domain, the average Australian is probably not aware of the extent to which the national social compact will be under pressure in coming years. Maintaining this social compact will itself involve a tight trade-off of expenditure decisions, savings decisions and how we go about raising taxes.

The earlier and more sensibly that Australia addresses these challenges, the better our chances of meeting them without major dislocation.

Conclusion

Based on the fiscal context outlined in this Part, it is clear that the tax system in and of itself cannot meet Australia's long-term fiscal challenges. Instead, tax reform must go hand-in-hand with fiscal discipline through structural improvements to government spending.

In addition, strong economic growth will place the government and the Australian community in a much better position to fund future expenditures. This highlights the importance of the tax system not unnecessarily impeding productivity and economic growth.

The significant burden in state governments also suggests that we cannot meet these challenges without examining the fiscal settings of our federal structure.

PART 2: AUSTRALIA'S FEDERAL SYSTEM. IMPLICATIONS FOR TAX REFORM

KEY POINTS

If we are to pursue effective tax reform across the federation in the next decade, then we should be mindful of the federal context and how a range of factors may impact on how we design and implement tax reform in line with a more effective federation. There are four key contextual factors with associated implications, that will be important considerations when pursuing tax reform across the federation.

- In the absence of access to income and sales taxes, the states have limited effective tax levers that they can utilise to replace inefficient taxes or fund an increasing level of services in their own right.

- Given that the benefits of eliminating inefficient state taxes will be different for each state government and there will be a major national economic growth dividend, there is a clear opportunity for the Commonwealth Government to work collaboratively with states to facilitate such an agreement. Achieving agreement would require consideration of a range of replacement taxes at both the Commonwealth and state level.

- While a level of imbalance between access to tax bases and expenditure responsibilities is a reality in all federations, the imbalance in Australia's case is relatively high by international standards, as highlighted by previous studies on federalism. This imbalance tends to undermine accountability for the effectiveness of expenditure and the autonomy of the states in service delivery. Taking account of the relative position on federal fiscal imbalances and the negative impacts on accountability, the potential to reduce this imbalance essentially falls to some kind of tax base sharing arrangement with the Commonwealth, particularly around the personal income tax base.

- While states should have greater autonomy over tax revenues, it should not create an unreasonable level of complexity in the tax system.

The previous section has highlighted the growing fiscal pressures on all levels of government. This of course, has significant implications for our federal fiscal system in which the Commonwealth collects the majority of tax revenue, while the states have responsibility for delivery of services in the fastest growing areas of expenditure such as health and education.

In pursuing comprehensive tax reform in the decade ahead, we must be conscious of the federal context and the broader implications across the federation of altering tax settings in any one area. As noted in the Henry review, the primary consideration in reforming the tax system should be the quality of the tax, but an important secondary consideration is the role of the states in the tax system and the manner in which certain reforms may provide a platform to improve the performance of governments more broadly.

Tax reform in and of itself will not improve the operation of our federal system but it should not distort the incentives for various levels of government to attain efficiency in their operations. The tax system should also wherever possible align with clear accountabilities and delineation of roles and responsibilities. The tax system also needs to support an efficient federation.

Tax assignment across our three levels of government has changed considerably since federation and it is inevitable that ongoing policy and other developments will require further flexibility in the future.

With these issues in mind, the following section briefly describes the current federal fiscal architecture, tax assignment within the federation and the main implications of this for the pursuit of tax reform on a comprehensive basis.

History of tax assignment and constitutional issues

The distribution of powers in many federal systems is a product of history rather than design. In Australia our distribution of powers can be partly explained by the Constitution, although the way in which it has been interpreted and applied over time offers a clearer explanation for the federal system we have today.

The roles and responsibilities of different levels of government have also evolved since the inauguration of the Constitution.

Under section 51 of the Constitution, states have residual powers not listed as belonging to the Commonwealth Parliament. The powers of the Commonwealth Parliament under this section include defence, trade, communications, statistics, immigration and foreign affairs. The states are left with powers related to many of the core infrastructure and services necessary for economic and social development, including health care, transport, policing and schooling.

While the Engineers Case in 1920 set a precedent for broader interpretation of Commonwealth powers, the Commonwealth gaining emergency control of income in 1942 to finance the Second World War gave the Commonwealth the financial means to exert greater influence and take a more significant role in a number of areas.[4]

Since this time, the Commonwealth has taken increasing or full responsibility in areas like schooling, tertiary education, trade practices, welfare, discrimination, family law, industrial relations and the environment.[5]

The evolution of taxation powers has been more significant than these areas of policy and service delivery. At the inauguration of the Constitution, state and local governments were responsible for raising almost 90 per cent of all tax revenues.[6] In contrast, today we have a system characterised by a relatively small number of effective state tax bases and large fiscal transfers from the Commonwealth to the states necessary to discharge their responsibilities.

In this context, it is useful to consider briefly the history and constitutional basis of the major tax bases of sales and income.

Sales tax

The Commonwealth has exclusive powers in relation to the imposition of excise and customs duties under section 90 of the Constitution. Based on the High Court's interpretation of this provision, states are not able to impose a sales tax, purchase tax or value added tax. Past attempts by state governments to develop new taxes without contravening this provision have

failed. For example, during the 1970s states introduced business franchise taxes on petroleum, tobacco and alcohol, which became a substantial source of revenue until the High Court handed down a landmark decision against them in 1997.[7]

Income tax

The Commonwealth and the states both levied their own income taxes from 1916 until 1942. The Commonwealth then took full control of income tax as an emergency matter during the Second World War.

In order to give effect to this emergency measure, the Commonwealth raised its own tax rates to a level equivalent to the previous state and Commonwealth taxes combined, and legislated to give priority to the collection of Commonwealth income tax.

To compensate the states for the loss of revenue, the Commonwealth utilised its power under section 96 of the Constitution to "grant financial assistance to any state on such terms and conditions as the Parliament thinks fit." It legislated to provide for the payment of annual grants to each state, contingent on the states not imposing their own income tax.

The application of this condition gradually weakened after 1959 and then in 1978 the Commonwealth passed the *Income Tax (Arrangements with the States) Act 1978*, which allowed each state to apply a surcharge or rebate to income taxes collected in their state by the Commonwealth. No state utilised this arrangement and the legislation was repealed in the early 1990s. In the absence of a reduction in the Commonwealth's income tax rates, the states would have been in effect lifting the overall level of income tax.

Current federal fiscal architecture

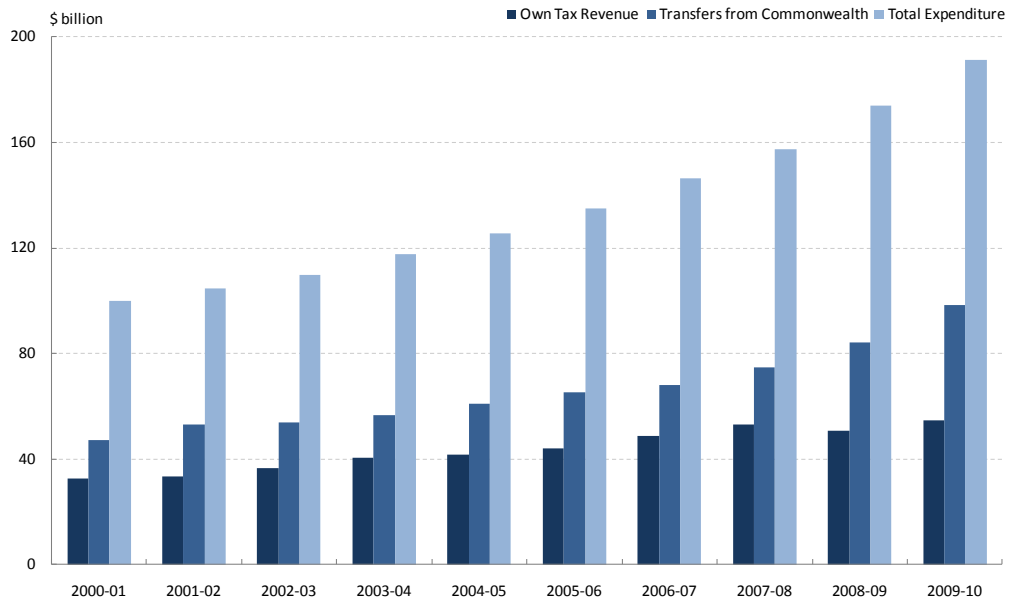
Revenue raising and expenditure responsibilities

Given the manner in which tax assignment and the application of the Constitution has evolved, it is not surprising that the current federal fiscal system is characterised by vertical fiscal imbalance which sees the Commonwealth collecting more tax revenue than it spends, while the states are responsible for expenditure that far outstrips their own revenues. It also reflects the practical difficulties of matching revenues and expenditures at each level of government in a federation.

In 2009-10, the states were responsible for collecting around 17 per cent of aggregate tax revenues but had responsibility for around 44 per cent of all expenditures.[8] The Commonwealth Government on the other hand collected 83 per cent of tax revenues and redistributed over a third of these revenues to the states through the redistribution of the GST and other financial transfers.[9]

Figure 4 illustrates this trend over the last decade, with state expenditure growing at a much faster rate than state own-source tax revenues, with the difference accounted for in large part by fiscal transfers from the Commonwealth.

Figure 4: States' Funding and Expenditure

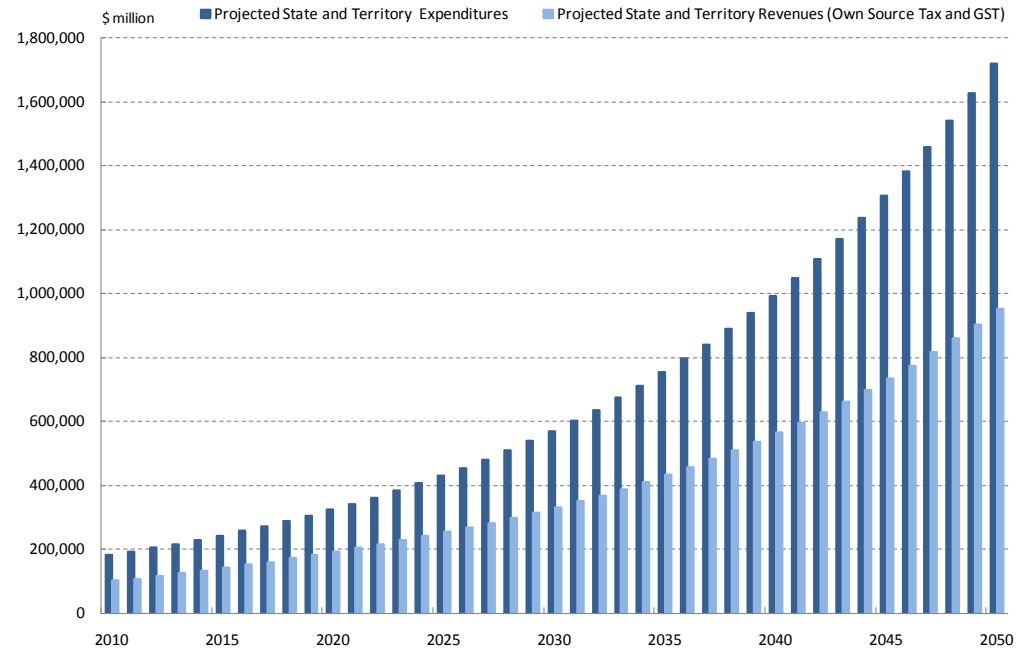


Source: ABS, *Government Finance Statistics, Australia*, Catalogue No. 5512.0, April 2011 & *Taxation Revenue, Australia*, Catalogue No. 5506.0, April 2011.

As noted by the Henry review, many of the tax bases that the states do have access to are amongst the most inefficient and narrow bases, with the exception of payroll tax and land tax (the former if it is applied to a broader base).

As outlined in Part 1, the states will have a responsibility for delivering high demand services, including health care over the decades ahead. To do this they will require more predictable and stable sources of funding. Figure 5 illustrates the extent to which states own-source tax revenues and the GST falls short of meeting projected spending.

Figure 5: Projected State Expenditures and Own Source Tax and GST Revenue



Source: Deloitte Access Economics, An Intergenerational Report for the States, Report for the Business Council of Australia

Commonwealth transfers to the states

Under the Intergovernmental Agreement on Federal Financial Relations, Commonwealth financial transfers are made to the states through two primary mechanisms: a redistribution of GST revenues to the states, and through payments to support specific state services through National Specific Purpose Payments (National SPPs), National Partnership payments and, from 1 July 2012, National Health Reform payments.

GST revenues are distributed on the basis of the advice of the Commonwealth Grants Commission. The Commission's fiscal equalisation approach attempts to distribute the revenue so that when states raise their own taxes at a comparable level of effort, states have the same capacity to provide comparable services to their population.

The Commonwealth Government has initiated a review of the method of GST distribution to be completed by late 2012. The review will seek to address the following three shortcomings of the current fiscal equalisation process:

- the current process can hamper the incentive for states to undertake reforms to improve service delivery and boost economic growth, by distributing gains away to other states;

- the current process can result in unexpected shocks to state finances, undermining the ability of states to plan their budgets on the basis of stable revenues; and

- the methodology underpinning the process is complex and not easily understood by taxpayers.

This review matters because present arrangements can produce outcomes whereby states undertaking worthwhile reforms independently of other states (e.g., reducing inefficient state taxes) can reduce a state's share of GST revenue under the equalisation process. This is because the state may effectively be recognised as not fully exploiting the revenue raising potential of its own tax base, particularly if the base expands, as intended by the reform, after the tax reduction.

Future efforts to effect state tax reform will need to be cognisant of the outcomes of this review and the effect any changes will have on the federal fiscal system. State tax reforms undertaken in isolation without regard to the impact of GST redistribution could have the impact of reinforcing or re-introducing potential disincentives to effective performance delivery or the pursuit of beneficial reform.

A more efficient method of re-distributing GST revenues – and a resolving of (at a high level) roles and responsibilities between the Commonwealth and the states – would be an important pre-cursor to any consideration in future of a greater role for the GST as a part of enhancing state revenue sources.

The remaining financial transfers received by the states come in the form of specific purpose payments, which the Commonwealth provides to pursue national policy objectives in areas administered by state governments including health and education. In 2011-12, these payments are estimated to be $45.5 billion.[10]

The architecture for these payments was substantially reformed in 2008 through changes to the Intergovernmental Agreement on Federal Financial Relations with the objective of giving states greater flexibility in how they delivered services.

However, it is not clear at this stage that the objectives of this reform have been maintained in practice. The recent proliferation of National Partnership Agreements has in many cases reinstated Commonwealth direction over funding and expenditure.

Other sources of revenue

In addition to transfers from the Commonwealth, the federal fiscal system sees states and territories highly dependent on their own non-taxation revenues from the sale of goods and services, interest and dividend income. This revenue amounts to over $54 billion and has grown at an average rate of almost 10 per cent over the last ten years.[11]

The mining boom means that mining royalties are contributing an increasing share to these other revenues. In 2009-10, states collected approximately $6.5 billion in mining royalties, compared to approximately $1.8 billion in 2001-02.[12]

While the role of mining royalties in these other source revenues is relatively well understood, the states' other non-tax revenues receive limited attention at a national level. It is possible that the limits of their own tax bases could give states an incentive to more actively exploit these revenues. It is not uncommon for user fees to be set at a level greater than cost with a view to using the proceeds to subsidise other expenditures. Equally, these revenues may rise naturally through the increased profits of state owned enterprises.

These issues are largely outside of the scope of the tax forum, but the dependence on this revenue source may be influenced by the configuration of taxes in the federal system. In the longer term it would be useful to examine the efficiency of these revenues relative to taxation revenue and whether the level of this revenue is appropriate and sustainable over time.

Overall impact on accountability

One of the risks of vertical fiscal imbalance in the federal–state architecture is that the accountability between the raising of revenue and the responsibility for funding programs can become blurred. For example, the Commonwealth could avoid accountability for expenditure of funds because it is the states that have actual responsibility for disbursing the expenditure. Similarly, states could argue that they are not able to deliver services adequately due to a lack of funding from the Commonwealth.

The Henry review itself noted that 'if a government is not accountable for the revenue it raises, it may not face the full cost of how it spends the revenue and may have less incentive to be disciplined in how it spends that revenue'.[13]

Implications for future tax reform

If we are to pursue effective tax reform across the federation in the next decade, then we should be mindful of the federal context and how a range of factors may impact on how we design and

implement tax reform in line with a more effective federation. There are four key contextual factors with associated implications that will be important considerations when pursuing tax reform across the federation.

1. Constraints on state tax bases

The states are relatively constrained in their ability to effect substantial reform of their taxes. In the absence of access to income and sales taxes, the states have limited effective tax levers that they can utilise to replace inefficient taxes or fund an increasing level of services in their own right.

As mentioned previously, there are exceptions to this in the form of payroll tax if it is applied to a broad base and land tax. These taxes could potentially play a greater role in raising revenue more efficiently at the state level. Another option would be to increase the base and/or rate of the GST, given its relative efficiency.

Some combination of these taxes could potentially raise the revenue required to replace inefficient taxes but it is unlikely that they could also serve the purpose of funding major marginal expenditure decisions by the states.

Sharing an income tax base such as personal income tax with the Commonwealth could be one way of giving state governments the flexibility to use the tax system to increase their spending, while being accountable to their citizens for the cost effectiveness of that spending. This will be particularly important given the expenditure pressures on state governments outlined earlier.

Such an arrangement is not without precedent. As noted previously, states had the power from the late 1970s to early 1990s to apply a surcharge to income taxes collected in their state but the Commonwealth Government did not reduce its rates to accommodate a state surcharge, without increasing overall income taxes. In Canada, provinces have a base sharing agreement with the federal government for personal income tax, which involves central administration but individual rates that apply in addition to the federal rate.

If personal income tax sharing with the states is to be contemplated in Australia, then a relevant consideration will of course arise as to how the Commonwealth can make the necessary room of its own to fund this.

2. There is potential to reduce vertical fiscal imbalance and clarify roles and responsibilities

While a level of imbalance between access to tax bases and expenditure responsibilities is a reality in all federations, the imbalance in Australia's case is relatively high by international standards, as highlighted by previous studies on federalism.[14]

The imbalance also means that there are a number of areas where there are major expenditure roles for the various levels of government (such as health and education). This tends to undermine accountability for the effectiveness of expenditure and the autonomy of the states in service delivery.

It is important to note that the GST has a limited impact on the adverse accountability effects of vertical fiscal imbalance. The states do not have control over the rate or the base of the GST, and the Commonwealth has limited incentives to adjust these settings given that it does not face the expenditure pressures that this revenue funds. The equalisation process further diminishes the level of control and discretion that states have over the revenues that are collected.

Taking account of this relative position on federal fiscal imbalances and the negative impacts on accountability, the potential to reduce this imbalance essentially falls to some kind of tax base sharing arrangement with the Commonwealth, particularly around the personal income tax base.

If tax reform that reduces vertical fiscal imbalance is pursued, then it should be complemented by a careful examination of the roles and responsibilities of different levels of government to ensure they are clear and conducive to effective policy and service delivery outcomes. Addressing this problem should not be about further centralisation.

3. The need for a multilateral reform agreement

The architecture of the federal fiscal system means that the fiscal benefits that flow to an individual state from undertaking tax reform alone are not compelling.

Neil Warren captured this with an illustrative example of what would happen if NSW undertook tax reform that directly contributed to a one per cent increase of its economy while other states remained unchanged.[15] In summary, the effects are that:

- taxes collected within the state would increase by $868 million – GST revenue increases by $144 million, personal income tax revenue increases by $660 million and payroll tax increases by $64 million; and

- of these increased revenues, NSW receives $106 million (i.e., $42 million as its share of the higher GST collections plus the full $64 million of the payroll tax increase) while the other states receive $102 million in increased GST revenue. The Commonwealth receives the entire additional $660 million in personal income tax revenue.

It is important to note that this example assumes that the NSW share of GST increases proportionately to the increase in total GST revenues, and therefore does not include the impact of horizontal fiscal equalisation which could further deplete the revenue benefit to NSW.

If all states were to undertake tax reform that generated a similar economic growth dividend, then it follows that the results would simply be magnified with the Commonwealth capturing the large share of the fiscal dividend through its tax bases.

Given that the benefits of eliminating inefficient state taxes will be different for each state government and there will be a major national economic growth dividend, there is a clear opportunity for the Commonwealth Government to work collaboratively with states to facilitate such an agreement.

The prospects of obtaining such an agreement and having states actively consider reconfiguring their more efficient tax bases to meet some of the cost of removing inefficient state taxes would

obviously be improved if the option of giving the states access to part of the personal income tax base and/or an increase in the GST and an improved process of distribution of the GST was in scope for discussion.

4. Balancing competition and cooperation

Much like the pursuit of national reform through COAG, having an effective tax system at the state level requires a careful balance between competition and cooperation.

Balancing these factors carefully is important if we are to maximise the benefits of a federal system. On the one hand, it is clear that as more business activity occurs on a national and global scale, there is a compelling case for seamless national regulation. On the other hand, there are also strong benefits to be gained from active competition between states when it comes to lowering business costs. Getting the balance right is critical if we are to enhance productivity.

States have actively competed in areas like payroll tax, reducing rates and lifting thresholds over time to reduce the costs of doing business in their particular jurisdiction. There are also signs that in the current economic environment, states that are less exposed to the benefits of the mining boom will increasingly look to lower tax and regulatory costs as a means of boosting competitiveness to increase business investment in their jurisdiction.

Similarly, if states are to be competitive then they will also need autonomy to raise sufficient tax revenues to deliver services to meet the growing needs and expectations of their citizens.

While states should have this autonomy, it should not create an unreasonable level of complexity in the tax system. As the OECD has suggested, 'discretionary control over a particular tax base could have important trade-offs between efficiency and compliance/administration costs for the whole tax system'.[16] This suggests that there is a case for state cooperation to harmonise administrative compliance requirements (as has been the case for payroll tax) and tax bases. Similarly, proposals for tax base sharing are probably best pursued through central administration to reduce compliance burdens.

Conclusion

The current federal fiscal architecture has significant implications on how we go about reconfiguring our tax system to address the challenges outlined in Part 1. Addressing long standing and seemingly intractable issues around vertical fiscal imbalance and inefficient state taxes will be difficult. However, it is critical that we begin to address these shortcomings now if we are to have a truly effective tax system across the federation.

PART 3: AUSTRALIA AS AN OPEN TRADING ECONOMY

KEY POINTS

Emerging economies, particularly in the Asian region, have become increasingly important drivers of global economic growth and will remain so in the coming decades.

As a small open economy in this region, our economic growth is based on a model requiring high capital inflows to fund large investments, which in turn generates jobs and exports.

As capital becomes more mobile and sensitive to tax arrangements, other countries in the region will attract greater amounts of capital. The increasing international mobility of people means that choices about where to work will also become increasingly sensitive to tax arrangements.

Cross country comparisons suggest that the tax systems of many of our regional neighbours are placing them in a better position to attract skills and investment, at a time when skills and investment will be critical to our future growth prospects. Our divergence from regional trends and the impact on competitiveness of the Australian economy should be a key consideration in reconfiguring Australia's tax mix.

Quite simply, if Australia is to continue to grow its economy we must maintain an open economy and continue to attract substantial investment. Having competitive tax settings will be critical to the investment task.

If Australia's tax system is to be effective in the long-term, then we will need to take account of our changing economic circumstances.

At the same time that Australia confronts significant expenditure challenges, and challenges with the federation, we need to recognise that as an open trading economy our regulatory and fiscal settings have to underpin competitiveness and fit within global settings.

If Australia's future tax system is to align with economic settings that maintain our competitiveness, then it is imperative that we take stock of:

- the changing global economic environment, including the fundamental shift in economic activity towards the Asian region; and

- the growing mobility of and competition for investment and skilled labour, which are increasingly sensitive to tax settings and critical to our long-term economic growth.

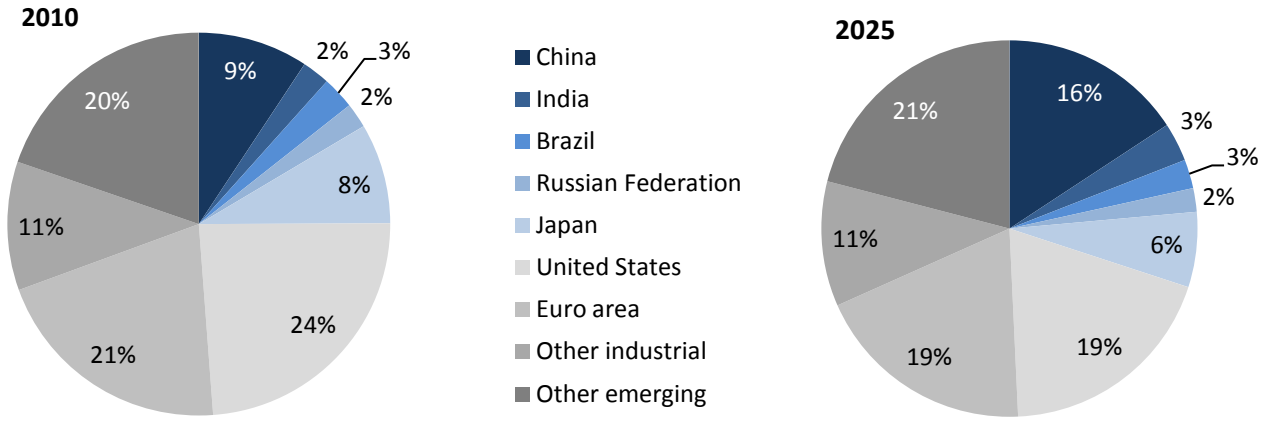
The changing global economic landscape

The BCA's submission to the Henry review emphasised the increasingly competitive global landscape, characterised by rapid emergence of new markets and developing economies presenting both opportunities and competition for Australia's economy. In the short time since this submission, these trends have only intensified with the continuing shift of global economic activity to Asia and the shift from developed to emerging economies.

In this environment, it is also critical to recognise that multinational companies from emerging markets will become increasingly important sources and drivers of global investment flows.

Emerging economies, particularly in the Asian region, have become increasingly important drivers of global economic growth. The World Bank[17] estimates that the emerging economies' share of global output will expand from 36 per cent in 2010 to 45 per cent by 2025 and by that time will account for the same volume of international trade and investment flows as the developed world.

Figure 6: Global Output Shares



Source: World Bank staff calculations. (Real shares expressed in terms of constant 2009 US dollar prices)

Moreover by 2025 leading emerging economies such as Brazil, India, Indonesia, Korea and Russia are likely to join China and the advanced economies as 'global growth poles'.

The World Bank has further noted that the shift in economic and financial power is having important implications for the global corporate environment. *'Emerging market firms have become an important force behind new foreign direct investment flows in terms of both cross border acquisitions and greenfield investments and are growing participants in international capital markets. .... Moving forward, multinational firms based in emerging markets will become important agents of change on a global scale, pushing for more open policies at home and abroad and posing greater competition to advanced country firms.'*[18]

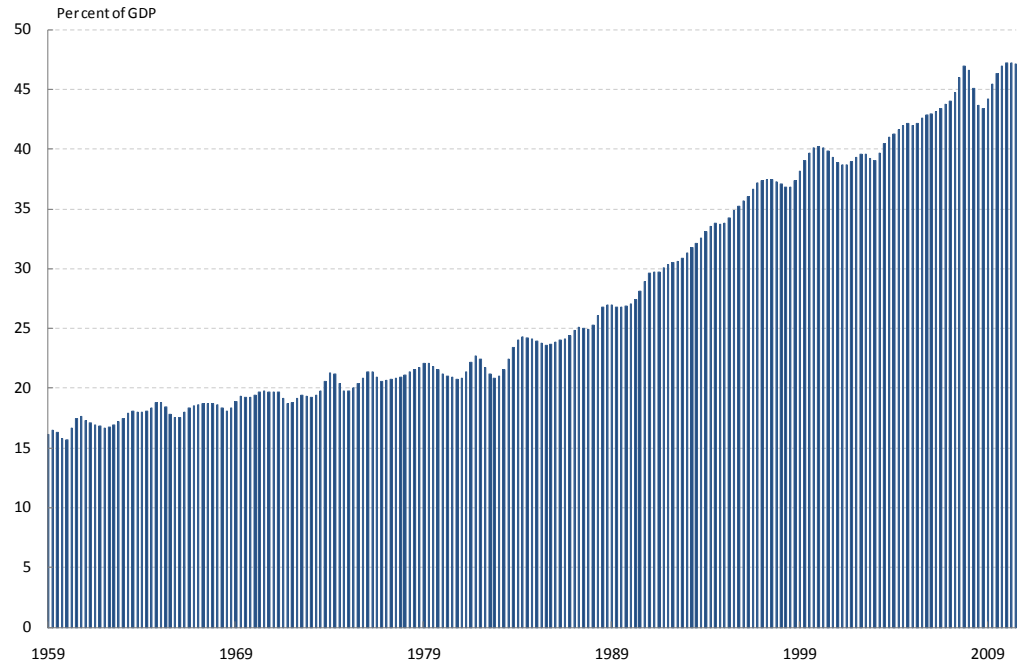
The Commonwealth Government acknowledged in the 2011-12 Budget that Asia's re-emergence in the global economy will have 'lasting effects on how Australia does business in the 21st century'.[19] The industrialisation and urbanisation of Asia has already seen strong demand for Australia's natural resources and the growing middle class in Asia has the potential to significantly increase demand for Australian products and services more broadly.

Australia's place in the global economy

Over recent decades Australia's economy has become more open, connected and integrated with the world economy. While our economy has strengthened, our markets have become more dynamic, we have many new products and services, and also new competitors.

Figure 7 highlights the increasing openness of our economy, including the sharp acceleration in trade in the 1980s that coincided with major structural reforms.

Figure 7: Australia Trade Share of GDP



Source: ABS, *Australian National Accounts*, Catalogue No. 5206.0, March 2011.

While the openness of our economy has created significant opportunities and been a major factor in our sustained economic growth, it also exposes us to increasing competitive pressures for trade, investment and skilled labour.

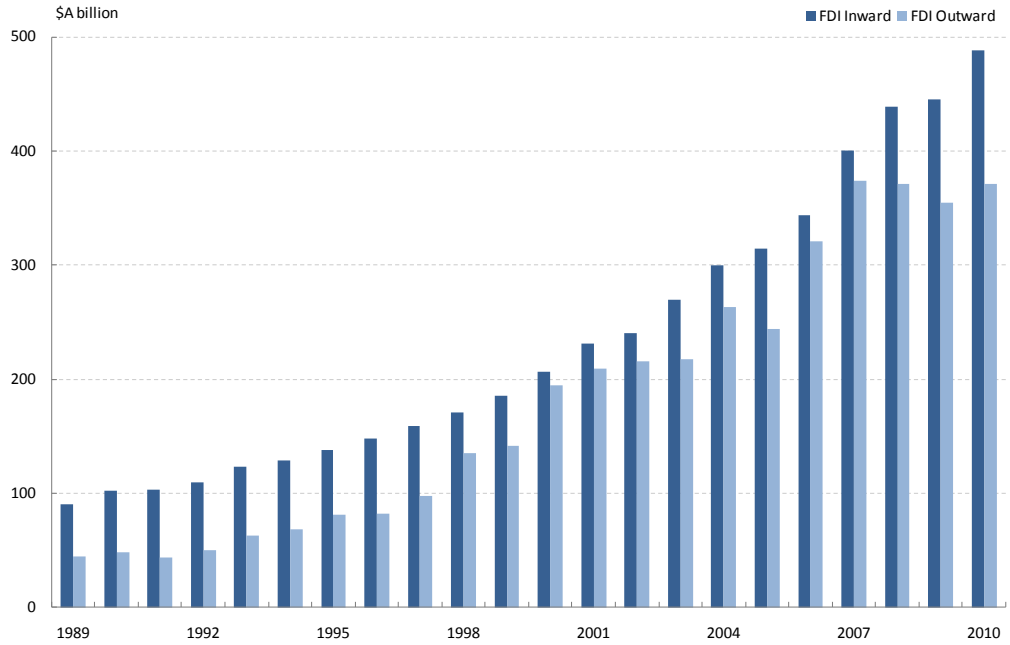
The mix of challenges and opportunities that come with the economic openness of Australia are acutely apparent in the current economic environment.

We are benefiting from our large stock of natural resources and geographical location near Asia, with this demand driving increased commodity prices and historically high terms of trade. A side effect of the high terms of trade, though, is the adverse impact on the non-mining export focused sectors, especially manufacturing.

Being in a strong position to attract international investment and labour will assist in managing the terms of trade boom and the structural changes in our economy. Strong inflows of capital and labour will allow the mining sector to grow while putting less pressure on other sectors of the economy.

As a small open economy, our economic growth is based on a model requiring high capital inflows to fund investment opportunities, which in turn generates jobs and exports. This is evident in Figure 8.

Figure 8: Stock of Australian Foreign Direct Investment



Source: ABS, *Balance of Payments and International Investment Position*, Catalogue No. 5302.0, March 2011.

Australia's dependence on foreign capital inflows has particular relevance for our future tax settings. Recent research on taxes and investment have found a general consensus that investment is increasingly mobile, with foreign direct investment becoming increasingly sensitive to tax factors over time.[20]

The Henry review also acknowledged that with the continuing process of globalisation, tax settings will be of increasing importance for decisions about where capital will be invested. As other countries in the region attract greater amounts of capital, Australia will have to respond if it is to remain an attractive place to invest.

Continuing to attract high levels of investment will underpin higher levels of income and bring world-leading technologies to Australia which will help to raise productivity. While multifactor productivity has declined in recent years, capital deepening has been stable in its positive contribution to total labour productivity, and it is vital that this contribution is maintained in the future.

Sustaining our growth model also requires us to have the skilled labour to deliver on these investments.

The clear message from international studies is that global competition for highly skilled labour is growing.[21] The increasing international mobility of people means that choices about where to work will also become increasingly sensitive to tax arrangements.

For Australia, this comes at a time when we face a period of high demand for labour, particularly skilled labour and large-scale retirements due to an ageing workforce.

Skills Australia projects there could be 9.3 million job openings over the next 15 years – 4.8 million from economic growth and 4.4 million as replacement jobs from retirement. Skills Australia says the skills shortfall will be most pronounced in the years to 2015, probably even more so than out to 2025, and has called for the participation rate to increase from around 65 per cent currently to 69 per cent in 2025.

Other studies point to these skills shortfalls, with the National Resources Sector Employment Taskforce identifying a potential shortfall in the resources sector of 36,000 tradespeople by 2015.

Exploiting opportunities in the region

The Henry review noted the shift in the centre of gravity in the world economy towards Asia is adding considerable value to our natural resource wealth and opening new investment, trade and employment opportunities. 'Australia will need to respond if it is to remain an attractive place to invest and do business. Part of this response should be to ensure the tax system supports investment, allocated resources to their most valued uses and does not inadvertently add to the cost of production through taxes on business inputs or excessive complexity and compliance costs'.[22]

While our position in this region presents opportunities, we cannot afford to be complacent. The reality is that the tax systems of many of our regional neighbours are placing them in a better position to attract skills and investment, at a time when skills and investment will be critical to our future growth prospects. This is apparent in Table 1.

Table 1: Regional Comparison of Tax Rates 2011

Country	Estimated Effective Corporate Tax Rate* (%)	Top Personal Rate** (%)	Standard VAT Tax Rate** (%)
Australia	**26.0**	**46.5**	**10.0**
Mainland China	16.6	45.0	17.0
Hong Kong	4.0	17.0	-
India	33.6	33.0	10.0
Indonesia	20.5	30.0	10.0
Japan	29.5	40.0	4.0
South Korea	29.5	38.5	10.0
Malaysia	18.0	26.0	10.0
New Zealand	17.6	33.0	15.0
Philippines	30.0^	32.0	12.0
Singapore	8.5	20.0	7.0
Taiwan	10.9	40.0	5.0
Thailand	17	37.0	7.0
Vietnam	11.7	35.0	10.0
Average	***18.1***	***33.7***	***9.8***

*Source: * Cato Institute Estimates of Effective Corporate Tax Rates on New Business Investment, February 2011; ** Ernst & Young 2011 Asia Pacific Tax Policy Outlook and 2011 Europe, Middle East, India and Africa Tax Policy Outlook. ^ Philippines Statutory Rate*

The Cato Institute estimates of effective tax rates on new investment are based on a World Bank methodology assuming a multinational company seeking to maximise value for its projects around the world. The company minimises its cost of finance by choosing an optimal debt and dividend policy, taking into account tax and nontax factors that influence financial decisions (independent of the investment decision). The cost of equity and debt is determined by international markets and independent of the availability of a domestic savings in a small open economy. Therefore, personal income taxes on dividends, interest, and capital gains do not affect the multinational's cost of financing even though those personal taxes do affect personal savings decisions.

Conclusion

While there are a range of non-tax factors that will also impact on Australia's competitiveness in the region, the extent of our divergence from regional trends on tax suggests that closing this gap should be a key consideration in reconfiguring Australia's tax mix. Given the global economic trends outlined and the openness of Australia's economy, securing long-term economic growth will depend on it.

PART 4: FUNDAMENTALS OF A GOOD TAX SYSTEM

KEY POINTS

In seeking to progress tax reform there is general acceptance of the usefulness of core principles for sound policy – covering adequacy, efficiency, equity, and simplicity.

In seeking reform of the tax system, these principles can conflict with each other and there will necessarily be trade-offs that need to be made in getting the balance right. A critical aspect of making these trade-offs is that they be made transparently.

In getting the balance right, there are three dimensions that must be considered:

- a contemporary dimension, involving research to confirm that traditional tax principle concepts continue to apply as economies and societies evolve;
- a forward looking dimension, involving strategic analysis of developments that will shape our economy, our community and the way we live into the future; and
- a comparative dimension, based on the experience of other jurisdictions and how they are adjusting their tax principles to meet future challenges.

In seeking to progress tax reform there is general acceptance of the usefulness of core principles for sound policy. These principles are well established – covering adequacy, efficiency, equity, and simplicity. The Henry review has also added the principle of policy consistency. The BCA endorses these goals for the tax system.

But it is acknowledged that these principles can conflict with each other making it difficult for policy makers to determine the appropriate weight to be afforded to them and there will necessarily be trade-offs involved when trying to determine which of the principles deserve the highest priority.

Inevitably elements of a tax system will reflect political realities, but taking account of a principles based approach can limit the potential for bad policy outcomes. We must also recognise that major changes in taxation will require an electoral mandate.

In seeking to reform the tax system it is necessary not only to review existing tax structures to deliver tax system objectives, but also to revisit the relative weight given to the tax principles. The current process is no exception.

Efficiency

All taxes and transfers affect the choices people and businesses make by altering their incentives to work, save, invest or consume things of value to them. A sensible objective for the tax and transfer system is that it should raise and redistribute revenue at the least possible cost to economic efficiency and with minimal administration and compliance costs.

An efficient tax does not discourage entrepreneurial activity, innovation or alter risk profiles, nor would it present an impediment to economic or business restructuring.

Instability in policy settings can reduce economic efficiency by increasing uncertainty about the expected payoffs to long-term decisions such as investing in education, choosing certain retirement products, investing in long-lived productive assets and the choice of business structure. These costs represent a net loss to society as a whole.

To the extent that taxes influence incentives they also have the potential to have a major impact on productivity.

Equity

Governments will in most instances share the community's view that the tax system should be fair and should be seen to be fair. Equity or fairness in a tax system has several dimensions:

- taxpayers in similar circumstances should be treated in a similar way (horizontal equity);
- those who earn more should pay relatively higher rates of tax than those who earn less (vertical equity);
- administrative procedures should not inappropriately advantage some and disadvantage others (administrative equity); and
- there should be fairness in any transitional arrangements associated with changes to the tax laws (transitional equity).

Satisfying an objective of horizontal equity is usually more readily achievable than satisfying vertical equity considerations. Trying to achieve both of these aspects has, however, tended to result in a more complicated tax structure that is cumbersome to administer and not revenue productive.[23]

Related to the issue of vertical equity is the extent to which the tax system should be progressive and whether the tax system is the best means of achieving this. Governments have typically sought to address vertical equity considerations through a mix of policies, including through the transfer payments system.

Simplicity

According to this principle, the tax law should be simple, so that taxpayers can understand the rules and comply with them correctly and with minimum cost.

A simple tax system will be cost effective and better enables taxpayers to understand the tax consequences of their actual and planned transactions.

Simplicity implies that the tax system will be cost effective in that the legislation is clear, the administration of the law is straightforward and taxpayer compliance costs are modest relative to the revenue raised.

Potential impediments to cost effectiveness of a tax system include the complexity that can arise in calculating tax liabilities, a lack of clarity in legislation and rulings (necessitating external advice), and a need to find resources to ensure compliance.

Other principles

Various tax system reviews in Australia have often advanced other tax policy principles.

- The 1998 the *A New Tax System ('ANTS') White Paper* identified revenue security, principally for the states and territories, through the GST revenue allocation as one of its reform objectives.

- The 2001 Victorian Review of State Business Taxes ('Harvey Report') also proposed that the resilience or buoyancy of the tax system should be a consideration; that revenue should ideally be sustainable and not subject to major fluctuations through changes in the level of economic activity.

- The Henry review similarly listed sustainability as a key tax principle – specifically how the tax system meets the revenue needs of the government and requires little adjustment for changes in the economy. The sustainability principle doubtless reflects a government focus in terms of revenue and fiscal balance, but it also raises issues around the demands of demographic change, structural durability and the tax system contributing to environmental sustainability.

- The ANTS White Paper listed incentives to work and save as important principles that would be achieved through a fairer tax system. The 1998 Ralph Review of Business Taxation similarly contended that business taxation should impose the smallest possible impediment to economic growth, including jobs growth, thereby reducing the resource allocation and risk-taking distortions necessarily associated with revenue raising from business taxation.

- Policy consistency implies that the tax system is both internally consistent (between different taxes) and consistent with the broader policy objectives of the government. The Henry review advocated that the tax and transfer policy should be internally consistent and that the rules in one part of the system should not contradict those in another part of the system. To the extent possible, tax and transfer policy should also be consistent with the broader policy objectives of government including over the long term. As outlined above, tax policy must be consistent with longer term fiscal policy settings.

- Transparency, as identified in the Harvey Report, implies that the purpose and principles underlying a tax are clearly identified, such as what is being taxed, who has the liability for payment and how the liability is calculated. A more transparent tax system increases certainty and typically makes compliance easier for taxpayers and administration easier for revenue authorities, thereby reducing some of the potential excess burdens. There is no certainty if the applicable tax rate or tax consequences of a transaction change or if tax laws are reformed without consultation.

Table 2: Tax Principles Summary

Asprey Report 1975	Tax White Paper 1985	A New Tax System 1998	Ralph Report 1999	Harvey Report 2001	Henry Review 2009
Simplicity	Simplicity	Simplicity	Simplicity	Simplicity	Simplicity
Equity	Equity		Equity	Equity	Equity
Efficiency	Efficiency			Efficiency	Efficiency
		Revenue Security		Revenue Buoyancy	Revenue Sustainability
		Incentives	Economic Growth		
		Consistency			Consistency
	Compliance				
	Inflation				
	Interaction with welfare				
	Harmonisation (Federalism)				
				Competitive Neutrality	
				Transparency	

Tax principles – an analytical perspective

The principles outlined above provide a policy framework for the design of taxes, taking into account desirable, but also conflicting objectives.

The inherent conflicts in the principles mean that policy makers often find it difficult to determine the appropriate weight to be given to one or more of the principles when designing a new tax or a change to an existing tax. These conflicts are well known:

- an efficient tax designed to minimise changes in behaviour, such as a lump sum tax or broad-based consumption tax imposed on all goods and services, will invariably raise concerns for many people over fairness;

- alternatively, a tax designed to meet the principles of both horizontal and vertical equity will not be simple.

However, taxation policy does not stand still. This history of taxation policy in Australia since federation has been punctuated with major tax reforms, as well as unsuccessful reform proposals. In most, if not all of these instances, reform of the tax system has meant not only a

review of existing tax structures to deliver tax system objectives, but also a review of the relative weight given to the tax principles.

It is arguable that simplicity in tax system design and implementation has become a less important principle than taxpayer equity in recent times. At the end of the 1970s, equity and complexity dominated tax system design over efficiency and simplicity. The personal taxation system was increasingly used to deliver multiple equity objectives, often conflicting and with little regard to tax system design or the relationship to tax policy.

During this time there was little by way of tax reform implemented by government that followed a strategic analytical framework. The weighting of tax principles toward equity, rather than efficiency or simplicity, reflected the prevailing views of the time. No strategic analysis was applied by government to what weight should be given to the tax principles should the economic and social settings of the previous 20 years change.

The 1975 Asprey review did develop such an analytical framework, although it took several decades for this framework to be reflected in contemporary tax structures. Asprey noted that:

> *"The present Australian fiscal legislation is best viewed more as an historical growth than as a system in the sense of a deliberately conceived and integrated structure in which every part has a defined role to play. The Anglo-Saxon tradition is to adapt slowly; but a periodical re-examination of the logic of what has grown up remains appropriate."*[24]

A summary of the changing focus of tax policy principles in Australia is outlined at Appendix A.

An important concern for the current tax reform process is to settle the relative balance between equity, efficiency and simplicity, and also to assess how this balance may change in the future so that the tax system can continue to deliver its objectives. However, this is not always readily apparent. It is also contentious. Major shifts in the emphasis on the principles have been central to major tax reform debates in Australia.

Resolving the balance between tax principles

Resolving this question of balance between the tax policy principles has three dimensions:

- a contemporary dimension, involving research to confirm that traditional tax principle concepts continue to apply as economies and societies evolve;

- a forward looking dimension, involving strategic analysis of developments that will shape our economy, our community and the way we live into the future; and

- a comparative dimension, based on the experience of other jurisdictions and how they are adjusting their tax principles to meet future challenges.

The combination of these three dimensions gives additional context against which to determine what is the right balance of principles in tax design, taking into account the extent to which current objectives are being met and how the relative weight given to principles may have to change in the future.

The contemporary dimension

The Henry review reiterated the core tax policy principles of equity, simplicity and efficiency, plus the principles of sustainability and policy consistency. Other principles that should be considered when assessing tax policy are fostering economic growth and revenue buoyancy. A further principle with contemporary relevance that should be considered is that, in an open capital-importing economy, the tax system needs to assist Australia's global competitive position.

The future directions for tax reform, including those outlined in the Henry review, present a long-term vision for the Australian taxation system, spanning the next ten years and beyond.

The forward looking dimension

A strategic analysis looking forward to major influences on the Australian economy and the Australian community suggests that a number of developments will become increasingly important for Australia and for the design of our tax system.

Demographic change. The ageing of the population will affect the productive potential of the economy through both a reduction in the pool of available labour and the productivity of the existing labour force. Increasing constraints in the growth of quality and quantity of the labour force will also affect the ability of governments to fund these services through traditional tax mechanisms.

The challenges of an ageing population highlight the importance of maintaining the efficiency of the tax system, particularly as it affects incentives to work in the face of a relative decline in the working population. Equity concerns will also arise both in relation to sharing the costs of an ageing population – particularly between generations, as well as who will bear the burden of the costs of an ageing population among the working population. Considerations around vertical equity and the capacity to pay will become more important in the context of a decline in the proportion of the population in the paid workforce.

Globalisation also has important consequences for future tax design and the application of tax principles. Developments in communication and access to previously closed markets have increased the supply and mobility of both capital and labour. Competition for both factors will become ever more intense.

Increased international competition and factor mobility will present a challenge to revenue adequacy as mobile factors of production become increasingly more difficult to tax and pressure emerges to compete more aggressively on taxation rates. Efficiency in tax system design will be important to ensure that scarce productive resources are applied to their best use and to support productivity and labour market participation.

The combination of a need for revenue adequacy and an efficient tax system should result in a shift in taxation so that there is a greater emphasis on immobile tax bases. Transparency, certainty and simplicity in tax design will also become more important features of tax systems as competition for mobile factors of production intensifies.

Rapid **technological change** continues to transform societal structures including and beyond the spheres of work, consumption and leisure choices. Technological impacts will also raise important considerations for tax policy principles. Technological advances have the potential to deliver greater simplification in the way that taxpayers interact with tax authorities. But at the same time, it is important to ensure that the tax system does not act as a barrier to the adoption of new technologies, particularly those already in use by our competitors.

The **social and environmental dimensions** of human activity also have significant implications for future tax design and the application of tax principles. The principles of neutrality and simplicity are important to minimise the welfare losses inherent in tax policy. However, certain narrowly-based taxes specifically designed to change behaviour can also be welfare enhancing. Where markets fail to reflect external costs and benefits in the prices of goods and services, a misallocation of resources occurs and overall economic and social wellbeing will be less than what it could be.

In considering such taxes it is important to be explicit about their purpose. Taxes directed at addressing social and environmental issues need to actually bring about changes in behaviour. They should not have general revenue raising or income redistribution as their main objective.

The comparative dimension

The comparative dimension of international economic experience reinforces the strategic analysis above.

Revenue adequacy remains a paramount concern for tax systems around the world. Those countries that weathered the global financial crisis best and are managing the current uncertainty are those with relatively strong fiscal positions. Analysis by the OECD and IMF confirm that a strong fiscal balance and sustainable debt positions support long-term, stable and sustainable economic growth.

The OECD study on the Political Economy of Reform noted that one of the most robust findings to emerge from recent econometric work on the political economy of structural reform is that sound public finances tend to be associated with more reform.

The comparative dimension provides strong support also for tax strategies that respond to the impacts of technology and globalisation with a move towards greater taxation of immobile factors, whilst maintaining competitive taxation structures for mobile factors.

In the face of the global financial crisis, many countries responded to weakening fiscal positions by increasing the burden of indirect taxation, particularly broad-based consumption taxes, rather than corporate or personal income taxes. The UK and New Zealand are two examples. The need to maintain efficiency remained a priority in the face of globalisation and technology change that would survive the impacts of the global financial crisis.

Conclusion

Tax policy principles have served previous tax review and reform processes well and there is significant benefit in continuing to assess proposals for tax reform against these principles. After

all, ultimately a balance of these principles will reflect the kind of future tax system that is in the best long-term interests of Australia.

In seeking reform of the tax system, it is inevitable that these principles can conflict with each other and there will necessarily be trade-offs that need to be made in getting the balance right. The most critical aspect in making these trade-offs is that they be made transparently.

PART 5: PROPOSITIONS TO GUIDE TAX REFORM

KEY POINTS

Any long-term changes to the tax system should be underpinned by good public policy principles. If changes to the tax system are guided by such principles, then the opportunity for short term, short sighted, poorly designed policies would ideally be reduced.

The BCA believes that a good tax system needs to reflect both important principles about equity and efficiency, simplicity and policy consistency and some fundamental elements about what a tax system is intended to do.

In any reform of this nature, there are obvious trade-offs and it is important that these trade-offs are transparent. However the BCA believes that if Australia is to have a fair tax system, future polices must meet the following fundamentals:

- the tax system must support and complement overall fiscal policy;
- revenue adequacy must be the highest priority – however governments at all levels must be efficient in their expenditure of public monies, recognising that the tax system alone won't be able to meet current projected expenditures;
- the tax system must be configured to promote productivity which will in turn promote our competitiveness and overall economic growth;
- the tax system must continue to be based on progression and the capacity to pay;
- efforts must be made to improve the simplicity, certainty and transparency of the system; and
- those taxes directed at addressing social and environmental issues should actually bring about changes in behaviour, rather than having revenue raising or income redistribution as their main objective.

Drawing together the economic and other policy foundations of the tax principles, the additional context from parts one to three, and the analytical perspective outlined above, the BCA considers that a series of key propositions can be used to guide tax reform.

These propositions are as follows:

- **an approach to tax reform should start off with a recognition of the broader fiscal context and that greater reliance on the tax system alone will not be able to meet projected growth in government expenditures;**
- **revenue adequacy should be the highest priority, including recognising that revenue adequacy is equally relevant to the states;**

- **configuring the tax system to promote investment and growth and reward productivity, including to expand tax bases over time should be next in priority;**

- **the tax system must continue to be progressive and premised on the capacity to pay;**

- **efforts must be made to improve the simplicity, certainty and transparency of the tax system; and**

- **those taxes directed at addressing social and environmental issues should actually bring about changes in behaviour, rather than having revenue raising or income redistribution as their main objective.**

Revenue adequacy

The analytical framework indicates that revenue adequacy will dominate future tax reform. This finding extends beyond the basic tax principle of funding future demand for government services. Strategic analysis and comparative analysis tells us that strong and stable fiscal positions will remain an important determinant of future wellbeing, principally as a buffer to global economic shocks.

Intergenerational equity also becomes important in this regard. Revenue adequacy not only underpins the wellbeing of the current generation, but also the wellbeing of future generations.

The revenue adequacy principle therefore extends beyond the needs of the annual budget cycle and in future requires the generation of stable, efficient revenue bases that can consolidate and support long-term fiscal targets.

In the Australian context, the division of taxing powers between the federal and state governments requires a method for revenue distribution from the centre to the states. The best possible balances must be found between issues of efficiency, for national economic growth, and horizontal equity, to equalise the different capacities of the states to deliver services. However, this must be done in a way that ensures that government spending is efficient.

Economic efficiency and growth

Over the last 30 years, economic efficiency has been a dominant theme of tax design as markets were deregulated and the international economy became increasingly integrated.

Ongoing pressures arising from demographic change, technology and globalisation will drive further improvements in economic efficiency, including in tax design. In turn, continued improvement in economic efficiency will drive strong and sustainable economic growth in those countries that choose to pursue reform.

While understanding the drivers of productivity is not straightforward, two important factors are ensuring the right incentives are in place and ensuring that firms have sufficient flexibility to adapt to meet the rigours of competition. As outlined above, taxes can have a significant effect on productivity by distorting incentives. The Henry review likewise highlighted the potential for reform of state taxes to deliver a significant increase in the long-term productivity of the Australian economy.

From all the perspectives there is clear support for lower corporate tax rates in response to heightened competition for mobile capital. This is also supported by empirical evidence from contemporary research on the growth effects of tax structures.

Together these also inform the other key features of tax design to support strong and sustainable economic growth. These are:

- broadly-based taxes that as much as possible are neutral in their effects on decisions to work, save and invest;
- removal of narrowly-based taxes that do not meet the efficiency criteria;
- relative decline in the contribution of capital taxation to the tax mix;
- reducing effective marginal tax rates affecting workforce participation and labour supply; and
- more neutral taxation of savings, with a reduction in the taxation of household saving as a step towards this.

Capacity to pay

One advantage of the analytical framework outlined above is its potential to resolve the conflicts between the tax principles in the current period and over time.

The framework highlights that economic efficiency should be a strong and defining feature of tax design. However, the contemporary and comparative dimensions of the analytical framework suggest that equity considerations will also continue to dominate tax design deliberations.

The history of Australian tax reform demonstrates the influential role that equity considerations have had in framing major tax reform. Vertical equity has played a central part even in the 25 year debate over indirect tax reform in Australia.

On a comparative analysis, progressive taxation systems, grounded in the concept of vertical equity, prevail throughout OECD tax systems, even though there is a wide variation in the degree of progressivity and the way it is systematically achieved.

As with Australia, the progressivity of the personal tax system provides a supporting mechanism to broad-based indirect taxes in other countries.

In Australia, broad community acceptance is an essential prerequisite to comprehensive tax reform. A credible and transparent equity principle based on the capacity to pay has been influential in gaining that acceptance.

However, while the equity of the tax system must be addressed and sustained it should not be at the expense of the critical efficiency objectives – namely, a personal tax and transfer structure that encourages workforce participation and can compete for labour internationally and a low corporate taxation rate to promote investment and productivity.

Simplicity, transparency and certainty

In large measure, it needs to be recognised that simplicity does not stand alone as a principle in its own right, but as a vital contributing element in the attainment of both equity and efficiency. Accordingly, its greater place in tax design will come in response to the pressures of globalisation, technology and the needs of an ageing population.

Simplicity will continue to be a key principle in tax design as it assists transparency and compliance, and so public understanding and support. Moreover, competition for mobile capital and labour will occur not only on rates of taxation but also on the cost of compliance.

At a federal level, the distribution of revenue to the states should also be transparent and simple, to ensure proper accountability and public understanding of government functions and their costs.

Social and environmental sustainability

Social and environmental sustainability depends strongly on key tax reform propositions. Tax design can and should address the sub-optimal consumption of environmental resources and assist with broader community objectives.

The role of the tax system in environmental and social sustainability is at one level, one of efficiency. Where external costs (or benefits) are present in the consumption of goods and services and those externalities are not accurately reflected in market prices, either an over-allocation or under-allocation of those resources will occur.

In the case of natural resources, underpricing has more often than not led to an over-allocation of these resources and therefore an inefficient supply.

At its simplest, the efficient use of natural resources – reflecting not only a pure economic value but also a broad community value – is an appropriate goal for well designed tax structures.

At a broader social level, the tax and transfer systems can assist with sustainability of communities both indirectly, through addressing external costs that affect amenity or directly through the tax and transfer systems. Both vertical equity and horizontal equity are important in this regard.

A sense of community will be encouraged when those who have the means to pay can do so, while those with the same capacity make the same contribution.

In relation to the carbon tax, the BCA contends that the proposal to introduce this policy has been flawed. The approach outlined will not lead to emissions reduction at lowest cost to the economy, nor will it maintain the reliability and viability of our domestic electricity industry. Furthermore, the fact that we are not moving in tandem with actions of other countries means that the competitiveness of many Australian industries will be jeopardised.

However, with the carbon tax designed as a transitional feature to support a move to an emissions trading scheme in the near term, it has limited implications for tax reform over the long run. Accordingly, the carbon tax does not feature in this paper on tax reform.

Conclusion

The strategic analysis suggests the **revenue adequacy**, both to support future demand for government services and to establish a strong, stable and sustainable medium-term budget framework is the highest order priority.

Contemporary and comparative analysis demonstrates that economies with strong fiscal positions, supported by revenue adequacy, will be best placed to sustain economic and social stability over the long term.

It is this stability that will underpin long-term improvements in wellbeing, social cohesion and environmental sustainability.

Underpinning the fiscal balance is the maximisation of **economic efficiency and growth**. Competitive forces domestically and internationally will drive the efficiency improvements that will underpin economic growth.

Achieving the fiscal balance through economic growth can in turn only be sustained through community acceptance. Vertical equity, or the **capacity to pay**, has been a defining influence on taxation reforms over recent decades.

Attracting the investment required to support growth and achieve fiscal targets will be assisted by a tax system that is **simple and transparent**. Tax competition will occur not just on rates of taxation but also on ease of administration and compliance.

A tax system well grounded in concepts of efficiency and equity will have the framework required to assist with the achievement of **environmental and social sustainability**.

A summary of the tax propositions and principles required to support them are summarised in the table below.

Table 3: Tax Reform – Propositions and Principles

Proposition	Main principle	Supporting principles
Fiscal balance	Revenue adequacy	Efficiency (as a support to economic growth)
		Intergenerational equity (as a core objective of fiscal policy)
Focus on growth	Efficiency	Equity (horizontal)
Capacity to pay	Equity (vertical)	Intergenerational equity
Simplicity, transparency & certainty	Simplicity	Efficiency
Environmental & social sustainability	Efficiency	Certainty

The propositions and principles to guide tax reform outlined above are not dissimilar to the approach articulated in the Henry review. However the Henry review was constrained on a number of fronts, which were a product of the terms of reference rather than the work of the Review. The Henry review was not asked to examine the size of government, which is a fundamental driver of what a good tax system should aim to achieve. The Review was also restricted from examining the full range of taxes, particularly the GST.

PART 6: A NEW ARCHITECTURE FOR THE LONG TERM

KEY POINTS

Vital Actions

In response to these budget challenges and the inefficiency and lack of competitiveness of the current tax system, four actions are vital:

- Australia must now begin to control and limit government spending;
- Australia must begin to comprehensively overhaul the tax system so that it can raise revenue more effectively while encouraging growth, productivity and investment;
- The spending accountabilities and revenue raising capacities of the Commonwealth and states needs to be re-designed; and
- Australia must simplify the tax system significantly.

If Australia fails to start that process now, future governments will be forced to make very, very tough decisions about what Australia can afford as a society, or they will be forced to impose unsustainable taxes on companies, families and individuals.

The BCA is calling for an independent Commission of Budget Integrity. This independent commission would have the following roles:

- to examine government activities and public sector performance to help inform the community about which programs are meeting their objectives and are delivering value for money; and
- to prepare regular independent reports on the sustainability of Australia's fiscal position, and look at longer term budget pressures across all governments (including in areas that might otherwise be considered off limits) and ways of dealing with them;

The BCA believes this body could also progress analysis to identify the most intelligent options for improving the tax system in tandem with more efficient spending by all levels of governments

Four main tax bases to underpin Australia's future tax architecture

The BCA supports the proposal of the Henry review that there be a focus on four main tax bases which should collect most of the necessary revenue required by all levels of government.

These are: personal tax, company tax, consumption tax and economic rent taxes.

These four taxes must be the core part of any future system. This will provide more stability and predictability for investors and business and the community.

KEY POINTS (CONTINUED)

Removing inefficient state taxes

The BCA believes Australia's governments must commence the removal of inefficient state taxes with stamp duties and insurance taxes having the highest priority for removal.

The removal of these inefficient unproductive taxes will leave a revenue gap for state governments. A cooperative approach to revenue replacement will be necessary.

This could include a combination of raising the GST rate or broadening the GST base and examining the potential to increase revenues from other existing state revenue bases that have the potential to be relatively efficient, including payroll tax and land tax. Consideration should also be given to the Commonwealth sharing personal income tax revenue with the states.

Improve the tax mix

The BCA believes the best approach to improving the tax system is to improve the mix of taxes, rather than introducing new forms of taxation. This is a critical part of tax reform. Our future tax mix should have less reliance on personal and company tax rates and more on indirect taxes, such as consumption and land tax, while also being much simpler.

Improving the mix of taxes will ensure Australia has enough money to pay for the things it needs and it will also create a more positive climate for investment by ensuring our personal and company tax rates are more competitive.

Four vital actions

In response to these fiscal challenges and the inefficiency and lack of competitiveness of the current tax system four actions are vital:

1. Australia must now take steps to better control and limit government spending across all levels of government;

2. we need to comprehensively overhaul the tax system so that it can raise revenue more effectively while encouraging growth, productivity and investment;

3. we need to clarify the spending accountabilities and revenue raising capacities between the Commonwealth and the states; and

4. we need to simplify the tax system significantly.

If we fail to start that process now, future governments will be forced to make tough decisions about what Australia can afford as a society or they will be forced to impose unsustainable taxes on companies, families and individuals.

Fiscal discipline

In considering the broader fiscal context for tax reform, it is important to recognise that the tax system alone cannot meet projected government expenditures and that constraining expenditure growth will be a necessary consideration.

Independent institutions such as the Reserve Bank of Australia, Productivity Commission and Australian National Audit Office strengthen Australia's economic performance through enhanced scrutiny, oversight and advice, both inside and outside government. There is a clear link between the strength and independence of economic institutions and national wellbeing. These institutions contribute to good policy governance at a national level and enhance public trust and confidence.

Although Australia has developed a strong reputation for the transparency of its Budget documentation, there is no institutionalised independent external assurance or interpretation of the 'official' view of the Budget and government finances.

Given the significant budgetary challenges which lie ahead, a good case can be made to effect further institutional reforms that will help drive long-term fiscal sustainability through increased transparency and accountability.

In its 2011-12 Budget Submission to the federal government, the BCA argued that the government's longer term fiscal strategy could be bolstered by the establishment of an independent Commission of Budget Integrity.

The establishment of a permanent independent fiscal authority would allow for government programs and public sector performance to be assessed independently and objectively. It would allow the community to consider whether programs are meeting their objectives and delivering value for money, and whether ongoing government involvement in particular areas is even appropriate.

The potential for greater independence of fiscal arrangements holds significant contemporary relevance given developments that are occurring in Europe and the United States. Appendix C outlines the main findings of the National Commission on Fiscal Responsibility and Reform that was established in the United States.

Box 1: A Crisis of Fiscal Imagination – Professor Dani Rodrik Harvard University

"There is no shortage of culprits for the economic crisis in which rich countries are engulfed. But there is also something more fundamental at play, a flaw that lies deeper than the responsibility of individual decision-makers. Democracies are notoriously bad at producing credible bargains that require political commitments over the medium term. In both the United States and Europe, the costs of this constraint on policy has amplified the crisis – and obscured the way out.

Democracies often deal with the problem of extracting commitments from future politicians by delegating decision-making to quasi-independent bodies managed by officials who are insulated from day-to-day politics. Independent central banks are the archetypal example. By placing monetary policy in the hands of central bankers who cannot be told what to do, politicians effectively tie their own hands (and get lower inflation as a result).

Unfortunately, US and European politicians have failed to show similar imagination when it comes to fiscal policy. By implementing new mechanisms to render the future path of fiscal balances and public debt more predictable, they could have averted the worst of the crisis.

Compared to monetary policy, fiscal policy is infinitely more complex, involving many more trade-offs among competing interests. So an independent fiscal authority modelled along the lines of an independent central bank is neither feasible nor desirable. But certain fiscal decisions, and most critically the level of the fiscal deficit, can be delegated to an independent board.

Such a board would fix the maximum difference between public spending and revenue in light of the economic cycle and debt levels, while leaving the overall size of the public sector, its composition, and tax rates to be resolved through political debate. Establishing such a board in the US would do much to restore sanity to the country's fiscal-policymaking."

The Crisis of Fiscal Imagination, Project Syndicate, 12 September 2011.

In the context of Australia's broader expenditure challenges – including those faced by the states – an independent Commission of Budget Integrity could have a remit to report at a national level (that is, across all governments). It could be charged with promoting an integrated, or at least coherently co-ordinated vision for federal arrangements, reform of public spending programs and reform of taxes.

Preparation of regular, independent reports on fiscal sustainability, which look at longer term budget pressures across all governments and ways of dealing with them, would be a useful addition to the public policy debate in Australia.

Carefully targeting the role of the Commission of Budget Integrity to look at significant areas of spending, including those that have previously been deemed *'off limits'* could significantly

increase transparency of government spending and enhance the efficiency of government programs. We note that an independent fiscal commission was recommended by the recent Victorian audit of state finances.

In providing more meaningful and strategic long-term analysis of fiscal pressures for the Australian community, a permanent Commission of Budget Integrity could play an important role in lifting the level of public debate by increasing the transparency and understanding of Australia's fiscal position at a national level.

A Commission of Budget Integrity would ensure the full and ongoing costs of new services and entitlement programs are independently reviewed to help Australia avoid the accumulative burden of future taxes and debts that burdened the governments of the United States and many states in Europe in recent years.

It could also progress analysis to identify the most intelligent options for improving the tax system in tandem with more efficient spending by all levels of governments.

A comprehensive overhaul of the tax system architecture for Australia

Australia will need to have a future tax system architecture that is able to meet future revenue requirements and foster economic growth.

The BCA believes that moving to a tax system architecture broadly in the direction outlined in the Henry review will be in Australia's long-term national interests. Such a system would also be consistent with the BCA's suggested propositions for reform. But the new tax architecture needs to be one with a different mix of taxes. We need to vastly reduce the number of taxes and also seek to reduce our reliance on direct taxation and over time increase reliance on indirect taxes.

The Henry review itself noted that 'there is growing evidence that a shift away from company income tax towards greater reliance on taxing other less mobile factors of production, or on consumption, has the greatest potential to increase GDP and growth'.[25]

Four broad bases

The Henry review recommended that revenue raising should focus on four robust and efficient broad-based taxes:

- personal income, assessed on a more comprehensive base;
- business income, with more growth-oriented rates and base;
- private consumption; and
- economic rents from land and natural resources.

The Henry review proposed that additional specific taxes should exist only where they improve social outcomes or market efficiency through better price signals. Such taxes should only be used where they are a better means to achieve the desired outcome than other policy instruments. Other existing taxes should have no place in the future tax system and over time should be abolished. The BCA supports this approach.

Abolishing inefficient state taxes and finding alternative revenue sources

The new architecture of a reformed tax system should recognise that a system whereby the most inefficient state taxes are abolished has the potential to deliver significant increases in productivity.

It is well established that the most inefficient of the state taxes are stamp duties on motor vehicles, taxes on insurance[iii] and stamp duties on conveyancing (the so-called transaction taxes). These taxes collectively raised around $20 billion for the states in 2009-10. The more efficient of the state taxes are land tax and gambling taxes.

As noted by the Henry review, at present state payroll taxes are characterised by significant variability in both the base and rates. The effect has been to create a regime combining relatively high rates and a narrow base. While a long-term objective might be to replace payroll tax, in the near term an objective could be to seek a restructuring of this tax to make it more efficient and less distorting.

While it is clearly desirable to abolish the transaction taxes to improve efficiency and productivity, if these taxes are to be abolished, then alternative revenue sources will be needed. To maintain revenue adequacy, consideration will need to be given to raising revenue from other more efficient tax bases such as consumption and land. The issue of how to fund the abolition of state taxes should be considered as part of improvements to the overall tax mix as outlined below – with a combination of options including increased use of GST and/or reconfiguration of existing state taxes such as those on land and payrolls.

Improving the tax mix

If we are to make the whole tax system more effective, then we must focus on improving the overall tax mix. Focusing too narrowly on one set of taxes makes the task of balancing trade-offs between tax principles difficult, and can result in unintended inefficiencies or revenue shortfalls in other parts of the system.

If Australia is to fund the abolition of inefficient taxes that stifle economic growth, then its tax mix will necessarily need to rely more heavily on more efficient bases. In addition to this efficiency argument, revenue adequacy also supports a reconfiguration of our whole tax mix to be more robust across the economic cycle.

In Australia there has been significant volatility in revenue from direct taxes (corporate and personal income taxes) over the past five financial years, while the indirect tax revenue (excise and GST) remained relatively stable, reflecting the resilience of the indirect tax base. Australian fiscal settings are therefore likely to be more buoyant and less volatile if there is a change in the tax mix from direct to indirect taxes.

A counter-case would be that part of the 'automatic stabiliser' function of the tax system – taxing incomes more heavily during strong economic conditions and less during weaker economic conditions – would be lessened by too great a shift from direct to indirect taxes.

[iii] Insurance taxes impose significant costs and are one of the least efficient taxes available to the states. Taxes on insurance generally lead to a reduction in the number of people insured, particularly among those on lower incomes who are not well placed to bear risks (i.e., insurance taxes are highly inequitable). Under-insurance or non-insurance can lead to inefficiencies and also the need for higher government expenditures in the event of certain disasters.

However, Australia raises a relatively lower proportion of revenue through indirect taxes when compared with most other developed economies.

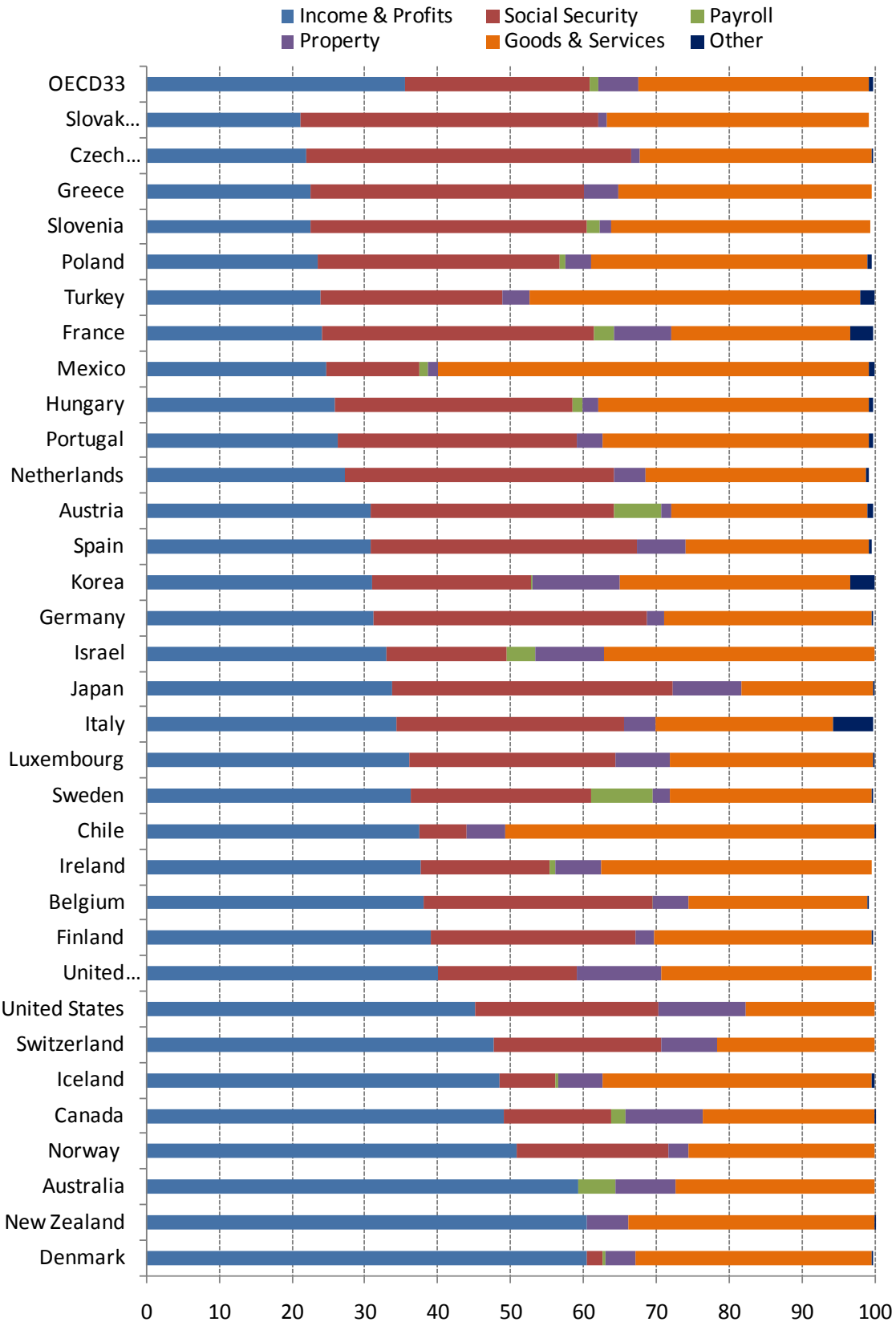
OECD revenue statistics illustrate the comparative mix between the taxation of income, social security, payroll, property, goods and services amongst the OECD member states (see Figure 9).

Compared with the OECD average Australia's share of indirect tax revenue is much lower. The United States has the lowest share of indirect tax revenue as a proportion of total tax revenue, largely due to the absence of a broad-based indirect tax such as a GST or VAT. If social security taxes are excluded, then Australia has the sixth highest share of income tax (individual and corporate) as a proportion of total tax revenue.[iv]

The BCA believes that Australia should ultimately aim to move to a tax system where there is less reliance on capital and income taxes (taxes on mobile factors) and increase the reliance on more efficient and less mobile indirect taxes (e.g., consumption and land tax).

[iv] Social security taxes are included in Figure 9 for completeness. In many cases this tax effectively funds retirement incomes. While Australia has no direct corresponding component of this tax, the Australian superannuation system performs this role. However, it is not included as a tax on the OECD measures.

Figure 9: OECD Tax Mixes (2008 Percentage of Total Tax Revenue)



Source: OECD, Revenue Statistics, 2010.

Reduced reliance on capital and income taxes

The predicted decline in workforce participation due to demographic change will mean that personal income tax on labour income will decline relatively over time as a revenue source, while global competition and the desire for economic growth will place limits on the taxation of companies. Over time, these factors should result in a relative decline in the taxation of income as a source of revenue. Appendix B outlines recent global developments in this regard.

Company tax

The evidence suggests that economic growth would be enhanced through a lower and more competitive corporate tax rate.

Competition for highly mobile capital also means that the global competitive pressure is more likely to be towards reductions in the corporate tax rates. The Australian tax system already relies heavily on personal and corporate income tax as a proportion of the total tax mix; it is therefore unlikely that there is significant scope to increase revenue from those income bases.

The relatively high statutory and effective tax rates that apply to corporate investments result in significant distortions and biases. As noted in the Henry review and by others, the current system may bias investment and other business choices.

"Company income tax can reduce productivity in a number of ways:

- where effective tax rates vary across assets, investment can be directed towards less productive uses;

- through its effect in discouraging direct foreign investment, taxes on investment can adversely affect technology transfers and knowledge spillovers;

- taxes on investment may also reduce investment in innovative activities, by reducing the after-tax return;

- complexity of the tax system can also reduce productivity by absorbing resources that could be reallocated to more productive uses. In addition, tax system complexity may also deter foreign direct investment; and

- company income tax can also distort financing decisions. This can affect productivity by distorting the allocation of investment across industries, favouring those sectors that can more easily access debt, relative to those that have to rely more on equity, such as those that invest more in intangibles". [26]

Against this background a strong case can be made that a lower effective rate on corporate investments would be beneficial. As has been widely noted,[27] the two most feasible and effective ways to reduce the tax rate on corporate investments are to reduce the statutory rate directly, or to increase the value of deductions corporations may make for new investment (for example, by allowing immediate expensing of investments).

Lowering the overall tax on capital should encourage new investment. Increasing the stock of available capital – including new businesses, factories, equipment or research – will help improve productivity in the economy.

A further advantage of lowering the company tax rate is that this may of itself reduce the incentive to use debt rather than equity to finance new investments (as the value of the deductions on interest would be lower under a lower company tax rate).

The BCA recognises that lowering the company tax rate would reduce tax revenues. Eliminating or limiting deductions, credits and other base narrowing features of the company tax system could help fund a lower rate. As noted in the Volcker Report,[28] broadening the corporate tax base is more difficult than simply eliminating 'loopholes' or tax provisions that some companies access, as many provisions that narrow the corporate tax base are intentional, involving deductions and credits (and are known as tax expenditures).

The BCA supports the recommendation of the Henry review that Australia's company tax rate should be reduced to 25 per cent over the short to medium term, acknowledging that the timing will be subject to economic and fiscal circumstances. The way in which such a cut could be funded is a matter for further consideration.[v] These considerations should however take account of the likely economic benefits that will come with a lower company tax rate, the potential for other base broadening measures and potential other sources of revenue.

More consistent taxation of investments

A finding of the Henry review was that, while previous reforms to Australia's capital allowance arrangements have reduced distortions to investment decisions and some aspects of complexity, a number of distortions remain.

One of its recommendations was that as a means of improving overall productivity, capital allowance arrangements should be enhanced and streamlined to ensure effective rates more closely match rates of economic depreciation, and to reduce administration and compliance costs overall.

The Henry review likewise contained a useful discussion of principles around the asymmetric treatment of income gains and losses and the impact of this on risk taking and entrepreneurship, noting that companies should be able to offset losses made in a particular year against taxable income from the preceding year.

These issues warrant further detailed consideration but should be considered in the context of the goal of moving towards a simpler system, predicated on a broad tax base with lower rates.

[v] Consistent with the overall approach taken in this paper, the BCA has not identified or developed specific options to fund a company tax rate cut, however various base broadening measures are being examined.

Deductions for corporate equity

Currently Australia's company income tax system permits companies to make a deduction for interest payments on debt. The effect of this is that company tax falls on the 'full return to equity'.

One potential alternative would be to pursue a company tax system whereby both interest payments on debt are deductible, as well as 'normal returns to equity' being deductible. In this instance the effect would be that company tax falls only on economic rents (i.e., those profits above normal returns).

This option could be implemented through the introduction of an Allowance for Corporate Equity (ACE) taxation arrangement.

In its submission to the Henry review, the BCA argued that the adoption of an ACE arrangement had the potential to deliver benefits, as it removes the bias in favour of debt financing that flows from the tax deductibility of interest on debt (however, it does this by effectively narrowing the tax base).

The BCA broadly accepts that implementing new tax arrangements that work to reduce an excessive reliance on debt will improve economic efficiency. Such an arrangement may also eliminate the need for 'thin capitalisation rules' which, in turn, would materially reduce complexity within the tax system.

However, few other countries in the world have introduced an ACE and the Henry review did not recommend moving to an ACE at this stage, instead suggesting that international developments should be monitored, with Australia being a fast follower rather than a pioneer in this area. The BCA believes that this is the right approach for now.

Personal income tax

The Henry review highlighted the significant role that the personal income tax system plays as the largest single source of taxation revenue in Australia. A central recommendation was that progressivity in the tax and transfer system be delivered through the personal income tax rates scale and transfer payments.

The Henry review proposed that a high tax-free threshold with a constant marginal tax rate for most people be introduced to provide greater transparency and simplicity. It was further argued that such an arrangement would remove the need for various tax offsets and would lower effective marginal tax rates for many people on lower incomes.

The Henry review also cited a view that it can be more efficient to impose higher tax rates on people whose behaviour is relatively unresponsive to tax rates (a finding also borne out in the UK's Mirrlees Report).

The BCA notes the general point that under current arrangements, the economic efficiency loss tends to be greater from tax distortions at the higher end of the income range than the lower end. This reflects three facts. First, the tax wedge is substantially higher at the higher end of the

income range and all else equal, the distorting effect of a tax increases more than proportionately with its rate. Second, the assumption that decisions to supply labour and invest in human capital are less sensitive to tax rates for higher than for lower and secondary income earners is likely to be inaccurate in an economy that competes globally for skills and which has many older income earners who face a choice between working and retiring from the labour force. Third, discouraging labour supply by people with relatively high skills and productivity costs society more in terms of foregone output than does discouraging labour supply by people with relatively low skills and productivity.

The OECD[29] has also found that a reduction in the top marginal tax rate can raise productivity in industries with potentially high rates of enterprise creation and, therefore, that reducing top marginal tax rates may help to enhance economy-wide productivity in countries with a large share of such industries (though the trade off with equity objectives needs to be kept in mind).

In July 2011 the government announced its intention to make a number of changes to the current framework underpinning the personal income tax system and associated tax offsets. These changes included a proposal to extend the tax-free threshold from $6,000 to $18,200, increases in some marginal income tax rates and changes to parameters of the Low Income Tax Offset.

The government claimed the changes are designed to provide targeted tax relief, as well as to improve the structure of the tax system by increasing transparency and improving rewards from working.

The announced changes do deliver lower personal income taxes for a large proportion of taxpayers and for some people there is a significant reduction in effective marginal tax rates. However the substantial (and costly) increase in the tax-free threshold is partly clawed back from increasing tax rates higher up the scale and changes to the low income offset arrangements. The effect of the increase in marginal tax rates (from 15 to 19 per cent and 30 to 32.5 per cent) is to increase effective marginal tax rates for many taxpayers.

In seeking to recast Australia's tax system architecture, it would be wrong to think that with the government's most recent announcement, necessary reforms to the personal income tax system have been achieved.

The BCA believes that there is a considerable way to go yet. We hold to the view that there is a strong economic case for reducing marginal tax rates and consideration therefore needs to be given to reducing the top personal rates. This rests both on the need for a tax system that is competitive in the region and that there is a clear rationale to lower personal tax rates as a means of enhancing productivity and increasing the income that individuals have available to invest productively in the economy through savings, shareholdings and other assets. The current top marginal tax rate of 45 per cent and the 37 per cent rate should be reduced.

Tax-transfer system

The complexity of the current tax-transfer system presents a strong case for simplification and increased transparency. The BCA supports significant consolidation of payments and tighter targeting to those in need.

The ongoing challenge is that tapered relief of benefits can result in high effective marginal tax rates (EMTRs). EMTRs are a function of both paying tax and losing benefits. Greater emphasis should be placed on the benefits side. Benefits paid to those fully able to work should generally be regarded more as a transitional feature with 'staggered withdrawal' to address the distortive impact once individuals begin earning income and paying tax. The exceptions to this are those benefits that support work effort such as child care.

A consistent treatment of savings

Concerns have been raised that differential tax treatment is adversely impacting on individuals' saving and investment decisions.

For example, the relatively unfavourable treatment of interest-bearing accounts is considered to have undermined the ability of domestic banks to raise capital through this channel, and has thereby increased the reliance on overseas borrowing to fund domestic lending. The Henry review also found that differential tax treatment appears to be delivering relatively higher benefits to higher income earners, for example, in terms of rental property losses.

These sorts of differential tax treatments are probably impacting on the type of saving and investment rather than the quantum of saving and investment. Reforms that better align the tax treatment of different forms of savings can be expected to improve the efficiency of saving decisions, with flow-on benefits in terms of the quality of investment and hence growth.[30]

On this basis, the BCA supports efforts to tax savings more consistently, including the Henry review's recommendation that individuals be provided with a 40 per cent discount for the returns and expenses from certain forms of taxable savings.

Greater reliance on indirect taxes

If Australia is to fund the abolition of inefficient transactions taxes and reduce our reliance on taxes on income and capital, then it is inevitable that we will need to look at increasing our reliance on indirect taxes, including those on consumption and land.

Consumption tax

The BCA acknowledges that changes to consumption tax will be controversial. Modelling such as that commissioned by other groups for the tax forum (and outlined ahead in Boxes 2 and 3) shows that modest increases in the GST rate or changes aimed at broadening the base, could raise substantial revenue, which would allow other inefficient transaction taxes to be removed.

As part of our view that Australia should increase its reliance on indirect taxes, and reduce its reliance on personal and company taxes, it is probably more important to set in place some principles for dealing with the consumption tax. These should aim to confine any future increases to paying for the reduction or removal of other taxes, not raising more revenue. That is, there must be explicit offsets associated with any increase to the GST. Another critical principle is reinforcing the need for a staged approach and appropriate compensation and transitional arrangements.

It is also important to recognise that increasing the GST is not the only solution in relation to eliminating inefficient state taxes. There is scope for the states to better utilise existing payroll or land taxes. Consideration needs to be given to the features of these existing taxes and in particular the opportunities that may arise from reconsidering associated rates, thresholds, exemptions and concessions, with a view to improving their overall efficiency. Indeed, a future tax system could incorporate a combination of revenue sources as a means of replacing existing inefficient state transactions taxes.

Nonetheless, the BCA remains strongly of the view that in order to improve the tax system, there must be a consideration of consumption tax and it should not be taken off the table completely.

Land taxes

Given its immobility, land has the potential to be an efficient tax base for the states and a land tax is capable of delivering significant and sustainable revenues. As the Henry review suggested, land tax is efficient because it reduces the price of land but does not impact on how it is used or how much it is used.

While the efficiency of local rates varies (and is heavily dependent on whether they are set on the basis of improved or unimproved land values), they do provide examples of how land taxes can be configured.

As outlined in the boxes below a number of recent studies have been undertaken as to how abolition of the worst of the state transactions taxes could be funded by better utilising existing payroll or land taxes.

Despite these considerable efficiencies of both GST and land taxes, we recognise that reform in these areas will be amongst the most difficult to deal with. In considering Australia's best long-term interests and recognising the significant challenges ahead, we should, however, be prepared to have a comprehensive discussion of these issues, to better understand potential impacts on the community and households.

Box 2: Abolishing Inefficient State Taxes – Research Commissioned by the *Finance Industry Council of Australia*

In May 2011 the *Finance Industry Council of Australia* commissioned Deloitte Access Economics to examine the potential gains that could be achieved from the abolition of inefficient state transactions taxes.

- The report modelled a number of different reform scenarios with the findings demonstrating the potential for large efficiency gains to be made.

- The report found that the abolition of all state transaction taxes would reduce state revenues by approximately $16 billion in 2008-09. However after taking account of second round revenue effects that would flow from efficiency gains (estimated to be around $5.7 billion), other taxes would only have to be raised by $10 billion to generate compensating revenues needed to deliver a revenue neutral result.

- According to the report, the most efficient way of funding the abolition of the state transaction taxes would be to increase the GST from 10 per cent to 13 per cent. Together, such a reform is estimated by Deloitte Access Economics to yield an efficiency gain of around 1.7 per cent (representing a benefit to Australian households of around $3 billion).

- Another scenario involved the abolition of property transactions taxes with revenue replaced by broad-based land taxes (i.e., through an increase in existing land tax rates of around 0.4 to 0.5 percentage points and applied on a wider base) and the abolition of other transaction taxes with revenue replaced through higher payroll tax (an increase of 0.4 to 0.6 percentage points) levied on a wider base (i.e., without exemptions). This reform is projected to also be revenue neutral and is estimated by Deloitte Access Economics to yield an efficiency gain of around 1.3 per cent (representing a benefit to Australian households of around $2.4 billion).

- The report noted that while the largest net economic benefit is where the abolition of state taxes is offset by an increase in the GST, there are *nonetheless significant gains to be realised by states acting unilaterally and shifting their tax base away from reliance on less efficient taxes.*

Box 3: Abolishing Inefficient State Taxes – Research Commissioned by *CPA Australia*

In September 2011, *CPA Australia* released a report prepared by KPMG Econtech which examined the economic impacts of increasing the GST to fund a reduction in state-based insurance taxes, motor vehicle taxes, commercial conveyancing duty and payroll tax.

- The report modelled four alternative scenarios designed by CPA Australia with the aim of improving efficiency in the Australian tax system and increasing the productivity of the Australian economy.

- Scenario 1 – 12.5 per cent GST raising approximately $10.5 billion extra to fund the abolition of insurances taxes, motor vehicle taxes, and around one tenth of commercial conveyancing duty.

- Scenario 2 – 15 per cent GST raising approximately $20 billion extra to fund the abolition of insurances taxes, motor vehicle taxes, all commercial conveyancing duty and around 40 per cent of payroll tax.

- Scenario 3 – 20 per cent GST raising approximately $40 billion extra to fund the abolition of all state transaction taxes (insurances taxes, motor vehicle taxes, all commercial conveyancing duty); the abolition of all payroll tax; with room also to fund minor reductions in company tax and personal income tax.

- Scenario 4 – 10 per cent GST applied to a broader base to include domestic consumption of products that are currently GST-free (raising approximately $11.5 billion extra) to fund the abolition of all insurances taxes, and motor vehicle taxes and a significant proportion of commercial conveyancing duty.

- The results from this study suggested that the approximate improvements in living standards projected under these scenarios ranged from $1.6 billion to $4.7 billion.

Social and environmental taxes

The social and environmental dimensions of human activity also have significant implications for future tax design and the application of tax principles. Certain narrowly-based taxes specifically designed to change behaviour can be welfare enhancing. In considering such taxes it is important to be explicit about their purpose. Taxes directed at addressing social and environmental issues need to actually bring about changes in behaviour. They should not have general revenue raising or income redistribution as their main objective.

Simplification

There can be little disagreement that reforms to reduce the cost and complexity of the community's interface with the tax system will be beneficial. Such reforms also have the benefit of increasing compliance and thereby maintaining the strength of tax bases.

Whether it is simplifying the personal income tax return system or reducing paper work for businesses, having a commitment from government to implement a number of administrative reforms recommended by the Henry review is a critical first step.

Reducing the complexity of the tax system has long been a goal of reformers, but achieving this goal has proven difficult in practice.

In the 1970s, the Asprey review considered the tax system to be complex, with the Income Tax Assessment Act at 750 pages in length.[31] By 1990, the Income Tax Assessment Act was 4,000 pages[32] in length and today it stands at around 7,000 pages.

While the length of legislation is just one indicator of the complexity of the tax system, it demonstrates the clear trend of increasing complexity of the tax system.

In line with the trade-offs inherent in tax principles, the extent of simplicity of the tax system is likely to be more a matter of judgement than an exact science. However, judgement and the findings of the Henry review would suggest that we can further simplify our tax system without compromising other principles, like revenue adequacy and equity.

There are also examples of governments internationally that are taking concrete steps to at least stem the increasing complexity of the tax system – the United Kingdom's Office of Tax Simplification is one such example (see Box 4 below).

Box 4: United Kingdom Office of Tax Simplification

In July 2010, the UK Government established the Office of Tax Simplification (OTS). The Office has been charged with identifying areas where the tax system has become unnecessarily complex for businesses and individuals.

The government established the office as a result of increasing complexity in the tax code, which doubled in length over the decade to 2010 to more than 11,000 pages.

The Office is supported by a board of tax experts and draws on external legal and tax expertise as necessary. The OTS is undertaking a rolling series of reviews in areas like pensioner taxation, employee share schemes and small business tax.

Source: http://www.hm-treasury.gov.uk/ots.htm

In order to progress simplification of the tax system, the government should commit to:

- Introduce pre-filled personal tax returns over time for the majority of taxpayers to reduce red tape for taxpayers.

- Support simpler tax returns, commit to rationalising and restructuring offsets, rebates and levies into personal tax rates as part of broader personal income tax reforms in the future.

- Proposals to simplify personal capital gains tax.

- A systematic review of the various concessions offered to taxpayers through tax expenditures. In 2009-10, 349 tax expenditures accounted for 8.8 per cent of GDP ($113 billion).[33] Such a review is long overdue given that the Ralph review recommended periodic and systematic review of all tax expenditures in 1999.

- A program of business tax simplification, including: continuing simplification of fringe benefits tax; continuing simplification of the taxation of trusts and increasing the take-up of Standard Business Reporting and following this, examine the possibility of building on this approach in other areas to further reduce tax compliance costs with business.

Conclusion

As outlined in this part, getting Australia's future tax architecture right requires coordinated action on a number of fronts. It means controlling government spending while at the same time changing the tax mix, addressing major fiscal imbalances in the federation and simplifying the tax system.

These actions cannot be fully implemented in the short-term but we must commence the process of working towards this future tax architecture now. If Australia fails to start that process now, future governments will be forced to make very, very tough decisions about what Australia can afford as a society, or they will be forced to impose unsustainable taxes on companies, families and individuals.

PART 7: A PATHWAY FOR PROGRESSING REFORM

KEY POINTS

It is important that the 2011 tax forum does not finish with one or two piecemeal changes. Instead it is essential that we start the process now of improving the system gradually and carefully including by considering central issues around the federation.

The long-term program of tax reforms required in Australia will therefore need to be:

- progressed at all levels of government;
- coordinated with broader government program developments;
- linked to fiscal policy developments; and
- multi-disciplinary and multi-layered, addressing issues of policy, legislation, administration and compliance.

The key steps to do this would be as follows:

- the Commonwealth Government should, in conjunction with the states, set out the projected fiscal challenge by extending the Intergenerational Report-type analysis across all levels of government;
- the Commonwealth and states should prepare a prioritised list of inefficient state taxes and an approximate timetable for their removal. As part of this, potential options to replace that revenue should be identified;
- the most useful way of dealing with such comprehensive change would be to progress analysis to identify the most intelligent options for improving the tax system in tandem with more efficient spending by all levels of government. Tax reform options would form the basis of an extensive consultation with the community. Such analysis would identify the impact of changes on families, individuals and companies, possible transitional and compensation arrangements and projected budget implications; and
- the government should consider what is the best institutional arrangement to progress tax reform

It will be difficult, particularly given the current configuration of parliament, to expect that governments can contemplate the full range of options without being forced to rule some things off-limits.

One option canvassed in this report is that the Commission of Budget Integrity, as proposed by the BCA, could also take on the role of examining options for improving the tax mix.

It is vital that in the parliamentary debate that follows the forum, the parliament commits itself to a detailed process of tax improvement over the next decade.

It is expected that the community will have a range of views on how we improve our tax system over time. As outlined above, there are many challenging and demanding issues that need to be resolved. What will be important, however, is to set out a clear pathway for progressing reform over the long term, including agreement on the scope and minimum aspirations for reform.

In this context, there are a number of critical steps that must be taken beyond the tax forum, if we are to put Australia on the right path to pursue long-term comprehensive tax reform. These steps include: to agree to formalised ongoing processes and institutions for reform; to establish a forward work program for long-term tax reform; to commit to abolish the most harmful and inefficient state taxes, but involve the states and territories in the conversation (including how they might be provided with greater certainty over their own-source revenue raising capabilities); and to keep all options open to fund the reduction of harmful taxes on a revenue neutral basis.

A formalised ongoing process

The analysis contained in this report highlights the importance of taking steps now, before the challenges become overwhelming. The analysis also highlights how dealing with issues around the federation must be a central feature of a broader tax reform agenda.

The long-term program of tax reforms required in Australia will therefore need to be:

- progressed at all levels of government;
- coordinated with broader government program developments;
- linked to fiscal policy developments; and
- multi-disciplinary and multi-layered, addressing issues of policy, legislation, administration and compliance.

Update the projected fiscal challenge

The analysis contained in Part 1 of this report, based on the preparation of an Intergenerational Report framework, highlights the full cost of government for both the Commonwealth and state and territory governments and the potential for an unfolding fiscal crisis to occur in Australia over coming decades. This is an important context because tax reform must address revenue issues across the federation.

The preparation of Intergenerational Report-type analysis does have some limitations and it is acknowledged that the projections prepared in this report are not forecasts. Rather they are a tool to provide an indication of future demographic and other fiscal pressures under existing policy settings. The results of such reports are typically intended to inform policy makers and the public of emerging pressures that will affect fiscal sustainability and in that respect can play a useful role in contributing to the policy debate.

This point was underscored by the release in September of an updated Intergenerational Report for New South Wales, which confirmed the pressures identified by Deloitte Access Economics in their report for the BCA.

It would be timely for the Commonwealth Government, in conjunction with the states, to set out the projected fiscal challenge by extending the Intergenerational Report-type analysis across all levels of government. This analysis would not only focus on health and social security, but may also take account of community expectations around the provision of infrastructure by state governments.

Commit to abolish the most harmful and inefficient state taxes

The need to abolish inefficient state taxes such as stamp duty and insurance taxes is largely incontrovertible. There is, however, disagreement in how this is best funded and facilitated.

A necessary precursor to resolution of this issue would be agreement from all governments on the need to eliminate these taxes with an appropriate replacement mechanism.

Pursuing any agreement in this area would also need to take into account the GST Distribution review that is currently underway.

In terms of an approach to abolishing the most harmful and inefficient state taxes, a multi-stage process could be warranted involving a:

- ***Phased implementation plan.*** Abolition of the most harmful and inefficient taxes could be implemented over a five to ten year period. Given the already crowded reform agenda on Commonwealth–state matters, there is a risk that too many reforms pursued at once could spread political capital for reform too thinly. A deliberate but gradual approach would allow governments to consider a cooperative arrangement in detail and implement it without major budget shocks.

- ***Cooperative approach to revenue replacement.*** Agreement from both the Commonwealth and the states to explore options for revenue replacement will be necessary, with some milestones established. This could include a combination of broadening the GST, giving states access to a share of income tax, as well as states examining the potential to increase revenues from other existing revenue bases that have the potential to be relatively efficient, including payroll tax and land tax.

- ***Continuity of reform and annual reporting of progress.*** The abolition of these taxes will need to be embedded in the legislature of each state and the Commonwealth if it is to be fully and effectively implemented over the long term, given changing political and other circumstances. In order to ensure a high level of transparency and accountability for reforms, a brief annual report on progress could be prepared.

- ***Replacement revenues should be flexible and efficient.*** An important consideration in revenue replacement will be the effect that different options have on the extent to which governments have sufficient autonomy to discharge their responsibilities, while being clearly accountable to their populations for service delivery.

It will be important to consider the effect of different options on vertical fiscal imbalance in the long term. It would be preferable that the abolition of the most inefficient state taxes does not further increase the level of vertical fiscal imbalance. At a minimum, revenues should be replaced by access to efficient tax bases rather than through tied funding agreements.

Identify options for improving the tax system

Government should progress analysis to identify the most intelligent options for improving the tax system in tandem with more efficient spending by all levels of government.

The tax reform options would form the basis of an extensive consultation with the community and could be fine-tuned into a preferred approach. Such analysis would identify the impact of changes on families, individuals and companies, possible transitional and compensation arrangements and projected budget implications.

It will be important that the development of these options is not constrained. If we are to pursue the abolition of inefficient state taxes or reduce the impact of other taxes that distort our decisions to work, save, invest and innovate, then we need to have as many tax policy levers available as possible.

This means a preparedness to consider the role of the GST and options raised in the Henry review such as the states sharing some of the tax base for personal income tax.

It does not mean that every tax lever available will necessarily be utilised in the preferred approach, but it does mean that governments must be flexible in their consideration of a wider range of means to realise a desirable tax system.

The more we limit the scope of taxes under consideration, the less chance we have of achieving an appropriate balance between the propositions of revenue adequacy, economic growth, progressivity, simplicity and sustainability.

Given the long-term challenges outlined in this paper, a significant shift over time in Australia's tax system is the only viable option both socially and economically, reinforcing the need to keep all options open. If Australia continues down a path of constrained ad-hoc tax changes over the next 10 years, then we will limit out choices of how to address our long-term fiscal challenges. We will confront a combination of higher rates of tax and/or less generous entitlements.

Institutional arrangements to progress tax reform

If a program of reform is to be pursued over the long term, then having rigorous institutions and processes will be imperative to effectively manage and coordinate the task. Issues for consideration include:

- further articulating views on the necessary high-level architecture of Australia's tax system (building on the foundation established by the Henry review), needed to meet the long-term challenges outlined earlier in this paper;

- designing a number of reform package options in line with this architecture, for detailed consideration by the community and governments; and

- undertaking analysis of the effects – including distributional impacts – of different tax changes.

As part of this, it will be essential to maintain a clear vision of the directions and options being pursued, with authoritative, respected, transparent and comprehensive analysis undertaken as a basis for decision-making.

As noted above, having an independent body to consult on, coordinate, develop and analyse options for a long-term reform program at all levels of government would assist in this task.

The BCA considers that an independent Commission of Budget Integrity could play a role in this regard. It could be established as a statutory body with a number of eminent members with broad public policy experience including in the area of tax reform. Critically, this body, like the Productivity Commission, would not constrain executive or parliamentary power, other than through the light it could shed on the relevant issues.

Having an independent body with responsibility for progressing long-term tax reform is one option that the government should consider in determining the best institutional arrangement for progressing tax reform beyond the forum.

Establish a forward work program for long-term tax reform

While options can be examined and consulted on in the shorter term, implementing a preferred approach for improving the tax system will necessarily be a long-term task. Therefore a preferred approach should ultimately be supported by an implementation plan, which outlines the sequencing of reforms to the tax system over a 10- year period.

As the OECD has suggested, setting out such a plan transparently can provide a measure of predictability, even where the entire reform cannot be implemented immediately.[34] This was the approach that was adopted for the UK Government's Corporate Tax Roadmap, which set out a five-year timetable, including legislative and other milestones, for reducing the corporate tax rate incrementally from 28 to 24 per cent.

If the long-term implementation of tax reform is to be credible and enduring, then it will need to transcend the electoral cycles. It will also need to be sufficiently flexible to accommodate economic developments. Establishing a reform program over these timeframes would require an intergovernmental agreement (and ideally bi-partisan agreement). This is ambitious, but it is what is required if we are to pursue comprehensive tax reform in the national interest.

The parliament is likely to be in the best position to discuss how this is best achieved including the most appropriate legislative arrangements. This issue could be pursued as part of the parliamentary debate that will follow the tax forum.

Conclusion

The Business Council recognises that progressing comprehensive tax reform will not be a straight-forward task. For this reason, it is imperative that we build a strong foundation upon which to pursue tax reform over the next 10 years coupled with a more efficient and accountable approach to government spending and to Commonwealth-state financial arrangements.

The plan we have outlined addresses the fundamental role of the tax system to raise sufficient revenue to pay for services properly expected from government. It also outlines how a good tax system can be designed in a way that provides incentives for savings and investment and drives productivity and competitiveness in the economy.

The sooner Australia gets its tax system right, the more likely we will be to generate the economic growth that will support the necessary revenue generation in the years ahead.

APPENDIX A – A CHANGING FOCUS OF TAX POLICY PRINCIPLES

Major changes in the Australian tax system have often been driven by circumstances such as the revenue demands of world wars and the Depression. More recently tax reforms have been driven by necessity as a consequence of changes in the structure of the Australian economy.

By the mid 1980s, the pressures of international competition and the need for reform of domestic markets within Australia started a long process of re-ordering the weight given to the various tax principles in tax system design.

Equity, and the complexity that it brought, remained a dominant theme of tax design throughout the 1980s and 1990s. The introduction of the Fringe Benefits Tax and the Capital Gains Tax were both noted for their contribution to tax system equity but criticised for their complexity, particularly in their original form.

These reforms were very much focussed on a contemporary, rather than forward-looking view of tax policy principles. The concept of a comprehensive income tax base was an accepted tenet of tax policy in a contemporary and comparative sense. Less attention was given to applying the strategic framework of whether the principles used to develop these taxes would remain as relevant in a world of increasingly mobile capital and labour.

However, steps were taken to improve both the efficiency of existing taxes and give greater consideration to efficiency effects in the design of new tax arrangements. Significantly, the top marginal tax rate was progressively reduced, as was the corporate tax rate. These were the first steps in responding to Australia's greater integration with international markets. The strategic framework had not yet developed to fully embrace the impacts of globalisation.

As the Australian economy became more open to international markets, incentives to encourage labour market participation and to attract international capital became increasingly important.

By 2000, these same pressures were a factor in the replacement of a narrowly-based indirect tax by a broad-based consumption tax, accompanied by reductions in personal tax and a systemic review of the corporate tax system.

For indirect tax reform, it was a 25 year journey to reach this point, starting with the Asprey review in 1975. This was in no small part due to the difficulty in adequately resolving the weight to be given to the efficient characteristics of a broad-based indirect tax against its negative implications for vertical equity.

Both the contemporary dimension and the comparative dimension were weighted in favour of equity over efficiency. Few broad-based indirect taxes were comprehensive and in many cases, such as in Europe, had specific design features intended to deliver equity objectives. Contemporaneously, the Australian taxation system contained numerous examples of both the direct and indirect tax systems being used to address taxpayer equity.

Ultimately in 2000, the weighting of efficiency, equity and adequacy could not be satisfactorily resolved. Australia implemented a broad-based indirect tax, covering around 70 per cent of final consumption expenditure, but with its adequacy diluted through the exclusion of fresh food, as

an equity objective. No strategic analysis was brought to bear on the trade-off between immediate equity against a cost to adequacy.

The tax reforms of the late 20th century were appropriate for their times. They broadly reflected both the contemporaneous and comparative dimensions of the time. In many instances it is difficult to see the application of a forward looking strategic analysis to many of the reforms.

The Henry review provides an opportunity to apply all three dimensions to future tax design.

The future challenges facing Australia are well documented and can be applied against the analytical framework to provide resolution to the tax policy principles.

APPENDIX B – GLOBAL TAX TRENDS

Capital is more responsive (and mobile) than labour in responding to changes in tax rates. The trend in taxation in the aftermath of the global financial crisis could be defined as a slight resumption in tax competition, constrained by significant fiscal imbalances in most developed economies.

Many countries have continued the trend towards lower corporate tax rates (or at least not increased them in an effort to repair their fiscal position) and placed an increasing reliance on indirect taxes as a more stable and immobile source of revenue.

The trend towards lower corporate taxes is supported by academic research including one study[35] which found that a 10 per cent reduction in the corporate tax rate is associated with a 1.82 per cent increase in the growth of per capita GDP.

On a similar theme, another study[36] found that corporate tax rates are negatively correlated with economic growth and that a 10 per cent increase in the effective corporate tax rate reduces the aggregate investment to GDP ratio by two percentage points.

The study also concluded that high effective corporate income tax rates are associated with slower economic growth, with a greater reliance on debt rather than equity finance.

The Henry review noted an OECD literature review of empirical studies found on average that a one percentage point increase in the rate of corporate tax would result in a decrease in foreign direct investment of 3.72 per cent and that the responsiveness of the foreign direct investment to tax has increased over time.[37]

Recent tax changes in selected economies, among them key export markets and competitors, are summarised below:

- In **Canada**, the federal corporate tax rate is being progressively reduced from 22.12 per cent in 2007 to 15 per cent in 2012. However, there are additional provincial taxes on corporate income which vary from 10 per cent to 16 per cent. The federal corporate rate in 2011 was 16.5 per cent but the combined federal and provincial tax on general corporate income may vary from approximately 26.5 per cent to 32.5 per cent. There have been no significant changes in individual marginal tax rates. Sales tax varies by province from 5 per cent to 15 per cent.

- **Mainland China** has a standard corporate tax rate of 25 per cent, with concessional rates of 20 per cent for low profit enterprises and 15 per cent for high technology businesses. China has a standard VAT rate of 17 per cent plus consumption taxes for luxury goods ranging from 3 per cent to 45 per cent and a business indirect tax which ranges from 3 per cent to 20 per cent.

- **India** has a base corporate tax rate for domestic companies of 30 per cent, uplifted by surcharges to 33.99 per cent and a base rate of corporate tax for foreign companies of 40 per cent. India has a complex indirect tax regime comprising state and union taxes including a standard VAT rate of 12.5 per cent for intrastate sales, a Central Sales Tax for

interstate sales imposed at either 2 per cent or the standard VAT rate and a services tax of 10.3 per cent.

- **Japan** had planned a reduction of 5 per cent in the 30 per cent national component of its corporate tax rate (from April 2011) but this was deferred following the Tokyo earthquake and tsunami. There has also been no change in the top individual marginal tax rates. Japan is conscious that the consumption tax rate of 5 per cent is very low by global standards, but this is unlikely to be increased prior to the next national election. Japan is also trying to boost the economy through domestic consumption, so a tax rise would run counter to that objective.

- **Korea** has corporate tax rates of 22 per cent for large businesses and 10 per cent for small businesses. The tax rate for large businesses will be reduced to 20 per cent in 2012. There is also a resident surtax (inhabitant tax) of 10 per cent of the corporate income tax liability which means the effective corporate tax rates in 2012 will be 22 per cent and 11 per cent. The VAT rate in Korea remains unchanged at 10 per cent.

- **New Zealand** has recently reduced its corporate tax rate to 28 per cent, possibly in response to the original (2 May 2010) announcement by the Australian Government that it would reduce corporate taxes to a 28 per cent rate. New Zealand has also reduced its top marginal tax rate to 33 per cent, offset by an increase in the GST rate from 12.5 per cent to 15 per cent.

- **Singapore** has not foreshadowed any changes to its tax rates; the corporate tax rate is 17 per cent, the top marginal tax rate is 20 per cent and the GST rate is 7 per cent.

- The **United Kingdom** reduced its corporate tax from 28 per cent to 26 per cent in 2011, with a foreshadowed reduction to 23 per cent by 2014-15. There is also a concessional rate of 20 per cent for small business. The standard VAT rate was increased from 17.5 per cent to 20 per cent in April 2011, after having been reduced from 17.5 per cent to 15 per cent in December 2008 in response to the financial crisis and returned to 17.5 per cent per cent in 2010.

APPENDIX C – THE BOWLES SIMPSON COMMISSION ON FISCAL RESPONSIBILITY AND REFORM

The National Commission on Fiscal Responsibility and Reform was established by President Obama in early 2010 to develop a bipartisan proposal to address the United States' fiscal challenges in this decade and beyond.

The commission was established amid dire fiscal forecasts from the Congressional Budget Office that by 2025, US Government revenue would only be able to finance interest payments, Medicare, Medicaid and Social Security.

The commission was guided by a number of principles and values and it delivered a six-part plan to put the US back on a more sustainable fiscal path.

Guiding principles and values

- A patriotic duty to come together on a plan to make the nation better off tomorrow than it is today;
- Don't disrupt a fragile economy;
- Cut and invest to promote economic growth to keep the country competitive;
- Protect the truly disadvantaged;
- Cut spending that cannot be afforded – no exceptions;
- Demand productivity and effectiveness;
- Reform and simplify the tax system;
- Don't make promises that can't be kept;
- The problem is real and the solution will be painful; and
- Keep the country sound over the long run.

Six-part plan

1. ***Discretionary spending cuts*** including strong spending caps for Congress and arduous processes for approval of spending over these levels, as well as cutting low priority programs and streamlining government operations.

2. ***Comprehensive tax reform*** including sharply reducing rates, broadening the base, simplifying the tax code and reducing the $1.1 trillion of tax expenditures which the report refers to as "another name for spending through the tax code".

3. ***Health care cost containment*** including overhauling existing savings programs that would not genuinely meet their targets.

4. ***Mandatory savings*** including by modernising military and civil service retirement arrangements and placing the Pension Benefit Guarantee Corporation on a more sustainable path.

5. ***Social security reforms*** directed at reforming the system for its own efficiency and better outcomes rather than for deficit reduction per se.

6. ***Process changes*** to provide greater transparency and accuracy around key fiscal measures.

APPENDIX D – DELOITTE ACCESS ECONOMICS REPORT

NOTES

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Deloitte Access Economics

An IGR for the States

Business Council of Australia

2 September 2011

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Peter Crone
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2 September 2011

Dear Peter

Report and modelling to provide a backdrop to the upcoming Tax summit

The Business Council of Australia (BCA) has commissioned Deloitte Access Economics (DAE) to assist them form a backdrop to the recommendations it will take to the Government's Tax Summit in early October.

In particular, the tax system of the future will have to cope with two important intergenerational pressures which will affect the revenue needs of the nation over coming decades. Those two trends have already been well flagged – the ageing of the population on the one hand, and the relatively faster cost growth in health care (where taxpayers subsidise spending by around 70 cents in the dollar).

To date the vast majority of the work in this area has been the Commonwealth Treasury's *Intergenerational Reports* (IGRs) of 2002, 2007 and 2010.

This report adds to the latest Commonwealth IGR a matching assessment of State Budgets and related spending pressures through to 2050.

Yours sincerely,

Chris Richardson
Director
Deloitte Access Economics Pty Ltd

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BCA	Business Council of Australia
CGC	Commonwealth Grants Commission
DAE	Deloitte Access Economics
IGR	Intergenerational Report

Executive Summary

Every nation taxes its workers and its businesses so as to pay for subsidies to the young and the old, the sick and the poor. Yet in many parts of the world, including here in Australia, that social compact will be under pressure in coming decades.

That pressure will come from two key trends – an ageing population on the one hand, and relatively faster cost growth in health care on the other.

To date the vast majority of the work in this area has been the Commonwealth Treasury's *Intergenerational Reports* (IGRs) of 2002, 2007 and 2010.

This report adds to the latest Commonwealth IGR a matching assessment of State Budgets.

Although pressures on the States are not quite as notable as those on the Commonwealth Government, they are considerable – and they have not been widely recognised.

The States, for example, bear a considerable load on the health care cost front, even after allowing for recent proposed changes in State arrangements in this area.

That means the problems for Australian fiscal finances in coming decades are greater than is usually realised. Moreover, there are additional complexities here:

- First, our federation has evolved into a system whereby the States spend more than they earn (and vice versa for the Commonwealth), leaving the national government providing subsidies to the States.
- Second, despite the relative efficiency of the GST (a Federal tax distributed to the States) and the potential efficiency of payroll taxes (if they were not as subject to exemptions as they are), State taxes as a group are rather less efficient than their Commonwealth counterparts.

That means the pressures on the States – and the age old question of 'who pays' that those pressures raise – becomes worse still in light of the small size of the State tax base and inefficient nature of many State taxes. In turn, as key trends add to spending needs at the Commonwealth and State levels, the tax system will need to be able to cope.

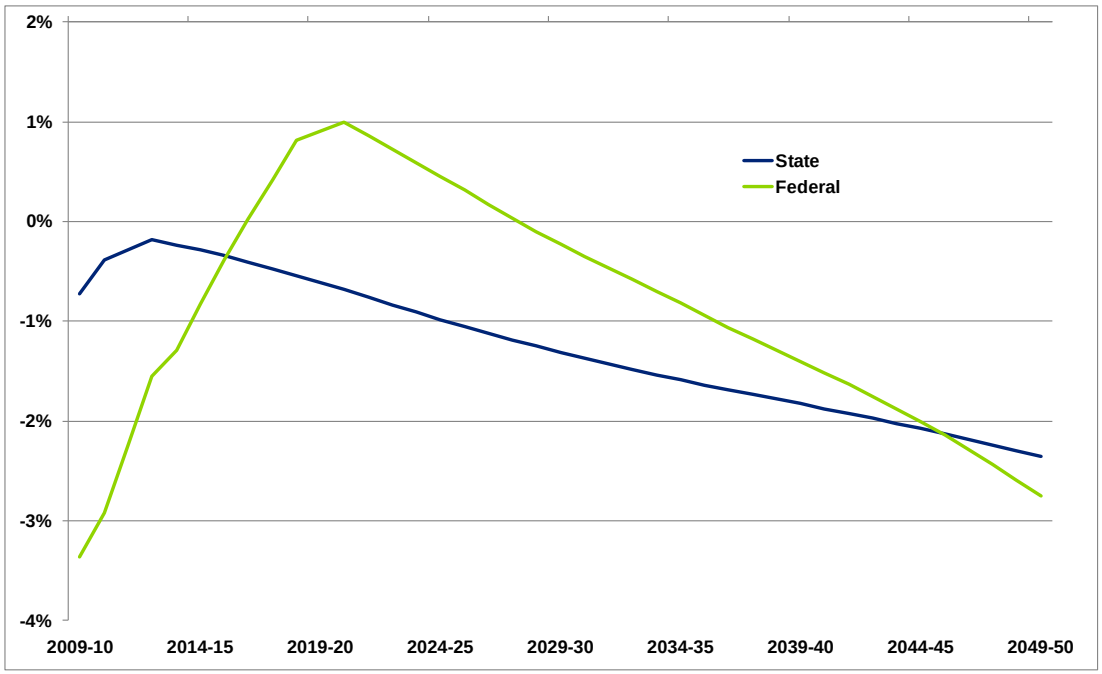
The 2010 Commonwealth IGR pointed to a shortfall on 'primary balance' of 2¾% of GDP by 2050 – and that is only projected to be achieved after expenditure savings are assumed to save an initial 1% of GDP by 2020.

The modelling here indicates that the States will see a shortfall of much the same size: almost 2½% of GDP by 2050.

That does not, by the way, mean that the effects of pressures such as ageing and health care cost inflation are the same for the States as they are for the Commonwealth. Rather, that end-point in 2050 is also affected by today's starting points, as well as by the Federal assumption that spending restraint will occur over the next decade.

The chart below shows the very different patterns over time in the results.

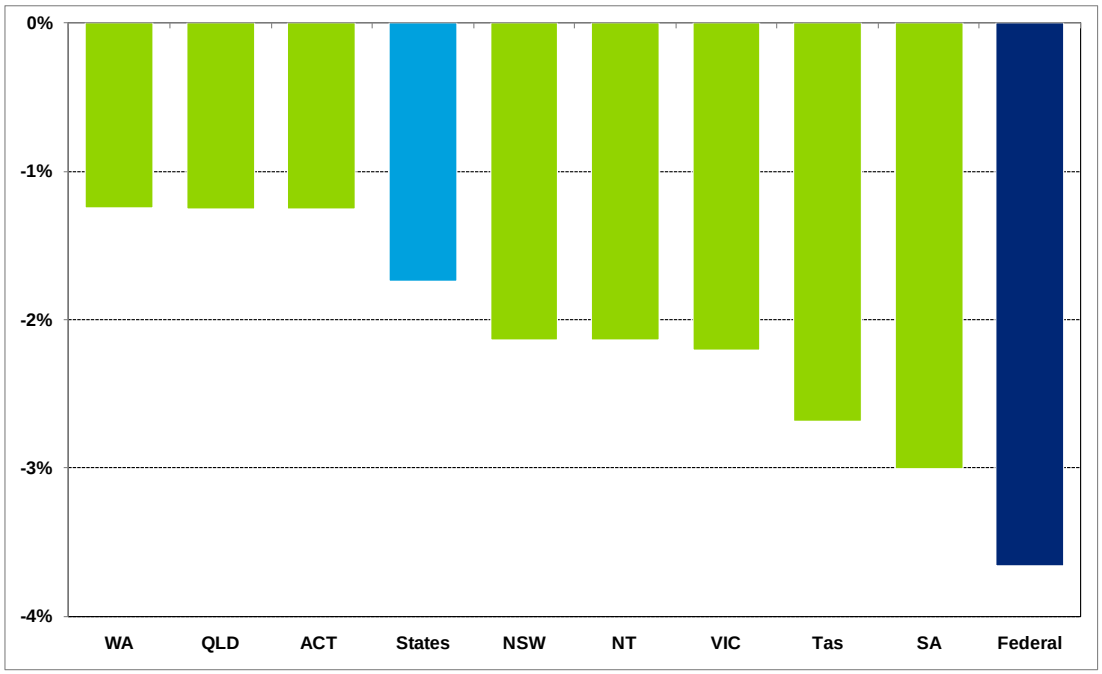
The different patterns in primary balances to 2050 (% of output)



Source: Deloitte Access Economics

(Note that these results are derived from long term models, and therefore do not match the announced forward estimates profiles of either the Commonwealth or the States. That may be seen, for example, in 2012-13, where the Commonwealth has budgeted a surplus.)

The worsening in primary balances between 2020 and 2050 (% of output)



Source: Deloitte Access Economics

The chart above starts the clock ticking after the impact of the Federal assumption on savings in spending, showing the worsening in primary balances between 2020 and 2050.

That makes it a better indicator of the key trends. The chart shows that, for 'the average State', the impact of key spending trends will be just under half its Federal equivalent.

Note the State results do not account for the impact of Commonwealth Grants Commission (CGC) deliberations. The latter would notably 'lean into the wind' of the relative changes across States evident here, though they would not fully eliminate them (in part due to lags, and in part due to CGC methodologies – it is also worth noting that, even though the CGC would narrow the gaps shown here, similar gaps would be evident in private incomes as increased numbers of older Australians had to fund a rising absolute dollar gap between their total health costs and those footed by taxpayers).

The total shortfall in national fiscal finances by 2050 would be just over 5% of GDP.

What can this nation do about that? There really are three choices about how we go about affording this. Either we:

- Try to fund the spending challenge by retaining the current tax system architecture, but scale it up to meet these costs. This would imply the need for significantly higher marginal tax rates on personal income and a high company tax rate (and even higher rates if we are not prepared as a nation to revisit the GST); or
- Retain the current tax architecture (with current tax rates and the like) but reduce entitlements through greater use of co-payments and user pays arrangements for health and aged care, provide less generous government pensions, and reduce other spending; or
- Maintain the safety net and major entitlements and have a reasonable redistribution of income, but fund this through an improved, robust tax system architecture focused on a small number of broad revenue bases with competitive rates.

It is this latter approach which would seem to make the most sense.

Yet – as the frog slowly boils – there is no guarantee that such good sense will hold sway.

By the way, you may think that there is a missing option in the above. However, **'doing nothing' is not an option**. Australia's governments have enviable fiscal positions. Indeed, that served us well through the recent global financial crisis, leaving us better positioned to defend against the downturn through stimulus spending. However, running rising fiscal deficits across four decades – the 'do nothing' outcome – would not be a viable option. Current events serve as a reminder of the vulnerabilities that nations risk if they do not pay their way over long periods.

So how big a task lies ahead? By way of illustration, it is useful to think of 5% of GDP in terms of today's tax take. To raise that money – the first funding option noted above – would require combined Commonwealth and State savings of more than $70 billion a year.

To achieve that would require, for example:

- **Lifting the company tax rate to 67%**, rather than cutting it to 29% from today's 30%.
- **Or lifting the GST rate to 24%**, rather than leaving it at today's 10%.
- **Or lifting all marginal personal income tax rates by 44%** – that is, the soon-to-be bottom rate of 19% would become 19% x 1.44 = 27½% instead, while the top rate of 45% would become 45% x 1.44 = 65%.

The above illustrations do not attempt to account for second round effects. For example, as all taxes are inefficient to some degree, then higher taxes equal a smaller economy, meaning that there could be a negative spiral – taxes would need to go higher to raise the initial target amount, thereby hurting the economy more, and so on. Similarly, some taxes are deductible against other taxes – hence, for example, higher company taxes would cut collections of personal income tax, also implying the need for higher taxes than suggested.

Or, in other words, these illustrations are likely to be conservative.

On the other side of the ledger, to save 5% of GDP from spending – the second funding option noted above – would require, for example:

- **Reducing all Federal payments to the States** – payments for specific services plus general revenue assistance – **by 73 cents in the dollar**.
- **Or eliminating all Federal payments to the aged and to families** – that is, eliminating both pensions and family benefits.
- **Or eliminating all Federal payments for health and to the disabled**.
- **Or eliminating all Federal payments for education, defence and hospitals**.

To put it mildly, these are big bucks.

To put it bluntly, although much of the modelling underlying these numbers – and their implications – is already in the public domain, we suspect that the average Australian is not aware of the extent to which the national social compact will be under pressure in coming years.

And, to draw the obvious conclusion, the earlier and more sensibly that Australia addresses these challenges, the better our chances of meeting them without major dislocation.

Deloitte Access Economics

2 September 2011

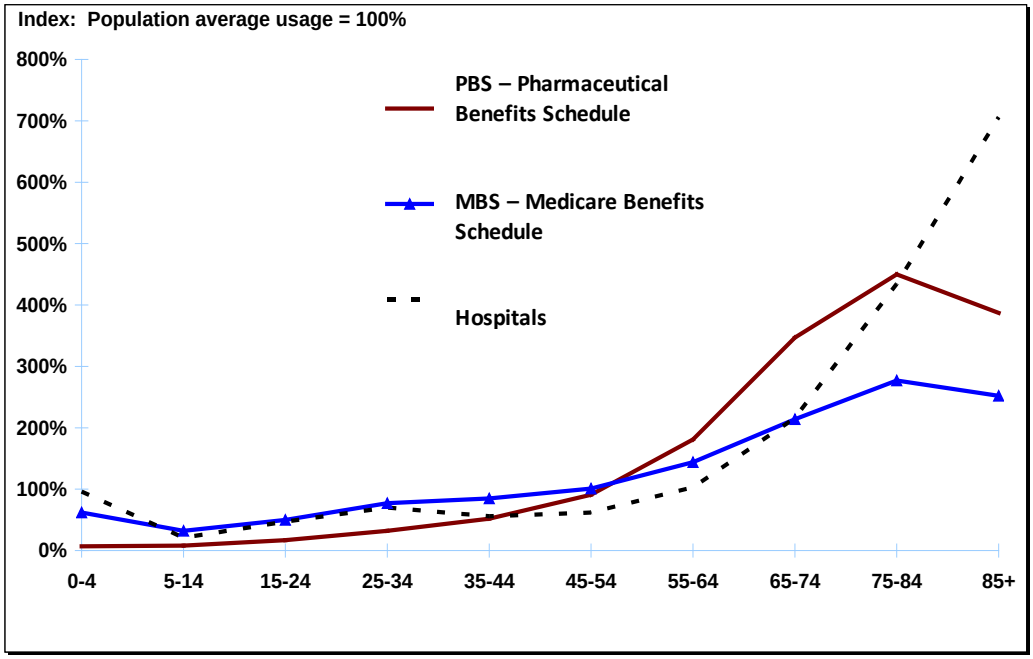
1 The problem

It has been known for a long time now that Australia's Federal Budget – this nation's social compact with itself – would run into trouble in coming decades.

We tax workers and businesses to pay for subsidies that – as Chart 1.1 shows – mostly go to the elderly, and the end result of the post-War baby boom is that the numbers of elderly will grow very fast in coming years.

Just as importantly, the spending that we subsidise the most – healthcare spending – sees its costs rising faster than other costs over time.

Chart 1.1: Relative usage of health services, by age



Source: Federal Treasury

In brief:

- Consumer demand for health services tends to grow at a faster rate than income over time. Spending on health is a function of income and the richer we are, the more we are willing to spend on health.
- Population ageing also drives relatively rapid demand gains. By 2020, the number of people over the age of 80 will be some 29% higher than it is today (and some 90% higher than it was a decade ago). The matching increases for those in their 70s will see a 43% increase over the coming decade. In turn, this change in the composition of the population will add to demands for Government services. Hospital costs for those aged 65 to 74 is double that of those 55 to 64, while hospital spending per person for those 85 and over is almost five times that spent on those 55 to 65.

- As we live longer, we are increasingly living with ailments that aren't life threatening, but require more health intervention than otherwise. There is an epidemiological transition underway towards chronic conditions (which are more costly to treat).
- Health care cost inflation is faster than the overall rate of price increase. Health care cost have grown faster than economy-wide prices in recent decades. Developments such as the listing of new medications on the Pharmaceutical Benefits Scheme and greater use of diagnostic procedures are likely to be the key driver of health spending pressures – contributing *three-quarters* of the projected increase in health spending. These new medications and new medical technologies are likely to be expensive.

So with more old Australians, and with steadily more expensive subsidies in health, we were always going to run into Budget difficulties down the track.

Or, in other words, demographic destiny poses challenges for us.

1.2 How much will that cost Australian taxpayers?

Luckily, we have a good handle on coming costs, because the Commonwealth Government has been informing us about these challenges. And although the challenge in Australia is smaller than that faced by the likes of Japan or Italy or Germany, it's still huge.

The latest Commonwealth Government *Intergenerational Report* (IGR), released in 2010, contained a lot of good news. Australia in the future will have a rather bigger economy than when Treasury last did these projections back in 2007. Indeed, forty years from now, the economy will be a full 18% bigger than Treasury was estimating just three years ago.

Yet the emphasis is on "bigger" – not better.

Our economy will be bigger because our population was projected to be bigger, mostly thanks to the assumption that migration will average 180,000 a year versus Treasury's earlier estimate of 140,000. Birth rates are also expected to be a little higher, albeit still below replacement rates.

Mind you, bigger isn't better on the population front. It never has been, and it never will be. However, where 'bigger' migrant numbers can generate a genuine gain for Australia is through the impact they can have on Australia's national social compact from higher productivity and participation. Our migrants are mostly highly skilled and relatively young – a combination which offers gains in both productivity (thanks to their skills) and participation (thanks to their age and to their skills). Other things equal, that means skilled migrants more than pay their way, contributing notably to tax collections while drawing on public spending by rather less than the average

Helped by more migrants, workforce participation has risen in recent years and is now projected to be 60.6% by 2050, more than 3 percentage points higher than the 2007 IGR.

And although Treasurer Wayne Swan, in releasing the latest IGR, noted that there will be only 2.7 Australian workers for every person aged over 65 by 2050, that is actually an improvement on the 2.4 estimated by Treasury back in 2007.

So the demographic news is good.

> Or, at least, it was. All hell broke loose when then PM Kevin Rudd released Treasury's updated IGR population forecast in late 2009. It pointed to a 2050 population of 35.9 million, and that proved politically unpopular.
>
> In the aftermath of that, and having peaked at year to rates of 320,000 during 2008, migrant numbers dropped to just 186,000 during 2010. Arguably the biggest impact on migrant numbers came in early 2010 when the Federal Government loosened the link between studying here and obtaining permanent residency here. That was a much needed policy change, but it hit at an unfortunate time for the foreign student sector.
>
> Yet, paradoxically, our forecasts of Australia's population have shifted little in the last couple of years, and are not much different (at 35.1 million in 2050) to the Treasury forecasts which provoked the furore on 'Big Australia'.
>
> How can it be that the political backdrop has shifted so sharply yet the numbers have not?
>
> That is because the projections made by Deloitte Access Economics and Federal Treasury ahead of the recent policy changes had always assumed that Australia was seeing a short term peak in its migration flows, driven up by a combination of factors that were never expected to last.
>
> Even if the Government hadn't cracked down on students studying in Australia as a better route to obtain permanent residency, the size of the international education sector in Australia would have levelled off anyway – meaning that the impact of student on migrant numbers (and overall population levels) was always mostly a one-off increase as those numbers accelerated.
>
> More broadly, all the major forecasts were always predicated on migration falling back to something like 160,000-180,000 per year. In practice, the peak in migration numbers in 2008 was higher than expected, and the political backlash it helped to generate means the winding back of migration numbers is happening now. Yet so far the expectation is the migration numbers will merely go close to halving from their peaks, not falling even further than that.

But, on some fronts, the economy in 2050 pictured in the latest IGR will actually look worse rather than better.

Productivity growth is now assumed to be lower than the matching 2007 IGR projections meaning that, in four decades, future incomes are now expected to be 3% less than they were projected to be in the 2007 IGR.

And there are more problems than meet the eye. At first glance the 2010 IGR was full of news of Budget improvements. The first *Intergenerational Report*, released in 2002, projected a future deficit of 5% of national income in four decades. The 2007 update reduced that to 3½%. And the 2010 IGR reduced it further still to 2¾%.

Or at least that's what was reported, but in fact, the Budget now looks worse than it did in 2007, weighing at an expected future deficit of 3¾% of national income versus the 3½% estimated back in 2007.

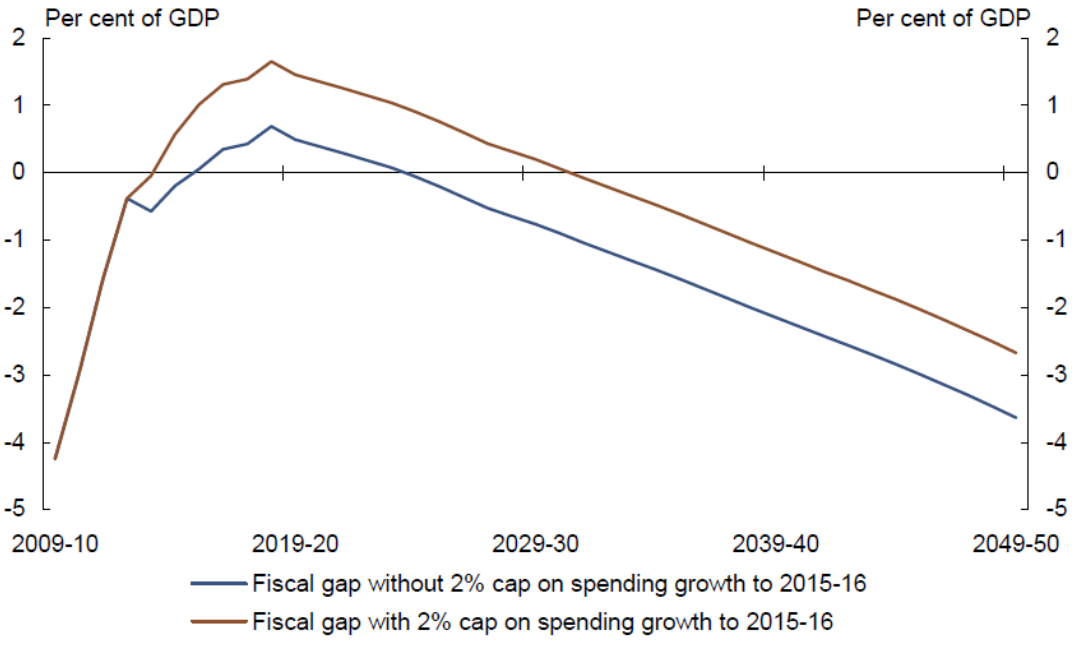
Yet you had to go to page 41 of the latest IGR before you found that out. The headline figure shown in the IGR assumes that the Government will save an extra 1 percentage point of GDP in spending cuts – about $13 billion a year in today's terms – before it even starts the clock rolling on these intergenerational estimates.

Specifically, the 2010 IGR assumes (see page xxiv) that:

> *"The Government's fiscal strategy will make an important contribution to addressing the fiscal pressures that will come with an ageing population. As the economy recovers, and grows above trend, the Government will allow the level of tax receipts to recover naturally and hold real growth in spending to two per cent a year until the budget returns to surplus.*
>
> *Constraining annual real spending growth to two per cent in years where the economy is growing above trend until the budget is in surplus will deliver permanent structural savings of around one percentage point of GDP from 2015–16. This Government has already delivered $56 billion in savings in the 2008–09 and 2009–10 Budgets."*

Allowing the tax-to-GDP ratio to rise as the economy recovers in coming years is an approach we agree with, but we have greater reservations on the assumption of ongoing spending restraint. Treasury highlight the impact of the latter assumption at page 42 of the IGR in a chart reproduced below (as Chart 1.2).

Chart 1.2: Projected fiscal gap with and without the fiscal strategy



Source: Federal Treasury

Finding an extra $13 billion a year in savings is no small matter. To flesh that out a little, it would mean making one of the following unsavoury choices:

- Cutting all Federal spending on schools; or
- Abolishing all health payments to the States; or
- Cutting all spending on universities as well as on vocational education; or
- Abolishing all disability pensions.

Moreover, that is the challenge to be faced within the next decade.

Thereafter the IGR pointed to the need to save a further 2¾% of GDP by 2050 – almost three times as much again.

As a final point here, it is worth noting that the IGRs have specifically focussed on Federal spending rather than revenue. As page 124 of the 2010 IGR notes:

> *"IGR 2010 assumes a constant tax-to-GDP ratio of 23.5 per cent (the historical average) from 2019–20. This methodology is similar to that used in previous IGRs. Prior to 2019-20, tax revenue is allowed to recover, in line with economic recovery, from the impacts of the global financial crisis. This is consistent with the Government's medium-term fiscal strategy."*

Deloitte Access Economics has previously pointed out that there are reasons to believe that the tax-to-GDP ratio may be under pressure from a long term downtrend in the terms of trade from their recent highs (see, for example, the Access Economics report – *How at Risk Is the Budget to the Economy?* – which formed Appendix A to the BCA's 2011-12 Budget Submission released in January 2011, and is available at http://www.bca.com.au/Content/99520.aspx).

The IGRs ignore the tax side of the equation. They simply assume that the tax take remains a constant share of the economy.

The IGR therefore assumes the boost to the company tax take as a share of GDP over the past decade was largely permanent, rather than the essentially temporary result of the profound demand shock of the past decade which saw the demand for minerals leap ahead of the supply of them, sending prices through the roof – and taking Australian Government tax receipts with them. The latter view would see mining supply lifting over the next decade, bringing down the terms of trade – and so tax receipts – more than the IGR assumes.

Moreover, the excise on petrol is not indexed, implying a growing hole in revenues over time, while current policy allows those over 60 to funnel income through the super tax system, meaning that – for many people over 60 – the effective top marginal rate of personal tax is now 15%. As the share of the population aged over 60 is just about to jump, that points to a significant deterioration in the sustainability of the Budget position over time. The abolition of benefits taxes means they will not ramp up to replace a hole in super tax revenues from contributions tax as workforce growth slows in coming decades.

Or, in other words, the IGR assumption of a constant tax burden implicitly assumes that other taxes will rise to make up the shortfall in these taxes over coming decades. That has not yet been recognised in the national debate.

We do not pursue these points further here.

1.3 What did the IGR assume about the States?

The Commonwealth's IGRs have, understandably, focussed on Federal finances.

That said, the IGR noted (at page 50) that:

> *"Health care services are funded and provided by the public and private sectors. The Australian government provides over 40 per cent of the total health funding, and is the major source of public funds. State and territory and local governments fund around one quarter of the cost of health services, while non-government sources contribute around one third.*
>
> *Since 1960, the fastest growing source of health care funding has been the Australian government. As a proportion of GDP, Australian government health funding increased from 1.0 per cent in 1960–61 to 3.8 per cent in 2007–08. State and Territory government funding increased from 0.9 per cent to 2.2 per cent of GDP over the same period and funding from non-government sources increased from 1.9 per cent to 2.7 per cent."*

The IGR further note (at pages 142-43) that:

> *"Historical trends suggest that the components of health spending will grow at different rates in the short to medium term. History also suggests that these differences are unlikely to be maintained over the long term. For this reason, the IGR transitions to an aggregate model of health expenditure from 2022–23. It does this by growing the projected real per capita spend in each age and gender group by an aggregate non-demographic growth rate.*
>
> *The non-demographic growth rate is calculated from the growth in real, age-adjusted per capita spending from all government sources — Australian, State and Territory, and local governments. This is equivalent to assuming long-term stability in funding shares between levels of government. The data shown in Chart C.14 suggests that this is a reasonable assumption; with the exception of major reform periods, funding shares have been relatively stable. The growth rate is calculated from after the introduction of Medicare — the last major reform to have a pronounced impact on funding shares.*
>
> *To aid a smooth transition between models, non-demographic growth in the aggregate model starts out at the rate implied by the component models at the end of their projections — around 1.8 per cent. This is transitioned up to the all-government growth rate of 3.2 per cent using a logistic curve."*

Those quotes essentially boil down to the Commonwealth acknowledging that the States will face some key cost pressures of their own.

1.4 What have we assumed about the States?

This report focuses on State finances. The modelling deliberately mirrors much of what was in the Commonwealth IGR of 2010.

For example, we assume that the total State tax-to-GDP ratio lifts back to its pre-GFC share over the first three years. After that it is a constant share of GDP/GSP. This is similar to the Federal methodology, except that the Federal share takes longer to be achieved.

However, and unlike the Commonwealth, there is no matching assumption that there will be a notable period of expenditure savings before demographic and non-demographic spending pressures are applied.

2 The State problem

As notable as the Commonwealth Budget challenge is, it understates the task.

Australia has a Federal system of government, and key responsibilities fall to the States.

For example, NSW Treasury has estimated that spending on health will almost double as a share of the State's total Budget — from 30% now to around 55% in 2032-33.

Indeed, the coming NSW Budget will update that jurisdiction's own IGR figuring.

Similarly, then Prime Minister Kevin Rudd noted last year that:

> *"Rising health and hospitals spending is already having an impact on state budgets.*
>
> *States and territories have experienced growth in health spending of around 11 per cent per year over the past five years.*
>
> *This contrasts with growth in state revenues of around 3 to 4 per cent a year.*
>
> *Rapidly rising health costs create a real risk, absent major policy change, as state governments will be overwhelmed by their rising health spending obligations.*
>
> *If current spending and revenue trends continue, Treasury projects that the total health spending of all states will exceed 100 per cent of their tax revenues, excluding the GST, by around 2045-46 — and possibly earlier in some states.*
>
> *... That is why 2010 must be and will be a year of major health reform."*[1]

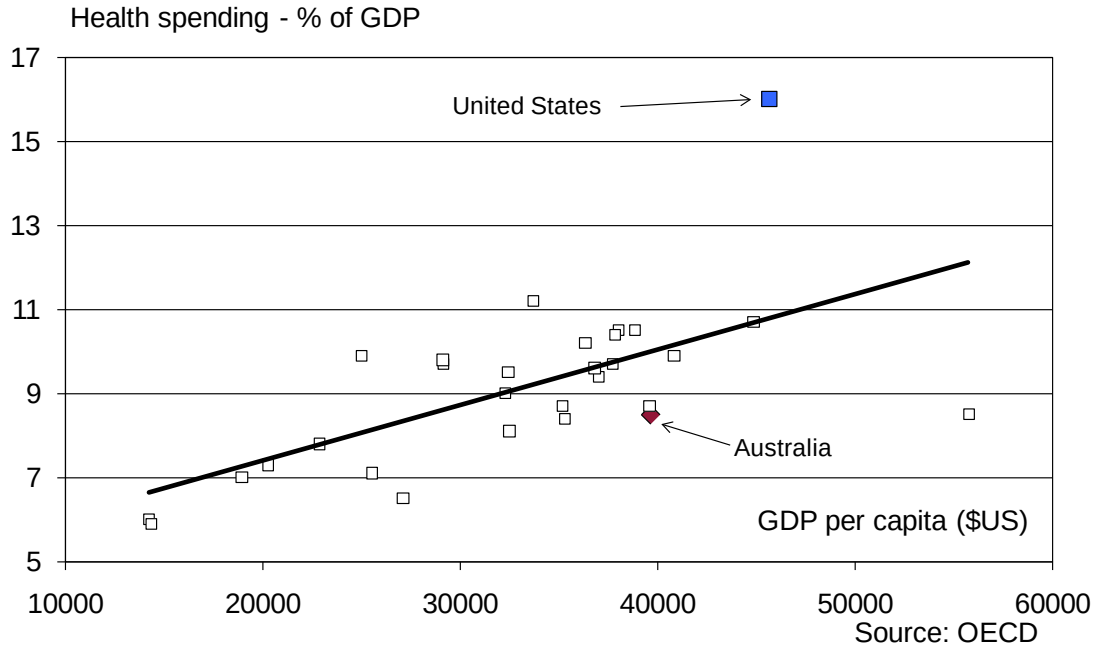
Health spending is likely to grow as our incomes increase. Traditionally, health spending has grown over time because health goods and services are highly income-elastic. That is, as income grows, individuals want to spend more of their income on health care. Indeed, health has one of the highest income elasticities of all types of spending – unsurprisingly, humans have a voracious appetite for a healthy life and, so far at least, health technologies have delivered in enabling the supply of greater longevity and wellbeing.

This effect can be seen by comparing across countries. As Chart 2.1 shows, spending per head on health care rises alongside income – the better off we are, the larger the share of our total income we are willing to pay for our health care.

(As Chart 2.1 also indicates, the health care spend in the United States is an outlier – even allowing for the high incomes in that nation.)

[1] Prime Minister's Australia Day Speech 2010, http://www.pm.gov.au/node/6437.

Chart 2.1: National health spending and incomes



That is another reason why the demand for health services will grow faster than most people realise.

These are pretty safe bets for Australian businesses considering future expansion plans: no forecasts are perfect, but long term trends in demographics and health care are among the best bets you will find.

Or, in other words, demographic destiny suggests spending grows from here.

Moreover, we already know what a lot of that increased demand will look like. In particular, the ageing of Australia's population will mean many more people of advanced age, who will therefore be suffering from a range of chronic conditions.

It is not just that Australians are living longer, and that there will be a relatively older population in the future. It is also that we will be wealthier, have access to more complicated (and probably more expensive) technologies, and be suffering from more chronic diseases which may be treatable without being curable.

The first challenge – **Australia's ageing population** – will boost the size of the health care market as, over the next quarter of a century, the number of people over the age of 85 in Australia rises from 400,000 to well over 1 million.

This change in the composition of the population will add rapidly to demands for health services, and those demands will rise even more rapidly than the base number of older Australians might suggest.

A **change in the composition of health demand** is also likely to be a key driver of future business opportunities. Rising life expectancies in Australia and other developed nations mean that we are seeing a shift towards chronic conditions such as diabetes, some types of

cancer, dementia, Parkinson's disease, cardiovascular disorders and musculoskeletal diseases.

These chronic conditions are likely to be future drivers of health spending. As Australians live longer, we are increasingly living with ailments that are not life threatening, but require more care than otherwise. There is therefore a transition underway within health markets towards chronic conditions.

What will that change generate? The Australian Institute of Health and Welfare (AIHW) has projected future disease costs as our population ages:

- **Diabetes** is projected to have the largest percentage increase in market size (with a 436% increase in spending projected between 2003 and 2033), followed by **dementia** (364%), **Parkinson's disease** (334%), **digestive disorders** (238%) and **sense disorders** (236%).
- The projected growth in diabetes spending (436%) is due to many reasons, though the expected increase in obesity is a major factor.
- In 2006-07 dollar terms, spending on **respiratory diseases** is projected to increase the most ($14.8 billion), followed by **dementia** ($14.0 billion) and **cardiovascular disease** ($13.2 billion). Although diabetes has the largest projected percentage increase, in dollar terms the increase in 'the diabetes market' is projected to grow by less than half the matching increase for respiratory diseases or dementia ($7.0 billion).

Yet that doesn't mean the future is certain. **Technological change** will mean more spending pressures, but there is debate over the impact of technology on the health sector. That said, new health technologies tend to increase treatment possibilities and can therefore feed patient expectations. That can eventually end up generating even greater demand for health care services:

- The Australian Government's 2010 *Intergenerational Report* (IGR) concluded that, while population ageing will play a significant role in boosting the size of health markets, non-demographic growth (such as the listing of new medications on the Pharmaceutical Benefits Scheme and greater use of diagnostic procedures) is likely to be the key driver – contributing three-fifths of the projected increase in health spending over the next 40 years. These new medications and technologies are likely to be expensive.
- The IGR makes the point (at page 52) that this non-demographic growth is driven by choice:

> *"This includes increasing use of doctors, tests and pharmaceuticals, and decisions to subsidise the introduction of new technologies or list new drugs on the Pharmaceutical Benefits Scheme*.

3 The results

As noted, although pressures on the States are not quite as notable as those on the Commonwealth Government, they are considerable – and have not been widely recognised. The States, for example, bear a considerable load on the health care cost front, even after allowing for recent proposed changes in State arrangements in this area.

That obviously means the problems for Australian fiscal finances in coming decades are greater than is usually realised. Moreover, there are additional complexities here:

- First, our federation has evolved into a system whereby the States spend more than they earn (and vice versa for the Commonwealth), leaving the national government providing subsidies to the States.
- Second, despite the relative efficiency of the GST (a Federal tax distributed to the States) and the potential efficiency of payroll taxes (if they were not as subject to exemptions as they are), State taxes as a group are rather less efficient than their Commonwealth counterparts.

That means the pressures on the States – and the age old question of 'who pays' that they raise – becomes worse still in light of the small size of the State tax base and inefficient nature of many State taxes.

In turn, as key trends add to spending needs at the Commonwealth and State levels, the tax system will need to be able to cope.

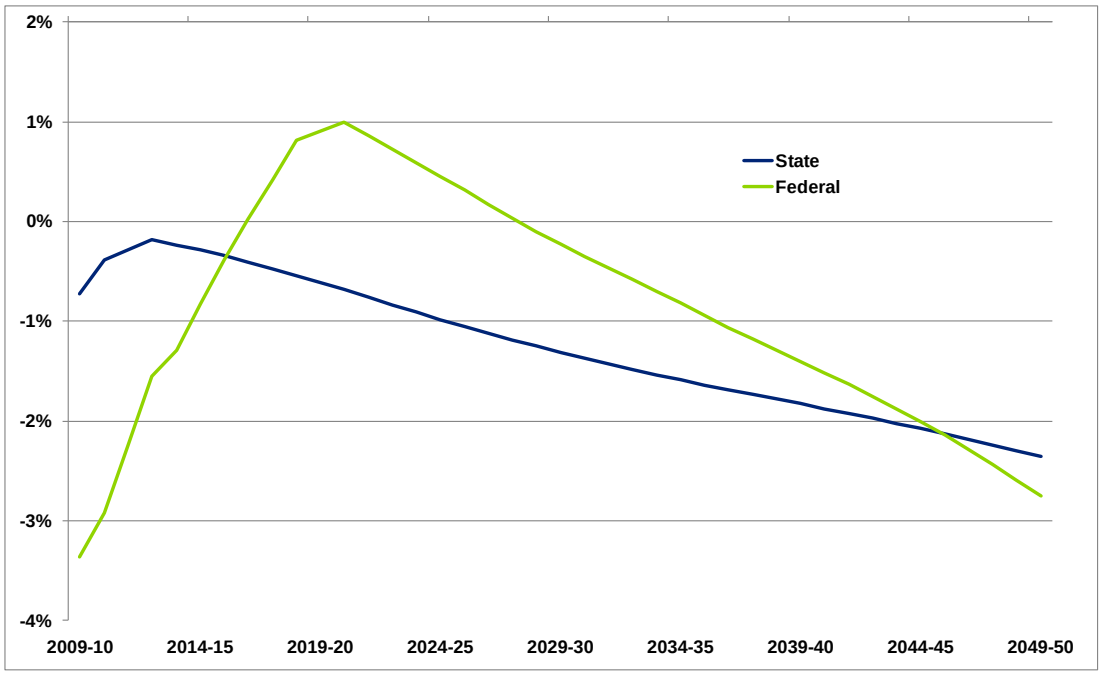
The 2010 Commonwealth IGR pointed to a shortfall on 'primary balance' of 2¾% of GDP by 2050 – and that is only projected to be achieved after expenditure savings are assumed to save an initial 1% of GDP by 2020.

The modelling here indicates that the States will see a shortfall of much the same size: almost 2½% of GDP by 2050.

That does not, by the way, mean that the effects of pressures such as ageing and health care cost inflation are the same for the States as they are for the Commonwealth. Rather, that end-point in 2050 is also affected by today's starting points, as well as by the Federal assumption that spending restraint will occur over the next decade.

Chart 3.1 below shows the very different patterns over time in the results.

Chart 3.1 : The different patterns in primary balances to 2050 (% of output)



Source: Deloitte Access Economics

(Note that these results are derived from long term models, and therefore do not match the announced forward estimates profiles of either the Commonwealth or the States. That may be seen, for example, in 2012-13, where the Commonwealth has budgeted a surplus.)

Chart 3.2 : The worsening in primary balances between 2020 and 2050 (% of output)

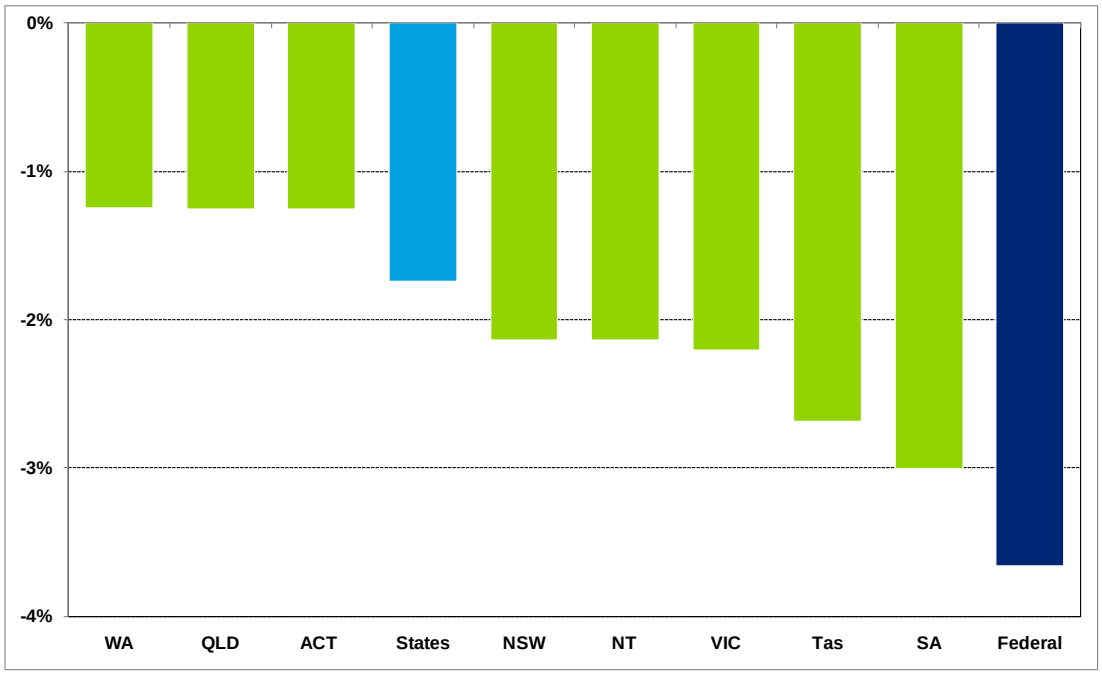


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Chart 3.2 starts the clock ticking after the impact of the Federal assumption on savings in spending, showing the worsening in primary balances between 2020 and 2050.

That chart shows that, for 'the average State', the impact of key spending trends will be just over half its Federal equivalent.

Note the State results do not account for the impact of Commonwealth Grants Commission (CGC) deliberations. The latter would 'lean into the wind' of the relative changes across States evident here, though they would not eliminate them (in part due to lags, and in part due to CGC methodologies – it is also worth noting that, even though the CGC would narrow the gaps shown here, similar gaps would be evident in private incomes as increased numbers of older Australians had to fund a rising absolute dollar gap between their total health costs and those footed by taxpayers).

Hence the total shortfall in national fiscal finances by 2050 would be just over 5% of GDP.

What can this nation do about that? There really are three choices about how we go about affording this. Either we:

- Try to fund the spending challenge by retaining the current tax system architecture, but scale it up to meet these costs. This would imply the need for significantly higher marginal tax rates on personal income and a high company tax rate (and even higher rates if we are not prepared as a nation to revisit the GST); or
- Retain the current tax architecture (with current tax rates and the like) but reduce entitlements through greater use of co-payments and user pays arrangements for health and aged care, provide less generous government pensions, and reduce other spending; or
- Maintain the safety net and major entitlements and have a reasonable redistribution of income, but fund this through an improved, robust tax system architecture focused on a small number of broad revenue bases with competitive rates.

It is this latter approach which would seem to make the most sense.

Yet – as the frog slowly boils – there is no guarantee that such good sense will hold sway.

By the way, you may think that there is a missing option in the above. However, **'doing nothing' is not an option**. Australia's governments have enviable fiscal positions. Indeed, that served us well through the recent global financial crisis, leaving us better positioned to defend against the downturn through stimulus spending. However, running rising fiscal deficits across four decades – the 'do nothing' outcome – would not be a viable option. Current events serve as a reminder of the vulnerabilities that nations risk if they do not pay their way over long periods.

So how big a task lies ahead? By way of illustration, it is useful to think of 5% of GDP in terms of today's tax take. To raise that money – the first funding option noted above – would require combined Commonwealth and State savings of $70 billion a year. To achieve that would require, for example:

- **Lifting the company tax rate to 67%**, rather than cutting it to 29% from today's 30%.
- **Or lifting the GST rate to 24%**, rather than leaving it at today's 10%.

- **Or lifting all marginal personal income tax rates by 44%** – that is, the soon-to-be bottom rate of 19% would become 19% x 1.44 = 27½% instead, while the top rate of 45% would become 45% x 1.44 = 65%.

The above illustrations do not attempt to account for second round effects. For example, as all taxes are inefficient to some degree, then higher taxes equal a smaller economy, meaning that there could be a negative spiral – taxes would need to go higher to raise the initial target amount, thereby hurting the economy more, and so on. Similarly, some taxes are deductible against other taxes – hence, for example, higher company taxes would cut collections of personal income tax, also implying the need for higher taxes than suggested.

Or, in other words, these illustrations are likely to be conservative.

On the other side of the ledger, to save 5% of GDP from spending – the second funding option noted above – would require, for example:

- **Cutting all Federal payments to the States** – payments for specific services plus general revenue assistance – **by 73 cents in the dollar**.
- **Or eliminating all Federal payments to the aged and to families** – that is, eliminating both pensions and family benefits.
- **Or eliminating all Federal payments for health and to the disabled**.
- **Or eliminating all Federal payments for education, defence and hospitals**.

To put it mildly, these are big bucks.

To put it bluntly, although much of the modelling underlying these numbers – and their implications – is already in the public domain, we suspect that the average Australian is not aware of the extent to which the national social compact will be under pressure in coming years.

And, to draw the obvious conclusion, the earlier and more sensibly that Australia addresses these challenges, the better our chances of meeting them without major dislocation.

4 The State-by-State results

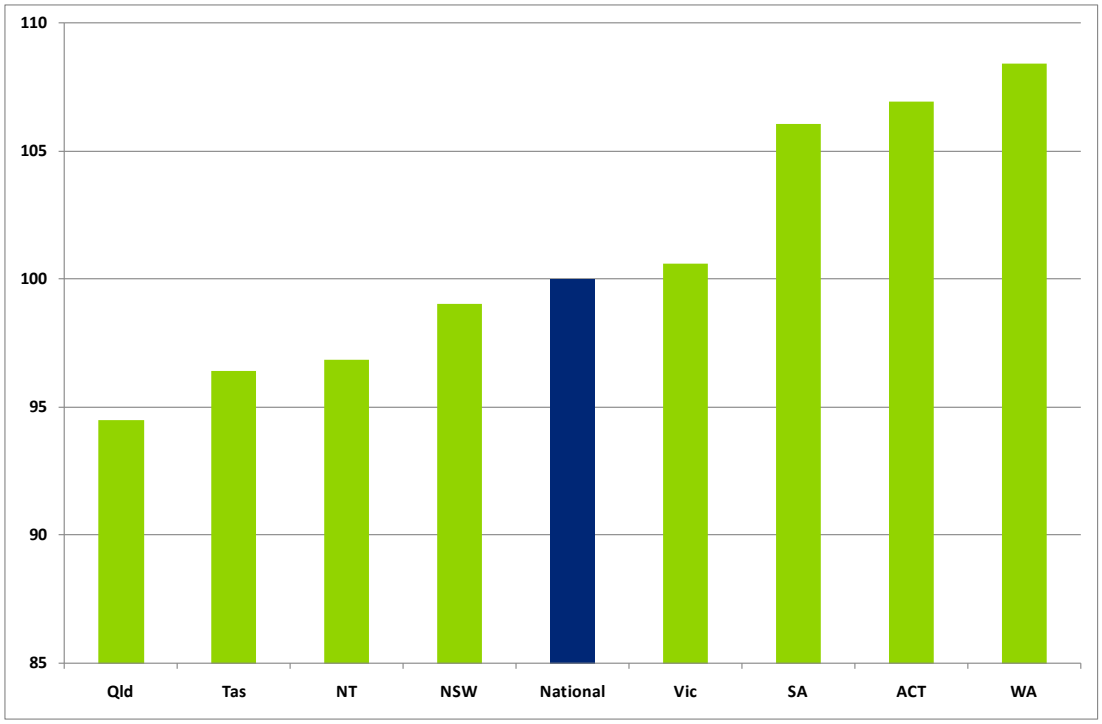
How do these results differ by State? Note the State results do not account for the impact of Commonwealth Grants Commission (CGC) deliberations – and hence overstate the swings in relativities by State that the future will hold.

That said, a State may be expected to do better (in terms of having a lower final deficit on primary balance in 2049-50):

1. The better its opening position in 2009-10 on its primary balance.
2. The less the projected lift in its aged dependency ratio from 2009-10 to 2049-50.
3. The less it spends on expenses at risk of more rapid cost inflation (such as health as well as law and order), or of ageing effects (health),
4. The more it spends on expenses likely to shrink as the population ages (such as education).

The following charts shed some light on those relativities. They show relative spending on school education and admitted patient services. Note these reflect CGC adjustments (see http://www.cgc.gov.au/publications2/publications/2011_update/2011Update/supporting_information/data_downloads). That is, for example, these charts take account of the relatively greater cost of 2009-10 service provision in the likes of the Northern Territory.

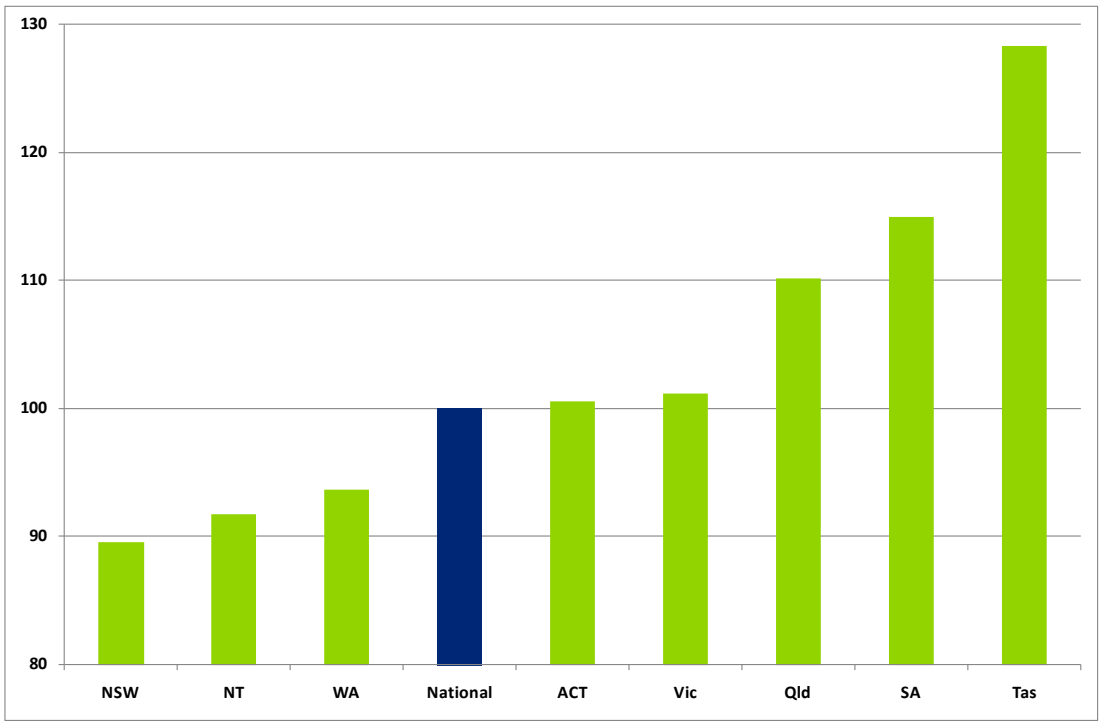
Chart 4.1: Relative (adjusted) spending on school education (index, national = 100)



Source: Deloitte Access Economics

The remaining relativities are intended to reflect 'genuine' differences at the jurisdictional level. That is, other things equal, Chart 4.1 suggests WA spends more on schooling than Queensland, while Chart 4.2 suggests Tasmania spends more on patients than NSW.

Chart 4.2: Relative (adjusted) spending on admitted patient services (index, national = 100)



Source: Deloitte Access Economics

4.2 New South Wales

NSW has had a tough decade, with its economy and its population shedding market share of the matching Australian totals.

This trend first became evident in the late 1990s as events resulted in a slowing of the State's growth relative to the rest of Australia: in particular, the Olympics and the IT and advertising booms all wound down through the course of calendar 2000.

Then the following developments also affected growth in NSW:

- Sydney's housing priced itself out of the market as a location for many people and businesses, reducing population growth in the city and the State.
- The commodity boom benefited the regions in Australia's west and north more than it did NSW. The boom also had an additional negative, in that it pushed up the $A, and hence squeezed the international competitiveness of NSW's manufacturers.
- A series of droughts began in 2002-03 and, in NSW, have barely let up since, proving a bigger negative for farming communities in NSW than in any other State, and reducing the demand in inland NSW for purchases and production from Sydney.
- The tension in national policymaking between the Australian Government's tax cuts and the Reserve Bank's interest rate rises also proved to be a clear negative for a

State where mortgages are the nation's largest. As a result, the lift in interest rates through to mid-2008 delayed NSW's potential for short term recovery.

- Then the global financial crisis hit. As Sydney is home to half the financial firms in Australia, the initial impact of that crisis was more notable in Sydney than elsewhere.

Yet NSW can claim some important advantages as well. In particular, NSW's spending on admitted patients is – adjusting for the series of special factors considered by the CGC – quite parsimonious.

That latter factor is particularly important. It helps to ensure that, on the modelling undertaken here, NSW is still worse than the average State in terms of spending pressures across coming decades, but not by a large margin.

4.3 Victoria

Victoria is a State in which population ageing will hit harder than the average. But thanks to its excellent economic and population outcomes of the past decade (until just recently Victoria was seeing its fastest population growth since the early 1970s), the impact of 'faster ageing' will be quite muted.

Although its health spend runs a little ahead of the national average (on the CGC measure shown in Chart 4.2), Victoria will also make a minor offsetting gain from its relatively higher spending on school education (seen in Chart 4.1), where pressures are set to ease in coming years.

4.4 Queensland

Queensland has some lead in the saddlebags as it looks to the future. On the one hand it has relatively higher health spending, a tendency which has been trending up in recent years as the State has moved to deal with problems in its health system.

On the other side of the ledger, it spends relatively less on school education.

That means it spends relatively more on what will be a fast growing component of its Budget, and relatively less on a slow growing cost item.

That said, Queensland's population is expected to remain younger than the national average.

In net terms the result is that the effects of ageing on Queensland's Budget occur later and are smaller – indeed, measured in terms of the change in primary balance between 2020 and 2050 (the measure of spending pressure adopted in Chart 3.2), Queensland (along with Western Australia and the Australian Capital Territory) is projected to see relatively less bad news in the decades to come than other jurisdictions.

4.5 South Australia

South Australia – like Tasmania – is an 'old' State, whose ageing pressures are projected to be felt earlier and more notably than in other States.

In addition, SA's relatively higher reliance on Federal grants would become a stronger negative if the latter were to fail to keep pace with real income growth in the wider Australian economy.

Further compounding the risks it faces – and as seen on Chart 4.2 above – the State's spending on health is relatively high (though there is an offset in its similarly high spending on school education seen in Chart 4.1).

On the other hand, the State has seen the writing on the wall, and its 2010 Sustainable Budget Commission and the responses to the Commission's report in the subsequent two State Budgets have represented a clear attempt to tackle some of the looming challenges on the expenditure front.

Even so, the net impact of the above leaves this State competing with Tasmania for the title of 'most at risk of spending pressures in coming decades'.

CGC effects

As noted, this modelling does not attempt to take into account of the narrowing in effects which would occur through the operation of the Commonwealth Grants Commission.

That said, South Australia is a good State to use to illustrate the complexities at play here.

In thinking about State finances, it is handy to think of a lifespan as broken into three parts. During the childhood years a State Government subsidies the education and health costs of a child (and some health costs of mothers). During one's working life a State Government benefits via the receipt of taxes (directly and indirectly, including for example via the GST). Finally, retirement is followed by increasing ill health, again at a net cost to State Government finances.

Therefore, and as a generalisation, there are two 'expensive' age groups – children and the elderly – and a 'working age' group which is a net positive to the State Budget.

South Australia's grants relativity is currently on the climb in response to past demographic shifts (and other factors). In coming years the initial decline in South Australia's share of national population is dominated by a decline in younger age groups. As the latter are (correctly) recognised in the CGC methodology as relatively expensive members of any State's population, South Australia's grants relativity might be expected to fall for much of the coming decade.

In the second phase, the first half of the 2020s, South Australia's demographic composition temporarily hits a 'fiscal and economic sweet-spot' relative to the demographic structure of Australia as a whole. That is, the State is expected to have lost the (relatively) expensive children, yet many of its mature workers will not yet have retired, meaning that there is a relative shift in the State's population towards those of working age (compared to Australia as a whole). As CGC methodologies recognise that, the State's expected grant relativity may fall at that stage.

The third phase in one in which mature aged South Australians are not merely retiring, but they are ageing to the point where their call on the State's health system is rising relative to that of Australia as a whole. Again the CGC methodologies would recognise that process, noting that the composition of South Australia's population is becoming relatively more expensive at that stage. By the end of the forty-year period, South Australia's grant relativity would be expected to be notably higher than today.

Or in other words, **CGC methodologies would notably lean into the wind of some important demographic developments**, in terms of the share of grants given to any given State.

4.6 Western Australia

Western Australia is seen as having a faster slowdown in population growth than that evident nationally. Other things equal, that would slow economic growth more in Western Australia.

Western Australia is a young State with a healthy fiscal and primary balance – or, at least, a healthy set of Budget balances compared with the average State. It is also a jurisdiction which spends relatively less on health and relatively more on education – all factors which stand it in good stead for the longer run.

The end result, mapped out in Chart 3.2 earlier, is that WA, along with Queensland and the Australian Capital Territory, is projected to suffer the least of among the States from ageing and related pressures on its spending.

4.7 Tasmania

Tasmania vies with South Australia as to which Australian State will be hardest hit by the expenditure modelling undertaken here.

Although the modelling allows for a variety of factors – for example, relatively fewer students generate cost savings to the States – the dominant drivers are ageing and its interaction with relatively high cost inflation in the health sector.

That is bad news for Tasmania, given that it is Australia's oldest State.

Yet it is also true that Tasmania spent much of the last decade getting its Budget in better nick, running large primary surpluses. And although the latter faltered more recently – in part because Tasmania's economy did the same – the past decade has definitely helped.

Even so, however, and as Chart 3.2 earlier showed, the turning demographic tide is expected to hit as hard in Tasmania as anywhere.

Moreover, even though that means Federal grants will slowly swing further towards the State to help offset those effects (through the operations of the Commonwealth Grants Commission), those effects tend to be slow and partial. Besides, they are not designed and cannot be expected to offset the effects of ageing and health cost inflation on private pockets. As an older State, relatively more Tasmanians will find themselves forking out to cover what will be a widening gap between the health costs they are charged and the subsidies on those costs provided by Federal and State Governments.

That could, for example, be a particular problem for Tasmania, as its relatively higher reliance on Federal grants may become a strong negative if the latter fail to keep pace with real income growth in the wider Australian economy.

4.8 Northern Territory

The good news is that the Northern Territory is a young jurisdiction facing a relatively modest demographic challenge in coming decades.

However, the Territory's relatively large indigenous population raises issues that differ from those facing most other jurisdictions. Other things equal, the indigenous population is projected to 'age' faster in terms of its demand for health services.

The impact of that latter challenge is ameliorated by the Territory's spending patterns (and their exposure to ageing effects). In particular, once adjustment is made for the difficulties of service delivery, the Territory's relative spending on admitted patients (see Chart 4.2) shows an important degree of restraint that may stand it in good stead.

Against that, the NT is also a careful spender with respect to school education costs, but the latter (seen in Chart 4.1) is likely to penalise it – that is, future savings from a relatively slower growth area for future spending are limited by the fact that the NT has already been parsimonious in this field.

On balance then, Chart 3.2 shows the Northern Territory being affected by spending pressures just slightly more than the average jurisdiction.

4.9 Australian Capital Territory

The ACT spends just above the (relative and adjusted) average on health (see Chart 4.2) and well above on school education (see Chart 4.1).

Other things equal, the latter factor helps, but the former hurts (a little).

There are also some important demographic trends for Canberra. In particular, although the expected increase in dependency ratios in the ACT matches that nationally, more of it is expected to occur early, with less damage 'later' (and hence less damage across the period from 2019-20 to 2049-50 which forms the focus of most of the comparisons in this report).

The net result, as Chart 3.2 shows, is that, along with Western Australia and Queensland, the ACT is projected to see the least pressures of any of the jurisdictions modelled for this report.

5 Model methodology

Deloitte Access Economics' IGR model is a tool for the long-term analysis of trends in State and national demography, economics and public sector finances. It consists of two modules, a **demographic module** that sets the broad framework of population change in the Australia and State sectors, and an **economic/budgetary module** that uses the broad demographic changes and other assumptions on relative inflation rates, expenditure decisions and financing options to determine the long-term movement in the national and State economy and Budgets.

5.1 The structure of the model

The model can be broadly thought of as having four sections – three of which can be further broken down into a national total, and State's components of that total. These sections are held in separate EXCEL worksheets in the two modules – which is probably the easiest way to graphically represent the model structure.

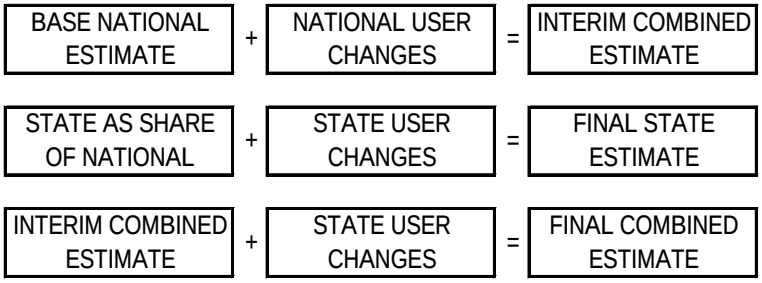
The four sections are:

- **Demography**: which consists of a national total and a State total.
- **Economy**: Which consists of a national economic model and a State economic model.
- **Federal Budget**: Which is modelled on its own.
- **State and Territory Budgets**: Which includes State Budget sections for each State. There are two calculations here – an 'interim' calculation, and final results. The reason for this distinction is covered below.

The relationship between the interim and final combined jurisdictions Budget is one of the most important in the modelling. The distinction is required to allow adjustment to spending patterns at both the broad and the specific levels. Adjustments at the broad level (across all States and Territories) obviously flow down to individual States in proportion to the State's relative share. For example, increasing general community health expenditure will boost expenditure in each State and Territory; this is an example of a broad adjustment. However, adjustments made to community health expenditure in NSW specifically will flow directly back to the total only.

Because we allow (indeed, it is a significant part of the modelling) both types of adjustment, both an interim and final iteration of the combined jurisdictions budget are required.

Figure 5.1: Effects of user changes



A similar set-up is not necessary for the economic section of the model. This is due to the fact that most of the flows from the budgetary to economic sections are in terms of final aggregates (that is, after adjustments have been applied). Because there is very little adjustment of the State economic model aggregates (other than that due to budgetary influences), there is no need for an interim and final version of the Australian economic model.

5.1.2 Linkages in the model

In general, the linkages flow from the broader level of each section (the national economy, national demographic and combined jurisdictions Budget) down to the specific level (State economy, population and Budget). Wherever practical, the lower level is modelled as a share of the broader equivalent. For example, State dwelling investment is modelled as a share of national dwelling investment; State expenditure on prisons is modelled as a share of the combined State and Territory jurisdictions expenditure on prisons; and so on.

5.2 The use of demographics in the model

The impact of demographic trends (particularly ageing) is a crucial determinant of the final model results. While the demographic module forecasts population (initially) by individual sex and year age group and (finally) in five-year age cohorts, it also creates a number of 'demographic indicator series' that are used to drive expenditure levels and shares in the model. An additional facility in the model is its ability to adjust the higher age cohorts to account for the expected increase in life expectancy over the course of the forecast period. This modelling, it interpretation as well as some of its possible short comings, is discussed in the section on age-from-death modelling.

These demographic indicator series are weighted averages of forecast population levels. The weights used are sourced from official publications or the ABS website, and have been multiplied by a constant factor chosen so that the national indicator series for June 2001 has a value of 100. The following points should be noted:

- The basic model assumes that the weights (in real terms) remain constant over time. That is, if a person of some age initially demands a level of services in the base year, then in twenty years time a person of the same age (or the same adjusted age if 'age-from-death' adjustments are being used) will use the same level of series. The impacts of inflation are modelled independently of this process. Note that because we only use growth rates, the values of these weights have no absolute meaning (particularly as

they are scaled for the base period), although they have a relative meaning between age-groups.

- There is an assumption that each State's weights are identical for each age-group. The State value of the indicator series gives a share of national demand when compared to the national total. This share of national demand is commonly used to determine relative movements in State aggregates compared to national totals.

5.3 Driving the States' shares of national total

Wherever possible, State levels are modelled as a share of a national total. In general, there are three different methods used depending on the assumed relationships between the two levels of modelling.

In some cases, a direct calculation of the States' share is made – where the State's share will be some determinable value of the national total. This is most likely where there is a known policy-driven relationship involved. The best example is the calculation of GST grants for each State. Because the distribution formula is set (as the State's share of population adjusted by Commonwealth Grants Commission GST relativities) it can be calculated and applied directly to the total. In this case, the current arrangements for distribution are assumed to apply into the future.

In other cases, the State's share will move to some (usually demographic determined) share of the national total. This is common in the State economic model. The underlying assumption of this methodology is that in the medium to long-run the State's share will be determined by this share.

The most common method used does not make the assumption used in the previous section. In this case, while the State's share is expected to rise or fall in line with underlying demographic trends, it is not expected to move towards a particular share. In this case, a modified version of the logit function is used to determine the State's share of the national total. While this is discussed further below, the main idea behind this method is that current State revenue and expenditure trends and priorities (for example, higher than average health expenditure, lower than average receipts in infrastructure grants from the Commonwealth and so on) will be maintained into the future.

Note that there are a few cases where a slightly different methodology is used. The best example is the modelling of State imports. While exports are modelled as a share of the national total, imports are modelled so that the impact of the balance of trade on the State's share of national demand is maintained. That is, imports are determined so that the final difference between the State's share of output and the State's share of final demand (investment plus consumption) is equal to the level seen in history.

5.3.1 Logit share modelling

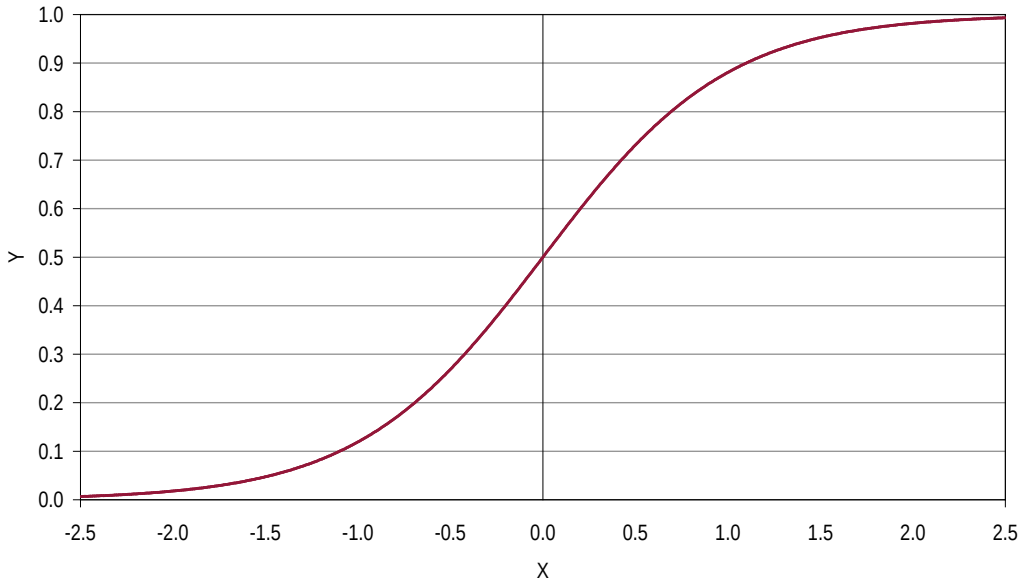
Unfortunately, it is impossible to explain the mechanics of the logit function without delving into some fairly detailed mathematics. While diagrams are used to illustrate the discussion, some technicality is unavoidable.

The logit function (and its inverse) is a mathematical relationship that maps the values of the entire real number line (between -∞ and +∞) to values between 0 and 1 (or, 0% and 100%). The benefit of this relationship is that we can take a State's share of some aggregate (which will lie between 0% and 100%), transform its value (using the inverse logit relationship), perform some sort of adjustment on in, and return it to a value that lies between 0% and 100%. This avoids the problems that may occur in adjusting the initial share itself – which may be moved below 0% or above 100%, or to unrealistic values.

While this is a useful ability, it is also true of any such transformation. However, the logit is also useful where comparing two series that grow over time. In particular, given two series that grow at constant (but not necessarily equal) rates, their ratio will move at a consistent speed along the logit curve.

The logit function is given by $y = \frac{e^x}{e^x + e^{-x}}$ and its inverse by $x = \frac{1}{2}\ln\frac{y}{1-y}$ where x is any number and y lies between 0 and 1. Graphically, the relationship is shown in Chart 5.1.

Chart 5.1: The logit function



The logit modelling of shares over time links the changes in the State's share of some aggregate to changes in its share of some indicator series. It follows the steps outlined below. We will assume without loss of generality that we are talking about the State's share of some expenditure variable:

Initially, the State has a given share Y_e of national expenditure and a share Y_d of the demographic indicator. We know that over the period in question, the State's share of the indicator series moves to Y_d*. Note that this indicator series may be adjusted for differences in relative productivity growth rates as discussed below in Section 5.3.2.

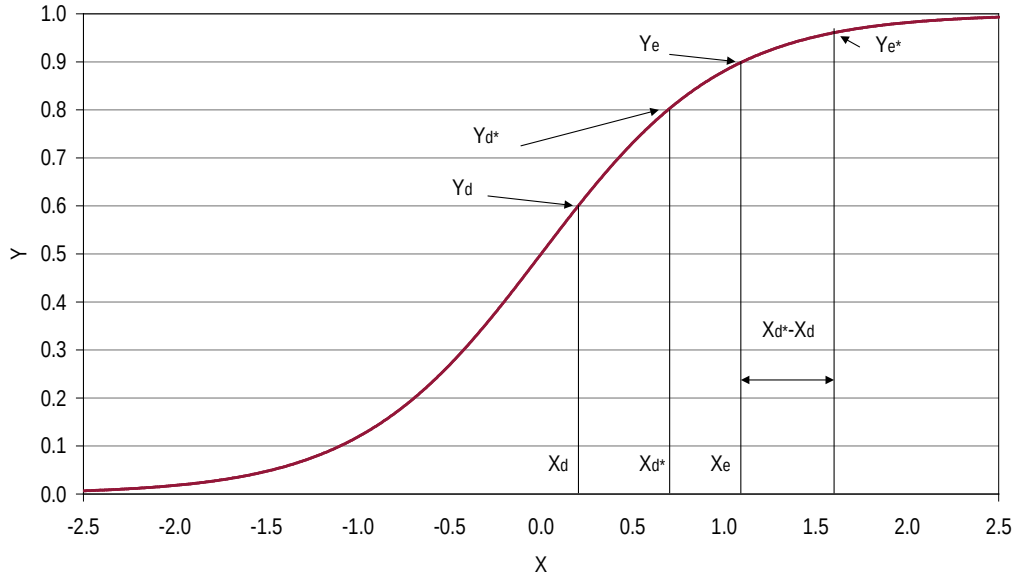
In logit terms, Y_e, Y_d and Y_d* are equivalent to X_e, X_d and X_d* respectively (using the inverse function). We note that the logit share of the demographic indicator has moved by X_d*-X_d.

We apply to same adjustment to the expenditure share, moving it from X_e to $X_e^*=X_e+X_d^*-X_d$.

The actual expenditure share is determined as Y_e^*, the logit equivalent of X_e^*.

Diagrammatically this can be shown as in Chart 5.2. In this example, the indicator series rises from 60% to 80% and the economic share rises from 90% to 96%. This implies all other States see their indicator series fall from 40% to 20% and their economic share falls from 10% to 4%.

Chart 5.2: Logit modelling at work



While the full algebraic workings of these changes is fairly involved, the final formula is quite simple, given by $Y_e^* = \frac{Y_e Y_d^* (1-Y_d)}{Y_e Y_d^* (1-Y_d) + (1-Y_e)(1-Y_d^*) Y_d}$ where Y_d, Y_d^*, Y_e and Y_e^* are as in the section above.

The superiority of this formulation over more simplistic methodologies can be seen in the following simple example. Assume that initially a State has 50% of an indicator series – which is usually general in focus – but only 1% of expenditure. If the State moves to 52% of the indicator series we would not expect its share to move up by 2% to 3%, as this would represent a trebling in its level for little change in its driver. Conversely, if the State moved to 48% of the indicator series we would not expect its share to fall to -1% of expenditure. This is why an additive methodology is not appropriate.

The opposite starting point (1% of the indicator series and 50% of the expenditure) shows why a multiplicative methodology is not appropriate, as a move to 3% of the indicator series would not move us to 150% of expenditure. Note also that we must consider what happens to the 'rest of Australia' shares as well – that is, the change that occurs when we move the shares of the State under consideration must be as sensible as the implied change rest of the total.

The logit formula shown above will only have problems if an indicator series moves to (or away from) 0% or 100% – and even then only in certain cases. However, this situation does not arise in any of the modelling used here.

5.3.2 Adjusting indicator series for productivity differentials

One of the additional features added to the model is the ability to change labour productivity growth rates for individual years at either the State or national level. Where the State rate is increased, the result leaves national output levels unchanged, and only increases the State's share of national output. It should be noted that there is no check performed on these adjustments – the State's share of output could be driven to over 100%. This is obvious unrealistic, and will cause the model to explode at a myriad of points.

The methodology used is this case is a 'probit' formulation, closely related to the logit modelling above. Unlike the logit formulation, which maps the values of the entire real number line (between -∞ and +∞) to values between 0 and 1 (or, 0% and 100%), the probit function only maps the positive real number line ((between 0 and +∞) to values between 0 and 1. The formulation is given by $y = 1 - e^{-x}$ and its inverse by $x = \ln\left(\frac{1}{1-y}\right)$. In the probit adjustment, the product of all State productivity adjustments is calculated and stored in the value k. For example, if State productivity growth is 1% higher for 8 quarters, the value of k will be given by $k = (1+1\%)^8$ or $k = 1.01^8$.

Initially, the State has a given share Y_d of the indicator series and a share g of national GDP. We know that at the period in question, productivity adjustments to the State's output lift this share to g×k. Note that g×k will be positive and a value of k>1 will imply that the State's share of the indicator series should rise (and vice verse).

In probit terms, Y_d is equivalent to X_d (using the inverse function). We note that the probit share of the demographic indicator has moved to $k \times X_d$.

The final indicator series share is determined as Y_d^*, the probit equivalent of $k \times X_d$.

The formula for this transformation simplifies to $Y_d^* = 1 - (1 - Y_d)^k$.

6 Main sections of the model

This section of the methodology examines each major section of the model in varying degrees of detail. This will explain the broad ideas behind the equations used. It is organised to show each section of the model in turn, with a more detailed equation listing following on later.

6.1 Modelling the Australian economy

Economic modelling takes a 'top-down' approach, with a small version of the AEM model (augmented with links to the Budget and Demographic models) for the national economy, and the State economy modelled as a share of Australia.

The model can be thought of as having of three sectors: the private business sector, the household sector, and the public sector; and three markets: the goods market, the labour market, and the financial market. Linking the sectors and markets are flows of goods, labour, expenditures, and taxes.

6.2 Modelling the State economy

The State economic modelling utilises a two-stage process that links an initial shadow account estimate – based primarily on the State's share of national economic aggregates – to a final account section, which can target a set growth rate based on labour force and productivity growth.

6.2.1 Main State economic aggregates

These variables follow the standard State accounts structure of consumption and investment for the public and private sectors. The total value of State output is normalised – either to hit a specific level, or adjusting in line with the difference between the preliminary (or 'shadow') measure of State output and the target value at the point normalisation was turned off.

6.2.2 State shadow account

Variables in this section are either calculated directly as a share of the underlying national aggregates, or as growth rates of interim variables that drive off shares of national totals. General government consumption is derived as a share of the national total, while private consumption is driven by the growth in components of consumption, which themselves are generally share of the national total.

6.2.3 Other State indicators

The shares themselves are based either on comparison of national and State budget aggregates or comparison of demographic levels in the State and nationally. Often the two are combined. In these cases, the State total is determined by (for example) the State Budget aggregate plus a share of Federal expenditure based on the State's population while

the national total is the sum of the combined jurisdictions Budget level and total Federal expenditure.

6.3 Modelling Budgets at the State Level

6.3.1 State taxation revenue

State and (interim) combined jurisdiction taxation revenue is calculated using similar formulas, but independently. Final taxation revenue is adjusted for user changes made at the State level. For example, initial combined payroll taxation may equal $5 billion and a given States base estimate $1 billion. If the user applies a +10% adjustment to State taxation (lifting it to $1.1 billion), final combined payroll taxation will be lifted to $5.1 billion. If a +10% adjustment were applied to the interim combined measure (lifting it to $5.5 billion) State receipts would also be lifted to $1.1 billion, but additional income would also be flowing to other States.

6.3.2 Other State revenue

Sales of goods and services are calculated on a cost recovery basis by portfolio. If the health sector usually makes 10% of its expenses back in term of sales of goods and services, this is assumed to continue – with the State's share moving over time to the national average to ensure consistency across the model.

Other components of revenue grow in line with output rates over time.

6.3.3 Portfolio expenditure

Total expenditure is determined twice, once by portfolio and once by purpose. Many of the estimates in the purpose calculations are adjusted to ensure the two sum to the same level, so the portfolio expenditure calculations are the more important.

Portfolio (and program) expenditure is determined at the combined jurisdictions level and is allocated to individual States using the logit modelling procedure discussed earlier. We will examine the formulas at each level to show how the procedure works.

At the **interim combined level** we have an equation of the form:

$$Expenditure = (Previous - Previous\ adjustments) \times Growth\ factor \times Restraint + New\ adjustments$$

The growth factor is a weighted combination of growth in the wages bill, growth in demand for services (based on demographic factors but also including a component for real income effects), a component for superannuation costs and 'other' factors, which rise with nominal output.

The restraint factor is an across-the-board restraint in expenditure.

Adjustments are user-defined expenditure levels by year. These are averaged for each quarter and turned into nominal values. The formulation here means they do not persist (that is, extra expenditure in 2021-22 will not result in higher expenditure in 2022-23).

At the **individual State level** we have an equation of the form:

$$Expenditure = Interim\ Total \times State\ share + State\ adjustments$$

The State share is the logit based share that maintains initial State spending relativities but adjusts for relative population structure changes. State adjustments are user-defined additional expenditures at the State level. Because the formula does not refer to earlier levels, user-changes do not persist.

At the **final combined level** we have an equation of the form:

$$Expenditure = Interim\ estimate + State\ adjustments + Share\ of\ additional\ portfolio\ depreciation$$

The State adjustments are added to total State expenditure. Because additional capital expenditure is another user adjustment and eventually leads to higher depreciation (based as it is on asset stocks), and because depreciation expenses are allocated across program areas, the additional depreciation caused by higher capital investment is also added to final expenditure estimates.

6.3.4 Portfolio asset modelling

The final area of interest in this section is the handling of asset stocks at the portfolio level. This covers a number of variables; purchases of non-financial assets, stock of assets and depreciation.

At the **interim combined** and **individual State levels** we have the following equations:

$$Purchases = Base\ (share\ of\ GDP) + User\ changes + Stock\ maintenance\ expenditure$$

$$Stock = Old\ Stock \times Inflationary\ impact + Purchases - Depreciation$$

$$Depreciation = Old\ Stock \times Depreciation\ rate$$

Stock maintenance expenditure is expenditure required to keep total State assets per effective worker employed at a stable level. This is a user-option, which if enabled allocates the additional expenditure across portfolios. It works separately for the State and combined levels – and should only be implemented for one of the two.

At the **final combined level** we have:

$$Purchases = Interim\ combined\ purchases + State\ user\ changes\ and\ maintenance\ expenditure$$

$$Stock = Old\ Stock \times Inflationary\ impact + Purchases - Depreciation$$

$$Depreciation = Interim\ Depreciation \times (Final\ Stock/Interim\ Stock)$$

Again, State adjustments are added in separately, to prevent them interfering with the State share calculations. Any additional depreciation is allocated across portfolios expenditure as required.

6.4 Modelling the Federal Budget

The Federal Budget modelling is, are closely as possible, identical to the State set-up. There are two obvious differences. The Federal sphere includes defence (as well as having expenditure in other areas that do not occur in the State sphere, such as unemployment benefits). In addition, the Federal Government collects the GST, which it on-passes to the States.

This section discusses where the Budget modelling differs from the equivalent State section.

6.4.1 Revenues

Taxation revenues rise with broad economic aggregates (such as output, employment, wages) and exogenous tax rates – although with the fiscal reaction function enabled the rate of income tax changes to close the Budget deficit.

In the standard case, petrol excise in not indexed for inflation (a large negative on revenue growth rates) but this can be turned back on.

As with the State Budget model, sales of goods and services are on a cost recovery basis while interest income is derived from the stock of Government cash and interest rates.

6.4.2 Expenses

Expenses are modelled in a similar way to the State section. Portfolio totals are determined separately, with purpose splits calculated to sum to the same value. Grants are determined either by the standard CPI plus population formula, or by need (growing with State spending) or a combination of the two.

Specifically, the proportion of grants tied to State hospital spending (around 80% of the total) rises in line with demographically driven demand (based on hospital bed nights by age), medical cost inflation and a technological factor. That is essentially the same methodology outlined in the Commonwealth's IGR of 2010. The remaining share of health grants rise in line with population and CPI.

Apart from a few additional categories (grants to universities and the like), this section is the same as the State equivalent.

6.4.3 Operating Statement, Cash Flow and Balance Sheet, Primary Balance etc

These sections are equivalent to the State section

6.4.4 Portfolio modelling

Portfolio modelling is generally similar to the State equivalent, with the difference that the four driving components are employee expenses, programme output expenses, grants to States and other – with grants to the States replacing superannuation expenditure.

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General use restriction

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