The Future of Tax

AUSTRALIA'S CURRENT TAX SYSTEM

Business Council of Australia

Contents

About this publication

The Business Council of Australia (BCA) is a forum for the chief executives of Australia's largest companies to promote economic and social progress in the national interest. This paper is the first in a series of papers that the BCA is releasing in order to build a shared understand of Australia's tax reform challenges and priorities.

Summary

Key points

Purpose of paper

This is the first in a series of papers that the Business Council of Australia will be releasing in the lead-up to the Commonwealth Government's tax white paper reform process.

It presents a platform for discussion and for building a shared understanding of why tax reform matters, the problems we are seeking to address, and agreement on broad directions and processes on how Australia might embark on comprehensive tax reform.

The paper outlines:

- Why tax reform matters for Australia's future prosperity.
- The characteristics of the current tax system, as a starting point for tax reform. Tax reform should seek to preserve some of the key strengths of Australia's tax system and address its shortcomings.
- Some future directions for reform, based on this starting point, and some fundamental matters for the upcoming tax white paper process.

A purposeful approach to reform

- Tax reform should be mindful of the need to raise enough revenue.
- It should also take into consideration the possibility of a change in the tax mix that can lead to a more competitive tax system to foster investment and growth.
- We should aim for a tax system characterised by a broad base and with low rates.
- Reform must be comprehensive, with effective community engagement that is conducted in a consultative and transparent way.
- As a key player in the Australian economy, the business community has an important role to play in the national discussion on tax reform. As a starting point, business must accept its obligations and be transparent when complying with its taxpaying responsibilities.

Why does the future of Australia's tax system matter?

The 2014–15 Commonwealth Budget prompted a number of questions around the capacity of Australia's tax base to raise enough revenue, the roles and responsibilities of the Commonwealth and state and territory governments, and the need for a structural solution to what is a structural budget problem. As part of addressing these questions, the Commonwealth Government has committed to white paper processes on reforming both Australia's tax system and the federation, to be completed by the end of 2015.

The tax system funds government services

The central role of Australia's tax system is to raise the revenue needed to fund essential government services, infrastructure requirements and a strong social safety net. It is the size and scope of government that determines the amount of tax that needs to be collected. An important dimension of this, however, is the impact that taxes have on the economy, predominantly through the way they affect incentives. In this context, tax reform can be viewed through the prism of fiscal repair and a desired position on the size and responsibilities of government.

But taxes also affect incentives

The imposition of taxes affects the choices individuals and businesses make by altering their incentives to work, save, invest, and consume goods and services. To the extent that taxes influence participation, investment, risk taking, innovation and entrepreneurialism, they have the potential to affect productivity and economic growth, which in turn may have material consequences for living standards.

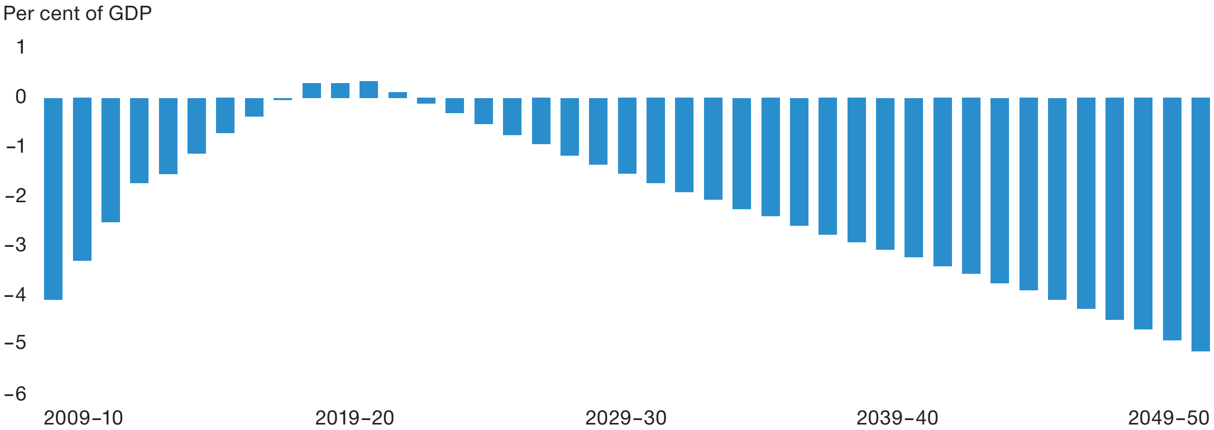
Globalisation, technology and the liberalisation of global markets have meant that almost everything is tradeable – goods, services, skills and labour. Increased competition, increased mobility of the factors of production, and disaggregation of value chains have meant an increasing influence from tax on decisions about where to work and invest.

Fiscal challenges today and into the future

The Commonwealth Government's fiscal position weakened significantly over the past several years, with the 2014–15 Budget making a start on putting the fiscal strategy back on track, which is a critical first step in the task of budget repair. However, the achievement of a substantial surplus over the next decade appears to be heavily reliant on changed arrangements to health and education payments to the states.

Australia's ageing population has already started to reduce workforce participation rates and this trend is expected to continue over the coming decades. The implications of an ageing population will place further pressures on Commonwealth and state government budgets as outlays on health, aged care and pensions rise, while the relative size of the labour force is expected to continue to fall. On the basis of past BCA work, the combined annual fiscal deficit across all levels of government in Australia could reach 5 per cent of GDP by 2050, or around $80 billion in today's terms.

Figure 1: Projected fiscal balance: All governments



Source: Deloitte Access Economics, 'An Intergenerational Report for the States', incorporated within the BCA Submission to the 2011 Tax Forum, October 2011.

Global forces also have an impact

Economic, demographic and technological changes around the globe are driving profound changes across all countries. As a medium-sized open economy reliant on foreign capital, and being a competitor in the global marketplace, our future economic growth and living standards rely on taking structural steps to correct government expenditure, and a strong and competitive tax system.

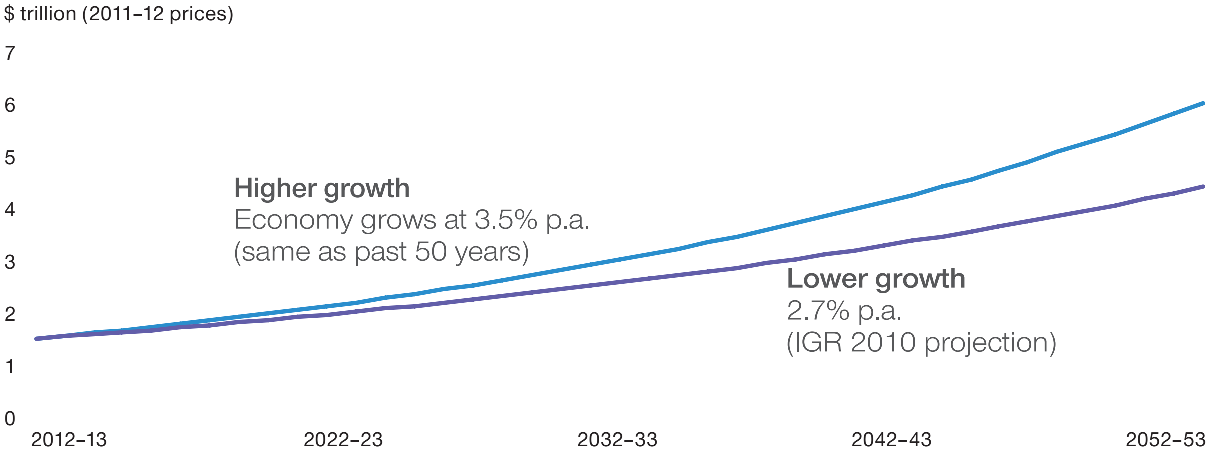
The reconfiguration of value chains and the global labour market, rapid economic growth and increased competition from emerging economies, and new asset classes have had, and will continue to have, profound impacts on Australia's tax base. Australia's increased reliance on direct taxes means greater exposure of government revenues to both the volatility and increased mobility in the global marketplace, particularly at a time when the terms of trade is expected to continue to decline.

The way forward

The forces outlined above show that there is much more work to do to deliver a sustainable long-term budget position across all levels of government; tax reform must also play a part. Tax reform should focus on the dual purpose of revenue adequacy, while supporting incentives to work and invest in a global environment. It must be done in tandem with structural corrections to Australia's fiscal position and greater clarity of the roles and responsibilities between Commonwealth and state governments.

The *Intergenerational Report 2010* suggests that without serious policy reform to lift Australia's economic potential, Australia simply will not experience the kind of growth over coming decades that we have experienced in the past. This is illustrated in Figure 2.

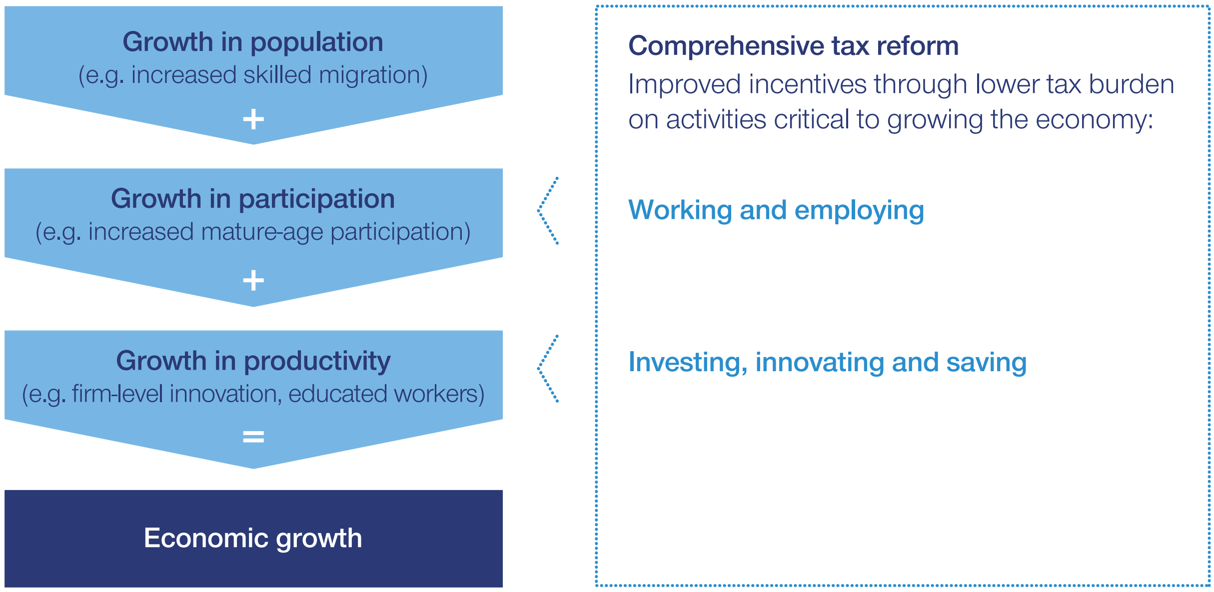
Figure 2: Long-term impact of different economic growth scenarios



Source: ABS cat. no. 5206.0 and BCA.

In this context, a key objective of comprehensive tax reform is to lower the tax burden on activities that are critical to growing the economy, such as workforce participation, investment, saving and innovation, if Australia is to replicate its long-run average growth rate of 3.5 per cent a year.

Figure 3: Link between tax reform and economic growth



What is the starting point?

Australia comes to the task of tax reform with considerable strengths, which should be preserved, and considerable challenges, which must be addressed.

Strengths

- **Historically strong public finances:** Along with expenditure discipline, Australia's tax system has contributed to Australia's historically strong public finances, embodied in Australia's AAA sovereign credit rating.
- **Equity:** The tax and transfer system is well targeted and highly redistributive and makes a substantial contribution to Australia having a fair society by substantially reducing inequality.
- **Relatively low overall tax burden, albeit from a narrow base:** Australia has a relatively low overall tax burden, below the OECD average – albeit from a relatively narrow base. This is critical given Australia's position as a medium-sized open economy in the world's fastest growing economic region and reliance on foreign investment.
- **Economic shock absorber:** Australia's tax and transfer system has been an effective economic shock absorber, responding to slower economic growth by automatically reducing the tax impost on the community.
- **Subject to periodic review and improvement:** Australia's tax system has been subject to periodic review and reform, at least every decade. While the process of reform could be more seamless and the degree of ad hoc change in between major reviews could be reduced, the fact remains that Australia's tax system has not stood still.

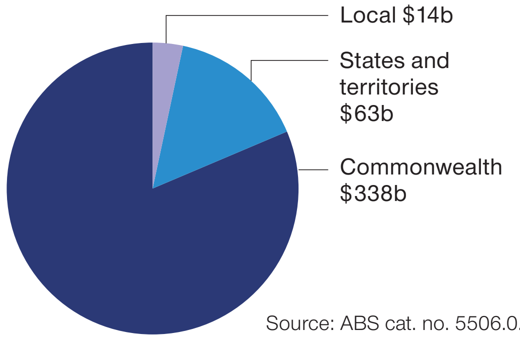
Challenges

- **Fiscal imbalance across the federation:** The tax system contributes to a major fiscal imbalance across the federation, contributing to reduced accountability and efficiency of government. The states control 15 per cent of total tax collected in Australia but are responsible for around 40 per cent of expenditure.
- **Reliance on inefficient sources:** Australia is heavily reliant on direct taxes on income that detract most from economic growth, as opposed to less harmful indirect taxes. This situation is set to worsen, with the most recent budget figures indicating that Commonwealth taxes on income will grow an average eight per cent each year over the next four years, compared with just three per cent for indirect taxes.
- **Volatility:** Australia is heavily reliant on more volatile tax bases such as stamp duty and corporate income tax, which drive much of the volatility in state and Commonwealth taxes respectively. With fluctuations in the housing market and commodity prices, this can make for a challenging budgeting task, with permanent expenditures dependent on fluctuating revenue bases.
- **Erosion of tax bases:** Australia's tax base is eroding over time, most evident in our relatively large tax expenditures by international standards and Australia's increased consumption of goods and services exempt from the GST. Recent estimates suggest that Australia has around 355 tax expenditures.
- **Less competitive:** Australia's tax base is less competitive than it should be. For example, Australia's statutory corporate tax rate is 30 per cent, while the average of our competitors in the Asia–Pacific region is 23.5 per cent and across the OECD is 25 per cent.
- **Complex:** Australia's tax system has become increasingly complex over time. Ten taxes raise approximately 90 per cent of Australia's tax revenue, while around 115 taxes raise the remaining revenue.

Australia's tax system at a glance

How much tax do we raise?

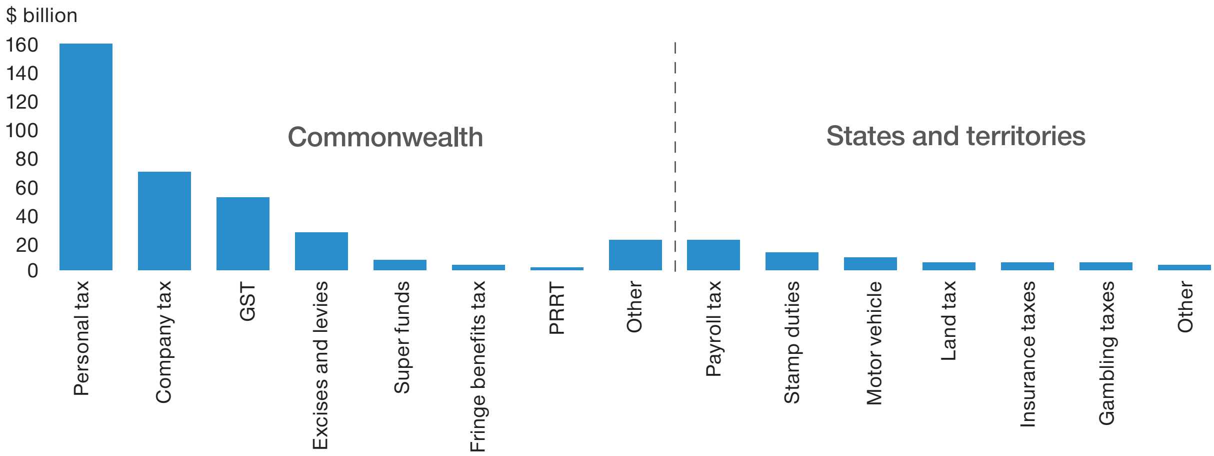
Australian governments raised around $415 billion in taxation revenue in 2012–13. The Commonwealth Government accounted for $338 billion, or over 80 per cent, of this revenue. State and territory governments raised $63 billion, or 15 per cent, while local governments accounted for the remainder.



Source: ABS cat. no. 5506.0.

Where does Australia raise its taxes?

Personal income tax is the most significant source of tax revenue, raising almost $160 billion, or around 40 per cent of total taxes in 2012–13. This is followed by company tax ($68 billion, or 16 per cent) and the GST ($50 billion, or 12 per cent). Payroll tax raised $21 billion, or 5 per cent of total tax revenue (or around a third of state tax revenue).

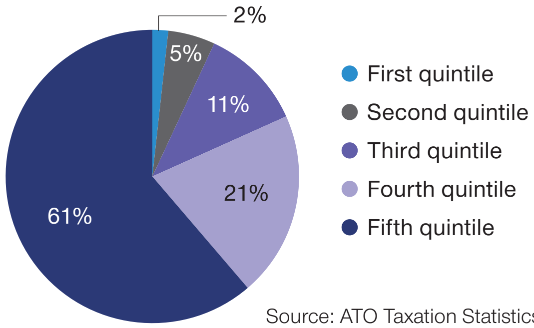


Source: ABS cat. no. 5506.0.

Who pays tax?

Almost 10 million Australians pay personal income tax. Given the relative progressivity of Australia's personal tax system, the top 20 per cent of taxpayers pay over 60 per cent of personal tax collected (see immediate right).

Over 300,000 companies in Australia pay company income tax. Around 3,000 companies with taxable income of over $5 million pay around 70 per cent of company tax collected, or more than $45 billion (2011–12).



Source: ATO Taxation Statistics 2011–12.

Characteristics of Australia’s tax system

Strengths of Australia’s tax system

Australia’s tax system is in need of comprehensive reform; however, it still has several strengths that any future reforms should seek to maintain.

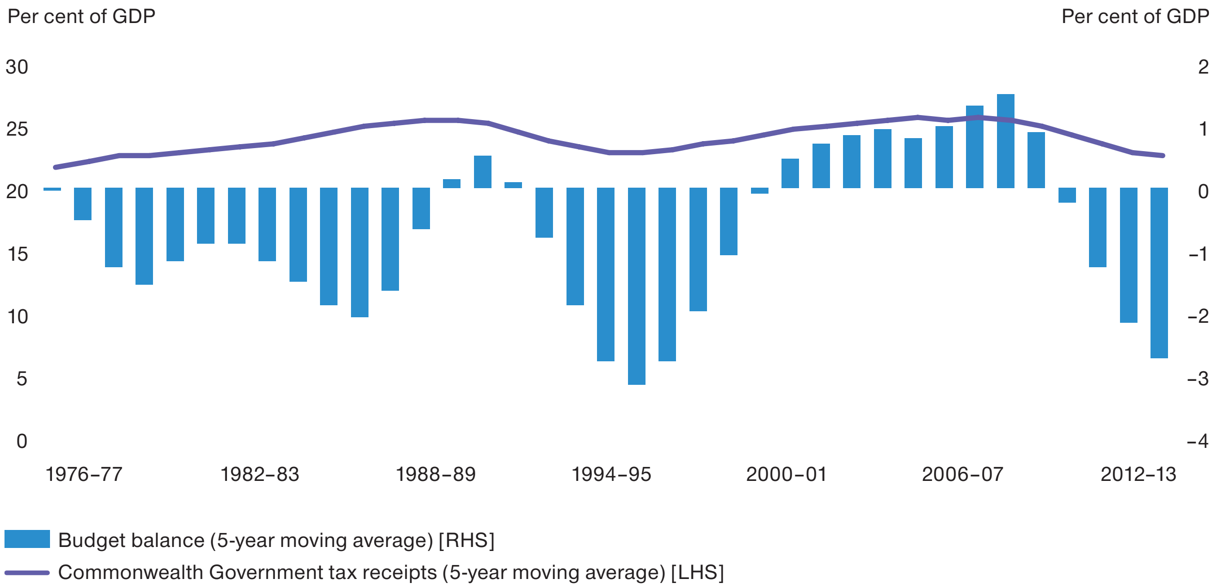
1. Contribution to historically strong public finances

Along with periods of expenditure discipline and robust economic growth, the tax system has played a strong part in keeping Australia’s public finances strong.

Australia has a AAA sovereign credit rating, which has important flow-on benefits for the economy in terms of keeping funding costs down and supporting the availability of funding.

Evidence

Figure 4: Commonwealth Government budget balance vs tax



Source: Commonwealth Budget 2014–15.

Implications

- The primary role of the tax system is to fund key functions of government, including essential services, providing a decent safety net, investment in skills development and key infrastructure.
- It is clear from Australia’s history that the tax system has to play its part both in terms of fiscal repair and in supporting a consistently strong budget position. This will occur through increased economic growth and reform to the tax system. Comprehensive reform can strengthen key parts of the tax system to reduce volatility and ensure that government is raising sufficient revenue, while taking steps to minimise as far as possible the tax system’s drag on economic growth.

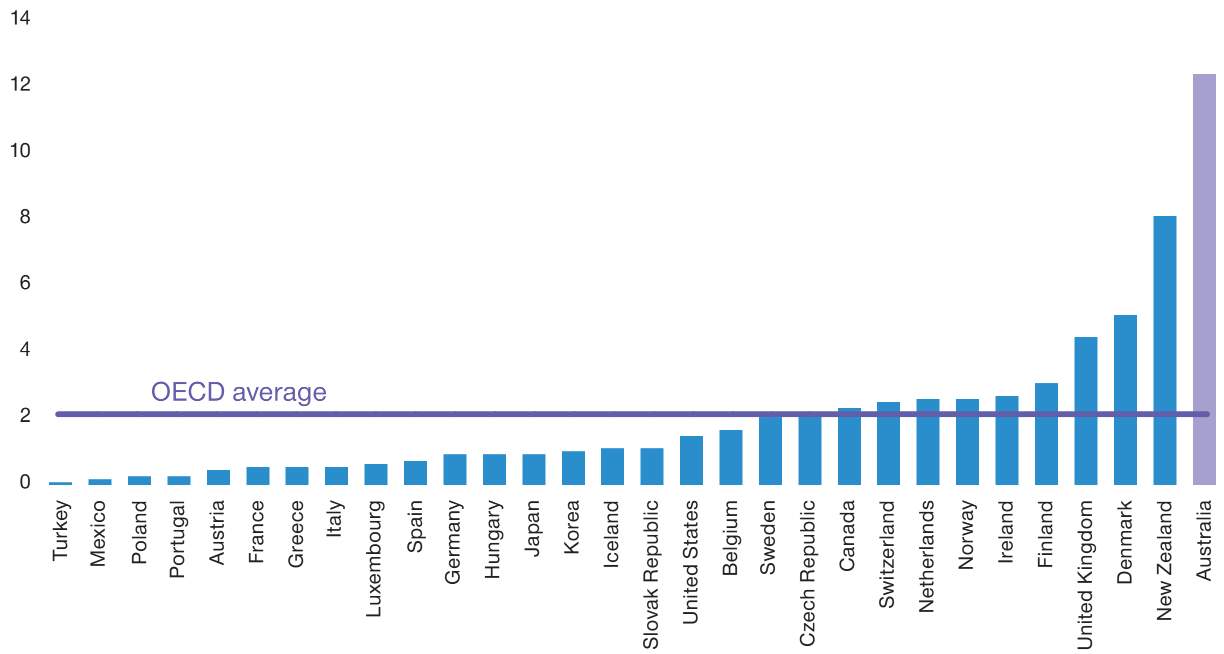
2. Contribution to equity across the Australian community

Australia's tax and transfer system plays a dual role in underpinning Australia's strong social safety net.

Evidence

OECD data suggest that Australia's tax and transfer system reduces income inequality by around a quarter, which is around the average for developed countries. Australia's tax and transfer system is also well targeted and highly redistributive, with the ratio of transfers paid to the bottom quintile relative to the top quintile the highest in the OECD.

Figure 5: Transfers paid to bottom quintile relative to transfers paid to top quintile, 2005



Source: P. Whiteford, 'The Australian Tax–Transfer System: Architecture and Outcomes', *The Economic Record*, Vol. 86, No. 275, 2010.

Implications

- Along with a strong social safety net, the relatively equitable distribution of income in Australia has underpinned social cohesion and has reduced the social and economic costs of entrenched poverty and disadvantage.
- Australia should seek to maintain a relatively progressive and targeted tax system that supports the equitable distribution of income, while also improving incentives for workforce participation, as it engages in comprehensive tax reform.

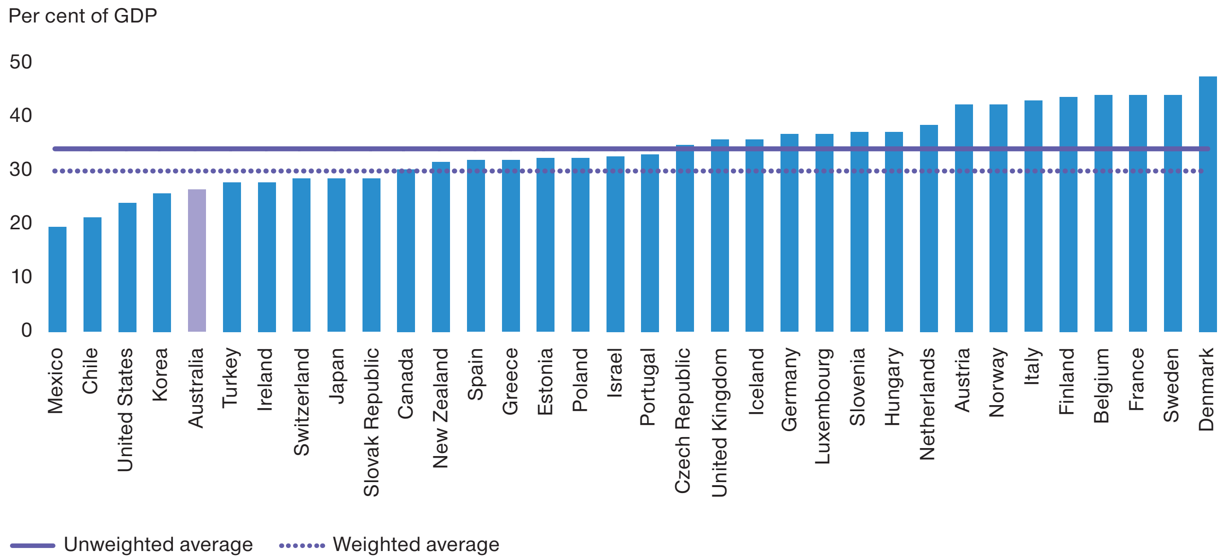
3. Relatively low overall tax burden, albeit from a narrow base

By OECD standards, Australia has a relatively low overall tax burden, with total tax collected across all levels of government around 27 per cent of GDP in 2011 – below the OECD unweighted average of 34 per cent. A comparison by government expenditure across the OECD also confirms the relatively small size of government in Australia compared with the rest of the OECD.

Australia's tax base is also relatively narrow, and while international comparisons can be difficult, tax expenditures are relatively large by international standards. The narrow base combined with a low overall tax burden lends itself to relatively high tax rates in some cases, as well as greater complexity. As labour and capital become increasingly mobile and supply chains disaggregate further, choices about where to work and invest will become increasingly sensitive to tax arrangements.

Evidence

Figure 6: Overall tax burden as a proportion of GDP, 2011



Source: OECD.StatExtracts database.

Implications

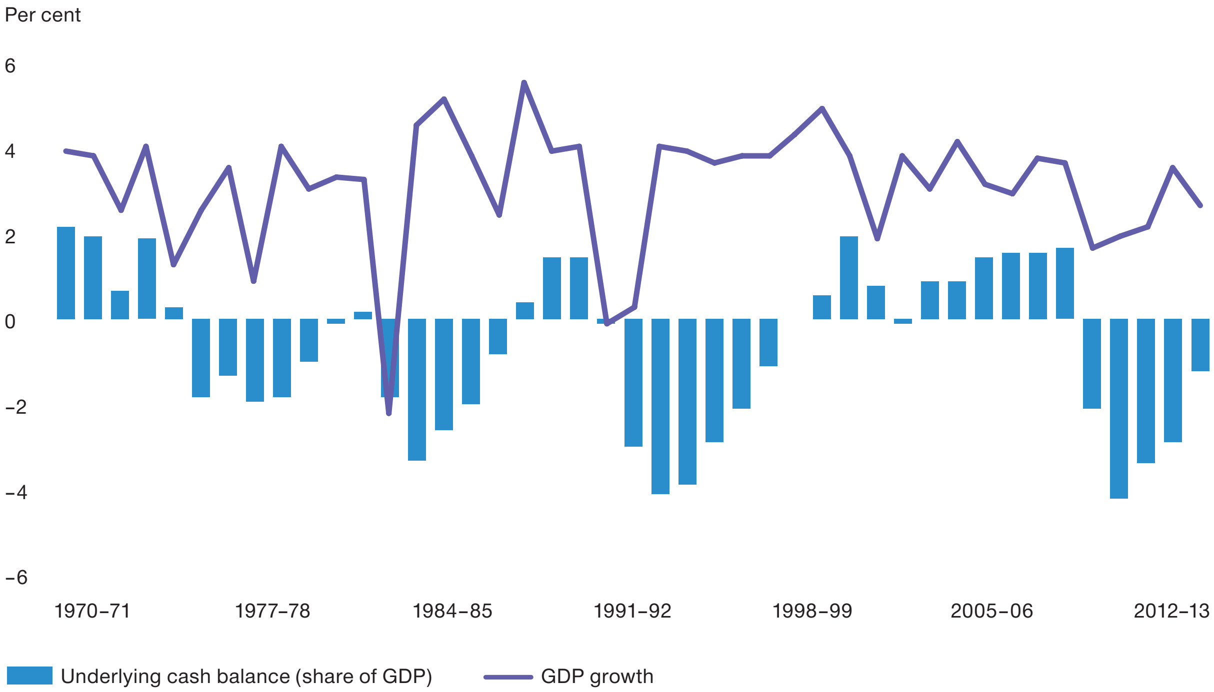
- While some see Australia's lower tax burden as grounds for increasing taxes to meet rising expenditures, instead it should be seen as a necessary competitive advantage, particularly given our relatively high tax rates.
  - Australia faces increased competition for investment and human capital from economies in the Asian region, which have much lower tax burdens and tax rates, and which are at the centre of the shift in gravity of the world economy.
- As long as Australia can prioritise its expenditures appropriately to still maintain a decent social safety net and have government investments in areas like infrastructure and skills contributing to the productive capacity of the economy, there should be no need for tax as a proportion of GDP to rise markedly.

4. Effective economic shock absorber

The tax system acts as an automatic stabiliser during times when Australia's economy faces periods of faltering economic growth. It reduces fluctuations in real GDP, as income and consumption tax revenues fall when economic growth slows. In the case of a progressive personal income tax system, tax revenue tends to fall faster during periods of slower growth as both income and marginal tax rates fall, but slower on the upturn as carry-forward losses are utilised.

Evidence

Figure 7: Annual GDP growth and budget balance



Source: Commonwealth Budget 2014–15 and ABS cat. no. 5206.0.

Implications

- While it would appear that Australia does have an over-reliance on a number of more volatile revenue bases, future tax reform efforts should ensure that the tax system still remains reasonably reactive to the economic cycle. Its burden should not be so broad or stable over time that it does not extract less from the economy when the economy slows.

5. Subject to periodic review and improvement

Australia's tax system has been subject to major reviews or reform at least every decade since the 1970s. It is notable that reviews and their accompanying reforms do not always occur in the same decade, suggesting that reforms to Australia's tax system are hard fought and discussed broadly across the community prior to their final design and implementation. While periods of reform have been important, the degree of ad hoc changes in between major reviews could be reduced in order to improve confidence and certainty with the tax system.

Evidence

Figure 8: Chronology of recent tax reviews and reform

Recent tax reviews and reform

1970s	1980s	1990s	2000s
1975 Asprey review of tax system	**1985** Tax White Paper Tax Summit CGT introduced **1986** FBT introduced	**1999** Ralph review of business taxation	**2000** 'A New Tax System' reforms, including GST **2006** Report into international comparison of Australia's taxes **2008** Australia's Future Tax System Review

Implications

- The case for comprehensive tax reform in Australia is growing stronger. Nonetheless, we also need to be realistic about the timeframes involved in making a compelling case for change, discussing it with the community and undertaking detailed design and analysis.

Challenges for Australia's tax system

Australia's tax system also faces a number of challenges, which are only likely to worsen without reform.

1. Fiscal imbalance across the federation

The allocation of Australia's taxation and expenditure responsibilities is highly imbalanced across different levels of government. Australia's vertical fiscal imbalance sees the Commonwealth collecting more tax revenue than it spends, while the states are responsible for expenditure that far outstrips their own revenues. To illustrate, the states and territories control 15 per cent of total tax collected in Australia but are responsible for around 40 per cent of expenditure – so-called vertical fiscal imbalance.

The horizontal fiscal equalisation methodology will be a crucial plank in the tax and federation reform processes. Horizontal fiscal equalisation is a mechanism for adjusting for the different capacities of states to raise revenue and deliver services. One way to measure the extent of horizontal fiscal equalisation is to compare GST distributions with each state's distribution if it were to be distributed on a per capita basis. The difference between the two is around 10 per cent of GST revenue for distribution in 2014–15, or $5.6 billion.

Evidence

Figure 9: State and territory expenditures and revenues

Source: ABS cat. no. 5512.0.

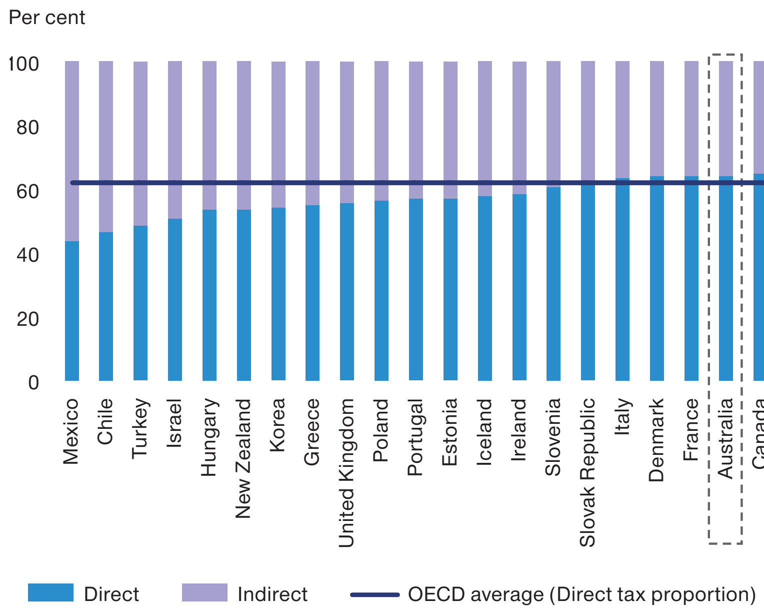
Implications

- The Commonwealth's fiscal dominance in the federation can result in the Commonwealth Government playing a more significant role in large policy and program areas like health and education, increasing the potential for inefficiency and overlap.
  - This is likely to place the allocation of roles and responsibilities in the federation further from what would likely occur if they were allocated on a first-principles basis according to which level of government is best equipped and has the right incentives for delivering the most efficient and effective outcomes.
  - Better alignment of taxation and expenditure responsibilities could enhance government's accountability to citizens and improve efficiency and service delivery.
- Vertical fiscal imbalance will be exacerbated over time as demand for health services increase while the tax base of states and territories is further eroded, for example due to the GST-exempt status of items such as health expenditure. Concurrently, the horizontal fiscal equalisation model exacerbates tensions within the federation and dulls state incentives to switch to more efficient tax bases.

2. Reliance on inefficient sources

Australia is mostly reliant on direct taxes such as personal and corporate income taxes to raise revenue. Direct taxes accounted for around two-thirds of total tax receipts in 2011, above the OECD average. Indirect taxes such as land and consumption taxes accounted for the remaining third.

Figure 10: Direct vs indirect taxes, 2011



Source: OECD.StatExtracts database.

Implications

- Australia's current tax mix is less conducive to growth than it could otherwise be. There is a strong body of evidence that changing the tax mix for a medium-sized open economy such as Australia so that it is less reliant on direct taxes and more reliant on broad-based indirect taxes would result in a more optimal tax system and increased economic growth.
  - This is especially important in an increasingly competitive international economy where investment and talent are ever more mobile.
- Australia's ageing population and predicted decline in workforce participation will mean that personal income tax will decline relatively over time as a revenue source. Meanwhile, global competition and the desire for economic growth will place limits on the taxation of companies. Australia will need to look at increasing its reliance on indirect taxes.

3. Increased volatility

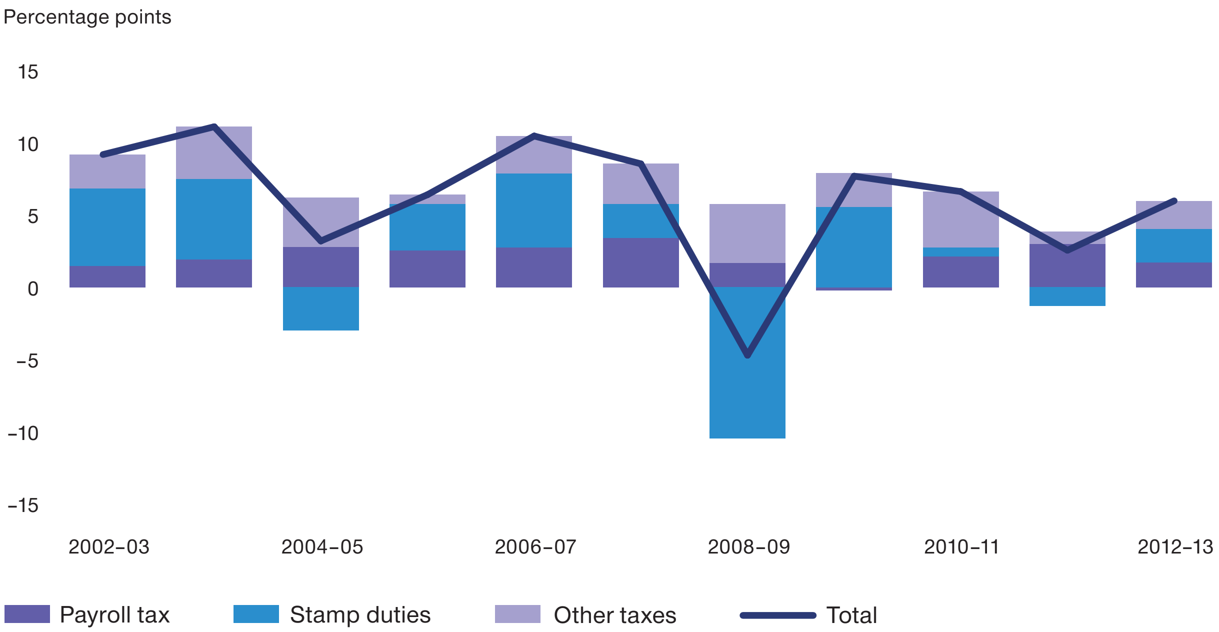
Australia's tax system would benefit from a reduced reliance on volatile tax bases, such as stamp duties and company income tax.

Evidence

Municipal rates are the least volatile and one of the most efficient tax bases. In contrast, stamp duties account for around a quarter of the states' and territories' total tax base but most of the volatility, with recent volatility driven in part by fluctuating asset prices both before and after the global financial crisis (see Figure 11).

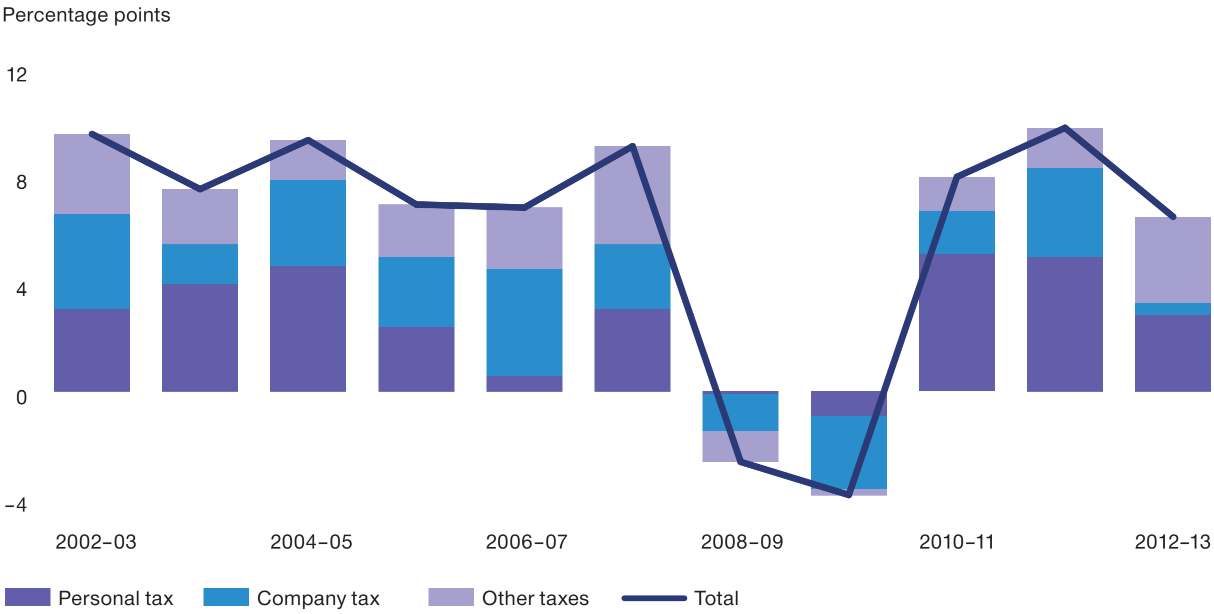
The corporate income tax base, despite accounting for around a fifth of the Commonwealth tax base, accounts for a large degree of the volatility in Commonwealth taxes – notwithstanding the significant contribution of personal tax. This may intensify due to the increased reliance on the resources and resources-related sectors in the corporate tax base (see Figure 12).

Figure 11: Contributions to the volatility of the state tax base



Source: ABS cat. no. 5506.0.

Figure 12: Contributions to the volatility of the Commonwealth tax base



Source: ABS cat. no. 5506.0.

Implications

- Increased volatility in the tax base may challenge government service delivery as it responds to this variability of revenue. Budgeting for permanent expenditures on the basis of fluctuating revenues presents major risks to Australia's fiscal position.
- At the same time that mining has become a larger share of the corporate income tax base, commodity price swings have increased in frequency and range. This has had an impact on revenue collections, with governments more likely to be required to borrow during downturns as these bases tend to be pro-cyclical, and the ability to plan and forecast is diminished as forecasting becomes more challenging.

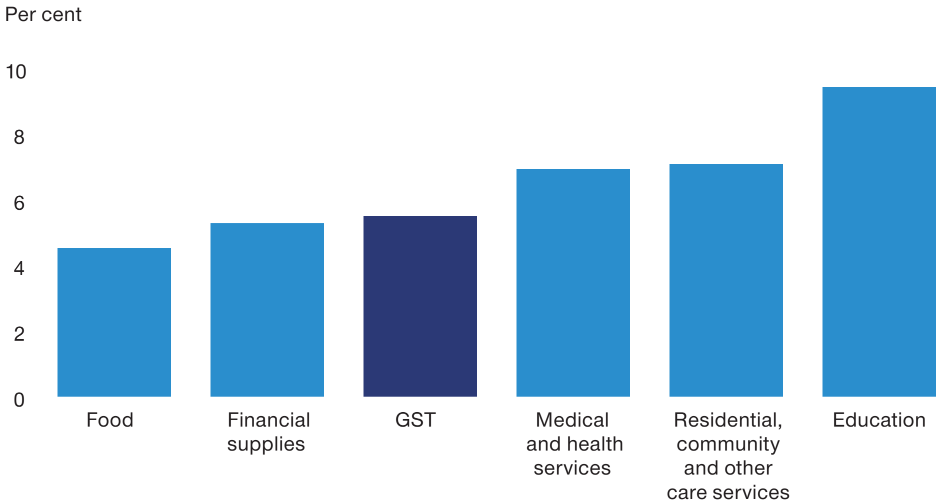
4. Erosion of tax bases

Australia has large and growing tax expenditures – that is, provisions of tax law that cause deviations from the standard tax treatment for an activity or taxpayer – particularly those related to the GST, taxation of housing assets and the retirement income system.

Evidence

The foregone revenue from GST-exempt items is expected to continue to erode the GST base. Expenditure on GST-exempt items has increased significantly over the past several years and this trend is expected to continue into the future. Health and education expenditures make up a large proportion of the erosion of the GST base.

Figure 13: Average annual growth in GST revenue vs largest GST–exempt items, 2013–14 to 2017–18



Source: Commonwealth Budget 2014–15 and Tax Expenditures Statement 2013.

Implications

- GST exemptions are estimated to cost more than $20 billion in foregone GST revenue, compared with GST revenue of $50 billion a year. Faster growth of some GST exemptions means they represent a growing share of consumption.
- GST exemptions distort consumption decisions and some transactions may not go ahead that otherwise would. Exemptions for personal and retirement income taxes also distort savings and investment decisions.
- The tax system can be made more efficient through broadening tax bases and using the additional revenue to fund lower tax rates and the removal of inefficient taxes.

5. Less competitive

Australia's heavy reliance on income taxes and both high corporate tax rate and burden relative to competitors detracts from Australia's competitiveness in the new competitiveness landscape.

Evidence

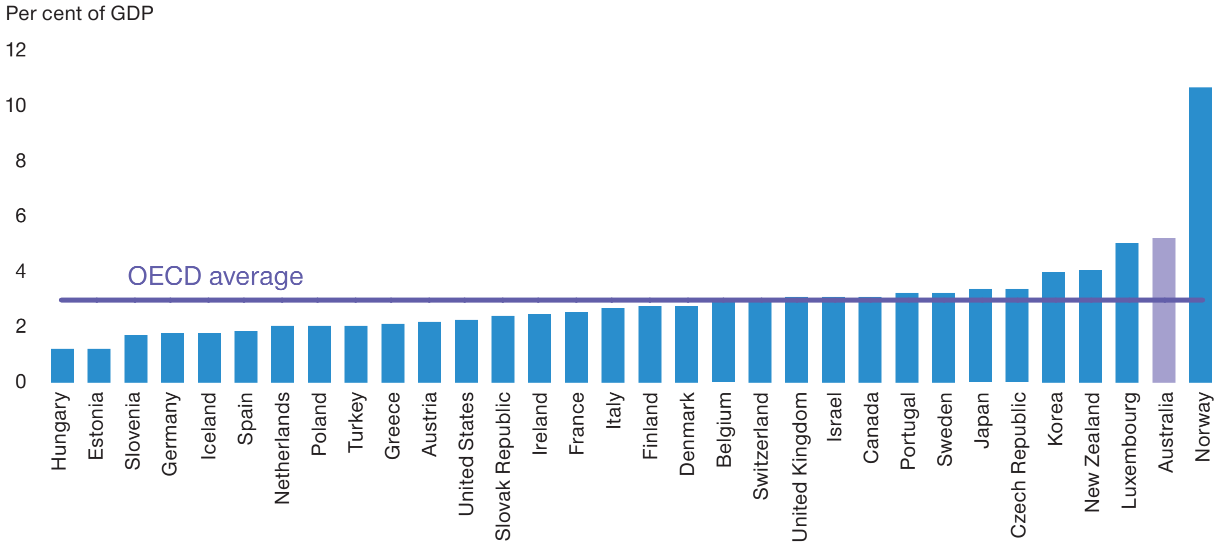
Australia's top marginal tax rate is now nudging 50 per cent following the introduction of the Temporary Budget Repair Levy, compared with an average top tax rate in Asia–Pacific economies closer to 30 per cent. All workers are also facing the prospect of increased average and marginal tax rates through bracket creep.

On the corporate tax side, Australia has a statutory rate of 30 per cent compared with an average statutory rate across the Asia–Pacific region of 23.5 per cent. The average OECD statutory rate is 25 per cent, with many countries reducing corporate income tax rates over the past decade while Australia's has remained unchanged over this period.

The ratio of corporate tax collected as a share of GDP in Australia is second only to Norway in the OECD. This reflects a number of factors including the capital-intensive nature of our economy, high level of incorporation, the integrity of our corporate tax system and dividend imputation. Business must accept its obligations and be transparent when complying with its taxpaying responsibilities.

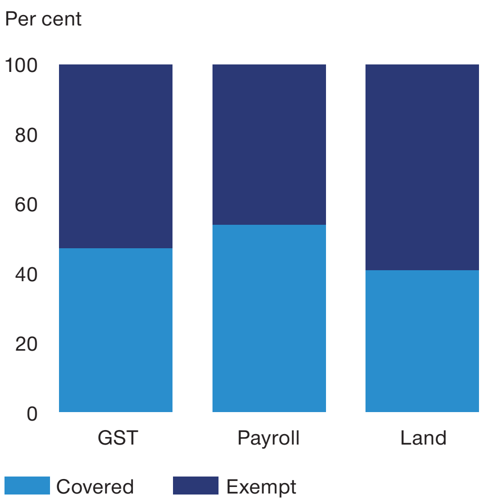
In addition, almost half of the potential payroll tax base is exempt, while more than half of the potential state land tax base is exempt – increasing the burden on those liable for tax (see Figure 15).

Figure 14: Corporate tax revenue as a share of GDP, 2011



Source: OECD.StatExtracts database.

Figure 15: Breadth of selected tax bases (indicative)



Source: BCA estimates based on ABS cat. nos. 5204.0, 5506.0, 5206.0 and 1376.0.

Implications

- Competition for highly mobile capital means that global competitive pressure is more likely to be towards reductions in corporate tax rates, with flow-through implications for issues such as base erosion and profit shifting. This is particularly the case for a country such as Australia with a high reliance on corporate tax revenues and a higher corporate tax rate relative to its peers.
- A lower corporate tax rate would encourage investment and facilitate economic growth. As investment increases, capital deepening increases labour productivity, which in turn flows through to higher real wages.
- Reducing taxes on personal incomes is also imperative in an environment where labour is increasingly mobile and Australia needs to attract the best talent.

6. Complexity

In having an effective tax system that balances a range of objectives including efficiency and equity, it is inevitable that there will be some level of complexity in the tax system. In Australia's case, there would appear to be considerable opportunities to simplify our tax system without undermining these critical objectives.

Evidence

Australia's Tax Act comprises more than 4,700 pages.

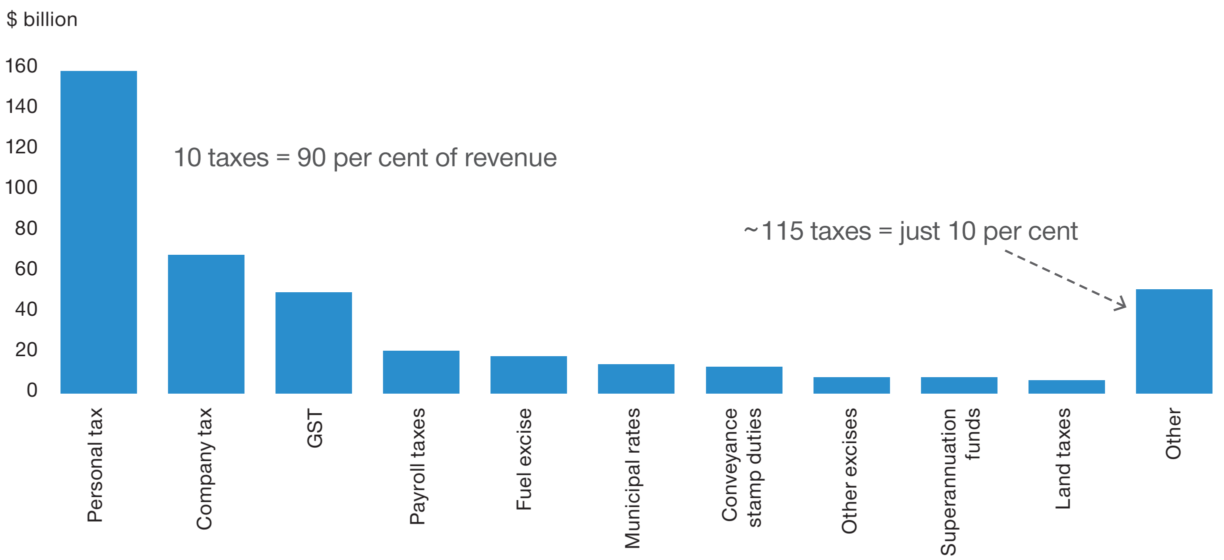
Chief Justice Keane of the Federal Court made the following comments in 2012 regarding the increasing volume and complexity of federal laws:

> *... Opening the Tax Act is like entering the door to a parallel universe*
>
> *... It's really hard. At the end of the day, our job is to make the best we can out of what emerges from the sausage machine.*
>
> *... Often, you could almost be forgiven for thinking that when legislation is being drafted, people come to a difficulty, and think, 'We could actually resolve that, but that would require a level of disputation that we don't want to have among ourselves at this stage, so we will leave it for the judges to work out'.*

Australia has a relatively large number of taxes that result in increased compliance costs while raising relatively little revenue.

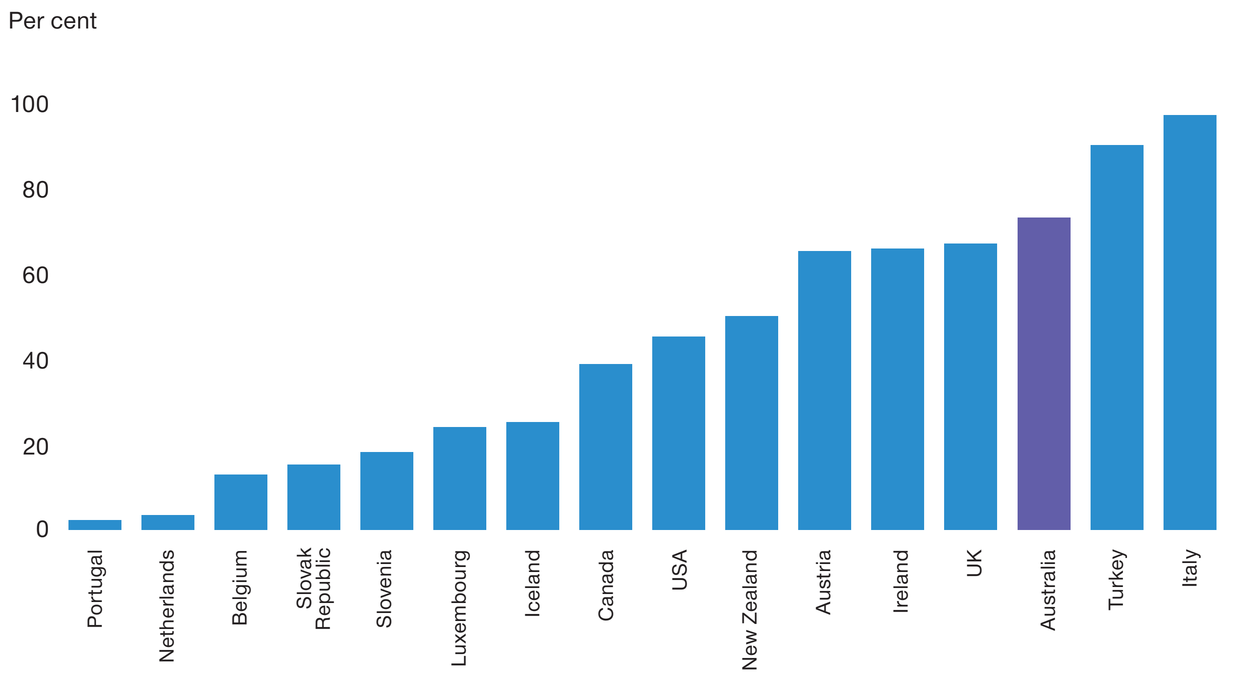
Australians also have relatively intense involvement of tax agents in their tax affairs.

Figure 16: Australian taxes by type, 2012–13



Source: ABS cat. no. 5506.0.

Figure 17: Proportion of personal tax returns filed by tax agent, 2009



Source: *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series*, (2010), 3 March 2011.

Implications

- Complexity increases the costs to governments and tax agencies in administering the tax law.
- Business and the community face increased uncertainty and compliance costs in managing their tax affairs, despite Australia's high level of compliance and integrity in the tax system. While simplicity may be traded away, such as for equity considerations, it can obfuscate decision making and the full impact of taxes.
- Increasing layers of legislative complexity are introduced to make the tax system administratively workable, without addressing the underlying complexity in the system.

Future directions for the tax system

Based on the current characteristics of Australia's tax system that have been outlined here, we believe that there are five key directions for the Australian tax system that the white paper on tax reform should pursue:

1. Raise enough revenue for an efficient level of spending
2. Better support economic growth and competitiveness
3. Support a more efficient federation
4. Maintain a strong level of equity
5. Simplify the tax system

1. Raise enough revenue for an efficient level of spending

A central objective of the tax system is to raise sufficient revenue.

Why?

- **Community confidence:** The community needs to have confidence that the government can sustainably provide adequate services, infrastructure and a strong social safety net over the long term.
- **Intergenerational equity:** If governments consistently fail to meet their expenditures, then debt will build and so too will concerns about intergenerational equity – future generations may face substantially increased taxes or a diminishing level of services from government. In other words, the current generation should not be able to receive the benefits of higher expenditure or lower taxes for a period if it then leaves future generations to face the fiscal consequences.
- **Readiness to counter economic shocks:** Previous BCA work has also shown that on average, fiscal policy has to make a three per cent of GDP contribution to the economy every 13 years in response to economic shocks. Therefore a tax system that raises sufficient revenue is also critical to building up readiness to deal with these shocks.
- **Maintaining a strong credit rating:** Our strong sovereign debt rating, as well as the strong credit ratings of our banks, are key advantages for Australia. However, with a portion of banks' credit ratings dependent on the rating of the underlying sovereign debt, there are risks for banks if Australia was to lose its AAA rating. Should this occur, Australian banks and the economy would face slightly higher funding costs and potentially lower availability of funding, which would doubtless reduce their ability to lend to fund growth.

How?

- **Review and reset government expenditure:** The magnitude of the task for Australia's tax system will be set by the level of government expenditure. This level of expenditure should be as efficient as possible in light of the role of government. Therefore, an important companion to tax reform is a process of credible budget repair to bring expenditure under control, while sustaining a strong social safety net, essential government services and investing in infrastructure. This started with the 2014–15 Budget but further work is necessary in future budgets.
- **Raise sufficient revenue efficiently:** It is also important that tax is raised as efficiently as possible, subject to equity and other considerations. Raising a given amount of tax revenue in the most efficient manner possible has the advantage of reducing the drag on economic growth over the long term, thereby increasing incomes and boosting the fiscal position.
- **Place discipline on size of government:** There should be a hard cap on the size of government to avoid a situation where the tax system is chasing ever-increasing and unsustainable increases in expenditure. This instils discipline on government and provides a prompt for community debate and discussion before the government pursues tax changes that would impose a permanent increase in the tax burden on the community.

2. Better support economic growth and competitiveness

If the tax system is to better support economic growth, then it will need to become more efficient and competitive.

Why?

- **Addressing demographic pressures:** Achieving the kind of growth we have achieved in the past will require ambitious policies that offset as far as possible the declining proportion of the population in the labour force due to ageing and that provide a basis for unprecedented productivity growth. A more efficient and competitive tax system will be a critical part of this equation.
- **International competitiveness:** Increasing competitiveness will become ever more challenging with increasing globalisation and the rise of emerging economies with lower tax rates in our region.
- **Reducing volatility:** A more efficient tax system that places less reliance on taxes on capital and income is also likely to be less volatile, thereby supporting revenue adequacy.

How?

- **Changing Australia's tax mix:** There should be a view to moving, over time, to a system where there is less reliance on capital and income taxes that distort incentives to work and invest, and increased reliance on efficient and less volatile indirect taxes.
- **Regional benchmarks:** Australia needs to benchmark itself not just against the OECD in terms of tax competitiveness, but also against the Asia–Pacific region with Australia increasingly competing against these economies for investment and talent.
- **Keep options on the table:** Unlike the 2009 Henry review, it will be critical that the scope of the tax white paper is not unnecessarily constrained by ruling out efficient tax bases for consideration.
- **Seek to achieve broad-base, low-rate taxes wherever possible:** Governments should wherever they can seek to reform existing tax bases and design new taxes to have as broad a base as possible with a low rate. This reduces economic distortions, complexity and reduces our vulnerability to base erosion and profit shifting.

3. Support a more efficient federation

Tax revenues should more closely align with expenditure responsibilities in our federation.

Why?

- **Future fiscal pressures:** The ageing population will collectively place just as much pressure on state governments as it does on the Commonwealth government over coming decades, despite state governments only collecting 15 per cent of tax revenue in the federation.
- **Hard budget constraint:** Aligning revenues with responsibility for funding programs can strengthen the budget constraint that a government faces. In other words, when a government is not accountable for the revenue it raises, then it may not be fully accountable to its citizens for how it spends that revenue and therefore could have less incentive to be disciplined in how it spends that revenue.
- **Stop drift of roles in the federation:** Commonwealth involvement in areas traditionally delivered by the states seems to be driven increasingly by revenue dominance rather than a first principles look at which level of government will be best placed to deliver services more efficiently and effectively.

How?

- **Resolve roles and responsibilities:** The starting point should be reviewing the roles and responsibilities of governments through the white paper on reform of the federation. Once this is resolved then there will be greater clarity on a more appropriate division of revenue raising between the Commonwealth and the states to better align with these roles and responsibilities.
- **Exploit efficient tax bases:** If the states are to remove their inefficient taxes and have greater revenue autonomy, then it is inevitable that they will need to raise more revenue from potentially efficient tax bases such as land.
- **More untied revenue:** An overarching goal of federal–state tax reforms should be to significantly increase the amount of untied revenue that the states receive through both increasing own tax collections and from more transfers from the Commonwealth being untied. Addressing issues with the horizontal fiscal equalisation formula is essential for effective tax reform. Transitional arrangements for states that require additional assistance should also be considered.

4. Maintain a strong level of equity

Australia should seek to maintain a strong level of equity in its tax system in line with community expectations.

Why?

- **Underpins Australia's social fabric:** Equity in Australia has been underpinned by the tax and transfer system. Our social safety net ensures that there is a reasonable level of protection and support for those most vulnerable in our society.
- **An unfair system is not sustainable:** Changes to our tax system that undermine fairness will simply not pass the test of time and there will be calls for further reform.
- **Social and economic costs:** An unfair tax system that does not provide reward for effort or places too heavy a burden on lower incomes will ultimately result in social and economic problems including low workforce participation, inadequate savings and increased welfare costs.

How?

- **Maintain progressivity in personal tax system:** While we should seek to lower marginal rates and simplify the personal tax system, we must also seek to maintain progressivity through tax rates and thresholds.
- **Carefully target transfer system:** Continuing to have a well-targeted transfer system that provides assistance for those most in need will also support equity.
- **Compensate for and offset changes where necessary:** Where there is a need to offset changes made in one part of the tax system or compensate a particular group of people such as low-income earners, then this should be pursued through changes to the personal tax and transfer system.

5. Simplify the tax system

Australia should seek to substantially simplify its tax system by relying on the four broad bases identified by the Henry review to reduce costs to government and the community.

Why?

- **Reduced cost to government and community:** Simplifying the tax system could substantially reduce the costs of tax compliance and administration for governments and the community.
- **Increased compliance:** A simpler system should be easier to understand, increasing taxpayer compliance and reducing opportunities for tax evasion and avoidance.

How?

- **Fewer taxes:** Governments should begin by removing the most inefficient taxes identified by the Henry review and focus on four robust tax bases – personal income, corporate income, consumption and land. Simplicity does not have to operate against equity and fairness.
  There should also be efforts to consolidate the more than 100 taxes that account for just 10 per cent of revenue, beginning with those most inconsequential to revenue where the revenue gain may not be justified by the costs of collection.
- **Simpler tax returns:** Individuals with relatively simple tax affairs must have avenues to lodge their tax returns simply and easily. This could build on the government's newly established *MyTax* platform.
- **Working with the ATO:** There are considerable opportunities to work with the leadership of the ATO under the Commonwealth Government's deregulation agenda to make existing tax law and practice work more efficiently and effectively.
- **Better technology:** Wherever feasible, business and individuals should be interacting with the tax system through online portals and technology.

Priorities for the white paper process

- **All options on the table:** A process of coherent, comprehensive and holistic tax reform should consider all tax bases and expenditures. This will bolster community support and buy-in on the process.
- **Extensive consultation with the community:** Community support for the process will be built on an open and transparent tax reform process that ensures all voices are heard and the impact of policy options is made fully transparent.
- **Coordinate with the federation white paper:** Close coordination between the tax and federation white paper processes is needed to address the vertical fiscal imbalance between the Commonwealth and the states.
- **Chart a course for reform:** Outline a comprehensive roadmap for reform to promote stability, certainty and confidence for the implementation of tax reform.

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