Protecting prosperity: Why we need to talk about tax

July 2013

Australia faces a historic choice in the years ahead. It could cut government services radically, it could build tax revenues by incremental change, or it could prioritise growth through carefully targeted expenditure cuts and tax reform.

pwc

Australia's challenge

After 22 years of continuous economic growth, Australia now faces the risk of falling incomes and increasing government debt.

PwC estimates that the combined annual deficits of Australian governments will rise:

- from $27.4bn (1.9% of gross domestic product [GDP]) in 2011-12 to $213.5bn (3.5%) by 2039-40 and to $583.1bn (5.9%)by 2049-50.

And our governments' debt levels as a proportion of GDP will rise:

- from 12.1% in 2011-12 to 32.9% by 2039-40 and to 77.9% by 2049-50.

These trends are unsustainable as the population ages. Australian governments risk not being able to meet the key needs of our community and a further slide into debt. And higher debt at the Commonwealth level would mean that another shock like the GFC in the next few years could see its debt climb to 30% of GDP by 2025-26.

We believe there is a clear need for comprehensive tax reform – done the right way. The 'right way' means increasing those taxes that have the least effect on investment and employment, and at the same time reducing reliance on taxes that distort incentives to work, invest and transact business. It also means addressing those factors which increase the complexity of the tax system and the cost of compliance.

Such a reform would complement a reinvigorated focus on productivity, and higher workforce participation from older Australians and women with children.

And a good, comprehensive tax system needs to be equitable. Any reform will need to include carefully targeted compensation packages and an examination of personal tax, company tax rates and concessions, retirement funding, retirement age, and welfare transfers.

This conversation is overdue

This is an issue that will not go away. As part of a broader community discussion about the challenges Australia faces, we need an informed and intelligent conversation on tax. Leaders of civil society, business, unions and the public policy community must drive this conversation if we are to realise the benefits across all parts of society. The overall objective is two-fold: economic growth, and enhancing the wellbeing of the Australian public.

This report is PwC's contribution to the debate. In it, we do not recommend an optimal package of taxes. Rather, we seek to emphasise that there is scope for raising government revenues while maintaining, or even encouraging, continued economic growth and a fair and equitable approach to the vulnerable in our community.

Luke Sayers
CEO, PwC

Acknowledgements

We would like to acknowledge the following people who provided input and contributions to the matters discussed in this publication:

Advisory Panel

David Flanagan, Chairman, Atlas Iron

Dr Lynne Williams, Economic consultant and board director

John Daley, Chief Executive Officer, Grattan Institute

Launa Inman, former Chief Executive Officer, Billabong

Louise Tarrant, National Secretary, United Voice

Mike Callaghan, former Deputy Secretary, Australian Treasury

Nicola Ballenden, Representative, Brotherhood of St Laurence

Professor John Freebairn, Ritchie Chair, Department of Economics, Melbourne University

Robert Neale, Chief Executive Officer, New Hope Corporation Limited

Ross Barker, Chief Executive Officer, Australian Foundation Investment Company

Toby Hall, Chief Executive Officer, Mission Australia

Tax Experts Group

Comprising the following Heads of Tax:

Adele Raj-Manning, Lion

Anne Richardson, Asciano

Anthony Portas, Anglo American Metallurgical Coal

Darren Day, Woolworths Limited

Frank Drenth, Corporate Tax Association of Australia

John Condon, BP Australia

Kathryn Davy, News Limited

Stephen Green, ANZ (now retired)

Tony Merlo, BHP Billiton

While the guidance provided by the Advisory Panel and Tax Experts Group has been most welcome, PwC acknowledges sole responsibility for the final document and recognises that members of the Advisory Panel / Tax Experts Group may not agree with all matters referred to in the publication.

Information presented in this report refers to PwC analysis. Where indicated, this refers to PwC's projections of economic growth and government finances, which have been estimated at both the state and national levels. These estimates are based on the methodology used in the Commonwealth Government's intergenerational report, underpinned by the 'three Ps' of population, participation and productivity. The long-term projections of economic growth and government finances take current government economic and finance forecasts as a base. Trend growth rates over the longer term are a function of the historical data and the assumptions are based on data from official sources.

Contents

Executive summary

Australia is facing fundamental challenges in maintaining prosperity into the future.

- Real income growth and strong budgets are at risk if productivity stays low and export prices fall.
- An aging population will progressively increase the proportion of the community dependent on those who are producing income and put pressures on aged care spending.
- These factors could lead to falls in real per-person income for the first time in a quarter of a century, and unless we rebuild strong budgets, governments might not be able to cushion us from the next global shock as they did from the GFC.
- State/territory governments in particular face a great challenge because the demands they face have grown faster than GST revenues.
- Ultimately, simply cutting waste is not going to be enough to do everything we wish. Significant action is required to enable governments to boost revenues and address current deficits.

Tax reform is the most comprehensive way of addressing these issues. And if we do it the right way – by ensuring we lift only those taxes that have the least effect on economic growth, reduce our reliance on taxes that are damaging, and direct any compensation measures to the most vulnerable – then tax reform can also help us drive productivity growth and lift real incomes per person.

But the community, the unions, business and public policy specialists all need to be involved. They need to understand the why and how of tax reform – and in particular, why it has generally failed in the past. There are questions we need to ask, and answer, before any decisions can be made.

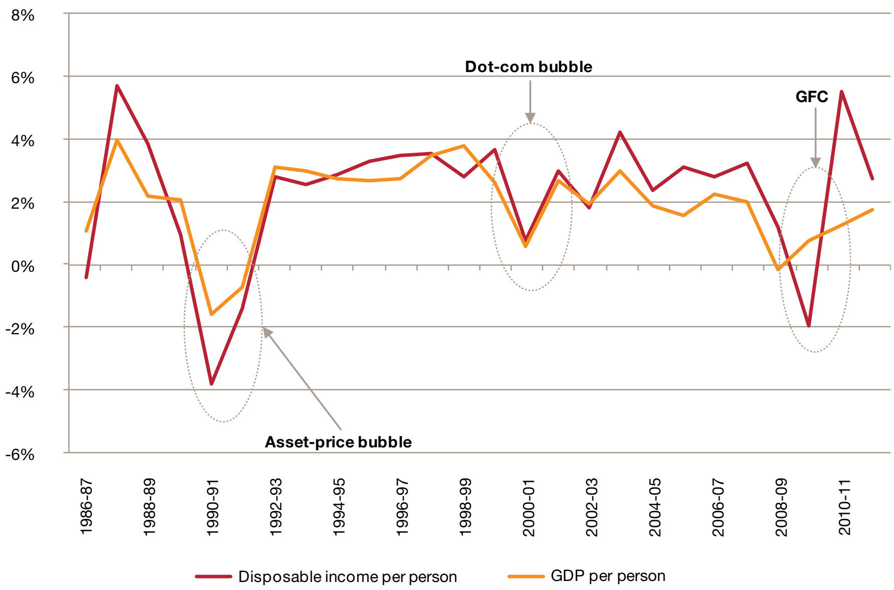
And above all, the overriding two-fold objective – to ensure growth, and at the same time enhance the wellbeing of Australians – must remain at the centre of the debate.

The case for action

Australia has enjoyed more than over 22 years of largely continuous growth in real income per person (Figure 1):

- In the 1990s and early 2000s this flowed primarily from productivity growth.
- From the mid-2000s, while productivity declined, this position was maintained because the prices of our exports, particularly minerals, rose and the prices of our imports – such as televisions, computers and cars – fell.

Figure 1: Disposable income per person and GDP per person, Australia, annual % change



Source: ABS Cat No. 5204.0

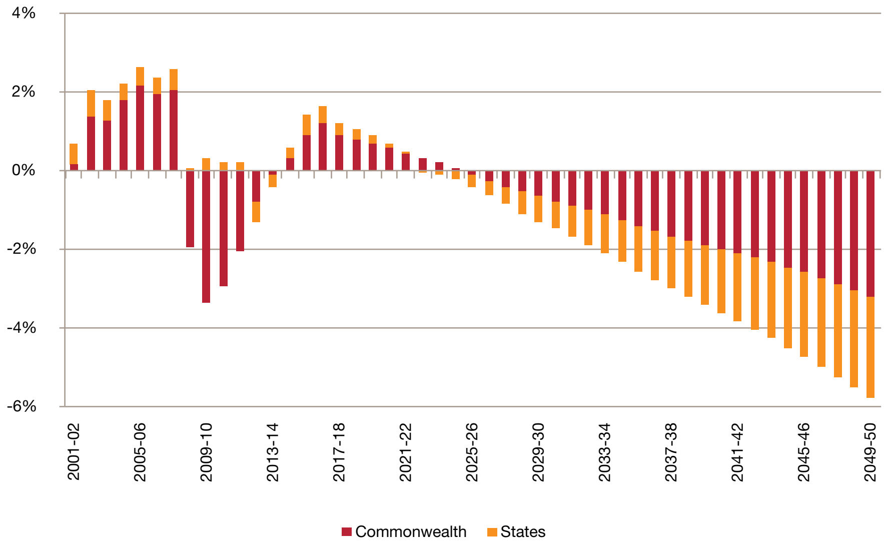
Since the early 1990s, governments at all levels were able to build a strong budget position, with low debt levels, due to a combination of asset sales, strong revenue growth and some expenditure restraint. However, real income growth and strong budgets in the future are both at risk if productivity stays low and export prices fall. This could result in falling real income per person for the first time in a quarter of a century. Exacerbating this problem is an aging population, which over time will reduce labour market participation rates and earnings, while at the same time adding to government costs.

Without changes in government spending and a broader trend towards addressing participation, productivity, and tax reform, PwC estimates that the combined annual deficits of Commonwealth and state/territory governments will rise from $27.4bn in 2011-12 to $213.5bn by 2039-40 and to $583.1bn by 2049-50 (Figure 2).

Unless we rebuild strong budgets, the Commonwealth Government might not be able to cushion us from the next economic shock as it did from the GFC. A global shock in the next decade could result from:

- the unresolved sovereign debt issues in the eurozone
- soaring government debt in Japan
- failed attempts to control the United States fiscal deficit
- efforts in China to restructure its economy and wind back stimulus
- geo-political stress in east Asia as China grows in economic and military strength
- a crisis in the Middle East
- irrational exuberance or an asset price bubble.

Figure 2: Primary balance: Commonwealth and state/territory governments, % of GDP



Source: PwC analysis
Note: The primary balance is defined as the difference between revenues and expenditures, excluding interest transactions. This chart uses official budget forward estimates where they are available. To this extent it relies on budget estimates of future revenue growth and expenditure paths. It is based on an assumption of a steady 1.5% improvement in productivity each year.

Australia has enjoyed more than 22 years of largely continuous growth in real income per person

Another shock like the GFC could accelerate the slide towards deeper government debt (Figure 3).

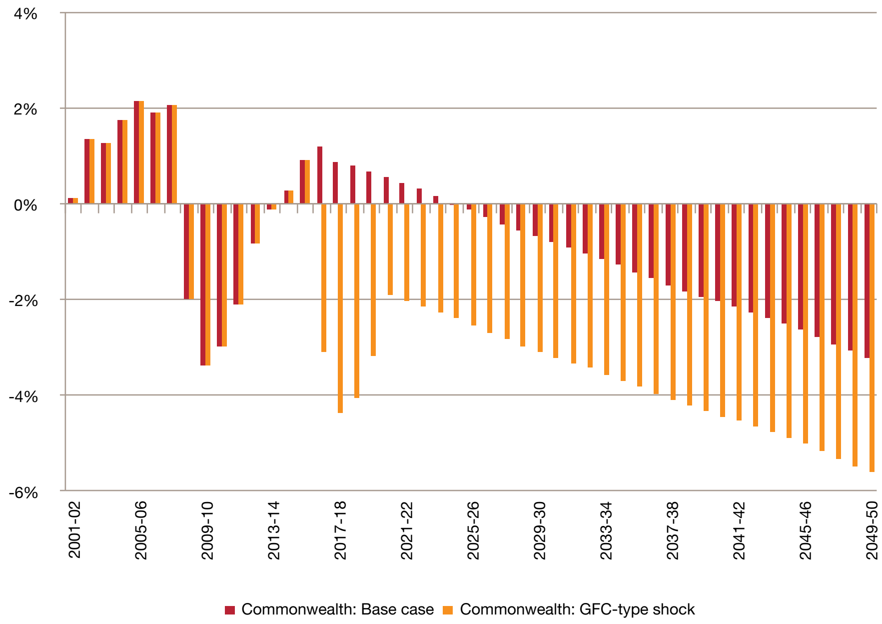
State governments face a particular challenge because the income they receive from the GST and their own tax bases has grown more slowly than the demands they face. This trend is expected to continue into the future, without significant changes to either the breadth of application or rate of GST.

Based on these trends, it is estimated that total general government debt will grow for all levels of government, with the cumulative deficits as a proportion of gross domestic product (GDP), rising from 12.1% in 2011-12 to 32.9% by 2039-40, and then to 77.9% by 2049-50. Rising net debt levels for governments also means increasing costs associated with servicing interest payable on this public debt. Figure 4 shows the path of debt with capitalised interest if these costs are not met along the way. In particular, it highlights that debt interest payments contribute to almost half the total liabilities (or 34% of GDP) by 2049-50.

In this calculation, 'interest payments' are based on current interest rates and no allowance has been made for any increase which might occur if the financial markets become less confident in Australia's creditworthiness or if global interest rates increase from their historically low levels. Higher interest rates would make Australian governments progressively more vulnerable to interest rate shocks. Recent experience in the European Union shows how rapidly rising interest rates and deepening sovereign debt can damage business confidence in the economy, and the need for dramatic public and private debt reduction.

The acceleration in deficits would present itself as cumulative debts building up each year – almost doubling normal funding requirements by 2049-50.

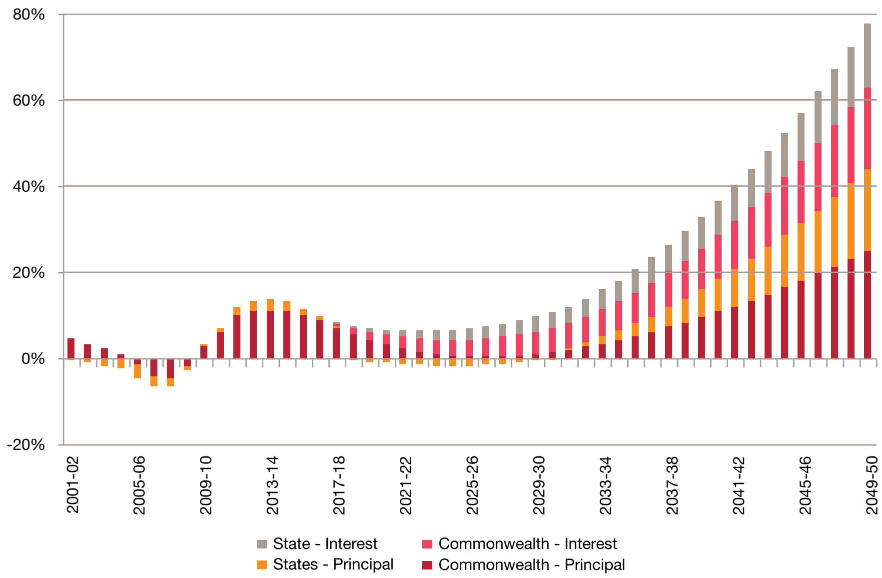
Figure 3: GFC type shock in 2016-17, primary balance, Commonwealth Government, % of GDP



Source: PwC analysis

Note: This chart uses official budget forward estimates where they are available. To this extent it relies on budget estimates of future revenue growth and expenditure paths. It is based on an assumption of a steady 1.5% improvement in productivity each year and with the addition of a GFC-type shock to revenue and expenditure.

Figure 4: Total public net debt: Commonwealth and state/territory governments, with public debt interest capitalised from 2016-17, % of GDP

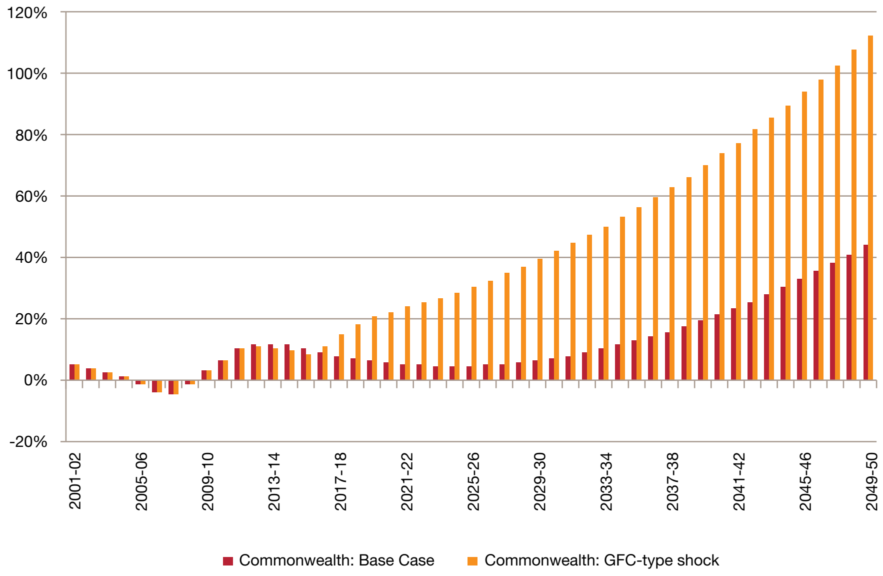


Source: PwC analysis

A further financial shock in this decade would also bring forward Australian governments' move into deep debt. In particular, sensitivity analysis shows how vulnerable Australia could be to this type of shock, and how debt can then increase exponentially if no action is taken to cut expenditure or boost revenue (Figure 5).

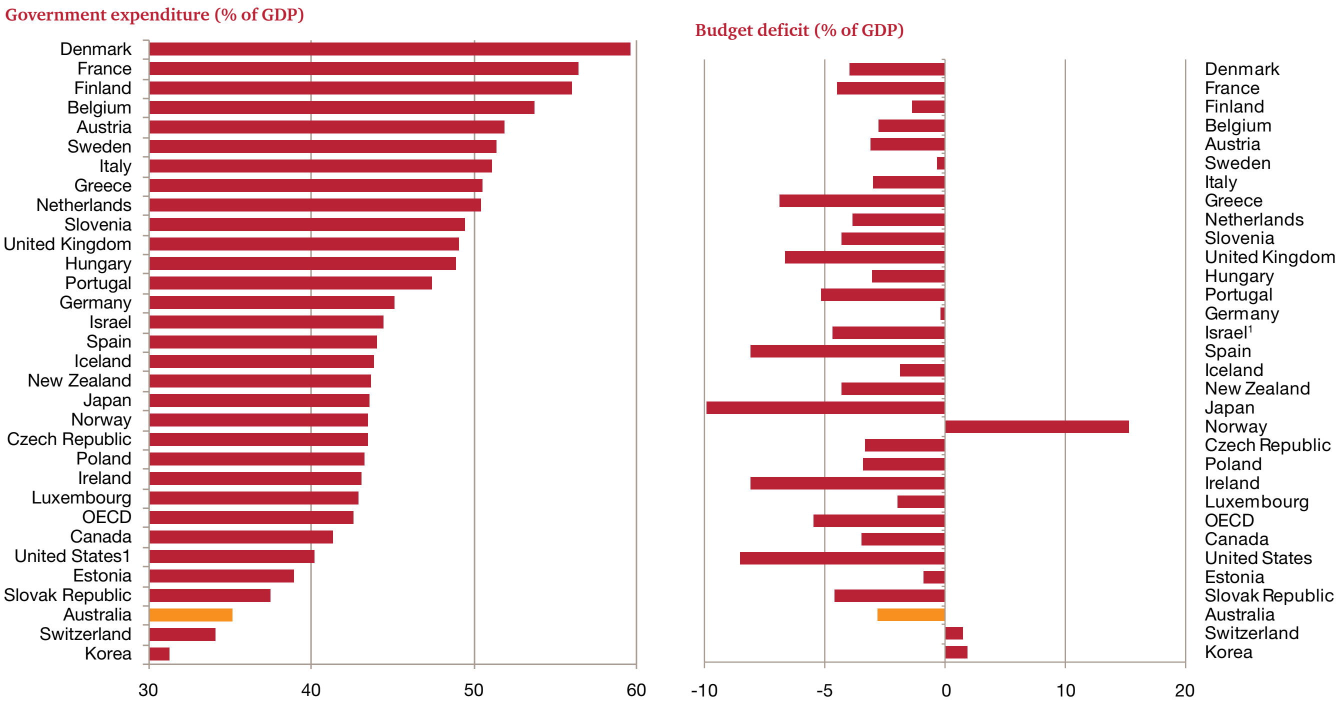
Therefore, governments at all levels will need to be very careful about which expenditure programs they choose to support, and will also need to focus on cutting waste. But Australia is not a big-tax, big-government spending economy compared with other countries with the same standards of living (Figure 6).[1]

Figure 5: Commonwealth public net debt with a GFC-type shock, including public debt interest capitalised from 2016-17, % of GDP



Source: PwC analysis

Figure 6: Government expenditures and deficits, OECD countries, 2011



Source: OECD 2012. ***OECD Economic Outlook****. Volume 2012, Issue 2, No. 92*

1. Some OECD countries levy a social security contribution from employers as an element of their tax system. Australia has a Superannuation Guarantee Charge which enforces saving for retirement with limitations on early access. However the funds raised from this charge do not move through the budget system, and at all times lie within the control of private sector financial intermediaries, financing both public and private investment.

Ultimately, simply cutting waste is not going to be enough to fund everything we wish to do: rebuild strong budgets; help fund community priorities like DisabilityCare Australia, education reform, and infrastructure in our cities and regions; and lift our defence investment to reflect the more clouded and uncertain medium-term strategic outlook.

In addition to making expenditure cuts, if we are to prevent what could become increasing long-term structural deficits growing even larger, governments need to boost revenues. If we do this the right way – that is, by lifting only those taxes that have the least effect on economic growth, by reducing our reliance on taxes that are damaging to economic growth, and by ensuring any compensation measures are targeted at the most vulnerable in our community – then tax reform can also help us drive productivity growth and lift real incomes per person.

Such a tax reform system should also include addressing those factors which increase the complexity of the tax system and the cost of compliance.

Why do taxes affect economic growth?

Taxes are mainly used to support public expenditure on services, investment, infrastructure, education and welfare. They are also used to secure equity, social or environmental outcomes.

However, taxes can have a negative effect on economic growth because they affect decision-making:

- decisions by householders to save, to buy services or property, to work or to pursue education
- decisions by companies to produce, provide jobs, innovate and invest
- decisions by investors about where and how to invest.

Globalisation has increased the effect of taxes on growth. It has also affected the stability of revenue from corporate sources. Countries like Australia which are small, open economies highly dependent on foreign investment, trade and skilled migration, and with well developed web-based commerce, have to be increasingly aware of the effect their tax mix can have on their competitiveness.

In essence, all taxes affect growth, but some are much more negative for growth than others.

- **Income taxes and means tests** can deter people from working at all, can influence them to work less than they would like, can deter them from pursuing higher skills and even cause them not to work in Australia.
- **Company taxes** can cut foreign, and plausibly to some extent domestic, investment[2] and the incentive to innovate, which in turn can cut growth, reduce productivity and reduce real per-person incomes.
- **Taxes on transactions** like stamp duty can stifle deals that would have brought economic benefits to all the parties involved – businesses or households – as well as to the community.
- **Taxes on consumption**, like the GST, affect economic growth less because they do not change behaviour as much, and especially so when applied uniformly to all goods and services.
- **Taxes on immovable resources** – such as land tax – have low economic costs.

2. The impact of company taxes on domestic investment is significantly reduced by dividend imputation which means that domestic investors' dividend returns are taxed at their marginal income tax rate. However, many in business also argue that to the extent company tax reduces companies' ability to retain funds, it can reduce investment capacity and growth in company value, which is also of interest to those domestic investors whose principal concern is capital gains.

Getting the structure of the tax system right can boost growth and lift productivity. The Organisation of Economic Cooperation and Development (OECD) has ranked taxes from most to least growth-friendly – with recurrent taxes on immovable property (eg land) having the least negative effect on growth followed by consumption taxes, other property and environmental taxes, and personal income tax. Corporate taxes have the greatest negative effect on growth.

Assessments of Australia's tax system indicate that we are heavily weighted towards those taxes which have a greater proportion of welfare loss per dollar of revenue collected. But taxes are about more than just growth, and we cannot lose sight of those other goals.

What are the features of a 'good' tax system? How does the Australian system measure up?

No matter how much revenue a tax system raises, a 'good' tax system should meet some key tests:

- **Does it enable healthy government?** – Australians expect all levels of government to provide a range of services, facilities and support for the disadvantaged, and to have the budget strength to deal with natural, economic or national security shocks. This requires an adequate revenue stream to governments.
- **Does it support an efficient federation?** – While the Commonwealth has the most effective capacity to raise taxes, states and territories should have access to a predictable revenue stream that grows in line with the demands for services they deliver.
- **Is it fair?** – The aggregate tax burden should properly reflect the capacity to pay and be supported by positive income support for the most vulnerable; people in the same position should be treated in a similar way; there should be no discrimination between states and territories; and future generations should not be burdened to make the life of the current generations easier.
- **Is it efficient?** – All taxes damage economic growth to some extent, but some much less than others. Most revenue should therefore be raised through those taxes which impose the smallest penalty on our economic wellbeing, are simple to understand and impose the lowest costs to collect.

These priorities will often compete. The challenge of tax reform is to balance improvements in efficiency with complementary measures to maintain or promote fairness and ensure the fiscal sustainability of all levels of government.

No matter how much revenue a tax system raises, a 'good' tax system should meet some key tests

The Australian system of taxes and welfare benefits is regarded as among the more equitable of the OECD countries because it generally focuses net government support on those most in need.

Recent changes have cut back on the support for families at income levels which would traditionally have been regarded as 'well off'. However, the tax treatment of superannuation incomes, indexation of pensions to earnings, and the treatment of the primary place of residence for means tests has resulted in many older 'well off' Australians (ie with considerable assets) receiving assistance. Those dependent on Newstart, Job Seeker or Parenting Payment, by comparison, have faced increasing financial stress.[3]

Compared to many developed countries and advanced developing countries, the Australian tax system does not support growth as well as it could. This is due to the large amount of tax revenue generated from income and corporate taxes, which tend to distort incentives more than other taxes, along with the application of exemptions and concessions which add administrative complexity and cost to the tax system.

Australia draws a relatively high proportion of its government revenue from taxes on business activities and a relatively low proportion from taxes on consumption.

For example, the proportion of tax revenue collected from corporate taxes is much higher than the OECD average (Figure 7). High taxes on business deter investment, encourage the movement of activities offshore and encourage artificial strategies to avoid tax. Tax revenues generated from these sources are also quite volatile across the business cycle.

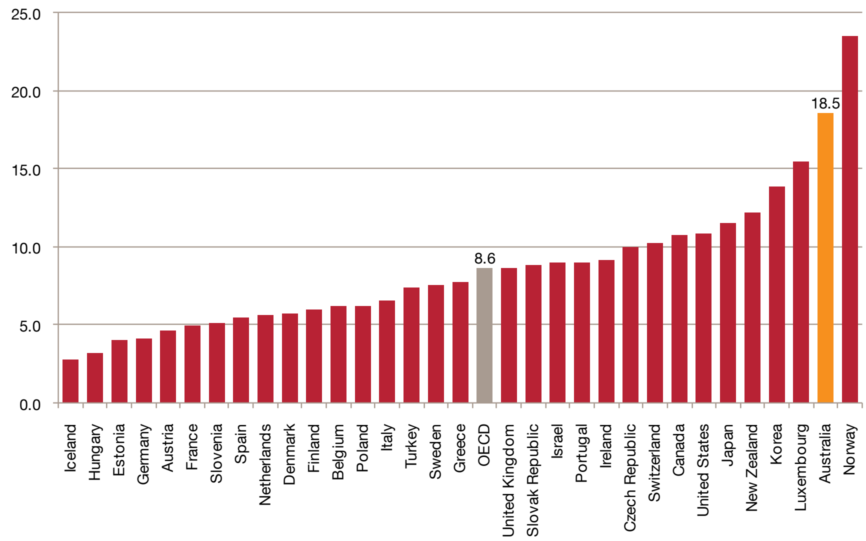
Tax revenue generated by consumption taxes, however, is generally lower than the OECD average (Figure 8). However, these taxes, along with taxes on land, are generally more stable and encourage saving.

Table 1: Assessment of Australian taxes against OECD countries[4]

Principle		Rating
Equity	Burden of tax & ability to pay	🟡
	Non-discrimination	🟢
	Limits to inter-generational impacts	🟢
Efficiency	Economic distortion (elasticity and mobility)	🔴
	Application of tax (broad)	🔴
	Effect on production	🔴
	Competitive levels of taxation	🔴
	Administration costs	🟡
Fiscal sustainability	Revenue to support essential service provision & revenue growth over time	🟡
	Limit vertical fiscal imbalance (VFI) between the levels of government	🔴

Source: PwC analysis on the basis of OECD reviews of tax and growth, and the academic literature

Figure 7: Corporate tax revenue, % of total tax revenue, 2010



Source: OECD 2012 ***Revenue Statistics 1965-2011****, 2012 Edition*

3. Daley, J. McGannon, C. and Savage, J. 2013. *Budget pressures on Australian Governments*. Grattan Institute, Melbourne
4. Traffic light reporting has been used to illustrate how Australia compares with other OECD countries with respect to the principles of a good tax system. A green icon suggests that Australia's tax system, or certain features of it, is consistent with or compares well against the other OECD countries; an orange icon suggests that our tax system, or certain features of it, is not completely consistent with the tax systems of other OECD countries; and a red icon suggests that our tax system, or certain features of it, is comparatively worse than other OECD countries.

What could a change in the tax landscape deliver?

Australia faces a historic choice in the years ahead. It could cut government services radically, it could build tax revenues by incremental change, or it could prioritise growth through carefully targeted expenditure cuts and tax reform.

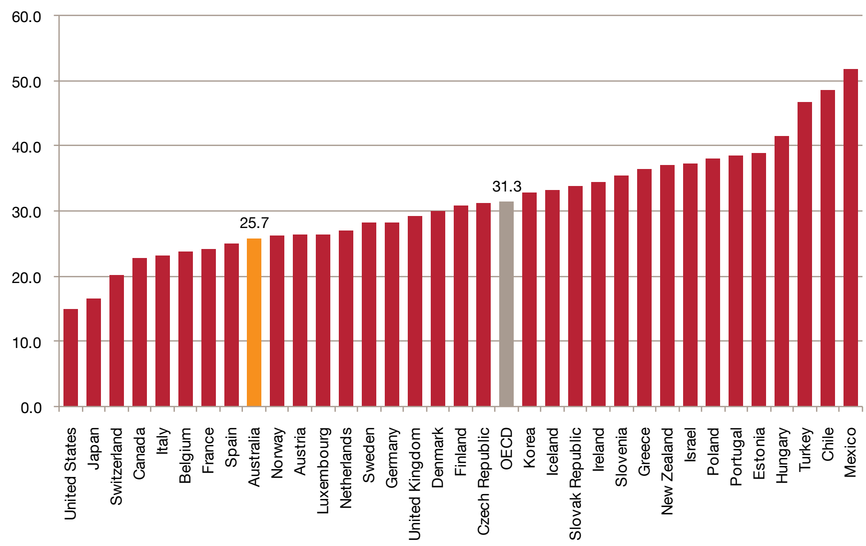
Poorly considered expenditure cuts and increases to growth-distorting taxes, such as company tax, personal income tax and stamp duty, will reduce economic growth and have broader impacts on the poor and vulnerable.

With carefully targeted expenditure restraint linked with comprehensive tax reform, we could help rebuild budget resilience at a state, territory and Commonwealth level, and increase the financial independence of states and territories. There would be a boost to economic growth, productivity and real per-person incomes if:

- Australia relied more on consumption and land taxes, and less on corporate and personal taxes, stamp duty, taxation of insurance, and payroll taxes in their current form
- taxes were more uniformly applied with fewer exemptions and concessions.

These two changes – together with expenditure restraint - have the potential to address the major economic and fiscal challenges facing Australia today. Any increase in GST revenue paid to states and territories – beyond that needed to make an appropriate contribution to restoring fiscal resilience – could be offset by a reduction in Commonwealth-tied payments. This would give the states and territories greater autonomy, provide latitude for states and territories to reduce or improve the targeting of inefficient taxes (eg stamp duty and payroll tax), and offer scope for reducing Commonwealth-state overlaps. It would also free up revenue for the Commonwealth to fund appropriate compensation through the personal income tax and transfer[5] systems to offset the effects of a broader or higher GST on the most vulnerable.

Figure 8: Consumption tax revenue, % of total tax revenue, 2010



Source: OECD 2012 ***Revenue Statistics 1965-2011****, 2012 Edition*

Such changes to the tax landscape, however, could bruise some of our other tax principles:

- Shifting the burden of tax to consumption tax and land tax may place more relative pressure on lower-income and older Australians who are home-owners.
- Rebuilding budget resilience will mean that not all the losers from the changes can be compensated.
- Reducing the corporate tax rate will confer some benefits on foreign investors and on some high-wealth Australians through capital gains.

The big question is whether the growth, private income and budget resilience gains from tax reform would be enough to support an effective strategy for protecting the more vulnerable in our community and ensuring a smooth transition. However, it is likely that it would be preferable to the alternatives: burgeoning deficits; savage cuts to government expenditure; or uncoordinated increases in taxes which distort behaviour and impede economic growth.

The way forward

Tax reform requires more than just the right conceptual solution. Previous efforts at tax reform have often failed to achieve meaningful change because certain elements were missing.

Successful reform requires some key conditions to be present. For example:

- a broadly based understanding that our public finances are unsustainable without change
- public acceptance that the hard work on making reductions in government expenditure has begun in earnest, before tax changes are considered
- public and political support for change
- appropriate compensation but also an acceptance that not everyone can be made better off
- a willingness to balance competing interests
- an ability to develop an emerging and at least tacit bipartisan consensus.

None of these conditions is easy to achieve but they can be established with an understanding of the problems tax reform should address and an emerging consensus on the way forward.

5. The transfer system consists of government welfare payments and tax relief provided to individuals and households.

An important concept, but one that is difficult to explain, is that it is Australian households who bear the principal tax burden, even for those taxes which are ostensibly focused on business. This is because business will often be competitively forced to pass those taxes on through prices, which affect consumers, or through lower wages or lower employment. Taxes can lead to Australia failing to secure foreign investment, with impacts on employment and income, which will affect households.

Reform is best achieved if any changes are part of a comprehensive package of tax and transfer or welfare payment changes. It is also necessary that it be seen as part of a coherent strategy for lifting incomes and resilience which also involves restraint in government expenditure. Public acceptance of reform, as well as business confidence, is damaged by continual ad hoc changes to taxes, allowances, investment rules and superannuation.

Although there is now some acknowledgement of the importance of these issues, in the past political leaders have found tax reform a difficult discussion to sustain given the complexity of the issues, the indirect and dispersed nature of many of the benefits, and the clear and direct effect on the potential losers. This has sometimes led to proposals being rushed and options prematurely foreclosed. As a result, Australia's record of comprehensive tax reform has been poor.

A lesson from Australia's major economic reforms is that public and political will for reform is possible, but only if the timeframes are realistic and there is a body of business, civil society and public policy leadership with a clear strategy for change. That groundswell of opinion will only emerge from an open and respectful conversation among all the stakeholders to design a tax and transfer landscape that will build growth and protect equity.

Questions we need to answer

Leaders of civil society (including welfare groups and unions), business and policy makers must be engaged in sustained conversation on a comprehensive approach to reform. If we are to realise the potential benefits for Australians across all parts of our society, that conversation needs to focus on some key questions:

- the challenges facing government spending and revenue as the community ages and the mining boom declines
- the need to sustainably lift productivity and the workforce participation of older Australians and women with children
- the opportunities to lift growth, productivity and participation, and to secure government finances, through comprehensive tax reform and targeted government expenditure restraint
- the implications for the vulnerable and lower-income groups, as well as higher income Australians and foreign investors, of comprehensive reforms in tax and government expenditure constraint
- the means to ensure that all Australians, over time, can share in the benefits of higher growth, while protecting the vulnerable and lower income groups in the transition.

The case for action

Key messages

- Australia has enjoyed more than 22 years of largely continuous growth in real per-person incomes:
  - In the 1990s and early 2000s this flowed principally from productivity growth.
  - From the mid-2000s, however, productivity levels declined and this position was only maintained because the prices of our exports, particularly minerals, have risen and the prices of our imports – such as televisions, computers and cars – have fallen.
- Since the early 1990s to the mid-2000s, governments at all levels were able to build a strong budget position, with low debt levels due to a combination of asset sales, strong revenue growth and some expenditure restraint.
- However, following the GFC this position changed dramatically, with the Commonwealth Government, and many state and territory governments, now in deficit.
- Real income growth and strong budgets are at risk if productivity stays low and export prices fall. We could see falls in real per-person income for the first time in a quarter of a century, and unless we rebuild strong budgets, governments might not be able to cushion us from the next global shock as they did from the GFC.
- State and territory governments in particular face a great challenge because the income they receive from the GST has grown more slowly than the demands they face.
- Ultimately, simply cutting waste is not going to be enough to do everything we wish: rebuild strong budgets, help fund community priorities like DisabilityCare, education reform, and infrastructure in our cities and regions; and lift our defence investment back to the long-term average.
- Significant action is required to enable governments to boost revenues and address current deficits. Tax reform is the most comprehensive way to address these issues.
- If we do this the right way – by lifting only those taxes that have the least effect on economic growth, reducing our reliance on taxes that are damaging and targeting any compensation measures at the most vulnerable – then tax reform can also help us drive productivity growth and lift real incomes per person.

Significant action is required to enable governments to boost revenues and address current deficits.

Is Australia's golden age at risk of ending?

Australia has had more than 22 years of almost continuous growth in real incomes per person. Continuous economic growth over such a long timescale is the envy of most advanced countries. This growth has been sustained in spite of external shocks like the Asian Financial Crisis, the technology share market collapse, the GFC and the deep problems in the eurozone.[6] Even the dip in real per-person incomes at the height of the GFC was modest and short-lived (Figure 9).

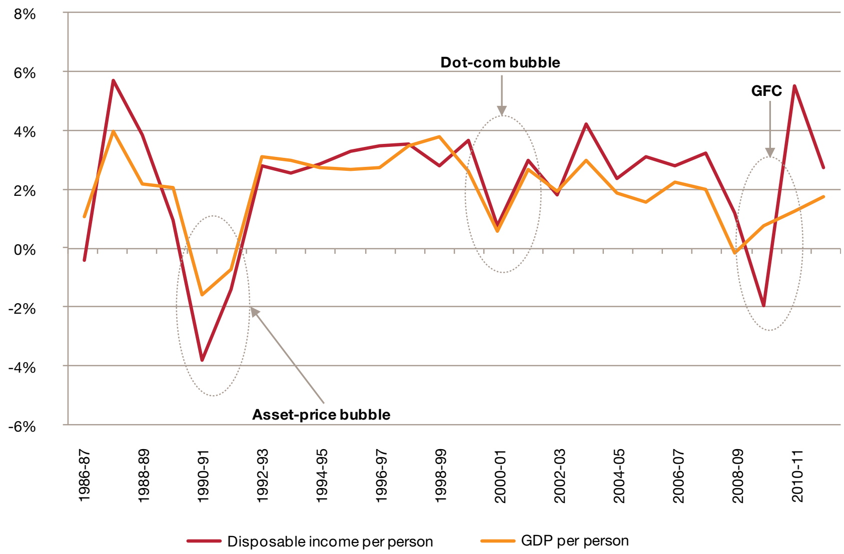
In part, we recovered so quickly from the GFC because Australian governments were able to put in place substantial discretionary stimulus in both fiscal and monetary policy, while maintaining a relatively strong fiscal position.[7] This was because they went into the GFC with a budget surplus and negative net debt. Australia also was helped by strong stimulatory action by China, which maintained the demand for our exports, particularly minerals.[8]

However, there are a number of reasons to believe that there are risks to continued growth in per-person incomes or government budgets. The main causes for concern are:

- Our productivity – growth in the value of what we produce for each hour we work and each dollar we invest – has been low over the past decade, until very recently when it rebounded somewhat. Without strong productivity growth, it is hard to sustain real wages and employment growth.
- Prices for Australian exports, particularly minerals exports, have either stabilised or reduced relative to their peak, and are expected to fall further.[9]
- As our population grows older, fewer people as a proportion of the total workforce are willing or able to work. This is beginning to happen now as the eldest of the baby boomer generation reach retirement age, and will speed up in the years ahead. This reduced workforce participation means lower growth in the economy overall and lower per-person incomes.
- GST revenue, on which Australia's states and territories rely heavily, has not recovered since the GFC. This is in part because the community is saving more. While this is a good thing, it means lower revenue for the states. Also, where consumers are spending more, an increasing share of this consumption is in areas not covered by the GST, such as private health, private education, fresh food, and (less importantly) small online purchases, further dampening growth.
- The relatively strong budget position at the Commonwealth level entering the GFC was not underpinned by sustainable expenditure and revenue arrangements. Instead, budget balances have become heavily reliant on revenue boosted by cyclical factors and the continuation of 'good times' associated with strong commodity prices.[10] With the easing of commodity prices, there is further risk to the ability of governments to bring budget deficits back into line.
- A range of expenditure commitments were entered into on assumptions of revenue streams from carbon pricing and the Minerals Resources Rent Tax, which are not likely to be met.
- Flat or volatile revenue growth at the same time as there are expectations of increased funding for critical services means that it will be hard for all levels of government to rebuild the strong fiscal position that the times call for.

While assessing the efficiency of current spending and cutting wasteful spending will provide one part of the solution, it is unlikely to adequately address current, and more particularly future, deficits.

Figure 9: Disposable income per person and GDP per person, Australia, annual % change



Source: ABS Cat No. 5204.0

6. Commonwealth of Australia. 2010. *Australia to 2050: Future challenges*. January 2010. Canberra: Australia
7. McDonald, T., and Morling, S. 2011. 'The Australian Economy and the global downturn. Part 1: Reasons for resilience'. *Economic Roundup Issue 2, 2011*. Canberra, Australia
8. Connolly, E., and Orsmond, D. 2011. 'The Mining Industry: From bust to boom'. *Research Discussion Paper*. Reserve Bank of Australia, Sydney
9. BREE. 2013. *Resources and Energy Quarterly*. March Quarter 2013. BREE, Canberra
10. Maher, Sid. 2013. 'Decade of deficits' puts focus on spending cuts, says new economic modelling'. *The Australian*. 4 March 2013

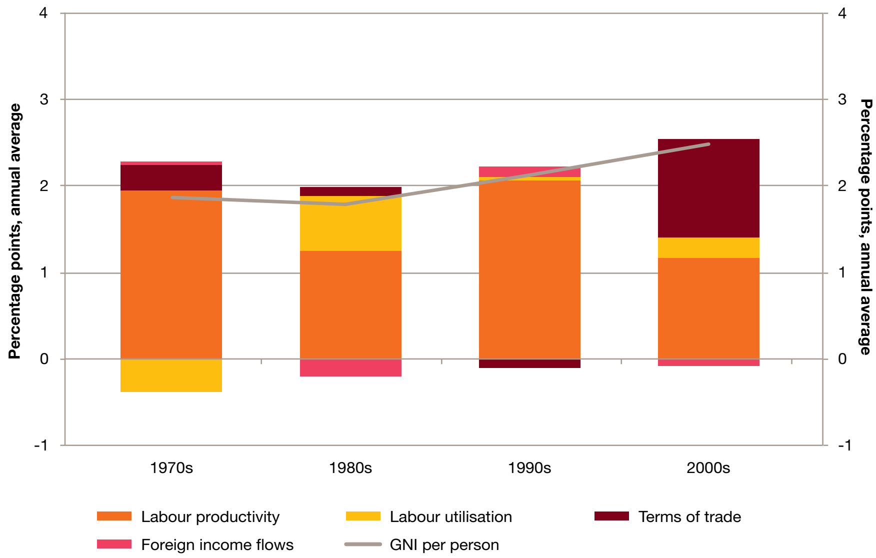
Risks to per-person income growth – productivity, prices and participation

We can get a better sense of the challenges ahead by looking at why we have grown so strongly in the past.

Real per-person incomes provide a useful measure of societal wellbeing or living standards and are directly related to the purchasing power of Australians. A number of factors directly influence growth in real per-person income, including productivity, terms of trade (the price for our exports compared to what we pay for imports) and labour force participation.

The picture over the past four decades is very clear (Figure 10). There was strong productivity growth in the 1970s offset by a decline in labour force participation as the effect of very low birth and immigration rates in the great depression years outweighed the beginning of the post-war baby boom. In the 1980s, productivity slumped but this was offset by the net impact of the baby boomer generation which supported workforce growth. Almost all the growth in real per-person incomes in the 1990s can be explained by productivity growth. As we reached the 2000s, productivity growth once again slipped to low levels but this time real incomes were supported by strong terms of trade underpinned by the positive surge in minerals prices and falling cost of imported products.

Figure 10: Contribution to growth in average incomes, by decade



Source: Australian Treasury calculations based on ABS cat. no. 5206.0, 6202.0 and unpublished ABS data Dolman, B and Gruen, D. 2012. 'Productivity and Structural Change'. ***41st Australian Conference of Economists. 10 July 2012***

The productivity story

Productivity measures the volume of production or output – that is, goods and services – for a certain volume of input (generally hours worked).[11] Productivity growth occurs when the volume of outputs increases for the same amount of work hours, and generally this can be linked to:

- development and use of new technologies (innovation/research and development, and capital investment)
- investment in capital and fixed resources (eg plant, equipment) which enable labour to produce more, for less effort
- workforce education and skills
- the effective organisation of the factors of production (labour, capital and fixed resources such as land)
- relocation of production and employment from less productive to more productive options.

Productivity matters because it 'grows the cake' per person, and assumptions regarding productivity levels significantly affect forecasts of economic growth. It does not guarantee real wage rises, but it creates the room for real wage rises without cutting job growth.

During the 1990s, productivity growth played a significant role in driving real per-person income growth and it is widely recognised that this surge in productivity was a result of economic reforms introduced in the 1980s and 1990s.[12] These reforms removed tariffs and subsidies, broke up monopolies, increased competition and also sought to improve work practices. They resulted in direct productivity gains, such as better utilisation of labour and capital, as these factors of production moved to sectors with higher returns and growth prospects. Indeed, productivity performance, as measured through real GDP per hour worked, increased during the 1990s, exceeding the long-term average (Figure 11).

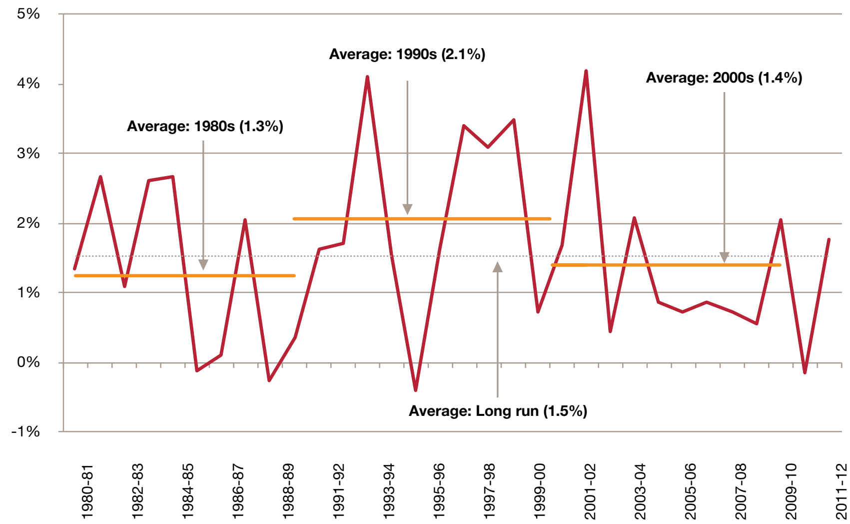
11. PwC. 2012. *Productivity Scorecard*. September 2012. The PwC Productivity Scorecard is a quarterly analysis of labour productivity by state and territory and across 16 key sectors. Copies of the publication are available at: http://www.pwc.com.au/consulting/publications/productivity-scorecard-series.htm
12. Parham, D. 2012. *Australia's Productivity Growth Slump: Signs of crisis, adjustment or both?*, Visiting Researcher Paper, Productivity Commission, Canberra; Megalogenis, G. 2012. *The Australian Moment*. Penguin Australia

Productivity performance in the 2000s has been quite different, with productivity levels actually falling below the long-term average. This can be attributed to the fading effect of earlier micro-economic reforms, along with heavy investment in mining development and infrastructure in power, water and communications. These investments take a long time to pay off – for example, desalination plants started during the millennium drought will not offer any real return unless they are needed again in a future major drought. Huge mining developments also take time to produce a return, and higher mineral prices have encouraged lesser quality mineral resources to be developed, requiring more investment per tonne of product.

Productivity levels were also much lower than the United States (Figure 12), along with a large number of Western European countries and a growing number of Asian economies.[14]

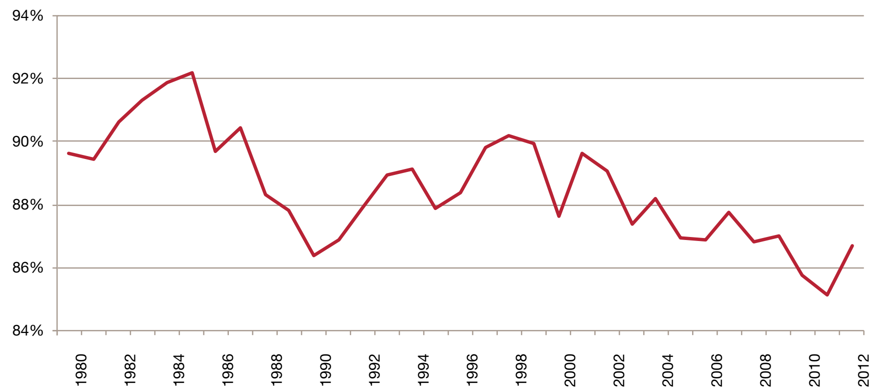
While there have been seven quarters of stronger productivity growth in the past two years, this is in part a cyclical rebound (the productivity series is quite volatile over short periods). Partly it reflects the lag between major capital investments in the mining sector and the increased production and revenue that they are now generating. It also likely reflects the shake-out of the lowest performing firms in the manufacturing and services sector placed under pressure by the high Australian dollar. There is insufficient evidence to conclude that we have moved to a sustained higher productivity growth path – a suitably conservative assumption would be to use an average of the productivity series over the past decade and a half. This would produce an annual productivity growth rate of 1.5%, higher than the long-term average, but much lower than the 1990s productivity surge.

Figure 11: Australia's labour productivity: Real GDP per hour worked[13]



Source: ABS Cat No. 5206.0 and 6202.0

Figure 12: Australia's labour productivity relative to the United States (%)



Source: The Conference Board Total Economy Database™, January 2013, http://www.conference-board.org/data/economydatabase/

13. Australian Bureau of Statistics, 2012. *Cat. 5260.0.55.002 Estimates of Industry Multifactor Productivity, Australia: Detailed Productivity Estimates*. [Online] Available at: http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/5260.0.55.002Main+Features12011-12?OpenDocument. [Accessed 3 March 2013]
14. Eslake, S. 2011. *Productivity: The lost decade*. Reserve Bank of Australia, Sydney

The export price story

While this deterioration in Australia's productivity performance during the 2000s could have seen reductions in the living standards of Australian citizens, real per-person incomes continued to grow. This was due to a surge in Australia's terms of trade to their highest level in at least 140 years, underpinned by a strong resources sector, which offset declining productivity levels.[15] At the same time, the value of the Australian dollar relative to the United States dollar and the currencies of other advanced economies also surged.

Our export prices have now stabilised or started to fall so they are no longer expected to lift our real incomes.[16] Budget forecasts assume that terms of trade will decline from their peak by 9% to 2014-15 and 16% to 2023.[17] Despite falling commodity prices and terms of trade, the Australian dollar has until recently, remained defiantly high, significantly affecting trade-exposed sectors of the economy.

These factors, combined with low (or declining) productivity performance, reductions in workforce participation associated with an aging population, and the absence of productivity-enhancing reform measures, mean that per-person incomes may fall for the first time in nearly a quarter of a century. Accordingly, in line with forecast lower terms of trade, any future growth in living standards is expected to be driven by productivity growth.[18]

The population and participation story

The population is aging, and birth rates, while they rebounded in the first decade of the 21st century, are now stable. These factors affect workforce participation rates and therefore affect economic growth.

Over the past few decades, labour participation rates have been increasing and actually peaked around 2010. This was partly due to a higher proportion of the population in the prime working years of life, along with higher labour force participation by women. It also reflected increased participation by older people, partly as a result of decisions to defer retirement following the GFC, and in part because of improving health among older Australians. The combination of increased workforce participation by women and older workers in the short term effectively reduced the impact of the aging of the population on per-person income levels.[19]

Estimates of economic growth and per-person incomes are quite sensitive to small changes in workforce participation rates. In the years ahead, the impact of population aging on workforce participation is expected to accelerate if there are no changes to the timing of access to pension entitlements and superannuation. Already, the participation rates of older workers (aged over 55) and women might have reached a plateau.[20] However, a finer disaggregation of age-specific participation rates might tell a more optimistic story of the prospect of a larger proportion of older people continuing to work into their later 60s and early 70s.[21]

While there is some uncertainty regarding movements in participation rates, it is expected that demographic change will, in the absence of interventions, be a drag on economic growth, growth in per-person incomes and government revenues at all levels. Moreover, it will simultaneously increase demands for pension, aged care and health expenditure.[22]

15. Eslake, S. 2011. *Productivity: The lost decade*. Reserve Bank of Australia, Sydney
16. Kent, C. 2013. 'Reflections on China and Minister Investment in Australia' *Address to the Committee for Economic Development Australia*. Perth, 15 February 2013; Gruen, D. 2012. *The Importance of Productivity*. Productivity Commission-Australian Bureau of Statistics, Productivity Perspectives Conference, 20 November 2012
17. Treasury. 2010. *Mid-year economic and fiscal outlook (MYEFO)*. The Treasury, Australia. Accessed on May 2013. [Accessed at: http://budget.gov.au/past_budgets.htm]
18. Parkinson, M. 2012. 'Challenges and opportunities for the Australian Economy. *Speech to the John Curtin Institute of Public Policy, Breakfast Forum*, 5 October 2012
19. Reserve Bank of Australia. 2013. 'Box C: The Labour Force Participation Rate' *Statement on Monetary Policy*. Sydney
20. Reserve Bank of Australia. 2013. 'Box C: The Labour Force Participation Rate' *Statement on Monetary Policy*. Sydney
21. Daley, J., McGannon, C., and Savage J. 2013. *Budget pressures on Australian governments*. Grattan Institute, Melbourne
22. Daley, J., McGannon, C., and Ginnivan, L. 2012. *Game-changers: Economic reform priorities for Australia*. Grattan Institute, Melbourne

Conclusion

The continuation of strong real per-person income growth is critical for ensuring high living standards in the future. Although strong export prices and falling import prices have enabled real incomes to grow despite falling productivity levels, these two factors are substantially beyond our national control, being a function of global movements in prices and global minerals demand and production.[23] Commodity prices have already stalled.

Productivity, on the other hand, is at least partly within our control. Rebuilding productivity growth through targeted reforms will help Australia cope with shocks, including from the possible decline in our export prices, and will offset the impact of an aging population. Addressing productivity levels is therefore critical given its importance for living standards and real per-person incomes, and "in the long run, productivity growth – producing more from the same inputs – is the only sustainable way for future generations to enjoy higher living standards".[24]

We also have some capacity to influence workforce participation by older Australians and women. This would require new incentives through changes to childcare support, effective tax rates, and timing of access to superannuation and the aged pension.[25]

Fiscal challenges for Australian governments

During the 1990s and into the 2000s, Australia's government fiscal balances were rebuilt to a strong position, largely due to asset sales and strong tax revenues. In the years before the GFC, rapidly rising commodity prices provided a major boost to company profits and wages growth in resources and in resources-related industries. This, combined with strong asset price growth, a maturing capital gains tax system, and strong household consumption growth, meant strong growth in tax receipts. Governments also felt confident enough to provide reductions in income tax rates, despite the fact that structural balances might not have been as strong as underlying cash balances.[26]

> ***"In the long run, productivity growth – producing more from the same inputs – is the only sustainable way for future generations to enjoy higher living standards".[24]***

23. With high prices for minerals come incentives for mineral resources development in other countries, including developing countries. Future commodity prices are therefore expected to be directly affected as new supply comes on line
24. Parkinson, M. 2011. 'Sustaining growth in living standards in the Asian Century'. *Address to the Seventh Economic and Social Outlook Conference*. Melbourne, 30 June 2011
25. Daley, J. McGannon. C and Ginnivan, L. 2012. *Game-changers: Economic reform priorities for Australia*. Grattan Institute, Melbourne
26. Parliamentary Budget Office. 2013. *Estimates of the structural budget balance of the Australian Government: 2001-02 to 2016-17*. Parliament of Australia, Canberra

It was this strong public sector balance sheet that provided the Commonwealth Government with the flexibility to respond to the GFC through discretionary stimulus, without exposing Australia to undue credit risk. Even today, Commonwealth finances are strong and the extent of confidence in Australia's public finances continues to be reflected in Australia's AAA credit rating.[27]

However, governments at all levels are facing a challenging situation.

Increasing budget deficits for Australian governments

The Commonwealth Government is now operating a budget deficit and has been for the past four years, due to a range of factors including the GFC and a reduction in company tax and capital gains tax. While our deficits are comparatively low when compared to other OECD countries, a return to surplus has been more difficult than anticipated. This position is also inconsistent with the primary objective of fiscal policy to maintain a budget surplus, on average, over the medium-term.[28]

Concerns over budget deficits are also amplified when considered though the lens of 'structural' budget balances. Structural budget balances adjust for major cyclical and temporary factors and can provide an indication of the health of a government's balance sheet and debt sustainability. Recent reports have suggested that it is structural rather than cyclical factors driving Australia's increasing budget deficits, reflecting actions by current and former governments to reduce taxes (personal income taxes, fuel excises) and increased spending levels.[29] According to estimates by the Parliamentary Budget Office, Australia moved into a structural deficit of around 3.25% to 4.25% in 2011-12, and while this has recovered somewhat, even with proposed savings it is expected to remain around 0.25% to 1.5% of GDP in 2016-17.[30]

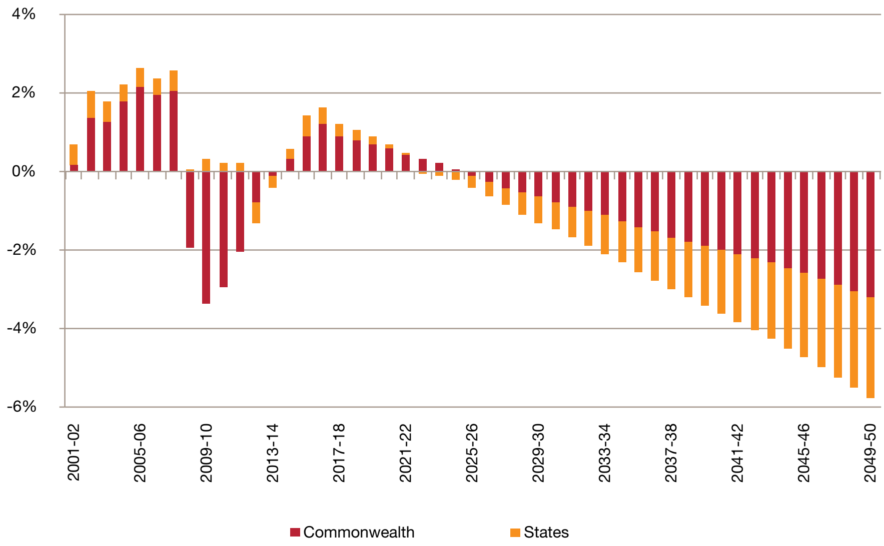
This short- to medium-term problem is exacerbated by:

- an aging population, which over time is expected to reduce participation rates and earnings, and at the same time add to government costs
- growth of per capita medical expenditure driven by technology and rising expectations[31]
- the expectation that the strong tax revenues of the early 2000s are unlikely to return, due to a range of factors (eg the GFC, continued subdued asset price rises, and a reduction in company tax and capital gains tax revenues)[32]
- the expectation that GST revenue growth, which is critical for the states, is unlikely to rebound.

The longer-term implications for fiscal balances at the Commonwealth and state/territory level of an aging population (with its associated demand for services) and low productivity are quite significant. PwC modelling to reflect these long-term forces shows a growing fiscal gap at all levels of government if expenditure and revenue policies remain unchanged, and productivity continues at the average of the past 15 years.

While the 2013 Budget suggests a return to a surplus in the years ahead, modelling using the long-run underlying drivers of the economy – productivity, participation and population – suggests that this might be difficult to achieve and sustain (Figure 13).

Figure 13: Primary balance: Commonwealth and state/territory governments, % of GDP

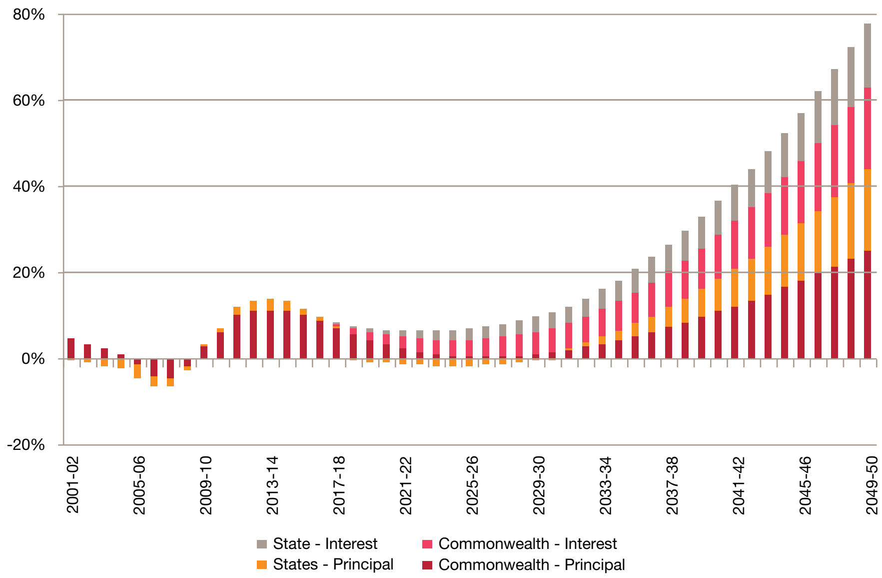


Source: PwC analysis
Note: The primary balance is defined as the difference between revenues and expenditures, excluding interest transactions. This chart uses official budget forward estimates where they are available. To this extent it relies on budget estimates of future revenue growth and expenditure paths. It is based on an assumption of a steady 1.5% improvement in productivity each year.

27. Parkinson, M. 2012. 'Challenges and opportunities for the Australian Economy'. *Speech to the John Curtin Institute of Public Policy, Breakfast forum*. Perth, 5 October 2012
28. Australian Government. 2012. 'Statement 4: Building resilience through national savings'. *Budget 2012-13*. Treasury, Canberra
29. Parliamentary Budget Office. 2013. *Estimates of the structural budget balance of the Australian Government: 2001-02 to 2016-17*. Parliament of Australia, Canberra
30. Parliamentary Budget Office. 2013. *Estimates of the structural budget balance of the Australian Government: 2001-02 to 2016-17*. Parliament of Australia, Canberra
31. Daley, J. McGannon, C. and Savage, J. 2013. *Budget pressures on Australian Governments*. Grattan Institute, Melbourne
32. Australian Government. 2012. 'Statement 4: Building resilience through national savings'. *Budget 2012-13*. Treasury, Canberra

Based on these trends, it is estimated that total general government debt will grow for both levels of government, with the cumulative deficits of all governments as a proportion of gross domestic product (GDP), rising from 12.1% in 2011-12 to 32.9% by 2039-40, and then to 77.9% by 2049-50. Rising net debt levels for governments also means increasing costs associated with servicing interest payable on this public debt. Figure 14 shows the path of debt with capitalised interest if these costs are not met along the way. In particular, it highlights that debt interest payments contribute to almost half of the total liabilities (or 34% of GDP) by 2049-50.

Figure 14: Total public net debt, Commonwealth and state/territory governments, with public debt interest capitalised from 2016-17, % of GDP



Source: PwC analysis

A growing list of spending pressures

Underlying, but not fully reflected in, this fiscal position is a growing list of spending pressures. These include:

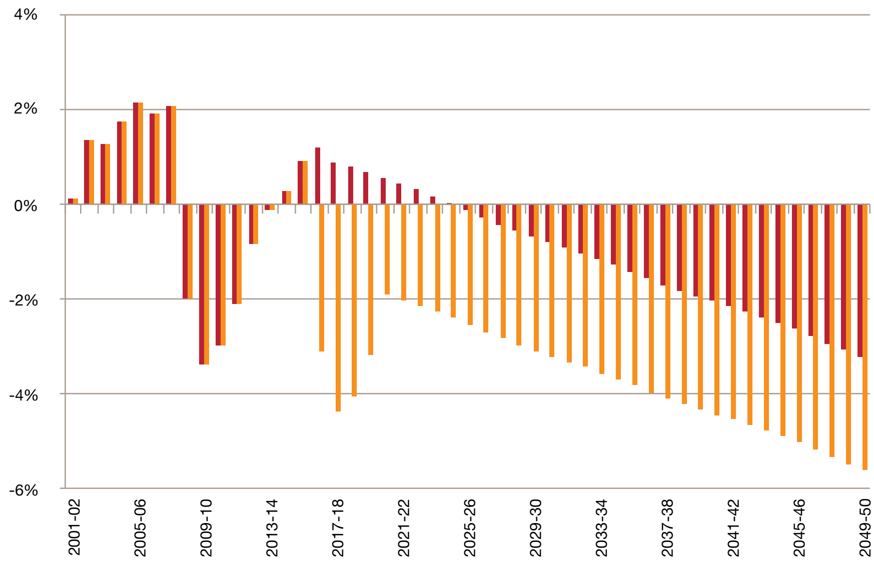
- **Increasing costs and demand for health care and related services** – demand for health care services in all Western countries is increasing rapidly. This is underpinned by:
  - the development of advanced health technologies, ranging from diagnostic equipment to biomechanics and pharmaceuticals, which means that while our ability to diagnose and treat patients improves so too do the costs of providing this higher level of service
  - increasing community demand at every age level for medical services, as people see doctors more often, have more tests and operations, and take more prescription drugs[33]
  - an aging population, which continues to place demands on the system and generate the need for continued investment in health and aged care policy initiatives.

  Improvements in the quality of care are having direct benefits – by increasing life expectancy and reducing morbidity – but this has come at a cost.
- **An aging population and greater demand for aged care policy initiatives** – an aging population will mean slower population growth rates and workforce participation rates, along with increased costs to governments as demand for aged care services expand. Indeed, the community expects much higher standards of aged care services than those received by our parents. An increase in the number and proportion of aged persons also drives greater payments of age-related pensions. This area of expenditure is expected to grow at a faster rate than GDP, meaning that it will take up a larger share of the economy over time.[34]
- **Population growth and increased demand for economic and social infrastructure** – a growing population, albeit at a slower rate than the past, needs to be supported by adequate infrastructure. This includes economic infrastructure, such as effective transport networks, communication and information technology infrastructure, and also health and social infrastructure. Infrastructure also needs to support changes to the composition of families, a reduction in household size, and changes in ethnic composition.
- **Responding to increasing welfare costs** – welfare costs are the single largest category of Commonwealth Government spending, at around 22%.[35] But there have been mixed trends across different types of welfare payments. Payments such as Newstart, Youth Allowance and Parenting Payments have been falling in real terms. It has also emerged that households dependent on payments, such as Newstart, are more financially stressed and likely to remain in poverty for an extended period, when compared to other households.[36] There is now significant pressure to increase the level of Newstart. Spending on pensions, on the other hand, has been growing faster than GDP, despite an increasing number of people retiring with superannuation. This is linked to the easing of asset and income tests introduced by former and current governments, and the generous treatment of owner-occupied housing compared to other asset classes.

33. Daley, J. McGannon, C. and Savage, J. 2013. *Budget pressures on Australian Governments.* Grattan Institute, Melbourne
34. Parkinson, M. 2012. 'Challenges and opportunities for the Australian Economy'. *Speech to the John Curtin Institute of Public Policy, Breakfast forum.* Perth, 5 October 2012
35. Daley, J. McGannon, C. and Savage, J. 2013. *Budget pressures on Australian Governments.* Grattan Institute, Melbourne
36. Phillips, B and Nepal B. 2012. *Going without: Financial hardship in Australia.* NATSEM report prepared for Anglicare Australia. Catholic Social Services Australia, The Salvation Army, UnitingCare Australia. Available at: http://www.natsem.canberra.edu.au/storage/2-Going%20Without%20MCP%20Report_Aug%202012.pdf. [Accessed on 13 May 2013]

- **Improve Australia's performance in education** – while Australia has maintained a relatively high-performing schooling system when measured against international benchmarks, over the past decade there has been declining student performance at all levels of achievement, notably at the top end.[37] This has created increased pressure to introduce effective arrangements for funding schools across all levels of government. Yet there is little evidence to suggest that more money for schools leads to better student outcomes,[38] which could suggest that consideration should be given to how funds are spent, as well as how much.
- **Implementation of a national disability insurance scheme** – Australian governments have agreed to establish DisabilityCare Australia. This scheme is based on a framework for providing care and support to disabled persons, their families and carers. Its implementation will be funded by both Commonwealth and state governments. The Commonwealth Government has announced an additional levy which will meet part but not all of the cost.
- **Any action to restore defence expenditure as a proportion of GDP** – Australia's defence spending sits at around 1.8 % of GDP.[39] This is lower than the long-term average and some expert commentators argue that a 2.5% minimum is required to sustain a credible defence capability.[40] In the recently released Defence White Paper the Commonwealth Government flagged its commitment to increasing defence funding towards a target of 2% of GDP.[41]

Figure 15: GFC type shock in 2016-17, primary balance, % of GDP



Source: PwC analysis

Expectations of support during economic shocks

There is also a general expectation that in the face of future economic shocks, governments will once again be able to step in to cushion any adverse impacts through automatic stabilisers and discretionary fiscal stimulus.

However, unless we rebuild strong budgets, the Commonwealth Government might not be able to cushion us from the next global shock as it did from the GFC. A global shock in the next decade could result from:

- the unresolved sovereign debt issues in the eurozone
- soaring government debt in Japan
- failed attempts to control the United States fiscal deficit
- efforts in China to restructure its economy and wind back stimulus
- geo-political stress in east Asia as China grows in economic and military strength
- a broad crisis in the Middle East
- irrational exuberance and business cycles.

Another shock like the GFC could accelerate the slide into debt.

Figure 15 shows the limited ability of the Commonwealth budget to absorb any external impacts, which would compound domestic funding pressures.

A further financial shock in this decade would also bring forward Australian governments' move into deep debt. In particular, sensitivity analysis shows how vulnerable Australia could be to this shock, and how debt can then increase exponentially if no action is taken to cut expenditure or boost revenue (Figure 16).

Declining revenues for state and territory governments

Since the GFC, state GST revenues have been depressed. This is because of increased householder savings and a change in the composition of householder expenditure to favour expenditure which is exempt from the GST (private health, private education, food and smaller online purchases).

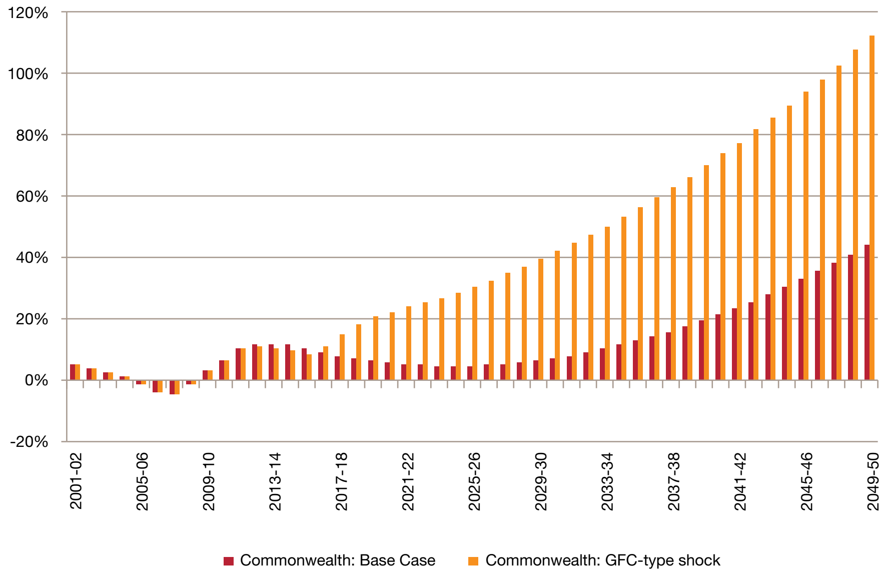
37. Department of Education, Employment and Workplace Relations. 2011. *Review of funding for schooling – final report.* Australian Government, Canberra
38. Jensen, B. Hunter, A. Sonnemann, J. and Burns, T. 2012. 'The Real Issue in School Funding: An Analysis of Increasing Government School Expenditure and Declining Performance.' *Australian Economic Review*, Vol 44 Issue 3, pp 321-329
39. Department of Defence. 2013.2013 *Defence White Paper.* Australian Government, Canberra
40. Brown, J. 2012. 'Weasel words on defence' *The Australian Financial Review.* 13 November 2012, p. 54
41. Department of Defence. 2013.2013 *Defence White Paper.* Australian Government, Canberra

This has resulted in a situation where state expenditure is expected to grow at a much faster rate than GST revenues (Figure 17).

States have also competitively bid down their own tax rates or increased exemptions (eg payroll tax) and in some cases become more reliant on narrow tax bases including stamp duty and gambling taxes. State government debt levels have begun increasing, primarily reflecting increased financing of infrastructure upgrades along with spending on health, education and other services.[42]

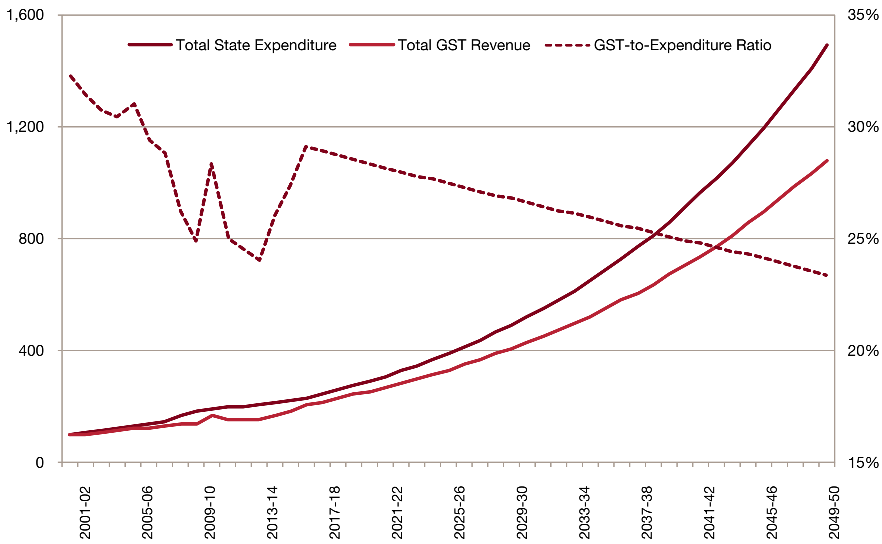
While the states are seeking to redress current debt levels through savings measures, this situation has already resulted in a credit rating downgrade for Queensland and South Australia, and other jurisdictions are at risk of the same unless things improve.[43]

Figure 16: Commonwealth public net debt with a GFC-type shock and public debt interest capitalised from 2016-17, % of GDP



Source: PwC analysis

Figure 17: State expenditure and GST revenue, index:2001-02 = 100 (LHS), GST revenue-to-expenditure ratio, % (RHS)



Source: PwC analysis

42. Di Marco, K., Pirie, M., and Au-Yeung, W. (date unknown). *A history of public debt in Australia*. Treasury, Canberra

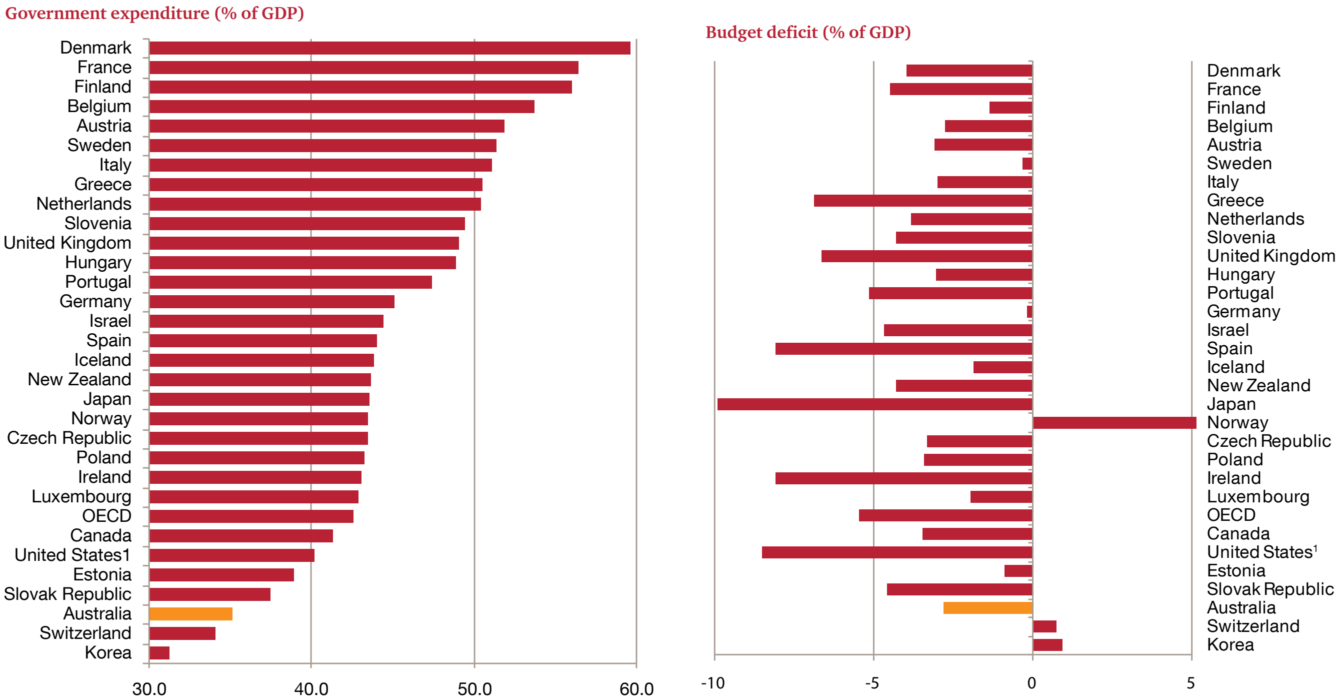
43. Standards and Poor's Rating Services. 2013. *Australian States' Credit Quality Hinges on Cost-Cutting Measures Amid Revenue Pressure.* Accessed online at: http://www.afr.com/rw/2009-2014/AFR/2013/03/21/Photos/0a69343a-91c6-11e2-9e2c-9d27ef4e6daa_AustralianStates_Mar2013.pdf. [Accessed on 6 June 2013]

Conclusion

Governments at all levels will have to be very careful about what they spend and where they cut waste. But Australia is not a big-tax, big-government-spending economy compared with other countries with the same standards of living (Figure 18).[44]

Ultimately, cutting waste is not going to be enough to do everything we wish: rebuild strong budgets; help fund community priorities like DisabilityCare, education reform, and infrastructure in our cities; and lift our defence investment back to the long-term average. Unless the Australian community is prepared to greatly reduce its expectations of the services and benefits governments provide, the only way of rebuilding and maintaining government balance sheets in the long run is to increase revenue and boost economic growth.

Figure 18: Government expenditures and deficits, OECD, 2011



Source: OECD Economic Outlook

44. Much of the difference between Australia and other OECD countries can be explained by the fact that Australia does not levy additional social security taxes. If payments which are effectively compulsory, such as Australia's superannuation guarantee contributions, were added to official tax estimates (or made into a government social insurance scheme), then Australia's tax levels would be closer to the OECD average (around 5% larger). (Daley, J. McGannon, C. and Savage, J. 2013. *Budget pressures on Australian governments.* Grattan Institute, Melbourne)

Tax reform – can it help sustain the golden age?

There are many things we can do to maintain per-person income and strengthen fiscal resilience, including:

- increasing workforce participation by older workers and women with children
- lifting labour, capital and multi-factor productivity
- addressing government balance sheets by restraining expenditure.

Tax reform (and reform in the associated income transfers and concessions) does not compete with these options, but it could be a very important contribution to all these aims.

After looking at all the available literature, the Grattan Institute concluded that tax reform could be one of the three biggest contributors to boosting productivity growth in the medium term (Figure 19).

Conclusion

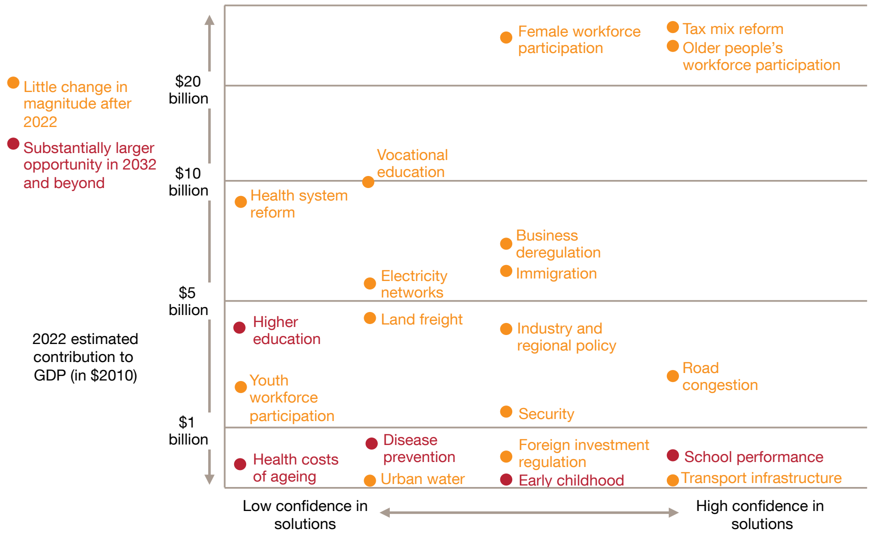
Cutting waste is not going to be enough to rebuild strong budgets and help fund community priorities or lift our defence investment back to the long-term average. We will also need action to lift government revenues through comprehensive tax reform.

If we do this the right way – by ensuring we lift only those taxes that have the least effect on economic growth, and reduce our reliance on taxes that are damaging – then tax reform can also help us lift real incomes per person. This also should include addressing those factors which increase the complexity of the tax system and cost of compliance.

Comprehensive tax reform, and associated changes to benefits and welfare transfers, could also provide incentives for women with children and older Australians to enter or stay in the workforce.

Comprehensive tax reform will not guarantee that the golden age will continue, but it could be part of the story.

Figure 19: Productivity reform priorities



Source: Daley, J, McGannon, C, and Ginnivan, L. 2012. ***Game-changers: Economic reform priorities for Australia****. Grattan Institute, Melbourne.*

Why do taxes affect economic growth?

Key messages

- Taxes are mainly used to support public expenditure to fund services, investment and benefits. They are also used to secure equity, social and environmental outcomes.
- Taxes also affect economic growth because they change decisions:
  - decisions by households to save, to buy services or property, to work or to pursue education
  - decisions by companies to produce, provide jobs, innovate, invest
  - decisions by investors about where and how to invest.
- Globalisation has increased the effect of taxes on growth. Countries like Australia, which are small, open economies highly dependent on foreign investment, trade and skilled migration, and with well developed web-based commerce, have to be increasingly aware of the effect their tax mix can have on competitiveness.
- The simple message is that all taxes affect growth, but some are much more negative for growth than others.
  - Income taxes and means tests can deter people from working at all, can influence them to work less than they would like, can persuade them not to pursue higher skills and even cause them not to work in Australia.
  - Company taxes can cut foreign and domestic investment and the incentive to innovate, in turn cutting growth, productivity and real per-person incomes.
  - Taxes on transactions like stamp duty can stifle deals that would have brought economic benefits to all the parties – businesses or households – as well as the community.
  - Taxes on consumption, like the GST, affect economic growth less because they do not really change behaviours.
  - Taxes on immovable resources (eg land tax) have low economic costs.
- So getting the tax mix right can boost growth and lift productivity.
- The OECD has ranked taxes from most- to least-growth friendly – with recurrent taxes on immovable property (eg land) having the least negative effect on growth followed by consumption taxes (eg GST), other property and environmental taxes and personal income tax. Corporate taxes have the greatest negative effect on growth.
- But taxes are about more than just growth and we cannot lose sight of broader equity considerations.

Taxes, tax concessions, and the government expenditure they fund, impact economic growth because they affect almost every decision we make. Complexity, administrative load and encouragement of avoidance are also features of the tax system that can reduce economic growth. The simpler, easier to implement, and more difficult to avoid a tax is, the less of a drag it will be on the economy (Figure 20).

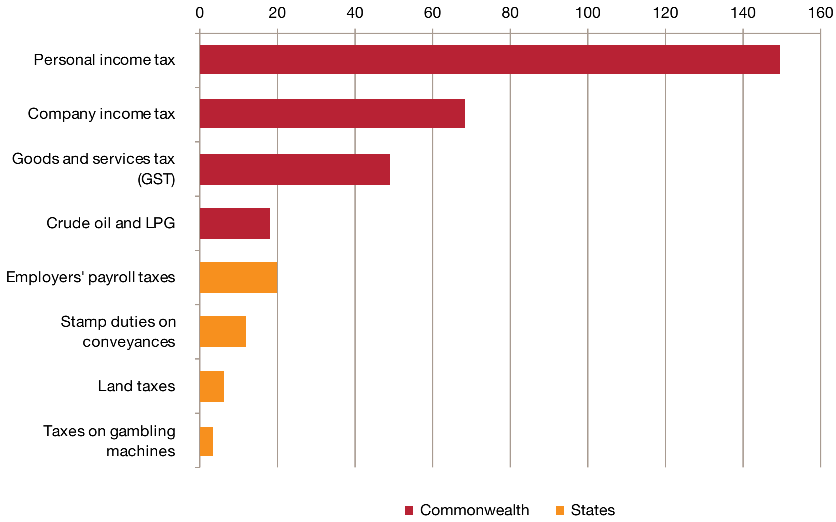
This chapter examines the major taxes at both the Commonwealth and state level, explains why and how they affect economic growth, and sets out which are the most growth friendly.

The major taxes in Australia are summarised in Figure 21.

Figure 20: Taxes affect the determinants of growth

Source: OECD. 2012. Tax policy reform and economic growth. OECD Publishing

Figure 21: Major taxes, Commonwealth and state/territory governments, $mil, 2011-12



Source: ABS Cat No. 5506.0

Personal income tax, tax concessions and transfer payments

Deciding whether or not to work longer hours, or go for promotion, can be influenced by the impact of taxes on actual take-home pay. For many people, longer hours might result in a small net increase in actual income, after allowing for loss of benefits and increased costs (which can include higher taxes and a reduction in any transfer payments). This is particularly so for women with children. Some will decide that the additional effort and responsibility is not worth it. This is a loss to the economy as a job goes unfilled or a less skilled worker is employed.

The same is true for individuals investing in education and training. Where any returns to further education and skills are reduced, the incentive to undertake these activities is also reduced.

Access to a pension or to untaxed superannuation income can encourage fit 60 to 65-year-olds to leave the work force. Unlike earlier generations, many are likely to live for another 20 to 25 healthy and active years. This is a blow to economic growth as we lose some years of work from people with experience and skills.

Box 1: Personal income tax, transfers and incentives to work

George is earning $60,000 a year. His partner, Natasha, stays at home to look after their two young children aged 2 and 4. George and Natasha are eligible for Family Tax Benefit Part A and Family Tax Benefit Part B. Together these payments add $10,172 to George and Natasha's income. After George pays income tax and the Medicare levy (2%), the family is left with a disposable income of $57,925, equivalent to a net average tax rate of 3.5%.

Natasha is on unpaid leave from her job as an office assistant. If she had returned to her job for three days a week, she would have been earning $27,000 a year. With their children in long day care for three days a week at $5.60 an hour, George and Natasha would be eligible to claim $14,824 in Child Care Benefit and Child Care Tax Rebate. The family's private income would be $87,000 and their disposable income would be $71,640. Effectively Natasha has paid 48% of her extra income in net childcare costs, tax and loss of benefits. This is a very high effective marginal tax rate and is a disincentive for many women with children to return to the paid workforce.

Business taxes

In a similar way, business taxes can affect investment decisions. Australia depends on overseas investment to fund many projects. Overseas investors look at a whole raft of issues that affect the return they can expect from investing in Australia, and obviously one of them is tax. If business taxes are higher than in other countries offering similar rates of return, we can lose in the competition to attract investment. Investment affects growth directly, but also through its impact on productivity. This is because investment brings with it new plant, equipment and knowhow. In these ways the international competitiveness of our tax system can affect economic growth.

Globalisation has increased this effect. Small open economies with strong trade, e-commerce and transport links are more exposed to the loss of investment and jobs from international competition than larger economies which are less trade-exposed. This is particularly so for economies which depend on the inflow of foreign investment to underpin growth. These economies are also exposed to the erosion of their corporate tax base as global companies, particularly those with a strong e-commerce and intellectual property base, arrange their distribution of assets and income to take advantage of low tax countries in reducing their overall tax bill. Investment, and where it is placed, is important in turn for productivity and living standards. Summer and Hines describe it this way:

> "Some aspects (*of globalisation*) are … foreign direct investment by multinational firms, portfolio investment by individuals and financial institutions, international trade, immigration of individuals, international licensing of intangible property, and other forms of international factor mobility.… the potential mobility of economic activity makes it extremely difficult for governments to exploit monopoly positions over much of their tax bases, thereby greatly contributing to the distortions created in the course of raising tax revenue."[45]

As a result small open economies are generally less reliant on company and income taxes, and more reliant on consumption tax.[46] Australia is a notable exception with a relatively heavy reliance on these revenue sources, and less reliance on consumption tax.

Transaction taxes

Taxes on transactions, such as stamp duty on the sale of a house, property or business, can stop some sales happening.[47] This means that some deals which would have benefited both the seller and the buyer simply do not take place. While this is a loss in its own right, suppressing these deals can have broader impacts. For example it can deter older homeowners from downsizing and making their accommodation available for a family. Younger families will have a harder search for housing, and the incentive to add new larger housing units will increase. This can lead to a misallocation of the housing stock – and perhaps more of our national savings – being spent on housing than would be necessary without stamp duty. It also makes it more difficult for some young people to enter the home ownership market at all. So transaction taxes also affect economic growth and community welfare.

Stamp duties are also highly variable in the amount of revenue they raise. During housing price booms government revenue also booms. The same is true during periods of strong business growth involving large volumes of merger or takeover activity. Conversely, government revenues can collapse if prices stall and acquisition rates slow.

States are particularly dependent on stamp duties and are exposed to these surges and falls in revenue derived from them.

Box 2: Corporate taxes and their effect on investment

Expansion Co is currently looking to set up its regional headquarters in preparation for an expansion into the Asia Pacific market. Based on its business objectives, it could set up these headquarters in either Singapore or Australia.

If Expansion Co were to establish its regional headquarters in Australia, profits would be subject to a flat 30% corporate tax rate. While profits may be offset by allowable deductions and there are concessions for the 'flow through' of income, the corporate tax system is complex and the tax rate is relatively high.

Further, Australia has a two-tiered system of taxes: there are both state and Commonwealth taxes. Not only does this create a significant administrative burden on Expansion Co, but there is tax on the transfer of Australian land (stamp duty and capital gains tax).

In contrast, if Expansion Co established its regional headquarters in Singapore, a flat corporate tax rate of 17% would be the maximum rate applied. Certain income could also be passed through Singapore tax free. Expansion Co could also apply for one of the many incentives offered by the Singapore Government, whereby the rate could be further reduced, and in certain circumstances almost eliminated, for the period during business start-up. Also, Singapore has a single-tiered and relatively simple tax system that has a minimal compliance and administrative burden.

In light of these considerations, other things being equal, it would be more attractive for Expansion Co to set up its Asia Pacific headquarters in Singapore.

45. Hines, J and Summers, L. 2009. *How Globalization Affects Tax Design.* National Bureau of Economic Research
46. Hines, J and Summers, L. 2009. *How Globalization Affects Tax Design.* National Bureau of Economic Research
47. Commonwealth of Australia. 2008. *Architecture of Australia's tax and transfer system.* The Treasury, Canberra

Box 3: Stamp duty and changes to living arrangements

Kate and Lehi are both aged 65 and live in a large, 4-bedroom house in Brisbane. They have a large backyard that requires ongoing maintenance, and as their children have all left home, they are no longer using three of the four bedrooms. They are therefore considering downsizing to a smaller townhouse that requires less maintenance.

After discussions with the local real estate agent they believe they should be able to get around $600,000 for their house. The real estate agent also identifies a number of newly-built townhouses, which are conveniently located near shops and health care services.

After doing more research they realise that these apartments will cost around $600,000 – the same as their family house. And while the apartments are more modern and offer a better lifestyle choice, with the additional expense of stamp duty, the cost of sale is increased by over $40,000.

Kate and Lehi therefore decide to remain in the family home. This results in a sub-optimal allocation of housing stock, as Kate and Lehi are now in a house that is too big for them. At the same time, it removes the opportunity for a young family with children to buy their house, which would arguably be more suitable for their living requirements.

Consumption-based taxes and excises

Other taxes like consumption taxes and excises on fuel have less impact on economic growth.

Consumption-based taxes, such as GST, have a minor impact on increasing savings and reducing spending because although prices are higher, this generally does not deter people from doing their regular shopping, nor affect what they choose to buy. Accordingly, these types of taxes do not discourage investment.

The effect on employment decisions associated with consumption taxes is also likely to be minor. Moreover, because they are applied to imports and refunded on exports, they do not reduce the competitiveness of our businesses. They can, however, influence where growth takes place (and increase the private and public costs of administration) if there are significant exemptions.[48] In the case of Australia, fresh food, private health and private education expenditure are exempted for social and political reasons, and in recent years these areas have grown in their share of consumer spending at a higher rate.

Box 4: Taxation on savings

Taxation of personal savings raises issues of equity and efficiency. Savings are derived from income that has already been taxed. Saving is effectively a decision to defer consumption. But this brings an opportunity cost (including inflation) which is usually reflected in some form of payment to the saver by the body in which the savings are held. Most simply this is interest on a bank account, but savings can be held in many other forms. As the review of Australia's tax system pointed out:

"Income from savings … is also taxed in a wide variety of ways. Varying arrangements apply to interest-bearing deposits, income from domestic shares, income from foreign shares, and rents from residential properties. A tax system for the future would tax these different forms of investment as consistently as possible, and also take account of the way inflation affects the effective tax rate on savings. It could do so by providing a common discount for a range of savings income or by applying a flat rate of tax to that income. Long-term, lifetime savings in the form of superannuation and owner-occupied housing should continue to be effectively exempt from income tax".[49]

Excise on fuels is hard to avoid because often people have no choice but to drive. In the long run it might encourage people to buy more fuel-efficient vehicles or make greater use of public transport where available. But overall, taxes of this nature have a minor impact on the economy providing appropriate restrictions are placed on their application to business inputs to the internationally traded goods sector.

Partly because they are hard to avoid, and partly because they proportionately affect the low to middle-income households, who spend a higher proportion of their income when compared to upper-income households, consumption taxes can be electorally unpopular.

48. OECD. 2010. Tax Policy Reform and Economic Growth. Accessed online at: http://www.oecd.org/fr/ctp/politiques-fiscales/taxpolicystudyno20-taxpolicyreformandeconomicgrowth.htm. [Accessed on: 25 March 2013]
49. Treasury. 2010. Australia's future tax system: *Report to the Treasurer.* The Treasury. Australia

Recurrent taxes on fixed property

The growth advantage of taxes on immovable property has increased as globalisation has increased. Land and fixed assets provide a very stable tax base, as these items cannot escape overseas to avoid taxation, and tax rates can be low and very broadly spread. Every business and every household needs somewhere to operate and live. These taxes do not affect the decisions by individuals on the supply of their labour and there is no disincentive to working longer, seeking promotion or investing in education. Fixed property taxes do not affect savings decisions and have a lesser affect on investment decisions (although this may be less so in relation to interstate competition for investment in land-intensive activities). In this way, land and fixed property are generally the most growth-friendly form of taxation.[50]

However, like consumption taxes, and perhaps because of their very broad base, land and property taxes (including rates) are generally electorally unpopular.

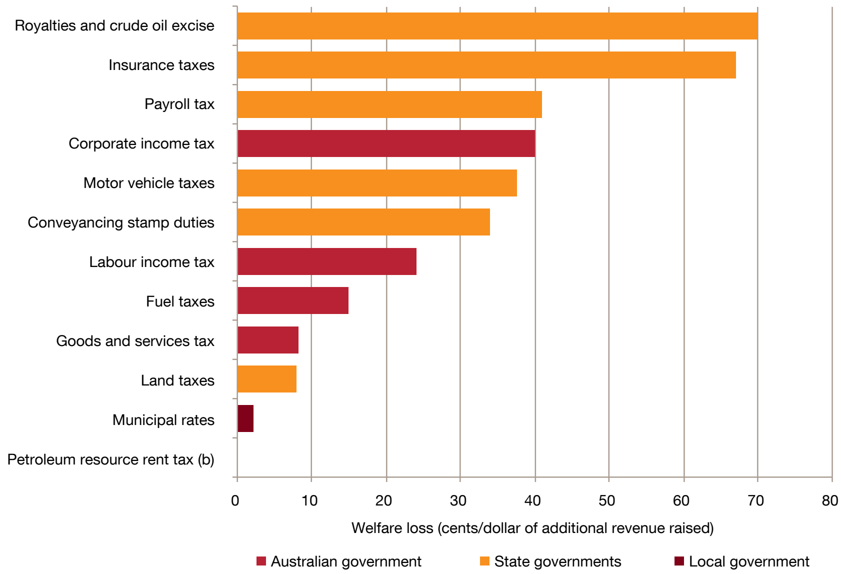
What does the evidence say about the affect of taxes on the economy?

There have been many studies aimed at estimating the effect of different taxes on economic growth. The OECD (2010) found the following from its empirical studies of tax reform in member countries over a 35 year period:

- A 1% shift from personal and corporate income taxes to consumption and property taxes could lead to 0.25% to 1% increase in GDP per person.
- A decrease in corporate tax funded by increased consumption and property taxes would have a bigger positive impact on GDP per person than a similar reduction in personal income tax.
- A switch of tax effort to property taxes is even more advantageous for growth than a switch to consumption tax.[51]

In economics, the term 'excess burden' or welfare loss is often used to describe the economic cost of taxation. It is calculated by taking the cost of tax (loss of living standards) and dividing it by the total revenue raised. Taxes with a high excess burden or welfare loss result in a greater decline in living standards per dollar of revenue, and therefore are less efficient. These measures are a useful mechanism for comparing the relative efficiency, and resulting effect on economic growth, of different types of taxes.

Figure 22: Marginal welfare loss from a small increase in selected Australian taxes (a)



Source: Treasury. 2010. ***Australia's future tax system: Report to the Treasurer****. The Treasury. Australia. Accessed 11 May 2013*

50. OECD. 2010. Tax Policy Reform and Economic Growth. Accessed online at: http://www.oecd.org/fr/ctp/politiques-fiscales/taxpolicystudyno20-taxpolicyreformandeconomicgrowth.htm. [Accessed on: 25 March 2013]
51. OECD. 2010. Tax Policy Reform and Economic Growth. Accessed online at: http://www.oecd.org/fr/ctp/politiques-fiscales/taxpolicystudyno20-taxpolicyreformandeconomicgrowth.htm. [Accessed on: 25 March 2013]

Figure 23: Commonwealth tax collection and efficiency

Source: Daley, J, McGannon, C, and Ginnivan, L. 2012. ***Game-changers: Economic reform priorities for Australia****. Grattan Institute, Melbourne*

The report of the Henry Review (*Australia's Future Tax System*)[52] contained estimates of welfare losses for each additional dollar of taxation raised (Figure 22).

The Grattan Institute's *Game Changers* reports linked these welfare losses with a measure of importance by looking only at the major tax groups (Figure 23).

Conclusion

The message is simple. Taxes do affect economic growth and some reduce it more than others.

Shifting the tax burden away from the taxes that have high marginal costs to economic welfare – corporate income taxes, personal income taxes, narrow payroll taxes – toward those like the GST and land and fixed property taxes could lift economic growth, productivity and provide room to boost participation.

But our tax and transfer system is about more than just economic efficiency. In the next section we look at these broader considerations, and the features of a 'good' tax system.

52. Treasury. 2010. *Australia's future tax system: Report to the Treasurer.* The Treasury. Australia

What are the features of a 'good' tax system? How does the Australian system measure up?

Key messages

- Regardless of how much revenue a tax system raises, a 'good' tax system should meet some key tests:
  - **Does it enable healthy government?** – Australians expect all levels of government to provide a range of services, facilities and support for the disadvantaged and have the budget strength to deal with natural, economic or national security shocks. This requires an adequate revenue flow to governments.
  - **Does it support an efficient federation?** – While the Commonwealth has the most effective capacity to raise taxes, states should have access to a predictable revenue stream that grows in line with the demands for services that they face.
  - **Is it fair?** – The tax burden should properly reflect the capacity to pay and be supported by income support for those most vulnerable; people in the same position should be treated in a similar way; there should be no discrimination between states; and future generations should not be burdened to make the life of the current generation easier.
  - **Is it efficient?** – All taxes damage economic growth to some extent, but some much less than others. Most revenue should therefore be raised through those taxes which impose the smallest penalty on our economic wellbeing, are simple to understand and impose the lowest costs to collect.
- These priorities will often compete. The challenge of tax reform is to balance improvements in efficiency with complementary measures to maintain/promote fairness and ensure the ongoing fiscal sustainability of all levels of government.
- The Australian system of taxes and welfare benefits is regarded as among the more equitable of the OECD countries because it generally focuses net government support on those most in need. However, compared to most developed countries and advanced developing countries the Australian tax system does not support growth as well as it could.
- Australia draws a relatively high proportion of its government revenue from taxes on business activities, and a low proportion from taxes on consumption.
  - High taxes on business are generally thought to deter investment, encourage the movement of activities offshore and encourage artificial strategies to avoid tax. They are generally quite volatile across the business cycle.
  - Taxes on land and consumption are generally more stable, have few efficiency effects and might encourage saving.

A 'good' tax and transfer system

Generating revenue to fund government activities is only part of the tax system. Regardless of the level of revenue raised, the way the tax system and its associated welfare transfer arrangements are designed can have a profound effect on Australia's economy and our economic and societal wellbeing.

Almost all taxes distort choices made by individuals, households and business. But not all taxes have the same effect on the economy, and the flow-through impacts on households and living standards can vary.

A good tax and transfer system is therefore about more than just a low overall tax burden. It is also about how taxes are raised and how the overall mix and level of taxes affect:

- drivers of economic growth, including investment, innovation, and entrepreneurship
- Australia's economic wellbeing and social equality
- the strength of Australian governments (at all three levels) and of the federal system.

A good tax and transfer system therefore provides a sustainable source of government revenue in a way that minimises its affect on economic activity while protecting the living standards of our country's most vulnerable citizens.

This section explores the features of a good tax and transfer system. It points the way for comprehensive tax reform, to reduce our reliance on costly and inefficient taxes while ensuring the equity of our tax system and the sustainability of all levels of government and the federal system.

The principles of a good tax system

Three objectives –fiscal sustainability, equity and efficiency for all levels of government – form the backbone of a good tax system. Each of these objectives and their associated principles is discussed below.

Fiscal sustainability

Good tax systems raise sufficient revenue to maintain healthy governments. The recent public debt crisis in Europe, together with challenges experienced by the United States, have highlighted the need for sustainable government revenues (together with prudent expenditure restraint) to ensure the ongoing fiscal health of governments. Large deficits today mean larger taxes in the future for the next generation.

The Australian context is complicated by its federal system, which requires the tax system to consider the respective service delivery responsibilities and income-generating capacities of Commonwealth, state and local governments. A good tax system for Australia supports the federal system by applying the principle of fiscal sustainability to all levels of government.

Principle 1

The level of government revenue should reflect the expectations of citizens of the services governments provide.

Australian governments across the three levels are expected to provide a range of core services, facilities and support for the disadvantaged. This includes establishing, enforcing and monitoring basic property rights necessary for a functioning competitive economy and democratic society, and providing public goods to correct market failures, including defence, law and order and basic research. Governments are also expected to have a degree of budgetary strength to deal with natural, economic or national security shocks.

Ultimately, taxes should generate sufficient revenue to meet these expectations. That is, the tax system should raise sufficient revenue to allow governments to provide effective government services without compromising the economic stability of low levels of government debt or burdening the taxpayers of future generations.

In a world of limited resources and incomes, the division of national income between the goods and services provided by governments and the goods and services purchased with after-tax incomes from the private sector requires a balance of the relative benefits and costs of public goods versus private goods.

The principles of a good tax system itself say little about the appropriateness or efficiency of government expenditure. Therefore, it is important to recognise that fiscal sustainability relies also on strong fiscal discipline and the efficient operation of government.

However, whatever the level of expenditure, this principle requires that the level of revenue received from the tax system should meet these costs and limit the accumulation of public debt.

This principle also favours taxes that automatically increase government revenue in line with likely increases in expenditure expectations. For example, at the state level, economic and population growth is a key driver of demand for government services. State-level services – particularly health, human services and education – are all influenced by the level of wealth and population in the state. Broad-based consumption or income taxes generate increased revenue as the economy grows (eg greater consumption or income generation) and provide a mechanism to support ongoing growth in state revenue in line with expenditure obligations.

Principle 2

The tax system should ensure sufficient revenue for all levels of government, and limit the reliance of one level of government on another to fund its expenditure obligations.

The importance of sustainable government revenue is concerned not only with total government revenue, but also with ensuring all levels of government (Commonwealth, state/territory and local) generate sufficient revenue to fund their service delivery responsibilities.

For Australia, this principle is concerned with the issues of vertical fiscal imbalance (VFI). VFI refers to the reliance of state and territory governments on funding from the Commonwealth Government, because of an imbalance between the respective-revenue raising capacities and expenditure responsibilities of the Commonwealth and the states.

A degree of VFI may always be necessary, reflecting the appropriate differences in the respective roles and responsibilities of different levels of government. The Commonwealth Government, for example, has advantages (in terms of efficiency and economies of scale) in raising and collecting income tax revenue. Meanwhile, lower levels of government (state and local) may be better placed to deliver government services in a way that meets the particular needs, preferences and contexts of their citizens. It may therefore be appropriate for the Commonwealth Government to collect revenues that exceed its expenditure responsibilities, on behalf of the states.

However, the strength ofAustralia's federation relies on both Commonwealth and state governments – which have obligations to deliver many important public services – to have access to a predictable revenue stream that grows broadly in line with the demands for services that they deliver.

Equity

A good tax and transfer system is fair and equitable. The principle of equity has several dimensions, focused on a fair sharing of the tax burden and the benefits of welfare transfers.

Principle 3

The tax system should ensure the burden of tax falls on those most able to pay and the benefits of welfare payments or support accrue to those most in need.

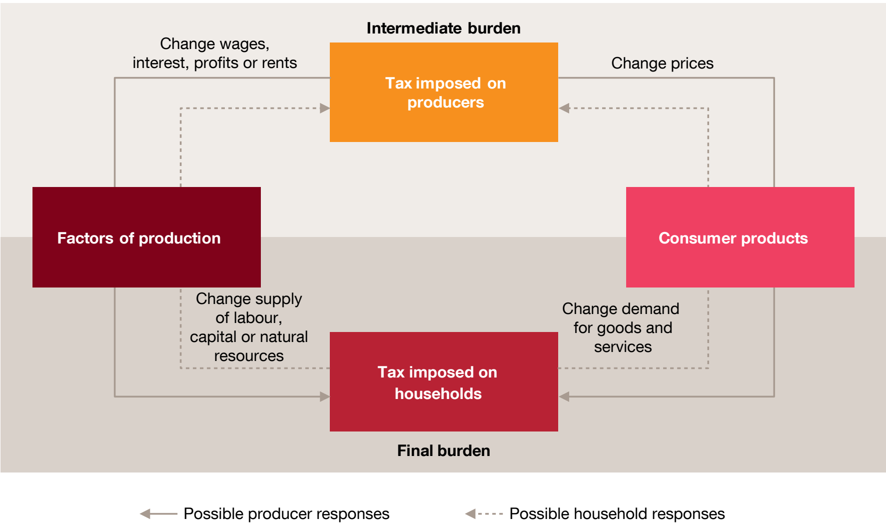
A fair tax system recognises that the different means and circumstances of its citizens affect their ability to contribute to government revenue and to maintain a reasonable standard of living. Though it should be acknowledged that terms such as 'fair' and 'equitable' can mean different things to different people, political parties and countries. Similarly, how progressive a tax and welfare transfer system should be remains a value judgement which even similar economies or cultures may manage differently.

In the context of equity and taxation it becomes increasingly important to understand the economic burden of taxes – that is, who actually pays the tax. It is often the case that the person or entity legally obliged to remit a tax (or pay the tax in the first instance) may not be the person, or the only person, whose income or consumption opportunities are altered. This can work in a range of ways.

For example, assume a business is subject to increased corporate taxation. This increased cost of business can be shifted from businesses to households through higher prices for products or lower returns to the use of domestic factors of production such as reduced wages, reduced rent, reduced returns to shareholders, or reduced prices for the use of natural resources (Figure 24).

Similarly, the actual incidence of a tax on land can also vary. For owner occupiers, it is clear that they will have to both pay the tax and bear the burden of doing so. The story, however, might be quite different in the rental sector. If all landlords face the same tax burden they are likely to pass it on to their tenants. In this way the principal burden might actually fall on business owners who lease properties or on private renters, not the landlords who initially pay the tax. On the other hand, if a tax is placed on the sale of a commodity or service for which there are easy substitutes, then households and other consumers will tend to avoid that product or service and the burden will fall on the producers.

Figure 24: How the ultimate burden of taxes can be shifted



Source: Treasury. 2010. *Australia's future tax system: Report to the Treasurer.* The Treasury. Australia

A fair tax system, therefore, seeks to ensure that the burden of the tax reflects an individual's ability to pay, so that those who enjoy higher levels of wealth and income contribute more to the tax revenues of governments. Similarly, in the context of income transfers, a fair system also ensures that the benefits of welfare payments or supports accrue to those most in need.

The tax and transfer system should be designed with this principle in mind. This means:

- income tax rates should be progressive, imposing a greater average rate of tax to those citizens enjoying higher levels of wealth and income
- exemptions, tax incentives or concessions for high income/wealth individuals should only be introduced or maintained where there are strong policy reasons for these measures, and should be carefully balanced against their regressive impact on the tax system (as well as their potential to distort economic decision-making)
- the tax system should provide adequate income support for Australia's most vulnerable citizens and ensure an adequate standard of living for all
- where possible, government transfers (including targeted support, such as subsidy for essential services) should be means- or income-tested, targeting households where they are most needed.

In the context of a federation, concerns of equity also apply to the ability of governments in each state to provide important public services. The Australian Commonwealth has a long history of supporting those states with lower capacity to generate revenue and/or higher costs of government services. This process, known as horizontal fiscal equalisation, seeks to ensure that all states have the same capacity to deliver services to their populations provided they make the same effort to raise revenue from their own sources.

Principle 4

The tax system should not discriminate between the way in which individuals earn or spend their income, unless there are good reasons for doing so.

The principle of equity is also concerned with ensuring the same level of tax is imposed on individuals or families with similar abilities to pay, unless there are good policy reasons to discriminate between them.

This principle is also important from an efficiency viewpoint. In general, the fewer distortions to business decisions to produce, employ, sell and invest, the higher the efficiency level.

This means that the tax system should be neutral towards the economic choices individuals make: how they earn or spend their income; the structure or vehicle through which they conduct their business; and where or how they invest. It should not favour one form of investment or employment over another, or discriminate between different types of consumption. This also means that the tax system should not treat one form of savings more preferably than another. For example, tax systems should avoid, where possible, the double taxation of saving that occurs when income or earnings are taxed before savings, and then taxed again on earnings generated from those savings (in the form of interest payments) without any allowance for inflation.

The exception is where there are sound policy reasons for doing so – for example, taxes on environmental pollution or the consumption of harmful substances (eg cigarettes and alcohol) that create broader costs for society.

Principle 5

The level of taxation and expenditure by Australian governments should prevent the undue accumulation of public debt that is borne by future generations.

An equitable tax system also is concerned with ensuring that future generations of tax payers are not unfairly burdened by the actions of the current generation; a principle referred to as 'intergenerational equity'. This principle recognises that the accumulation of public debt represents a deferral of taxation. That is, funding public expenditure today through borrowing funds that will need to be repaid by future tax revenue.

The principle of intergenerational equity therefore places a limit on the accumulation of public debt. It does not prohibit it. For example, debt incurred to fund productivity-enhancing investments in infrastructure or a future skilled workforce is likely to improve the wellbeing of future generations. Nevertheless, the accumulation of debt to fund the delivery of services for the current generation should be limited.

The accumulation of expenditure obligations for future governments should also be avoided, or funded through the savings of present governments. This is particularly relevant in the context of an aging population, which is expected to increase the health services and pension obligations of future governments. While not formally 'debt', these future obligations will be paid out of the tax contributions of future generations and with a smaller proportion of the population participating in paid employment.

This principle therefore promotes the use of measures that increase the self-sustainability of an aging generation. Examples of this are incentives for superannuation (albeit balancing the equity concerns associated with tax advantages for high income individuals) and modifications to the pension system (lifting retirement ages).

More generally, this principle also encourages sustainable government fiscal balances, encouraging low government debt or, indeed, net public savings.

Economic efficiency

The cost of taxation is not simply the revenue tax collects. This revenue is a transfer from the private sector to the public sector which can be put to productive use (building infrastructure, providing public services, etc) and, if well spent, can enhance our nation's wellbeing.

A tax system also creates costs in administering or complying with the tax system, both for tax payers and governments.

And while all taxes create these costs, some do so more than others. A good tax system minimises these costs, by focusing on taxes that impose the minimal cost to our economic wellbeing.

Principle 6

Tax should focus on activities where decisions will change as little as possible after the tax is imposed – ie the behavioural impact of the tax is as small as possible.

The economic cost of taxation depends to a large extent on the degree to which the taxed activities (income, investment and consumption) shrink or grow as a result.

For example, from the 17th and 19th century a number of European nations had a tax on windows, because in the absence of comprehensive accounting records, windows were easy to identify and count. This led to many windows being bricked up, and new houses being built with little natural light. In this way the tax had a significant negative impact on the glass industry, led to gloomy and unpleasant homes, and failed to collect the revenue its designers had expected.

Of course the more choice an individual, an investor or a company has on where or in what to invest their funds, the more likely they are to change their behaviour to avoid a tax. For example, a company or investor might simply decide not to invest in a country or an activity if the tax take is too high compared with the returns they can earn elsewhere.

So while it is important to consider our national interest, and to ensure that Australians get a fair return from allowing access to our resources and markets, it is also important not to drive investment or services away by setting our tax take too high.

Taxes can also change behaviour by encouraging elaborate ways to avoid them.

Complex and artificial arrangements can sometimes be designed to avoid personal or company tax – some forms of family trust or deliberately manipulated pricing of services and products between subsidiaries of global multinational companies. In these cases there is a misdirection of skilled resources away from socially productive activities to ones designed to avoid tax. A 'good' tax is one that is hard to avoid.

And of course, it is always a difficult decision for low-income people, particularly if they have dependent children, to work longer hours if as a result they pass income thresholds which mean they incur additional tax, lose benefits, and have to pay for childcare. They might avoid the high effective marginal tax rate by simply not doing work that they would have liked to do.

There will always be activities which are difficult to change. For example we know that when the price of petrol goes up, demand will fall but only slightly in the short term. This is because for many people there are few alternatives to using a car. Similarly it is hard to adjust your use of land – as a business or householder – in the short run. So increased land taxes do not necessarily cause much change in business strategies or living style. And most people have strong consumption habits. Australians spend approximately 90% of the income they receive, and while savings rates have increased slightly since the GFC it is very unlikely that overall spending would change very much with modest increases in GST.

All this suggests that from an economic perspective, taxes which focus on these immobile assets or fixed expenditure patterns are less likely to affect economic growth.

Not surprisingly, however, because for the household sector many of those activities – owning a house, doing the weekly shopping, driving, buying over-the-counter medication, using power and water – are regarded as necessities rather than luxuries, there is often resentment when they are taxed more highly.

In this way there is often a conflict between society's short-term preferences and long-term living standards.

A good tax system focuses on activities that are relatively inelastic. This means shifting the balance of taxation:

- away from activities that are highly responsive to tax changes – including much business investment and employment income, and transactions (eg stamp duty)
- towards activities that are unavoidable – such as the use of land or resources and (if defined broadly) consumption.

Principle 7

Taxes should apply to as broad and comprehensive a tax base as possible.

Tax bases should be broadly applicable, with minimal special exemptions and deductions, unless there a strong grounds for exempting certain activities (and those grounds cannot be addressed another way).

The 'breadth' or 'narrowness' of a tax base refers to the amount of activities, within the class covered by the tax, to which the tax applies. It includes the breadth of the tax base (the activities to which the tax applies), as well as the prevalence of exemptions or differences in the way the tax applies.

Narrow taxes – those which apply to only a limited number of activities and/or have large exclusions – create a range of challenges.

First, narrow taxes create opportunities for taxpayers to change their behaviour and choose substitutes that avoid the tax. This increases the responsiveness (elasticity) of private choice to the tax and therefore its economic cost.

Second, to generate a given amount of revenue, a narrower tax base requires the application of a higher tax rate. Higher tax rates increase the distorting impact of the tax. Indeed, the economic cost of tax increases more quickly as the rate of tax is increased.[53] In practice, imposing higher rates of tax may not be possible (if desirable), meaning a narrowly defined tax can (either immediately or over time) fail to generate sufficient revenue to meet its purpose.

Finally, special exemptions and deductions with narrow tax bases create definitional complexity and uncertainty about what activities the tax does or does not apply to. Broader taxes tend to have more certain scope. This improves the clarity and simplicity of the tax, and reduces the costs associated with collecting, administrating and complying with the tax. It can also reduce the opportunity for taxpayers to avoid the tax and the resources they expend attempting to do so.

Principle 8

The tax system should minimise its effect on income-producing activities.

One of the key ways that a tax imposes economic costs on society is by discouraging individuals or businesses from engaging in productive activities. These activities already incur an opportunity cost to the individual, including the cost of forgone leisure and household production in relation to paid employment, the cost of capital in relation to investments, and so on.

Tax therefore adds to the cost of these activities and has the potential to deter these productive activities. This can include decisions to work below an economically optimal level, or altering investment decisions. Where this occurs, future growth in national incomes and productivity can be undermined.

Principle 9

The tax system should provide levels of taxation which enable it to compete for internationally mobile capital and labour (eg capital investment).

As noted earlier, taxes create the greatest economic distortion in relation to those activities that are highly responsive to tax changes (ie highly 'elastic' activities).

The presence of a global economy requires that the tax system be cognisant of the ability of some economic activities – particularly capital investment – to move across borders. Lower tax jurisdictions compete with Australia for international capital and investment, an important driver of productivity and economic growth. They also, to a lesser degree, compete for human capital, in the form of high-income-generating individuals.

This principle favours a tax system that promotes Australia's long-term economic and productivity growth by encouraging capital and investment. It is also based on the recognition that international capital markets favour a tax system of lower corporate and business taxes – the key effective tax on investment – to encourage these activities and minimise distortions.

This is not to say that differences between Australia's corporate taxes and those of our competitors should not exist. Rather, the benefits of imposing higher corporate taxes should be balanced against the reality that doing so creates incentives for potential Australian investment to be redirected elsewhere.

Principle 10

The tax system should be supported by clear, stable and convenient tax rules.

The economic efficiency of a tax system is also undermined by the administrative costs associated with paying tax, including:

- for tax payers – the costs of understanding their tax obligations, planning or modifying business activity in response to tax rules, and administering tax returns and compliance
- for tax collection authorities – administering tax collections and monitoring and enforcing compliance.

A good tax system minimises the cost of administration, compliance and enforcement (for both tax payers and tax collection authorities). To this end, the tax system should be:

- clear and simple, imposing certain requirements on tax payers, to minimise the cost and uncertainty in compliance and the opportunity for structuring activities to avoid tax
- stable and predictable, allowing long-term business and commercial decisions to be made with minimal tax-related uncertainty
- administered in a convenient and efficient manner, minimising the administrative and compliance cost.

This principle also justifies the exclusion of some activities from taxation if the costs of compliance and administration outweigh the additional revenue that would be obtained.

53. Commonwealth of Australia. 2008. *Architecture of Australia's tax and transfer system.* Pg. 176

Summary of design principles

Table 2: Principles of a good tax system

Fiscal sustainability		***Economic efficiency***	
1	The level of government revenue should reflect the expectations of citizens of the services governments provide.	**6**	Tax should focus on activities where decisions will change as little as possible after the tax is imposed – ie the behavioural impact of the tax is as small as possible.
2	The tax system should ensure sufficient revenue for all levels of government, and limit the reliance of one level of government on another to fund its expenditure obligations.	**7**	Taxes should apply to as broad and comprehensive a tax base as possible.
Equity and fairness			
3	The tax system should ensure the burden of tax falls on those most able to pay and the benefits of welfare payments or support accrue to those most in need.	**8**	The tax system should minimise its effect on income-producing activities
4	The tax system should not discriminate between the way in which individuals earn or spend their income, unless there are good reasons for doing so.	**9**	The tax system should provide levels of taxation which enable it to compete for internationally mobile capital and labour (eg capital investment).
5	The level of taxation and expenditure by Australian governments should prevent the undue accumulation of public debt that is borne by future generations.	**10**	The tax system should be supported by clear, stable and convenient tax rules.

Managing competing priorities

The unfortunate reality is that the principles of a good tax and transfer system often compete. Achieving the economic objectives of a more efficient tax system may create challenges for the other two objectives of a good tax system: equity and sustainable revenue for all levels of government.

Often the most efficient taxes are also the least equitable, shifting, or appearing to shift, the burden of taxation away from those most able to contribute. Examples are common.

- Broad-based consumption taxes represent highly efficient taxes. However, with a uniform tax rate applying equally to high and low income householders, it could be argued to be regressive. This is because low-income householders tend to spend a higher proportion of their limited disposable income on consumption and therefore pay a higher proportion of their income in consumption tax.
- Progressive income tax rates – which impose higher rates of tax and withdrawal of benefits as incomes increase – are more equitable but can discourage work and investment.
- Reducing tax rates on capital income encourages savings and investment (supporting long-term economic growth), but its benefits accrue disproportionately in the first instance to wealthier individuals through capital gains and to foreign investors (however, in the longer run, because lower taxes attract mobile international capital, the real beneficiaries might be Australian households through receiving higher real per-person incomes).

Similar challenges affect the transfer system (ie payments or tax concessions for the elderly, the disabled, single parents). For example, while 'means testing'[54] transfer payments can ensure support payments are targeted at households that need them most, removing these payments as income increases discourages low and middle-income individuals from working.

More generally, tax reform (or indeed any policies) that promote economic growth may in fact disadvantage some members of society, if the benefits of this growth do not accrue to them.

54. Means testing' is a process which can limit a person's eligibility for a particular government benefit based on their level of income.

These households may experience the effect of any associated price rises without commensurate increases in their income.

Many government transfer payments (such as pensions) are explicitly or implicitly linked to changes in the consumer price index (CPI). Such links mean the value of these transfers will automatically compensate recipients for any increase in inflation associated with tax reform. However, the adequacy of this automatic compensation relies on transfer recipients having the same consumption patterns as the broader community (reflected in the calculation of the CPI). Furthermore, low and middle-income earners who are not in receipt of transfer payments might also be disadvantaged by the price increases associated with these policies.

The net effect of tax reform on these households is complex. However, it is most likely that a movement towards more efficient taxes (specifically, consumption taxes) will result in transfers of wealth away from lower-income households.

At the same time, efforts to improve the efficiency of a tax system should be aware of the effect of these changes on the revenue or expenditure responsibilities of different levels of government.

There is also a need to ensure that in managing any changes, the interests of each level of government are respected and overall fiscal discipline is maintained.

The Australian tax system has faced these challenges before. Our tax reform history shows how meaningful tax reform can be achieved when combined with additional measures targeted at achieving equity or fiscal sustainability objectives in more economically efficient ways.

This suggests an approach to tax reform that 'packages' complementary measures that include:

- tax changes to promote Australia's economic wellbeing through a more efficient tax system
- welfare and revenue transfers to retain the fairness of our tax and transfer system and ensure the fiscal sustainability of all levels of government.

Doing so would not mean that all individuals would be better off. While tax reform measures would improve Australia's overall economic wellbeing, changing the structure of Australia's tax and transfer system inevitably creates 'winners' and 'losers'. And, while theoretically possible, compensating all those who are worse off under a new tax system is not always desirable and undermines the need to generate greater levels of government revenue to fund growing expenditure responsibilities.

Rather, tax reform packages should be designed to retain the overall equity and fiscal sustainability of the tax and transfer system while improving its efficiency and ability to support long-term economic growth.

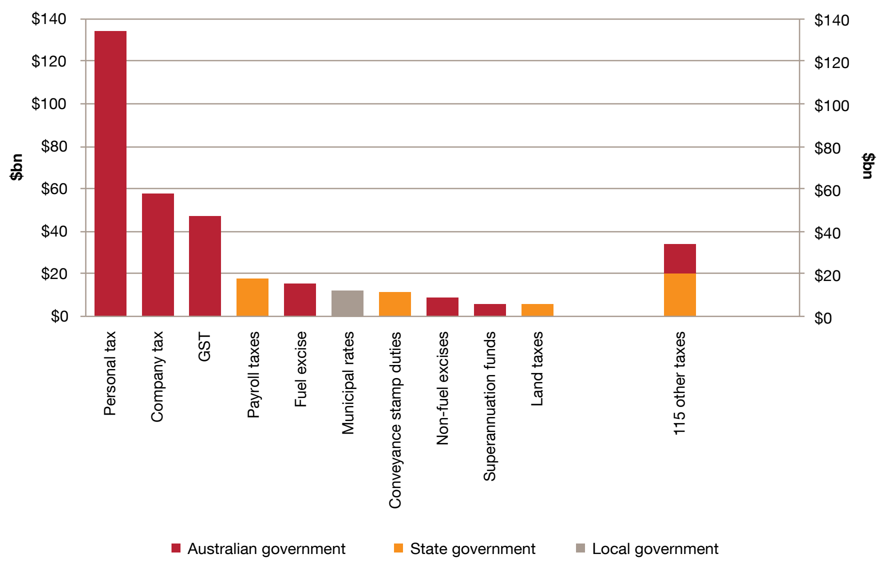
How does Australia measure up?

Australia's tax and transfer system spans three levels of government and is comprised of different arrangements, designed and administered across all levels of government.

There are over 125 taxes paid by Australians every year. Of these taxes, 99 are levied by the Commonwealth Government, 25 by state and territory governments and one by local governments (ie council rates). Of the total tax revenue collected by Australian governments in 2010-11, over 90% was derived from 10 taxes, reflecting 95% of Australian government revenue, over 60% of state government tax revenue and 100% of local government tax revenue.[55] (Figure 25)

This section considers the appropriateness of Australia's tax system, and in the context of the key taxes that are critical for revenue generation. This includes seven key taxes – personal income tax, company income tax, GST, payroll tax (state-administered), stamp duties on conveyances (state-administered), and superannuation fund tax.

Figure 25: Tax generation, by tax type and level of government[56]



55. ABS. 2012. *Cat 5506.0 Taxataion Revenue, Australia, 2010-11.* Accessed online at: http://www.abs.gov.au/ausstats/abs@.nsf/mf/5506.0
56. ABS. 2012. *Cat 5506.0 Taxataion Revenue, Australia, 2010-11.* Accessed online at: http://www.abs.gov.au/ausstats/abs@.nsf/mf/5506.0

There are a number of concessions or transfer arrangements that apply to business and personal tax arrangements. For businesses, these arrangements include accelerated depreciation for capital investments, research and development tax incentives and thin capitalisation rules. For individuals, they include superannuation tax and Family Tax Benefit (Part B) payments. Concessional arrangements are significant components within Australia's overall tax and transfer system. These arrangements should be considered as an element of overall tax reform, against clear principles of the avoidance of retrospectivity, but are not considered further in this report, which focuses on major tax structural issues.

Assessment against the design principles

Australia's taxation (and transfer) system provides a reasonable foundation for achieving socially acceptable distributional outcomes in a fiscally sustainable manner, however the structure and nature of some of Australia's most significant taxes have direct implications for fiscal sustainability, equity and economic efficiency.

Table 3 provides an overview of how Australia's tax system measures up against the objectives of fiscal sustainability, equity and economic efficiency and the 10 principles of a good tax system. Traffic light reporting has been used to graphically present the findings, where:

- a green icon suggests that the tax system, or certain features of it, is largely consistent with the specified principle
- an orange icon suggests that the tax system, or certain features of it, is not completely consistent with the specified principle
- a red icon suggests that the tax system, or certain features of it, is not consistent with the specified principle.

Australia's tax system is highly complex, comprising numerous taxes. The purpose of the assessment provided below is to highlight the strengths and weaknesses of the tax system more generally.

Table 3: Assessment of Australian taxes

	Equity			*Efficiency*					*Fiscal sustainability*	
Tax	Burden of tax & ability to pay	Non-discrimination	Limits to inter-generational impacts	Economic distortion (elasticity and mobility)	Application of tax (broad)	Effect on production	Competitive levels of taxation	Administration costs	Revenue to support essential service provision & revenue growth over time	Limit VFI between the levels of government
Personal income tax	Green 1	Green	Red 2	Green	Green	Red	Green	Green	Orange 2	Orange
Company income tax	n.a.	n.a.	Red 2	Red	Red	Red	Red	Green	Orange 2	Orange
Goods and services tax	Orange	Green	Red 2	Green	Orange	Green	Green	Orange	Orange 2	Orange 3
Payroll tax (State)	Green	Green	Red 2	Orange 4	Orange 4	Green	Green	Orange	Orange 2	Orange 3
Stamp duties on conveyances (State)	Red	Red	Red 2	Orange	Orange	Red	Red	Green	Orange 2	Orange 3
Superannuation fund tax	Red	Green	Red 2	Green	Green	Orange	Orange	Green	Orange 2	Orange
Land tax (State)	n.a.	Red	Red 2	Green	Orange	Green	Green	Green	Orange 2	Orange 3

1 Australia's tax and transfer system is relatively progressive, particularly with respect to the income tax regime.
2 Australia's overall tax revenue goes close to meeting current expenditure requirements and is thus avoiding high tax debts for future generations. It is noted that personal income tax and company tax raises around 50% of total Commonwealth Government tax revenue. There is uncertainty whether these arrangements will be sufficient to meet future expenditure requirements.
3 GST, payroll tax and land tax are critical revenue sources for state governments and enable them to fund essential services. These revenue sources however have failed to keep pace with expenditure requirements.
4 Payroll tax is the largest source of state tax revenue. However, while states have made good progress in harmonising their payroll tax bases, almost every state has recently cut the payroll tax rates and narrowed the base, effectively reducing the effectiveness of the tax and the total revenue collected.[57]

57. Parkinson, M. 2012. 'Challenges and opportunities for the Australian Economy. *Speech to the John Curtin Institute of Public Policy, Breakfast Forum*, 5 October 2012

How does Australia compare internationally?

By international standards Australia's tax-to-GDP ratio is low. In 2010, Australia had the fifth-lowest tax burden of OECD countries, and this is consistent with its historical performance, ranking in the bottom third of OECD countries since 1965. In 2010, Australia's tax-to-GDP ratio was 25.6%, below the OECD average of 33.8%, acknowledging that some of Australia's compulsory payments such as compulsory superannuation payments by employers are not reflected in Australia's total tax revenues. Australia's deficit in 2012 was 2.8% of GDP, which is well below the OECD average of a 5.5% average. The only three countries with a government surplus in 2012 were Norway (15.2%), Korea (0.9%) and Switzerland (0.7%).[58]

Table 4 provides a high-level assessment of how Australia's tax system compares to other OECD countries or the principles suggested by the OECD in its review of the impact of tax on growth[59], within the framework of the objectives of fiscal sustainability, equity and economic efficiency and the 10 principles of a good tax system. We have again used traffic light reporting to illustrate the findings, where:

- a green icon suggests that Australia's tax system, or certain features of it, is consistent with, or compares well against the other OECD countries
- an orange icon suggests that Australia's tax system, or certain features of it, is not completely consistent with the tax systems of other OECD countries
- a red icon suggests that the tax system, or certain features of it, is comparatively worse than other OECD countries.

Table 4: Assessment of Australian taxes against OECD countries

Principle		*Score*	*Key issues*
Equity	Burden of tax & ability to pay		• Australia's tax and transfer system is regarded as one of the most targeted and redistributive transfer systems in the OECD – Linked to the use of means testing and lower levels of direct taxation on poor households.[60] • Personal incomes tax rates are comparable with OECD countries. • Significant concessions for home ownership, pension growth linked to AWE and treatment of superannuation provide considerable support for some older Australians. 'Middle class welfare' is not as significant as the levels recorded in Europe.
	Non-discrimination		• Largely equitable in the application of income tax arrangements.
	Limits to inter-generational impacts		• Comparatively low government debt and expenditure levels. • Superannuation guarantee charge an important way of causing individuals to prepare more thoroughly for their future. • Emerging expenditure obligations, including rising health costs and costs associated with an aging population, are consistent with other OECD countries.
Efficiency	Economic distortion (elasticity and mobility)		• Corporate incomes tax and personal income tax generate much higher proportion of tax revenue than the OECD average. • Payroll taxes generate more tax revenue than the OECD average (however, many OECD countries administer social security payments which are analogous to payroll taxes). • Larger proportion of tax revenue generated through financial and capital transfer taxes (eg stamp duty). • GST contributes less to total tax revenue than the OECD average – reflecting exemptions and a lower total tax rate.

58. OECD. 2012. "Government deficit / surplus as a percentage of GDP", Economics: Key Tables from OECD, No. 20
59. OECD. 2010. Tax Policy Reform and Economic Growth. Accessed online at: http://www.oecd.org/fr/ctp/politiques-fiscales/taxpolicystudyno20-taxpolicyreformandeconomicgrowth.htm. [Accessed on: 25 March 2013]
60. While spending is relatively low in an aggregate sense, of the 27 OECD countries for which data is available, Australia has the highest proportion of public transfers flowing to the quintile of the population with the lowest private incomes. It also has the lowest rate of direct taxation on the quintile of the population with the lowest private incomes of the 19 countries that provide this data.

Table 4: Assessment of Australian taxes against OECD countries (continued)

Principle		Score	Key issues
Efficiency	Application of tax (broad)		• A number of exemptions apply to corporate income taxes, payroll taxes, stamp duty and land taxes and GST. – Reduces the economic efficiency of these taxes – International trends support tax reform packages which increase the base across which taxes are applied and reduce tax rates.[61]
	Effect on production		• Tax system is not sufficiently structured to ensure growth. • Generally high taxes on business are thought to deter investment, encourage the movement of activities offshore and encourage artificial strategies to avoid tax.
	Competitive levels of taxation		• Australia's company income tax is higher than the OECD, though noting that a number of tax deductions and offsets can apply. • High company income tax rates affect the competiveness of Australia for foreign investors and, plausibly, domestic investors in spite of dividend imputation.
	Administration costs		• Surveys of global tax costs indicate that Australia's GST regime is more expensive to administer for companies than systems with fewer exemptions.[62] • However, New Zealand is one of the only countries with a comprehensive base.
Fiscal sustainability	Revenue to support essential service provision & revenue growth over time		• Australia's current tax system is not generating sufficient taxes to meet current and future spending requirements. – Heavy reliance on taxes which are volatile – stamp duties and company tax – GST exemptions mean this revenue has not grown in line with forecasts – Despite this, Australia's debts levels are comparably better than other advanced countries.
	Limit VFI between the levels of government		• VFI is larger in Australia than other federations. – States have a narrow tax base and limited abilities to raise tax revenue – States are heavily reliant on Commonwealth funding (GST payments, Specific Purpose Payments, National Partnership Payments).

Conclusion

The Australian tax system does not support growth as well as it could. This is due to the mix and rates of different types of taxes, and the high proportion of government revenue generated from taxes that are thought to have greater distortionary impacts on economic efficiency.[63]

Australia's tax system is heavily reliant on company income tax, payroll taxes, and stamp duty – all of which have significant adverse effects on economic growth. It is noted, however, that the level of payroll tax in itself does not significantly affect economic efficiency. Instead, it is the narrow application of the tax, through exemptions which can influence business decisions, and create economic distortions.[64] In addition, Australia generates less tax through more efficient mechanisms such as consumption and land taxes.

However, the combined tax and transfer system is one of the most equitable among advanced countries.

Progressively altering the mix of taxes to support economic growth, while simultaneously supporting the fiscal sustainability of governments and protecting the vulnerable, will produce clear benefits in the future. This is discussed in further detail in Chapter 4.

61. OECD. 2010. *Tax Policy Reform and Economic Growth.* Accessed online at: http://www.oecd.org/fr/ctp/politiques-fiscales/taxpolicystudyno20-taxpolicyreformandeconomicgrowth.htm. [Accessed on: 25 March 2013]
62. PwC. 2013. *Paying taxes 2013: The global picture.* Available online at: http://www.pwc.com/gx/en/paying-taxes/assets/pwc-paying-taxes-2013-full-report.pdf. [Accessed on 26 March 2013]OECD. 2010. *Tax Policy Reform and Economic Growth.* Accessed online at: http://www.oecd.org/fr/ctp/politiques-fiscales/taxpolicystudyno20-taxpolicyreformandeconomicgrowth.htm. [Accessed on: 25 March 2013]
63. OECD. 2010. *Tax Policy Reform and Economic Growth.* Accessed online at: http://www.oecd.org/fr/ctp/politiques-fiscales/taxpolicystudyno20-taxpolicyreformandeconomicgrowth.htm. [Accessed on: 25 March 2013]
64. Australian payroll taxes have a similar economic impact to social security taxes which are used in Europe, or even the compulsory superannuation guarantee paid by Australian employees. While the initial incidence of the tax is on employers, ultimately the tax results in lower wages, and therefore become a proportional tax on labour income.

What could a change in the tax landscape deliver?

Key messages

- Australia faces a historic choice in the years ahead. It could cut government services radically, it could build tax revenues by incremental change, or it could prioritise growth through carefully targeted expenditure cuts and tax reform.
- Comprehensive tax reform linked with expenditure restraint could help rebuild budget resilience, at both state and Commonwealth levels, and increase the financial independence of the states. There also could be a gain in economic growth from changes to the tax landscape if:
  - Australia relied more on consumption (GST) and land taxes, and less on corporate and personal taxes, stamp duty, taxation of insurance and payroll taxes in their current form
  - taxes were more uniformly applied with fewer exemptions and concessions.
- Any resulting increase in GST revenue paid to the states beyond that needed to make an appropriate contribution to restoring fiscal resilience could be offset by a reduction in Commonwealth-tied payments. This would provide the states with greater autonomy and offer the scope for reducing Commonwealth-state overlaps. It would also free up revenue for the Commonwealth to fund appropriate compensation through the personal income tax and transfer systems.
- Changes to the tax landscape in this way could bruise some of our other tax principles:
  - Shifting the burden of tax to consumption tax and land tax without compensating changes to social security payments and income tax would place more relative pressure on lower-income and older Australians who are home-owners.
  - Rebuilding budget resilience will mean that not all the losers from changes can be compensated.
  - Reducing the corporate tax rate will confer some benefits on foreign investors and high-wealth Australians.
- The big question is therefore whether the growth, private income and budget resilience gains from tax reform would be enough to make these compensating changes to social security payments and income tax in a way that protects our vulnerable and low and middle-income earners and ensures a smooth transition. In the longer run a larger and more productive economy will bring broad benefits.

What could a changed tax landscape look like?

Australia's tax (and transfer) system falls short against many of the principles of a good tax system. Most of these shortcomings relate to its inefficiency: we rely too much on taxes that are inefficient and discourage income-producing activities. At the same time, Australian governments face growing fiscal challenges in meeting their service delivery obligations in the context of an aging population, increasing health care expectations and a tax system that is strongly influenced by movements in the price of our exports.

Australia, therefore, faces a historic choice in the years ahead. It could cut government services radically, it could build tax revenues by incremental change, or it could prioritise growth through carefully targeted expenditure cuts and tax reform.

While there is much that governments can and should do to reduce unnecessary expenditure in the next few years, poorly considered expenditure cuts could severely reduce government services and affect the poor and vulnerable. Moreover, incremental changes to growth-distorting taxes, such as company tax, personal income tax and stamp duty, will result in reduced economic growth.

By comparison, the third option – carefully targeted expenditure restraint linked with comprehensive tax reform, which cut wastes, increase those taxes that have the least affect on investment and employment and reduces reliance on taxes that distort incentives to work, invest and transact business, could help rebuild budget resilience at a state, territory and Commonwealth level, while maintaining and supporting economic growth.

Features of a growth-friendly tax system

The goal of tax reform should be to lift overall growth and to rebuild a sustainable revenue base for governments, without compromising the overall equity and fairness of the system.

A more growth-friendly tax system would have two key features:

1. A greater reliance on taxes that do not damage incentives to invest, work and learn. Specifically this will mean:
   - increasing revenue from consumption taxes and land taxes
   - reducing corporate and personal taxes and/or state-based stamp duties, insurance and fire levies and reforming or reducing payroll taxes.
2. A broader application of key taxes by allowing fewer exemptions and concessions. In particular, this means broadening the application of existing consumption taxes, removing exemptions which apply to other taxes (eg land tax, payroll tax, and company tax) and examining closely concessions under income and company taxes.

These two changes have the potential to help address the major economic and fiscal challenges facing Australia today.

- First, they would promote long-term economic growth by encouraging greater investment and employment and eliminating the impacts of transaction taxes (stamp duty) or narrowly applied taxes on the smooth operations of markets for business and housing.
- Second, they would promote the fiscal health of Australia's governments and the federation. In particular, a broadened GST would provide a more sustainable revenue base for state/territory governments and, linked with greater state use of efficient taxes (like land taxes), and a reduced use of inefficient taxes (like stamp duty), provide them with greater fiscal autonomy and responsibility. As GST revenue flowing to the states increased, the Commonwealth would wind back its tied grants to the states, and seek means to reduce the overlap between Commonwealth and state bureaucracies. This would also leave the Commonwealth fiscal headroom to fund appropriate compensation for the vulnerable and for low and middle-income earners as well as reducing its own growth-sapping taxes.

However, these changes have the potential to damage some of the other principles of a good tax system: most importantly, those related to fairness and equity. Without compensating action on personal taxes, allowances and benefits payments, these changes are likely to reduce the overall progressivity of the tax system, as follows:

- Greater use of consumption and land taxes places a greater proportionate burden of taxation on lower-income and older Australians who are home-owners.
- There would be a need for a very close examination of the extent to which GST on private health and education would flow back into increased government expenditures, either because of substitution of public for private services or because of commitments to support expenditure on these sectors.
- The extension of GST to private health services could particularly affect the aged and chronically ill in a way that might not be fully compensated by movements in pensions.
- Lower corporate tax rates would in turn reduce the tax burden on foreign investors and high-wealth Australians (to the extent that lower corporate tax rates boost retained company earnings, share price and capital gains).
- Less directly, unless care is taken, the benefits of economic growth generated by reform may not accrue to the more disadvantaged members of society, while they face the impact of any associated price rises.These trade-offs require tax reform packages using some of the additional revenue generated to fund accompanying changes to personal income tax and the welfare transfer system, in order to protect the living standards of low to middle-income members of society and the chronically ill. This would also help to retain the overall fairness of the tax and transfer system. However, the goal of rebuilding budget resilience will mean that not everyone affected by the changes can be compensated and effective transition strategies may need to be considered.

In this context, the key question for embarking on tax reform is whether the expected gains – through greater economic and productivity growth and improved fiscal resilience for governments – are sufficient to support an effective transfer program to retain the standard of living for Australia's most vulnerable citizens.

It is however likely that it would be preferable to the alternatives: burgeoning deficits; cuts to government spending; or uncoordinated increases to taxes which distort behaviour and impede economic growth.

Conclusion

Good tax reform will require careful and specific design, to manage the competing priorities of economic growth, a wide sharing of the benefits, creditworthy governments and a more vibrant federation. This design will require a patient and extended conversation among Australians, with a proper contribution from governments, business and civil society. The expected benefits from this reform suggest that this conversation is well worth having.

The way forward

Key messages

- Tax reform requires more than just academic identification of the 'right' solution. Previous efforts at tax reform have failed to achieve the meaningful change we need.
- Successful reform requires some key conditions to be present, including:
  - public acceptance that the hard work has begun on reductions in government expenditure before tax changes are considered
  - public and political support for change, and acknowledgement that it is needed if we are to maintain key benefits and services provided by governments
  - appropriate compensation, a recognition that the changes are fair in the overall interests of the community, but an acceptance that there will be some losers
  - a willingness to balance competing interests and develop appropriate transition strategies
  - an ability to develop an emerging and at least tacit bipartisan consensus.
- None of these conditions is easy to achieve. They can be built, however, on an understanding of the problems tax reform should address and an emerging consensus on the way forward.
- Reform is best achieved if changes in the tax landscape are part of a comprehensive package of tax and transfer changes, and can be seen as part of a coherent strategy for lifting incomes and resilience which also involves government expenditure restraint, enhancing workforce participation and building a more skilled society.
- Public acceptance of reform, and business confidence, are damaged by continual ad hoc changes to taxes, allowances, investment rules and superannuation.
- It is the leaders of civil society, business, union and public policy community who must drive this debate, seeing the potential benefits for Australians across all parts of our society.
- The way forward for tax reform is therefore to begin a public conversation. This means involving these broad stakeholders in a discussion about tax reform, and bringing them together to design a further tax and transfer landscape and build momentum for it to be achieved.
- A lesson of Australia's major economic reforms is that public and political will for reform is possible if the timeframes are realistic and there is a body of business and public policy leadership with a clear strategy for change.

What we can learn from the past

Australia has had a number of attempts at tax reform in the recent past. Business groups, academics and inquiries have made careful studies and provided excellent recommendations. However, each has failed to achieve the broad-ranging changes that Australia's tax landscape requires.

Since the introduction of the GST in 1999 much has been written about tax reform but little has been done. Recent partial attempts at reform to resource rent taxes, carbon pricing, business taxes and the treatment of superannuation have been divisive and rushed and may not be sustainable.

Frequent ad hoc changes to tax rules, forward tax commitments and personal income tax allowances damage business confidence, raise the risk profile of investing in Australia and increase the public's cynicism about the political process. Successful reform is about more than simply demonstrating the potential economic or social value of change. It requires sustained and patient building of community acceptance of the need for change. This has to place comprehensive tax reform within an overall narrative about protecting Australia's hard-won living standards, maintaining an equitable society, building our competitiveness and security and ensuring financially sound governments.

Australia has achieved major reform in the past. Through the 1980s and early 1990s with business, union and bipartisan support, governments at the Commonwealth and state levels negotiated a great opening-up and reform of the Australian economy. There were disputes and there was conflict, but overall there was acceptance that Australia had no choice other than to become more competitive if it wished to build living standards and drive unemployment and inflation down. The Australian reform process was a model; it achieved major change without the social and political disruptions that were the mark of similar reforms in Britain, New Zealand and the United States. But the major changes were staged and took nearly a decade to negotiate. That careful cadence was important, as governments can only tackle one or two really major initiatives in each term.

What we can learn from overseas

Successful tax reform is lengthy and complex. The OECD has looked at successful reforms and distilled some lessons:

- Articulating broad aspirational goals can help taxpayers and voters to understand why change is needed and what it is aiming to do. It also makes it easier to resist special-interest lobby groups.
- Considering the tax and transfer system as a whole, rather than isolating parts, allows larger benefits, subtle trade-offs and the funding of concessions for potential losers.
- A strong analytic and evidence base is vital, but not enough by itself, to underpin change.
- Independent groups and institutions can be very important in reassuring the public.
- Timing and phasing is important.[65]

None of these criteria has been fully met in recent attempts at partial tax reform.

Creating the conditions for change

Governments at all levels will not act successfully on the comprehensive tax reform we need until they are convinced that the community and political conditions for reform are ripe. Governments have to believe in the willingness, and readiness, of leaders of business and civil society, including unions and public institutions, to engage in a 'grand bargain' that balances their competing objectives and priorities. The conditions for a successful outcome probably require the following:

- An acknowledgment that governments at all levels have done enough to cut wasteful and unnecessary expenditures – while Australia is not a high-taxing and high-spending country there is clear scope for expenditure reductions. These must begin before any significant tax changes.
- An acceptance that, even after generous compensation, there will be some losers – that if the revenue base of our governments is to be rebuilt, a greater tax burden must be a reality for (at least some) taxpayers, and compensation would have to be limited to those on low and middle incomes.
- The development of appropriate transition strategies.
- An understanding that in the long run we could all be better off through improved economic performance and building more resilient government budgets.
- Confidence that government can deliver and sustain the reforms.
- A willingness to balance competing interests – recognising that no reform is possible if every party to the discussions insists that change will not happen unless its interests are maximised.
- Building consensus on the way forward – in particular, to achieve at least a tacit bipartisan consensus on reform directions.

65. OECD. 2010. *Tax Policy Reform and Economic Growth*. Accessed online at: http://www.oecd.org/fr/ctp/politiques-fiscales/taxpolicystudyno20-taxpolicyreformandeconomicgrowth.htm. [Accessed on: 25 March 2013]

None of these conditions is easy to achieve. However, all these conditions can be built on a broad understanding within the community that change is necessary. This means a public conversation about the economic and fiscal challenges of our present time and the need for measures to promote productivity growth while sustaining government revenues. Tax reform should not be rushed.

The conversation the community has to have

To be successful, tax reform requires public and political support for action. There must be a broad and collective understanding of the problems tax reform should address and an emerging consensus on the way forward.

No reform is possible if the community does not understand why change is needed. The community needs to know the challenges our nation faces and how those challenges risk our ability to achieve our economic and fiscal goals including:

- maintaining the real growth in incomes and employment we have become accustomed to
- providing governments with the capacity to meet our expectations of services, including improving our support for the disabled, making the investments in education that are necessary to underpin longer-term economic wellbeing, maintaining our national security, and supporting an aging population
- making sure that our governments retain their very high international standing as budgetary managers and their credit ratings, and ensuring that governments have fiscal room to move in the future if there is a further shock or shocks to international financial systems
- maintaining the health and secure future of a vital federal system.

Another necessary factor is demonstrating that it is ultimately Australian households who bear the principal burden of taxes, even for those taxes which are ostensibly focused on business.

Beginning the move towards tax reform

A lesson of Australia's major economic reforms is that public and political will for reform is possible if the timeframes are realistic and there is a body of business and public policy leadership with a clear strategy for change.

The momentum for tax reform is unlikely to come solely from our political leaders. There is some recognition of the need for comprehensive tax reform from some of our political leaders, but we are well short of the sort of bipartisan commitment that was so important in driving the major reforms of the 1980s. That commitment is only likely if there is clear evidence that leading figures in civil society (including welfare and unions), in the public policy community, in state governments and in business agree that these changes are necessary. From a timing perspective, this means that tax reform should not be an issue for the current political cycle. Time has to be allowed for the community to discuss and consider ideas, and for governments at all levels to address expenditure restraint before the community is asked to provide a mandate for reform.

More profoundly, it also means that business and community leaders cannot shirk the leadership role their predecessors played 30 years ago. Tax reform must be led by an engagement of the full range of business and community stakeholders, from:

- civil society –who see the need to protect the welfare support and government services that the most disadvantaged in our society require
- the public policy community which has had the privilege of having thought about these issues, and which possesses the tools to analyse and explain them
- the labour movement – who see the benefits in jobs and income growth
- business – which sees the benefits of fostering productivity growth and investment.

Bringing these stakeholders together to take key roles in shaping an improved tax system and building the momentum for it to be achieved is the way to realise the reform we need. This paper is a small contribution to making that necessary debate well informed.

A lesson of Australia's major economic reforms is that public and political will for reform is possible if the timeframes are realistic and there is a body of business and public policy leadership with a clear strategy for change.

www.pwc.com.au