

A stylized, low-poly map of Australia is positioned in the upper right quadrant. It is composed of various shades of red and white triangles. A network of white lines with small square nodes connects different points across the map and extends towards the left side of the image.

Where next for Australia's tax system?

How our tax system can help
reboot prosperity for Australia

June 2020



Key findings

Australia entered 2020 with an economy growing slower than desired, but with public finances that were in a relatively strong position – low debt compared to most other advanced economies and a forecast Commonwealth budget surplus.

Even then, Australia's tax system was ill-equipped to support a growing economy, due to:

- an over-reliance on personal and corporate taxes
- inequities (particularly intergenerational)
- a reliance on unsustainable tax bases
- a misalignment between revenues and responsibilities
- a reliance on distortionary and inefficient taxes
- high compliance costs
- an inability to keep up with global business
- tax avoidance throughout the cash economy.

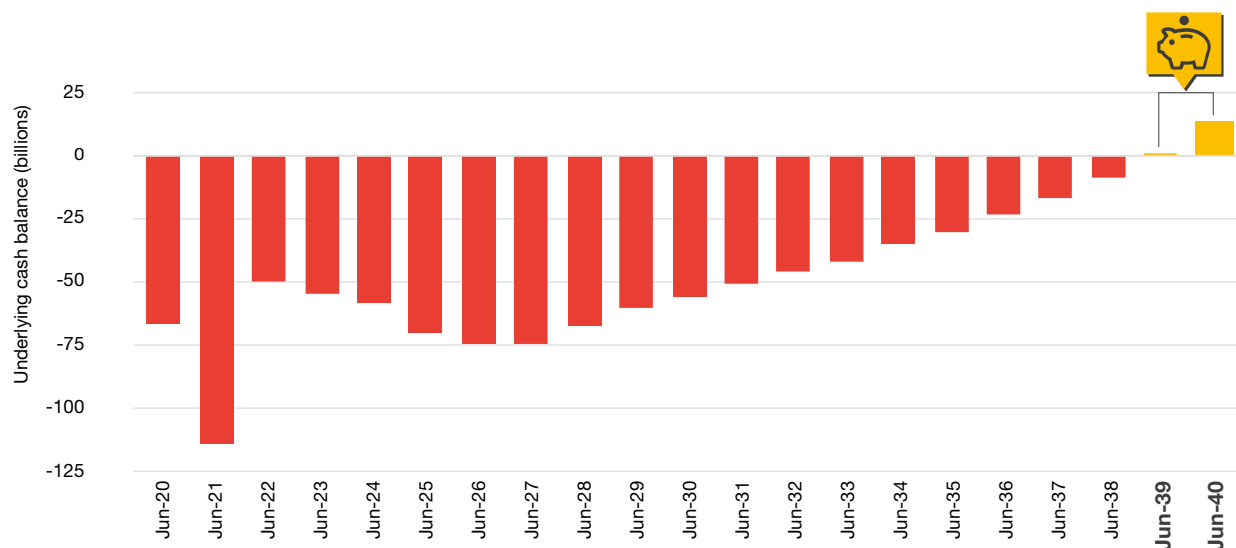
As outlined in PwC's recent *Australia Rebooted* report, steps taken to address the COVID-19 pandemic (e.g. shutting down certain activities, social distancing obligations, and border restrictions) have created a deep (but hopefully relatively short) recession and have exacerbated the ongoing challenge of raising economic growth over coming years.

Steps taken to support businesses and individuals during this time of disruption have resulted in:

- ballooning government expenditure
- shrinking government revenue
- increased government debt.



Projected Commonwealth budget position (\$ billions, year ending June)¹



These factors mean that, without changes to Australia's tax system, PwC estimates the nation will not return the Commonwealth budget to balance for the next 19 years (see figure, above), let alone generate the surpluses needed to pay down the new debt. In the 2020 Commonwealth budget it was projected that Australia would reach zero net debt in 2029-30; with the projected deficits shown in the figure, PwC now forecasts this to occur in 2056-57.

An 18 year old entering the workforce this year could have expected to work under consecutive federal budget surpluses for the foreseeable future, and to see the Commonwealth achieve zero net debt by the time they were 28 years of age. Now that same worker cannot expect a budget surplus until they are 37 years old, and net debt is not predicted to reach zero until they are 55.

In a post-COVID-19 Australia, tax reform will become even more important because of the need to:

- generate revenue to support ongoing government expenditure
- improve equity, particularly intergenerational equity given that the costs of The Great Lockdown will be borne disproportionately by the young
- support economic growth.

Australia should be planning comprehensive tax reform now, but the implementation of this reform should wait. Tax reform in the middle of an economic shock will pose another level of disruption to businesses that are already being asked to change in so many ways, and may give rise to reforms that will need to be recalibrated once some stability returns. That does not mean, however, that Australia shouldn't act; now is the time to plan for reforms as the nation emerges from the immediate crisis.

Emergency and temporary taxation and spending measures are already in place to deal with some of the immediate challenges of COVID-19. These measures are not 'tax reform' in the traditional sense, and will not address the inherent flaws in the tax system.



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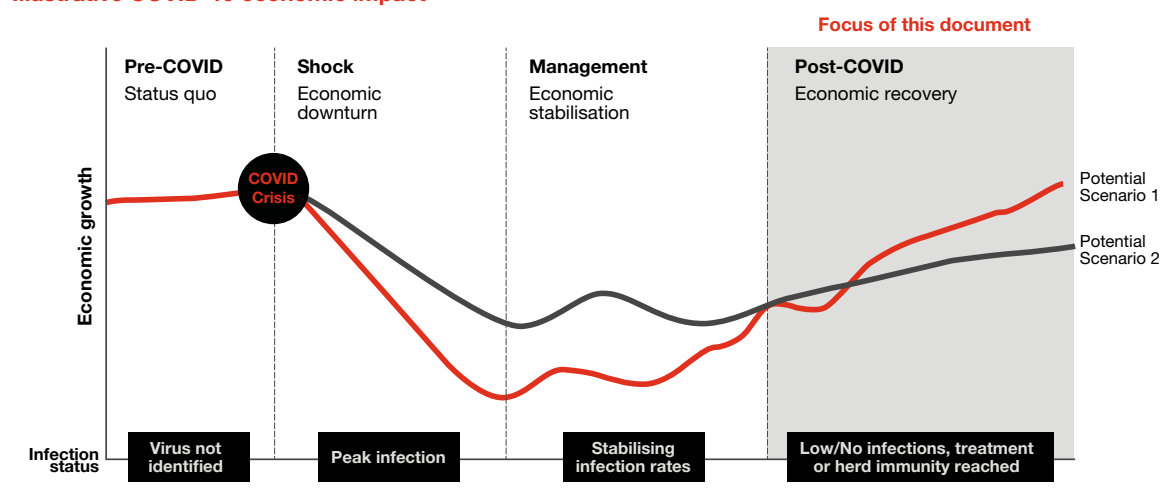
Introduction

While businesses, government and society more generally are naturally focusing on the immediate ‘shock’ and ‘management’ phases (see figure 1) of the COVID-19 pandemic, it is important to look beyond to consider what the economy and nation will look like in a post-COVID-19 world.

FIGURE 1

The four phases of the COVID-19 pandemic

Illustrative COVID-19 economic impact



There is a risk that Australians will collectively move forward in the hope that, having crossed the ‘bridge to recovery’ in a relatively short time, the nation will return to something approximating the previous understanding of ‘normal’.

Such nostalgia would be a mistake; both in the desirability of that previous state and the ability to return to it. The pace and scale of the shock caused by COVID-19 means that Australia has already changed, and further change is inevitable.

This report is the first in PwC’s *Tax reform in the wake of COVID-19* series, exploring the important role that tax plays in supporting Australia’s longer-term recovery and how the tax system will need to adjust to support the future prosperity of all Australians. This report considers: the pre-COVID-19 environment (economically and from a tax perspective); changes arising from the COVID-19 pandemic, including the way tax reform incentives may have changed; and when and how Australia’s leaders should contemplate tax reform.

To understand the post-COVID-19 options, it is important to understand both the economic environment and the sustainability of the tax system as at the beginning of 2020. This is the baseline that many people commonly aspire to when talking about a recovery – but should it be?

1.1 The Australian economy entering 2020

The year 2020 started with physical challenges front-of-mind for many Australians, with various parts of Australia being challenged by bushfires, floods and the drought. The Reserve Bank of Australia (RBA) has suggested that:

- over the December and March quarters, the fires have reduced Australian gross domestic product (GDP) growth by around 0.2 percentage points
- the drought would reduce GDP growth by a quarter of a percentage point in 2020.



Despite these environmental challenges, and a general sense that the Australian economy was still underperforming – with below par GDP, productivity and wages growth – the Governor of the RBA expressed the view in February that the Australian economy had ‘reached a gentle turning point’.²

The Governor supported this positive view of the coming years by noting:

- the International Monetary Fund’s (IMF’s) prediction that global growth would be stronger in 2020 than in 2019
- the RBA’s projection that economic growth in Australia would pick up from an average rate of 2 per cent over the past couple of years to 2.75 per cent in 2020 and 3 per cent in 2021. Drivers of this growth were identified as including accommodative monetary policy, a new expansion phase in the resources sector, stronger consumer spending, a recovery in dwelling investment later in 2020, high levels of spending on infrastructure and strong growth in public demand
- promising evidence in forward-looking indicators such as job vacancies.³

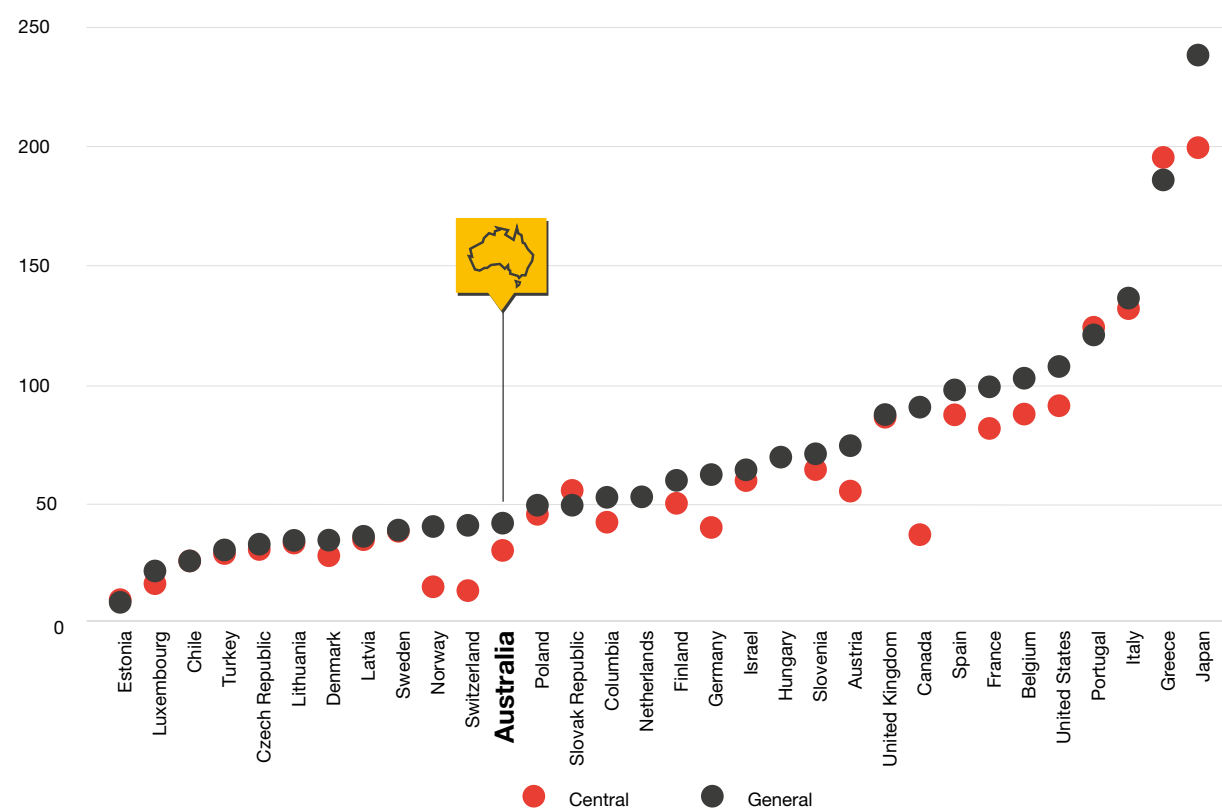


Similarly optimistic, the Australian government was predicting a return to a modest budget surplus in 2019-20 after deficits every year since the global financial crisis (GFC).⁴

Even with the decade of post-GFC deficits, Australia had relatively low central government debt (i.e. Commonwealth) compared to other advanced economies (see figure 1.1). Similarly, total government debt (i.e. central, state/territory and local governments) was relatively low in comparison to other advanced economies.

FIGURE 1.1

General and central government debt (% of GDP, 2018)⁵





1.2 The pre-existing need for tax reform

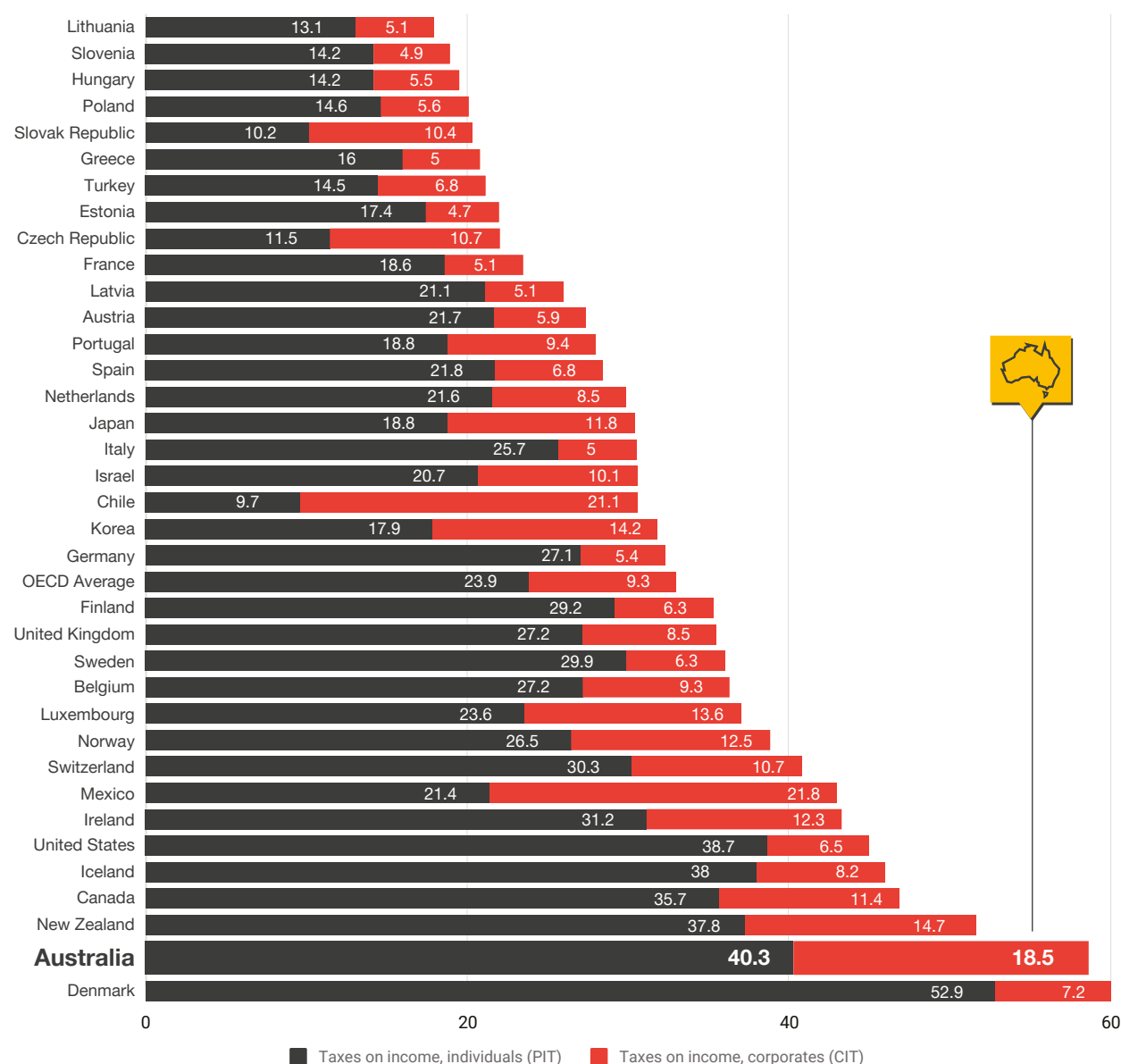
Despite the gently improving economic picture at the beginning of 2020, before the shock to the system imposed by COVID-19, the Australian tax system was struggling to meet the needs of the Australian community. The following sections consider the pre-existing challenges evident in the Australian tax system.

Over-reliance on personal and corporate taxes

Australia has a high reliance on income taxes, including company income tax. As shown in figure 1.2, more than two-thirds of the Commonwealth's tax receipts come through personal and corporate income taxes - more than twice the OECD average.

FIGURE 1.2

Income tax revenue as % of total central government tax revenue (2017)⁶

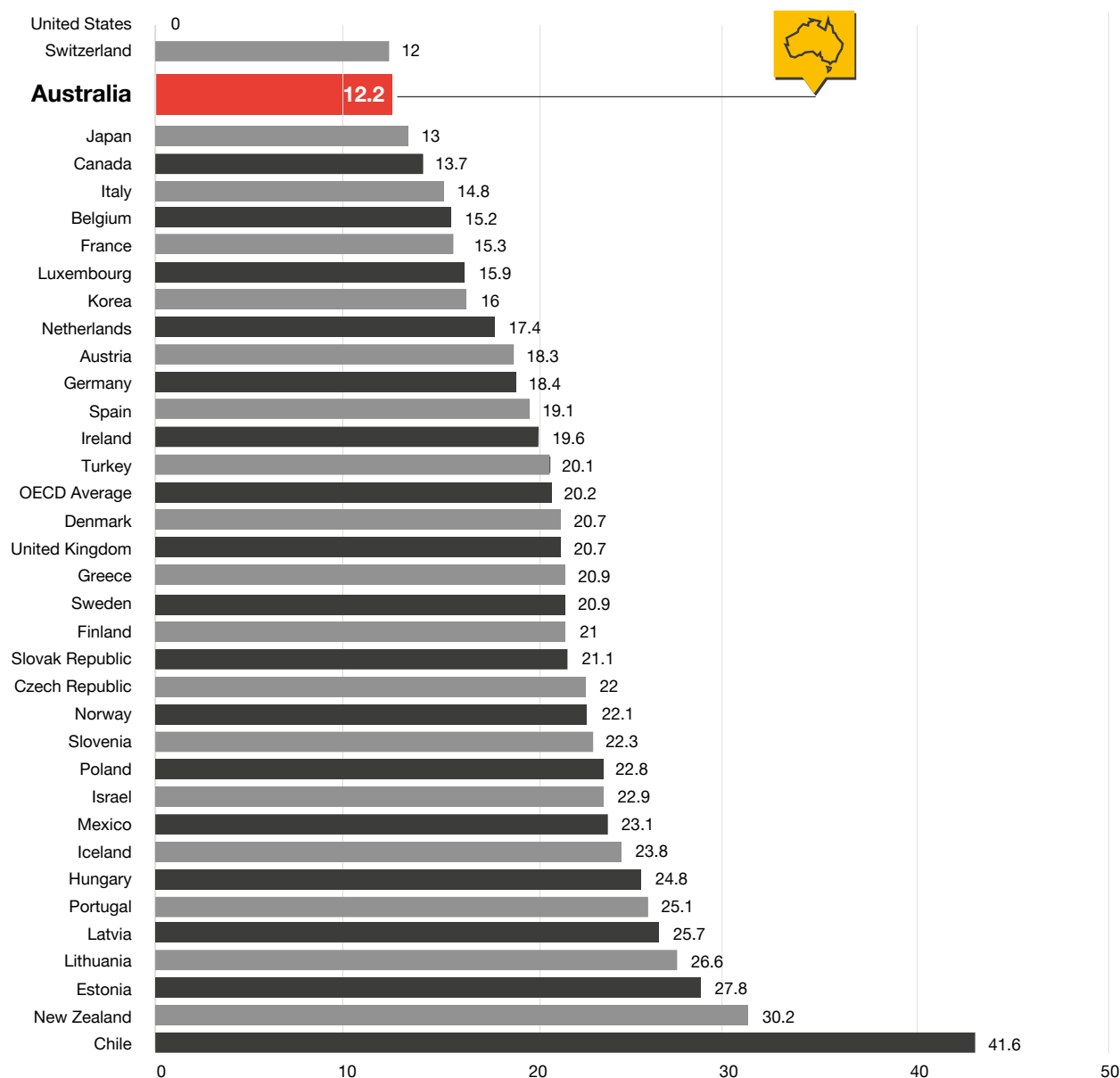




Most other advanced economies have placed a considerably higher reliance on the taxation of consumption (or value added) taxes (see figure 1.3).

FIGURE 1.3

Value added tax receipts (% of total tax revenue in 2017)⁷



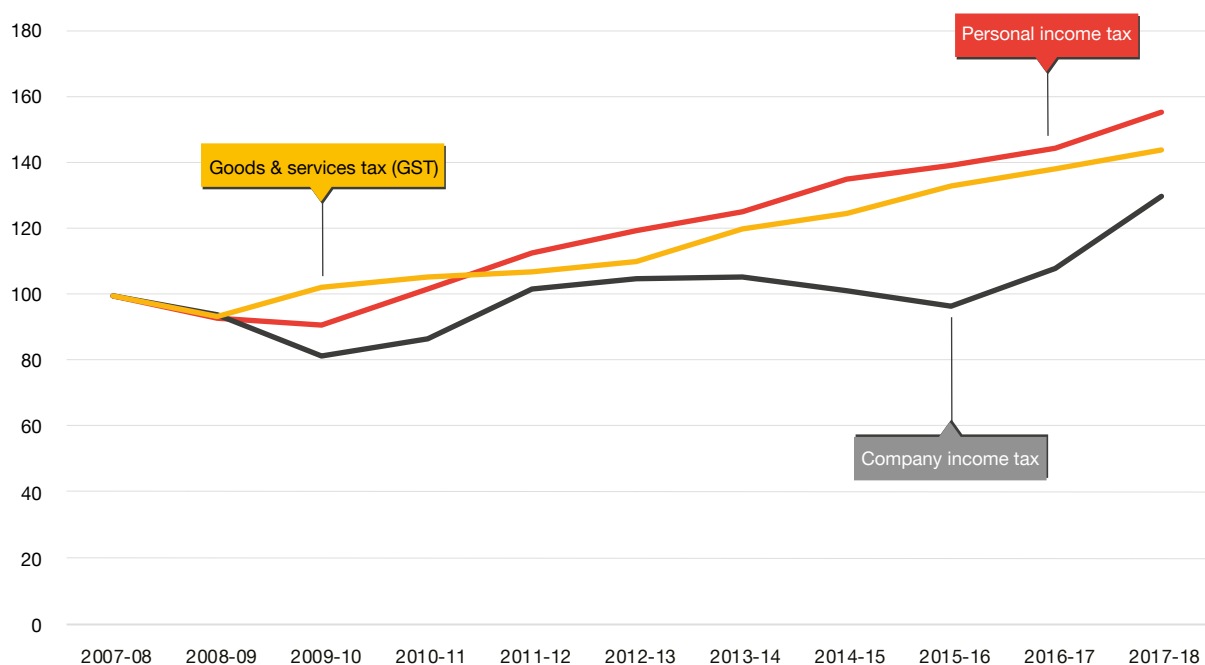


A benefit of greater reliance on taxing consumption is that movements in goods and services tax (GST) revenues have been relatively stable compared to company tax. As shown in figure 1.4, since the GFC, GST tax receipts have held up relatively strongly and had stable growth,⁸ whereas company tax receipts took longer to recover to previous nominal levels, and have grown in a slower and more volatile manner. This relative volatility reflects that consumption will always be ‘positive’, whereas companies can generate a tax loss and can carry such losses forward. Furthermore, companies may have mechanisms to reduce taxable income in a manner that cannot be replicated for personal consumption.

Lower growth and higher volatility threatens the Australian government’s ability to regrow the tax base in a timely and reliable manner.

FIGURE 1.4

Growth in major taxes since the GFC (2007 - 08 = 100)⁹



Also, the relatively high tax rate associated with company tax can hinder growth, with the effects from this largely being borne by workers. There has been considerable discussion about the potential reduction of the company tax rate, though it is acknowledged that Australia’s company income tax regime is partly acting as a tax on economic rent, in lieu of alternative tax arrangements. Australia’s experience from the GFC suggests that it will take a long time for corporate taxes to recover from the COVID-19 downturn for the reasons set out above (e.g. carry-forward of tax losses). This puts additional pressure on personal income taxes to carry the load.

The increase in unemployment (even with JobKeeper subsidising wages), and even further expected weakness in wage growth, suggests that personal taxes will also not provide a stable or growing base for the Commonwealth for many years.

Personal income tax bracket creep is also increasing the average tax rate faced by all workers (even after recently legislated tax cuts). Bracket creep is highly regressive, as the increase in average tax rates is greater for those on lower incomes. It can also undermine work incentives for these workers and can create incentives for tax minimisation by high income earners.



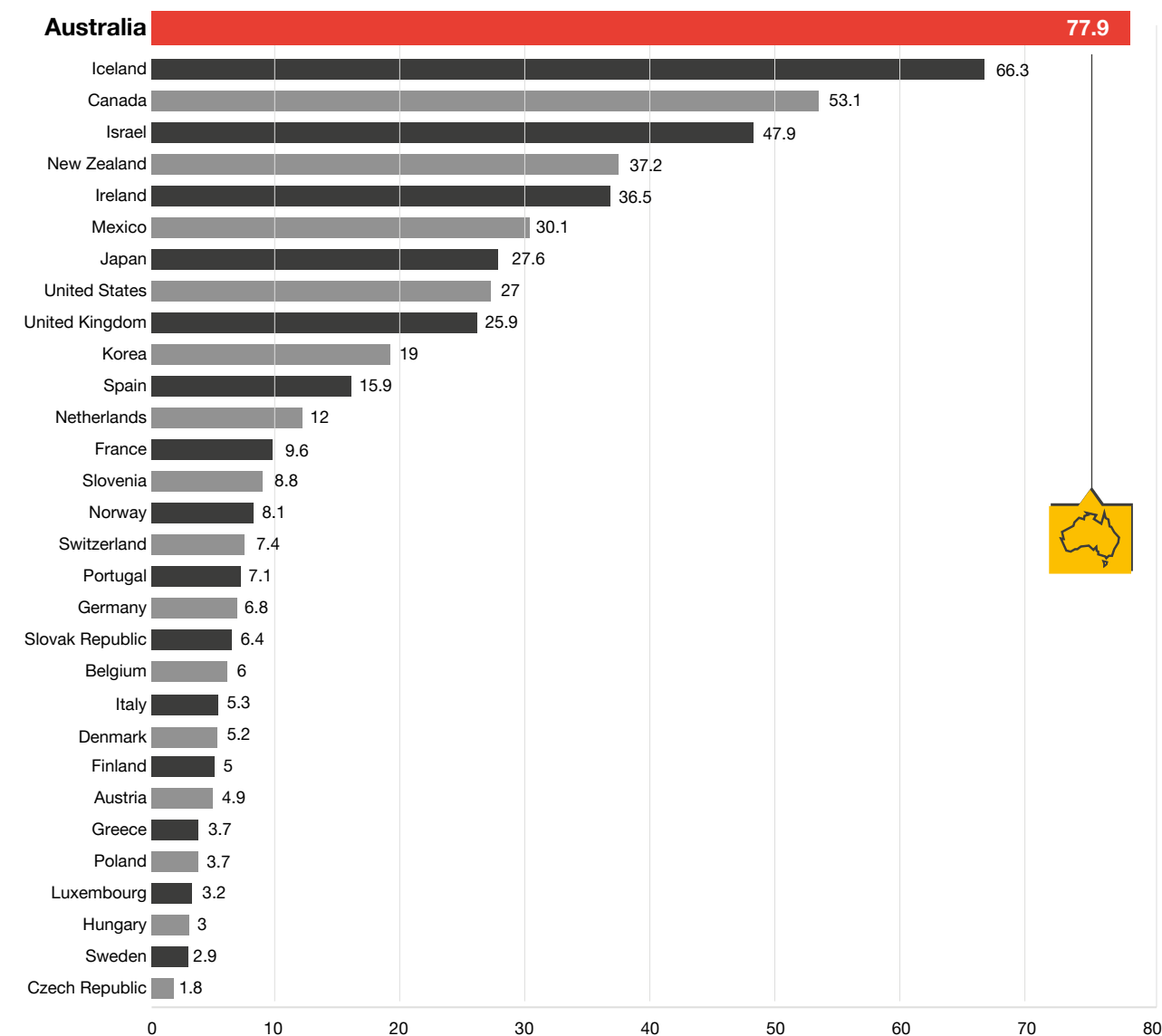
Inequities

Australia is recognised as:

- having a highly targeted tax and welfare system (see figure 1.5), and consequently is highly redistributive
- levying a low level of direct taxation on lower income groups. This is partly due to progressive personal income tax arrangements (e.g. the high tax-free threshold, the low income tax offset (LITO) and the low and middle income tax offset (LMITO)).

FIGURE 1.5

Spending on means - or income-tested cash benefits as percentage of cash public social expenditure¹⁰





As a result of this targeted and redistributive tax and transfer system, about a third of Australians pay no net tax. As shown in figure 1.6, households in the bottom three income quintiles receive, on average, more in cash and in-kind benefits from the government than they pay in taxes. In effect, the top two quintiles of households fund expenditure on the bottom three quintiles.

FIGURE 1.6

Net tax/welfare position (2015 - 16)¹¹

	Equivalised disposable household income quintiles					
	Lowest	Second	Third	Fourth	Fifth	All households
Income	343	833	1493	2280	4458	1871
Social assistance benefits (cash)	369	324	211	113	58	215
Selected social transfers in kind						
Education benefits	181	155	138	120	99	139
Health benefits	229	271	244	204	202	230
Social security and welfare benefits	101	93	73	44	27	68
Housing benefits	24	2	0	0	0	5
Electricity concessions	3	2	2	1	0	1
Total selected social transfers in kind	538	522	456	369	328	444
Taxes on income	35	114	238	420	1120	382
Total selected taxes on production	124	151	189	224	313	200
Net position	748	581	240	-162	1047	77

There are also questions around the equity (vertical, horizontal and intergenerational) of existing arrangements due to the following:

- Labour income is taxed differently to capital gains income (e.g. the capital gains tax (CGT) discount).
- Investment income may be taxed at either full tax rates (e.g. interest income, returns on certain assets such as gold) or discounted rates (e.g. in relation to CGT assets, superannuation).

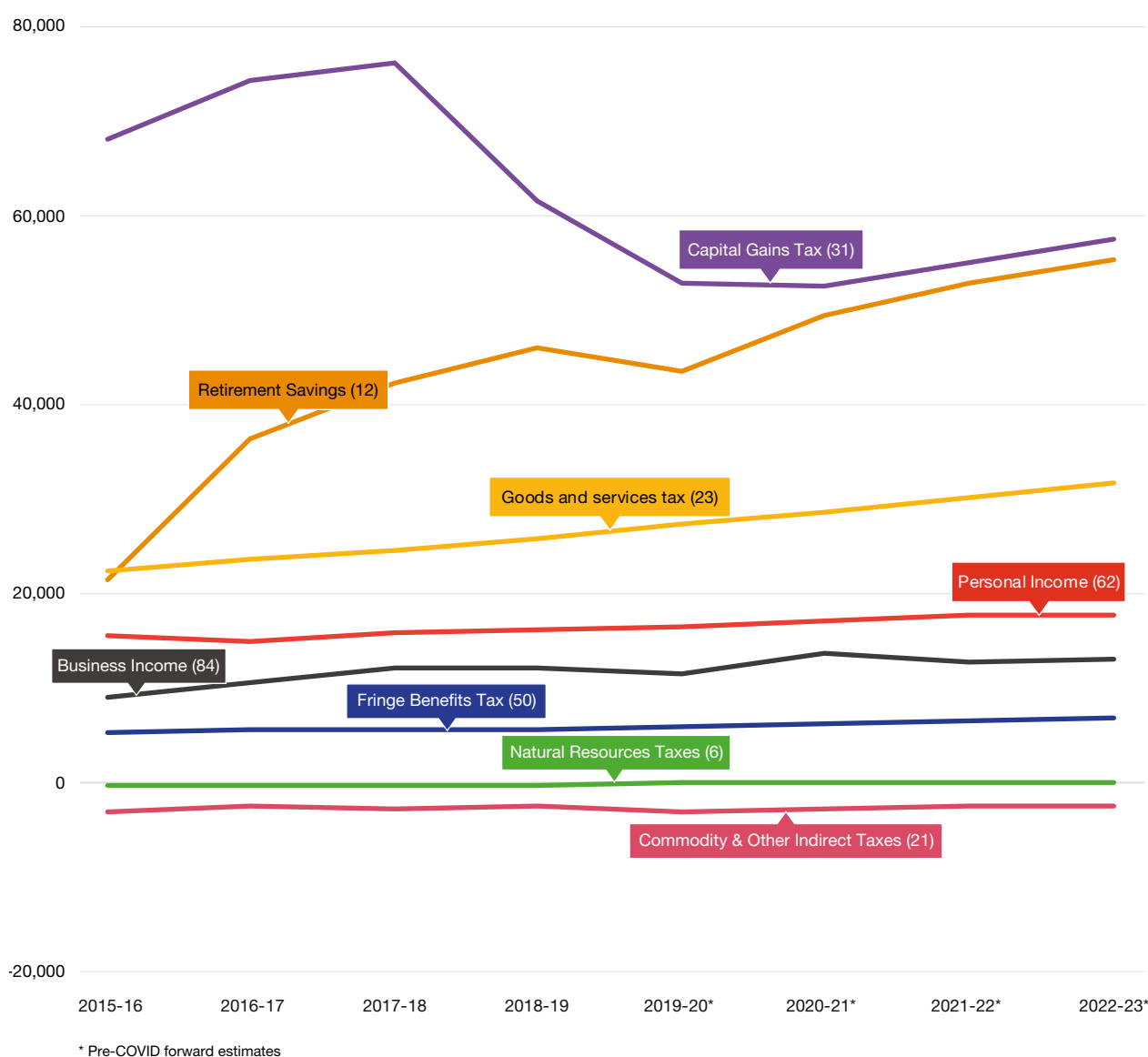
Additionally, a number of inequities result from Australia's reliance on tax expenditures. Tax expenditures arise when the 'normal' tax liability is reduced in order to encourage a particular behaviour, or to assist a particular group. Tax exemptions, tax deductions, tax offsets, concessional tax rates and deferrals of tax liability are examples of tax expenditures. In effect a tax expenditure is a deviation from the normal level of tax applied.



The Commonwealth Treasury publishes an annual catalogue of estimates of revenues forgone as a result of tax expenditures.¹² While not just an issue for the Australian government¹³, Treasury estimates that in 2018-19, where possible to generate estimates, the net Commonwealth revenue foregone was \$158.6 billion. As shown in figure 1.7, concessions in respect of capital gains tax and retirement savings comprised the bulk of the value.

FIGURE 1.7

Net tax/welfare position (\$ million)¹⁴



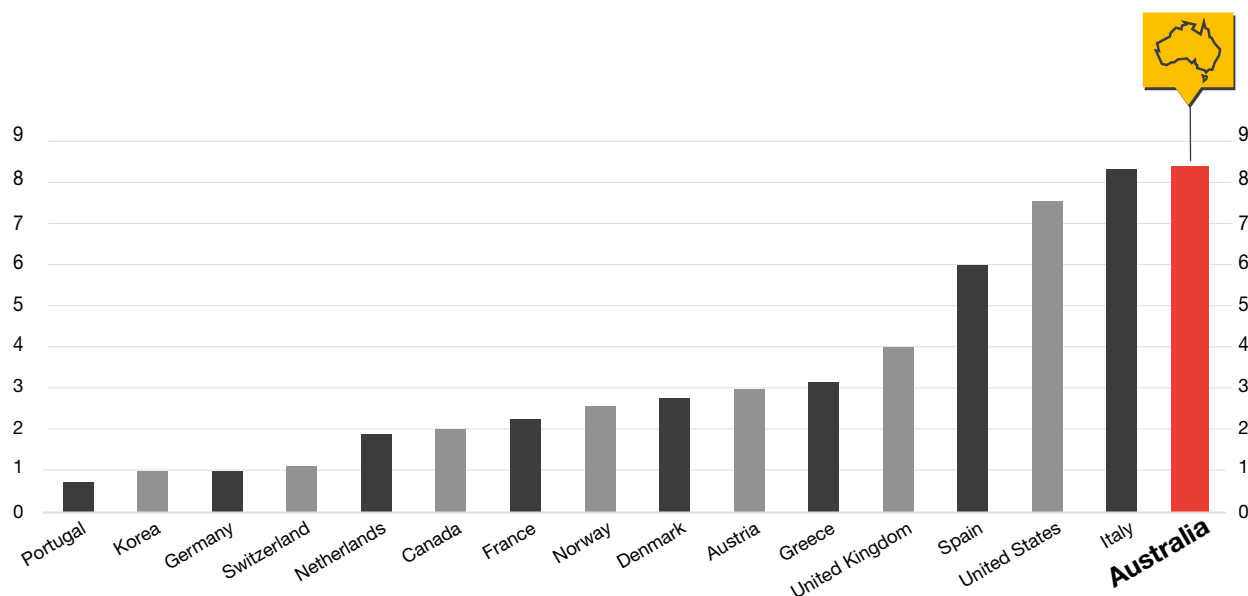
As a percentage of GDP in 2018-19 total net tax expenditures accounted for approximately 9.5 per cent of GDP.¹⁵ This is in contrast to direct payments made by the Australian government that are 25.4 per cent of GDP.¹⁶



While international comparisons are difficult, OECD data suggests that Australia is significantly more reliant on tax expenditures than most advanced countries (see figure 1.8).

FIGURE 1.8

Tax expenditures in selected advanced countries (% of GDP, 2010)¹⁷



A frequent concern in relation to tax expenditures is that they lack transparency and are seen to benefit those that need it the least, or result in taxpayers in the same circumstances facing different tax burdens.

Reliance on questionable tax bases

In some areas, significant tax revenue is generated from activities that the government is seeking to reduce for non-tax reasons. Therefore, government actions may hurt the budget bottom line in the short term. Examples include:

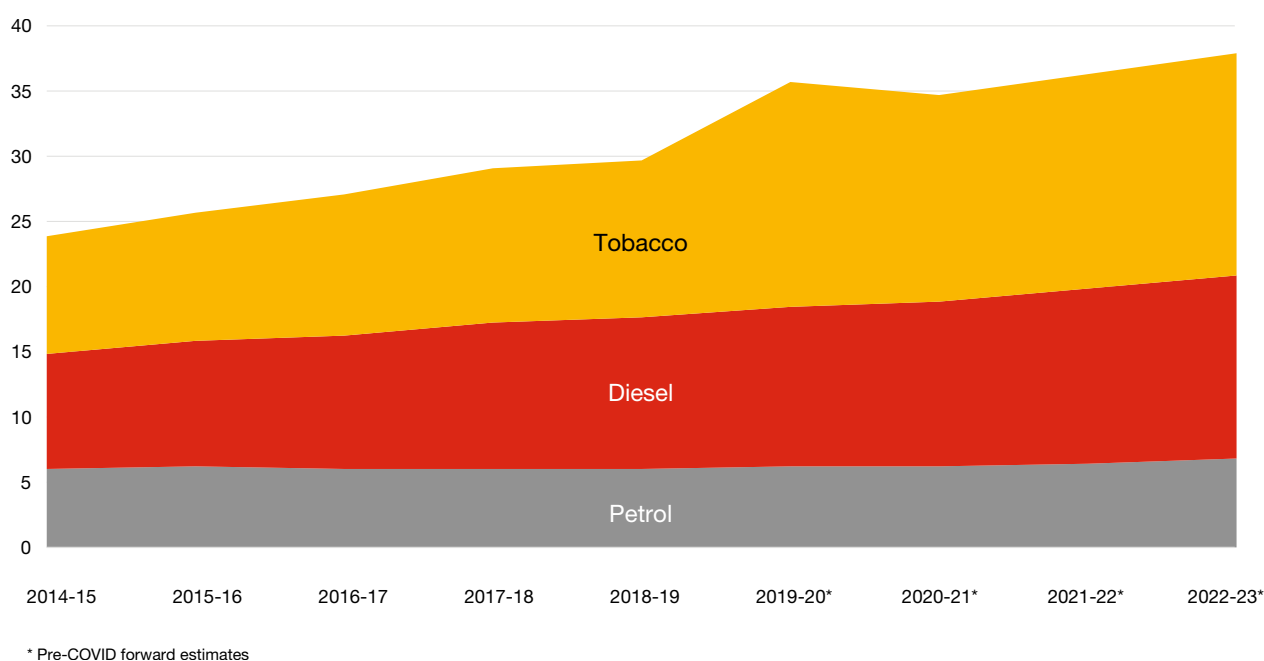
- **Health:** Governments have actively sought to reduce smoking rates and tobacco consumption through price rises, bans on smoking in certain locations, advertising bans and extensive information campaigns. This has reduced the Commonwealth Government's tobacco excise receipts.
- **Environmental:** The Commonwealth has actively sought to improve the efficiency of vehicles, and state governments have subsidised electric and fuel-efficient alternatives. These measures have reduced reliance on petrol, lowering fuel excise receipts.



Significant tax revenue continues to be captured from activities that are expected to be unsustainable in the medium term, or activities that government might actually have reasons for minimising. As shown in figure 1.9, the Commonwealth earns significant revenues from fossil fuels and tobacco. These are substantive revenues (close to \$30 billion in 2018-19) that would appear to be questionable in their sustainability given changing consumer preferences and technologies.

FIGURE 1.9

Select Australian government (cash) receipts (\$ billion)¹⁸



Similarly, states earn considerable revenues from gambling activities, many of which are declining (e.g. racing) or reflect a significant social cost (e.g. receipts from problem gambling).



Misalignment between revenues and responsibilities

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.

However, Australia has a significant misalignment between revenues raised and revenues expended across its three tiers of government:

While the states were responsible for nearly half of Australian general government operating expenditure in 2017–18, their limited taxation capacity means they contributed only 24 per cent of revenues. By contrast, the Commonwealth raises considerably more revenue than it needs for its own expenditure. The provision of grants to the states seeks to redress the misalignment of spending and revenue raising powers, known as vertical fiscal imbalance.¹⁹

A degree of vertical fiscal imbalance (VFI) may always be necessary, reflecting the appropriate differences in the respective roles and responsibilities of different levels of government. For example, the Commonwealth has advantages (e.g. efficiency, economies of scale and lack of interstate tax competition) in raising and collecting income tax revenue, and hence it may be efficient for the Commonwealth to collect more taxes than it directly expends.

The concern is that VFI is excessive in Australia, largely having arisen from the consolidation of taxing powers with the Commonwealth during World War II.

At the core of Australia's VFI is the centrality of its tax collections, as shown in figure 1.10.

FIGURE 1.10

Tax revenues of sub-sectors of general government in federal systems, 2017 (% of total tax revenue)²⁰

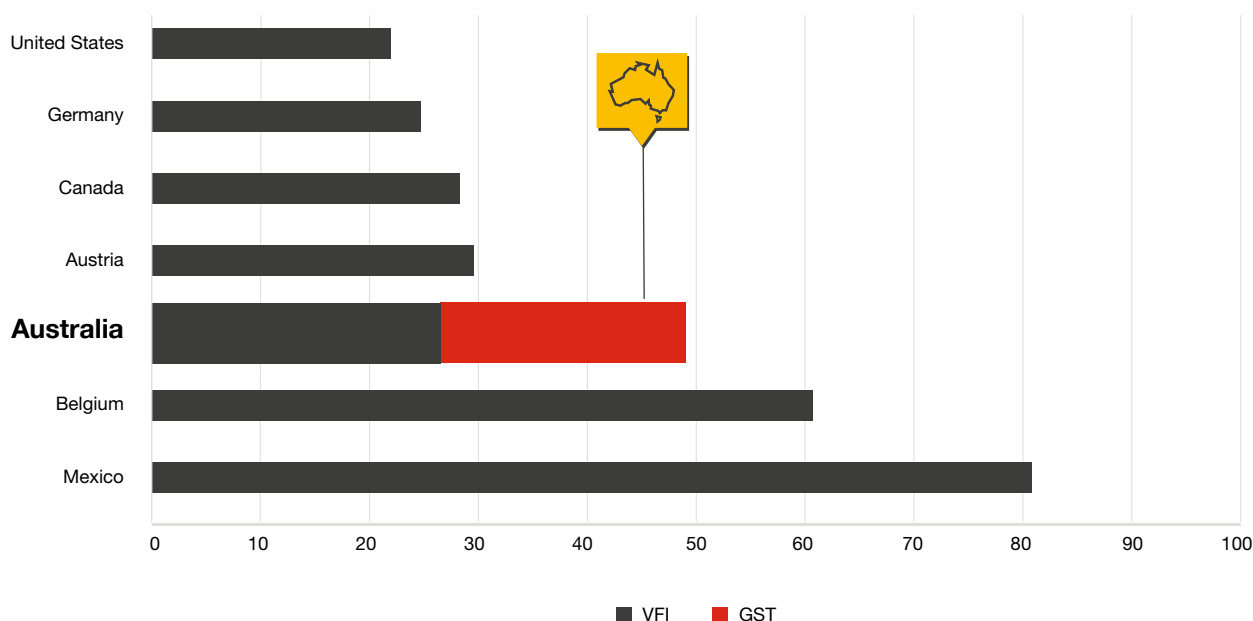
	Supranational	Central government	State or regional governments	Local government	Social security funds
Australia	-	80.6	16	3.4	0
Austria	0.4	65.8	1.6	3	29.2
Belgium	1	51.4	10.8	4.9	32
Canada	-	40.9	39.8	10.3	9.1
Germany	0.6	29.5	23.5	8.6	37.9
Mexico	-	81.1	4.1	1.6	13.3
Switzerland	-	36.5	24.6	15.3	23.6
United States	-	44.5	18.3	14.2	23
Unweighted average	0.7	53.8	17.3	7.7	21



While taxes are disproportionately collected centrally, it is the transfer of such funds to the states and territories for spending that creates the relatively high VFI shown in figure 1.11. In an Australian context, VFI should include GST as the Commonwealth collects the tax.

FIGURE 1.11

Vertical fiscal imbalance across selected federations (the share of national payments in total state revenue).²¹



There exists a consensus that significant VFI imposes a range of costs. In particular, it can:

- weaken government accountability to the public by breaking the nexus between a government's decisions on the level of service provision and the revenue raised to fund it
- reduce transparency regarding who is responsible for which government services, allowing governments to avoid responsibility by shifting blame for funding and operational shortfalls to other levels of government
- create inefficiencies, including through bureaucratic overlap, duplication and excess. and the cost of administering grants between government
- misallocate resources, including the inadequate or inappropriate funding of services. In particular, when a government does not have to raise the revenue it spends, this can create 'fiscal illusion', potentially leading to an over-provision of services. This is because governments that receive grants might obtain a political benefit from providing services without the political cost of raising revenue
- create a disincentive for states and territories to undertake reforms, as some of the benefits of those reforms may be equalised away to other states and territories because of the inconsistency of VFI across jurisdictions, coupled with the resultant horizontal fiscal equalisation process.



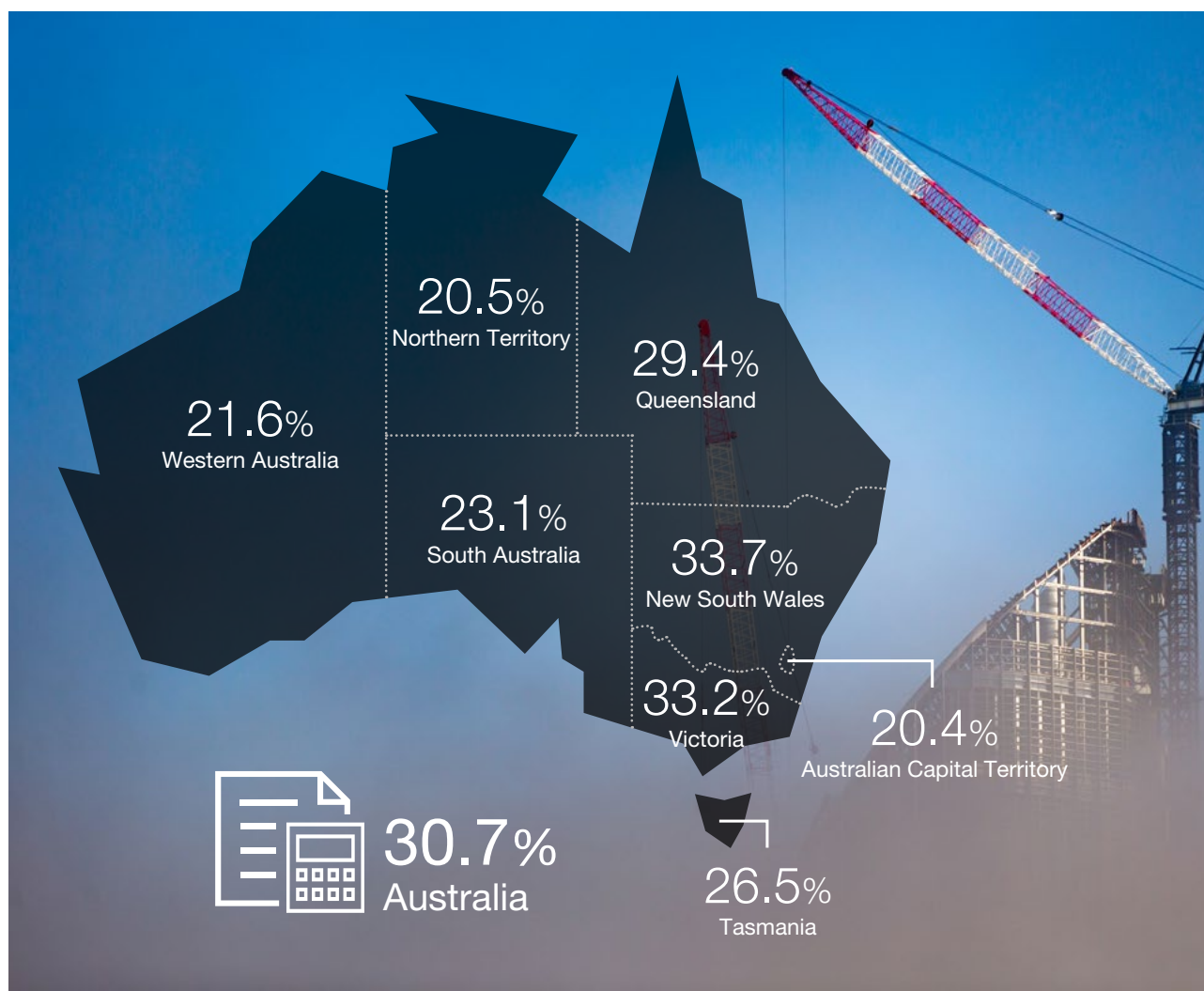
Reliance on distortionary taxes

A challenge facing Australian state and territory governments is that they have become increasingly reliant on a narrow range of taxes that have certain undesirable characteristics. This challenge is acknowledged by states and territories themselves.²²

Inherently inefficient: Due to limited revenue raising options, Australia's states and territories, continue to levy a number of highly inefficient transaction taxes, such as stamp duties and insurance levies. It is well established that both stamp duties and insurance levies are inefficient and can deter otherwise beneficial transactions from occurring. Australian states and territories currently rely heavily on both these taxes for their revenue (see figure 1.12), and apply comparatively higher tax rates when compared to other OECD countries.

FIGURE 1.12

Share of state taxes collected from tax bases with low economic costs (%).²³





Inefficient due to exemptions provided: The efficiency of a number of state and territory taxes is compromised by exemptions which influence decisions and create economic distortions. This can drive poor economic outcomes. For example:

- payroll tax-free thresholds create disincentives for businesses to grow and invest
- GST applies to all goods and services, except fresh food, private health and private education expenditure. Treasury estimates the value of these exemptions at \$18.54 billion in 2018-19, with spending on food, education and medical health services growing fast (figure 1.13). These exemptions were created to address equity factors but have reduced the economic efficiency of the tax by increasing complexity and the cost of administration (on average it costs the Australian Taxation Office \$1.36 to collect every \$100 of GST revenue, compared with 96c for other taxes).²⁴ Even the equity justification is challenging given that the value of the exemptions '[is] larger for high income households'.²⁵

FIGURE 1.13

Value of GST exemptions²⁶ (\$ millions)

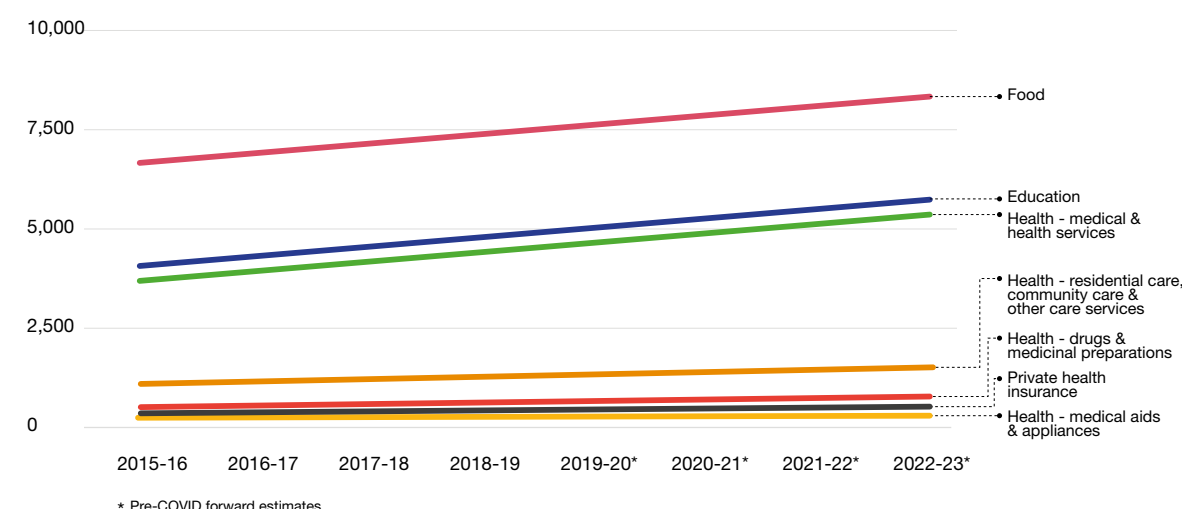
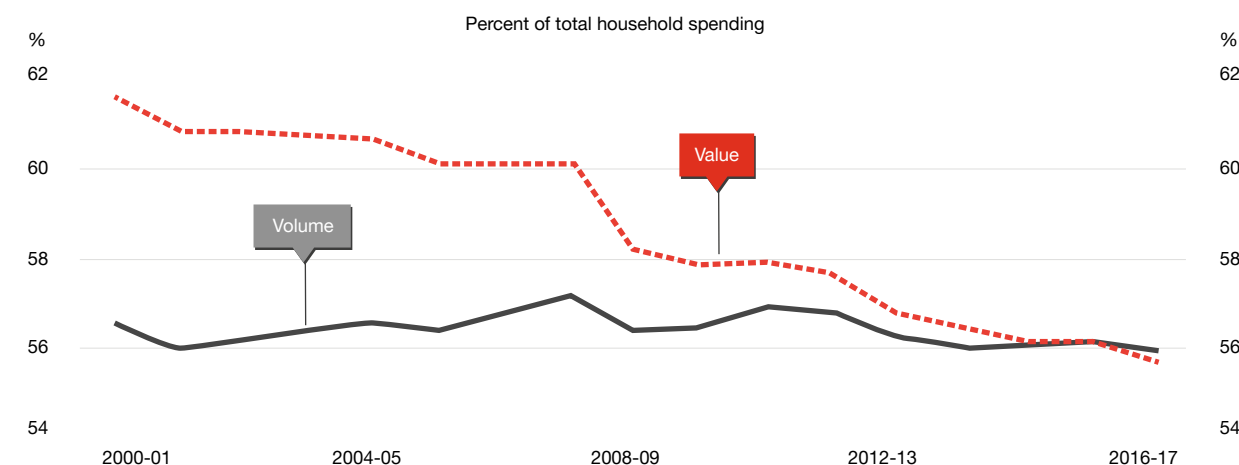


FIGURE 1.14

Household spending subject to GST²⁷



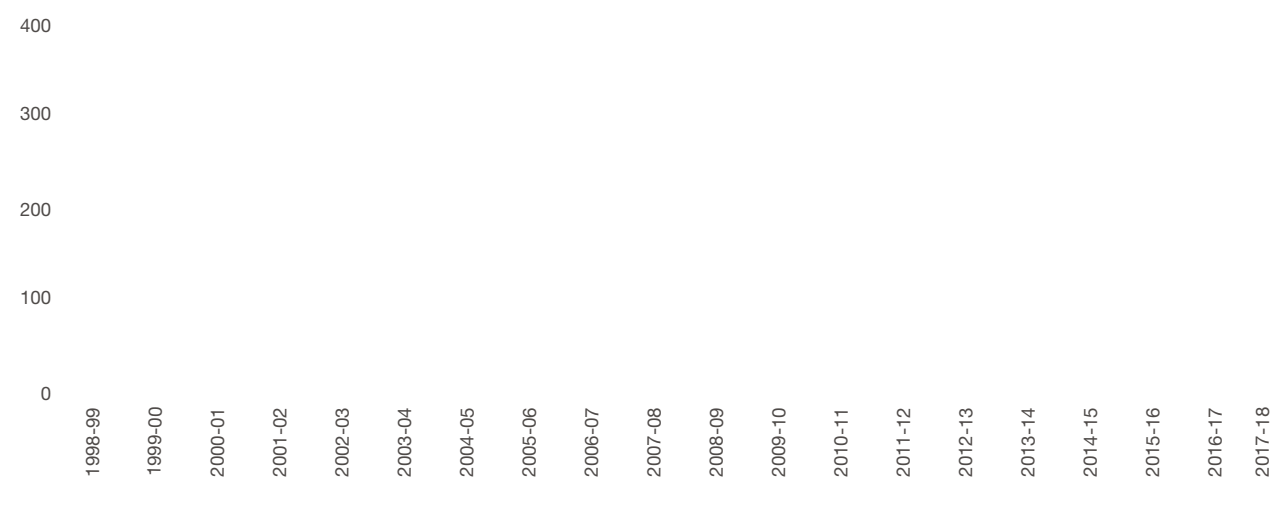


High compliance costs

While compliance costs appear to have levelled out over recent years (see figure 1.15 for figures in relation to individual tax compliance), Australia's tax system continues to impose high compliance costs due to exemptions, tax-free thresholds and the complexity of the law.

FIGURE 1.15

Average cost (\$) of managing tax affairs for individuals²⁸



Avoidance through the cash economy

A year ago, it seemed like a big task to even adopt a cash payment limit of \$10,000 per transaction, let alone move towards a near non-cash world. It has also been the case over a long period of time that people who have an in-substance employment relationship have adopted sham contracting arrangements, leading to potential under-declaration of income and accompanying tax liabilities.

During the COVID-19 lockdown it has become apparent that people can adapt quickly to contactless payment options, necessitated by health concerns. The importance of a clear employer/employee relationship was also evident when employee support payments were introduced to provide a safety net for the loss of earnings.

The cash economy remains:

*manifestly unfair, allowing some to play by their own rules and penalising businesses, employees and consumers who do the right thing ... vulnerable workers are exploited, criminal groups flourish and social capital and trust are undermined.*²⁹

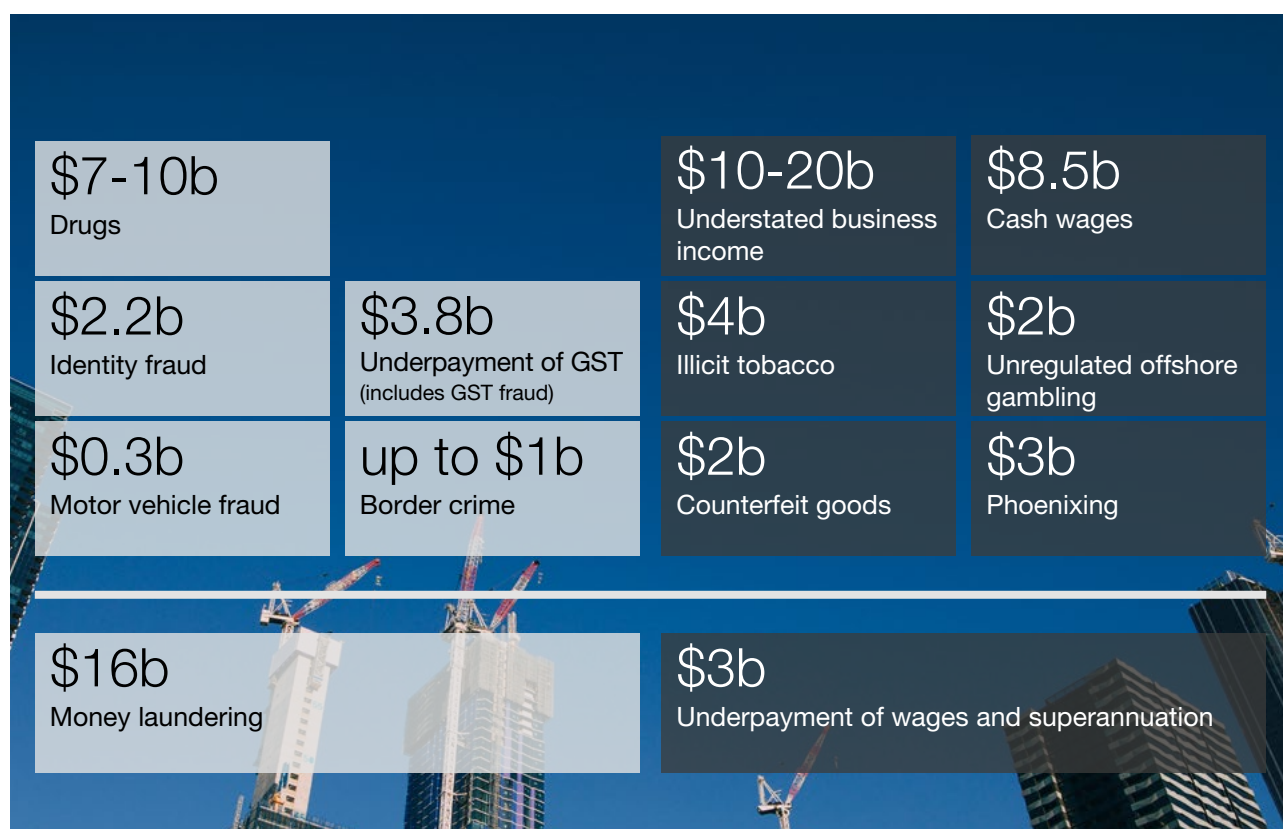


The broader black economy is estimated to be worth \$50 billion per year (based on an estimated 3 per cent of GDP, as shown in figure 1.16),³⁰ or nearly 40 per cent of the original estimate for the 2020 JobKeeper support program. Accordingly, there is an urgent need to address this issue through ease of compliance and a campaign to address the cultural norms of the past.

The amounts shown in figure 1.16 are the estimated components of the costs of the black economy in Australia. The amounts ‘above the line’ broadly equate to the \$50 billion per annum estimate noted above. The two categories ‘below the line’ are presented separately, as they are also reflected in the above-the-line activities

FIGURE 1.16

Partial indicators of ‘black economy’ activity³¹



What has changed as a result of the COVID-19 pandemic?

2.1 The Great Lockdown

Slowing the spread of COVID-19 has been necessary in order to manage the resources of Australia's healthcare system and, in so doing, save lives.

To minimise the risk of person-to-person transmission of COVID-19, Australian governments progressively and swiftly shut down swathes of the economy by:

- prohibiting certain activities (e.g. elective surgery; ruling that everyone should stay home unless shopping for essentials, receiving medical care, exercising, or travelling to work or education, etc.)
- placing constraints on how certain activities are undertaken (e.g. imposing social distancing obligations; establishing attendance limits for events such as weddings and funerals; requiring that no more than two people should be out in public together, with the exception of family and household groups, etc.)
- closing or limiting the use of public spaces and services (e.g. closure of beaches; recommending or requiring that non-essential workers keep children home from school)
- requiring or encouraging private sector enterprises to shut down or reinvent their service offering (e.g. closure of pubs and bars; requiring restaurants to provide takeaway only)
- imposing restraints on the movement of people across some domestic borders and more stringent restraints on travel into Australia.

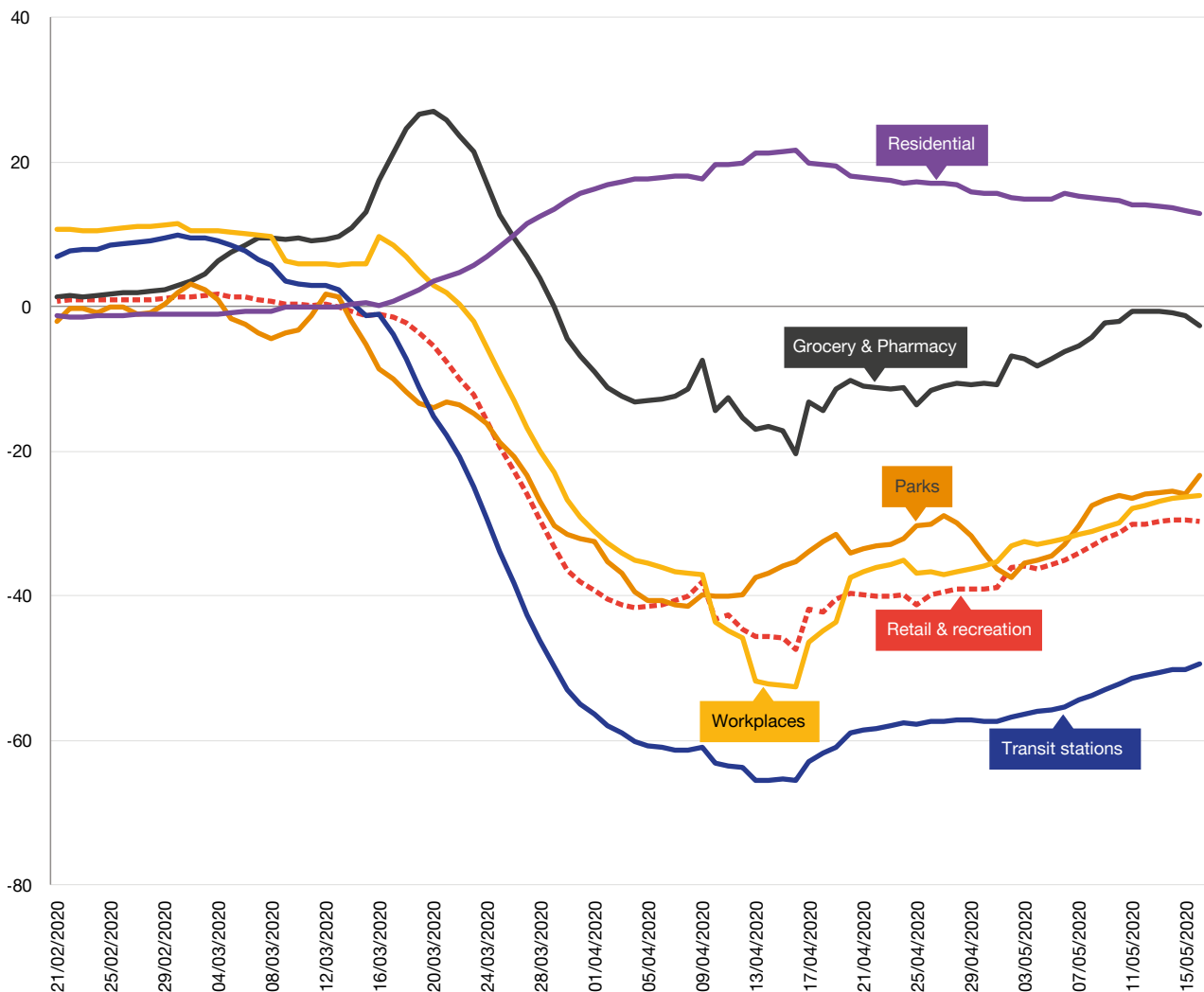




The effect of this ‘Great Lockdown’ (as the International Monetary Fund (IMF) termed the current economic crisis) has been to more than halve community mobility (see figure 2.1) and dramatically reduce resultant economic activity (see section 2.2).

FIGURE 2.1

Changes in Australians’ mobility (seven day moving average compared to pre-COVID-19 baseline)³²





2.2 The economic shock

The shutting down of economic activity to address the spread of COVID-19 has created a range of short-term impacts that have the potential to shape Australia's medium and long-term future:

- **Negative economic growth:** The Governor of the RBA suggests that “we are likely to experience the biggest contraction in national output and income that we have witnessed since the 1930s.”³³ The IMF suggests that Australia's GDP will decline by close to 7 per cent in 2020.³⁴
- **Higher unemployment:** The ABS suggests that 7.5 per cent of workers on business payrolls were lost from 14 March to 18 April.³⁵ Adjusting for off-payroll workers (e.g. business owners, independent contractors, other self-employed people, etc.) suggests that, of the 13 million Australians who were working in mid-March, up to a million no longer are. A number of features regarding unemployment are noteworthy:
 - Things will get worse before they get better. With estimates from the RBA Governor of 10 per cent unemployment by June, Australia can expect that unemployment could edge higher before starting to recover.
 - Higher unemployment will be a challenge for years. Previous economic shocks show that unemployment frequently remains persistently high for many years (figure 2.2); and the present circumstances are likely to be any different.
 - Not all industries have been equally affected: As shown in figure 2.3, social distancing obligations and the broader slowdown have affected economic sectors differently, with employment in some industries (e.g. mining, utilities, education and financial services) largely unaffected in aggregate.
- **Business failures:** The movement of Virgin Australia into voluntary administration is the highest profile failure at the time of writing.

FIGURE 2.2

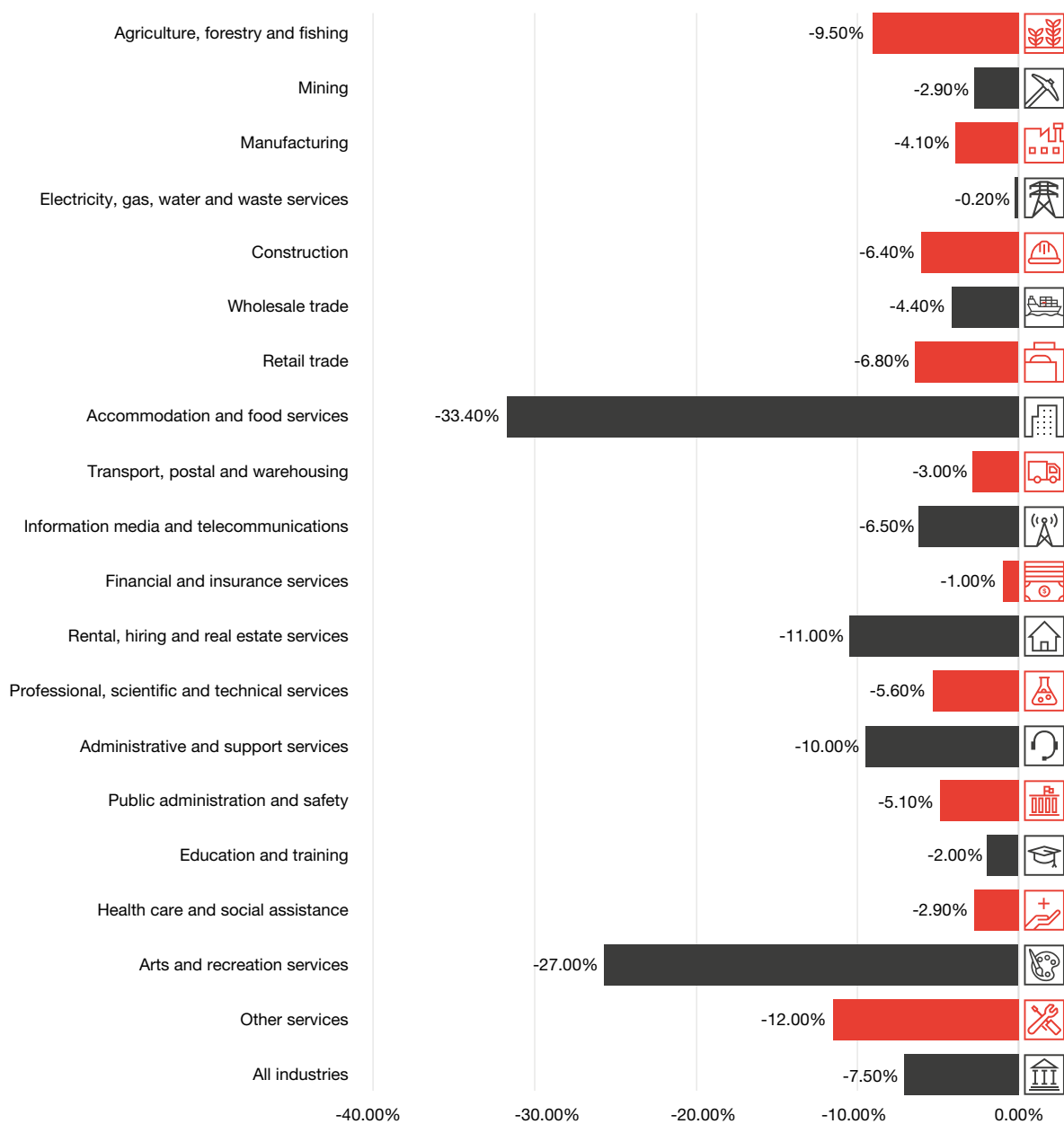
Months for unemployment to recover to pre-recession levels³⁶





FIGURE 2.3

Change in employee jobs between 14 March and 18 April ³⁷



Given these negative COVID-19-driven economic shocks, PwC's *Australia Rebooted* modelling indicates a GDP decline of \$279 billion over the next two years.³⁸



2.3 The impact on public finances

Restricting permissible economic activity (section 2.1) has necessarily reduced national income (section 2.2), and not surprisingly affected public finances through two channels: increased government expenditure to assist people and businesses during the lockdown; and reduced tax receipts. These channels are discussed in turn.

Ballooning government expenditure

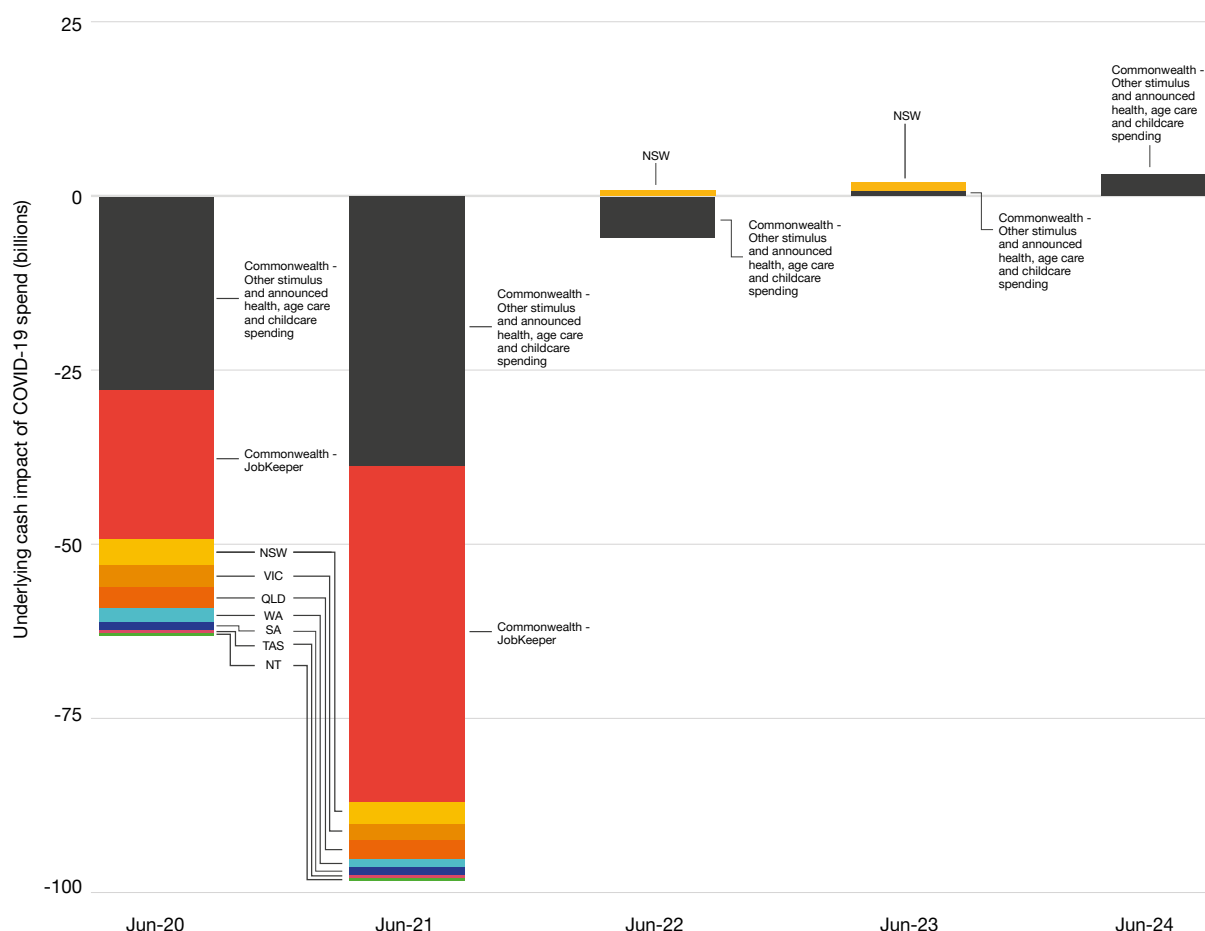
In response to a slowing economy, Australian governments are spending at a rate never before seen (see figure 2.4) through direct support of:

- businesses and employers through a range of support schemes (e.g. JobKeeper, tax holidays, deferred taxes, direct payments, etc.). Some of these supports have taken the form of delayed obligations to pay taxes (e.g. payroll tax)
- the unemployed (e.g. through additional JobSeeker payments) and households more generally (e.g. free childcare, one-off payments to pensioners, etc.).

In addition to this special support, spending will also increase as ‘automatic stabilisers’ kick in to support people on welfare (e.g. rent support).

FIGURE 2.4

Temporary fiscal measures in response to COVID-19³⁹





Shrinking government revenue

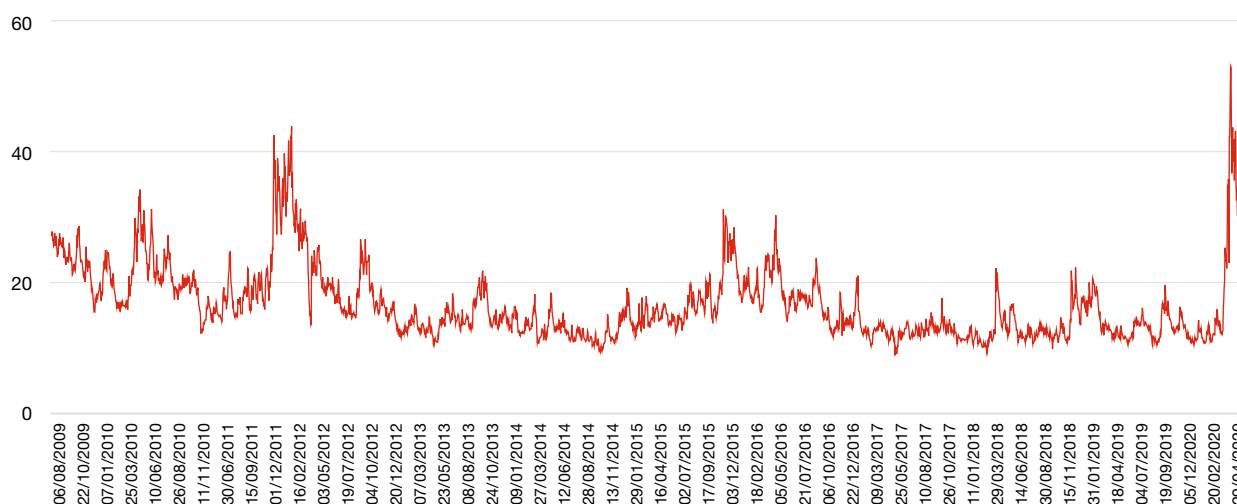
As at 30 March 2020, the underlying Commonwealth Government cash balance was almost \$10 billion worse than projected at 31 December 2019 (i.e. a deficit of \$22.36 billion against a deficit of \$12.45 billion).⁴⁰ This is before the majority of the stimulus to-date was implemented (i.e. JobKeeper and JobSeeker).

Tax revenues are expected to fall during the COVID-19 pandemic. This will be due to a reduction in employment (lower personal tax receipts) and an anticipated decline in corporate tax receipts, reflected in the:

- significant volatility in the Australian Stock Exchange (ASX), as measured by the VIX Index, which implies significant uncertainty about future corporate profits (see figure 2.5)
- announced and anticipated profit downgrades by major corporates.⁴¹

FIGURE 2.5

S&P/ASX, 200 VIX Index





Increased government deficit and debt

The consequence of reduced revenue and ballooning expenditure will necessarily underlie budget deficits and an increase in government debt.

The Parliamentary Budget Office notes that “Australia’s net debt at the end of March 2020 was around \$430 billion, which is around \$37 billion higher than the most recent forecast for the end of this financial year.”⁴²

PwC has undertaken long-run modelling to estimate possible impacts of COVID-19 and subsequent policy actions on the Commonwealth’s budgetary position. This modelling approach is described in Box 2.1.

BOX 2.1

Long-run fiscal modelling

PwC developed an economic model to understand the potential fiscal impacts of COVID 19 in the immediate, medium and long term. This modelling incorporates the best available current information but has been conducted at a time of uncertainty and so will need to be refined as more information becomes available on: the path of the COVID 19 pandemic; the near term hit to the economy; the shape of recovery; and the take up of key stimulus measures.



Economic parameters

- In the short term (current and next year), economic parameters (such as employment, participation, population and wages) are based on actual values as reported by the ABS and forecasts provided by the IMF.
- In the medium term (up to eight years), PwC modelled recovery profiles for these parameters based on historical analogies, and current best available information on when key restrictions (e.g. international migration) will lift.
- In the long term, PwC assumed reversion to long term trends.



Expenditure projections

- All announced COVID 19 related expenditure (as at 22 May 2020) have been included.
- All non social welfare expenditure is assumed to be consistent with most recent budget forward estimates, and then assumed to grow in line with population and inflation.
- All social welfare expenditure is modelled based on key economic parameters of population (including migration adjustment), unemployment, age and participation.



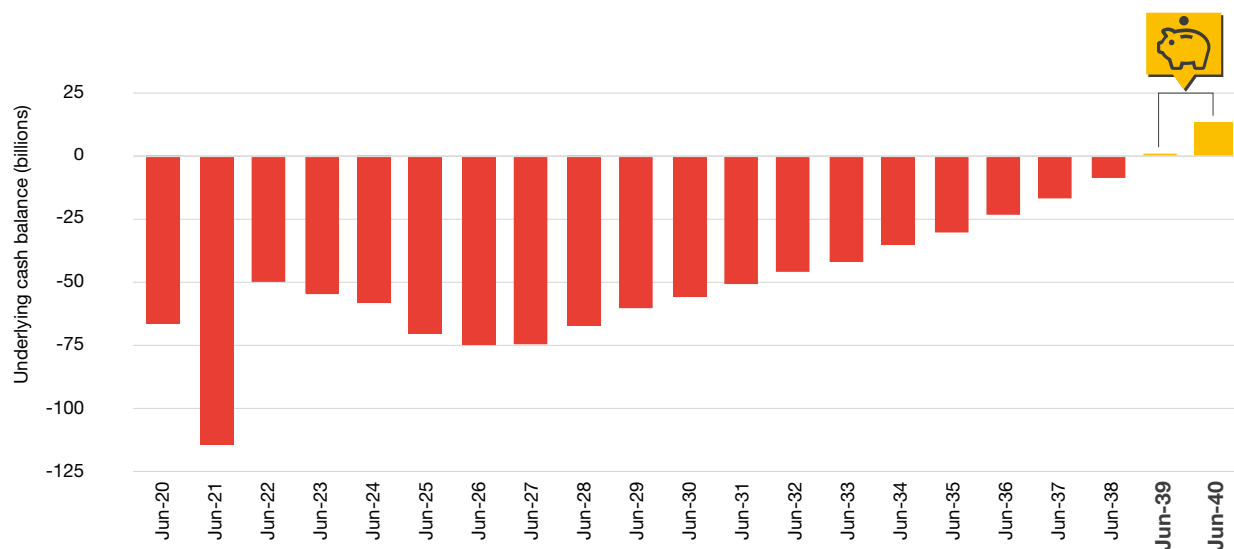
Revenue projections

- All revenue projections are modelled in line with relevant economic parameters (and are not assumed to be consistent with forward estimates) and account for previously legislated changes to personal income tax rates and corporate income tax rates for small businesses.
- Corporate income tax revenues are forecast to account for loss carrying after the initial economic shock, by size and industry gross operating surpluses, where relevant.



FIGURE 2.6

Projected Commonwealth budget position (\$ billions, year ending June)⁴³



PwC predicts that, without changes to Australia's tax system, the Commonwealth budget will not return to balance for the next 19 years (see figure 2.6), let alone generate the surpluses needed to pay down the new debt. In the 2010 Commonwealth budget it was projected that Australia would reach zero net debt in 2029-30; with the projected deficits shown in figure 2.6 PwC now forecasts this to not occur until 2056-57.

This means that an 18 year old entering the workforce this year could have expected to work under consecutive federal budget surpluses for the foreseeable future, and to see the Commonwealth achieve zero net debt by the time they were 28 years of age. Now that same worker cannot expect a budget surplus until they are 37 years old, and net debt is not predicted to reach zero until they are 55.

While Australia entered the COVID-19 pandemic in a relatively enviable state, and it may emerge in a position of relative strength given the apparent success in minimising the spread of COVID-19, the short-term impact identified in the previous chapter will create ongoing challenges for all Australian governments.

The case for tax reform existed pre-COVID-19; and the pandemic has merely exacerbated existing problems and brought them to the fore.



3.1 Revenue

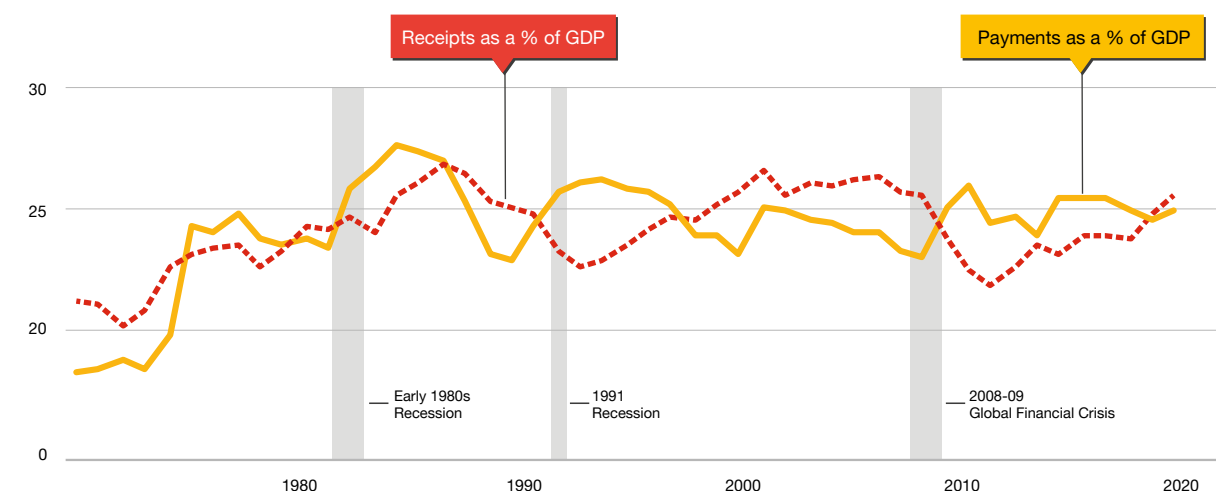
Public finances have been thrown out of balance. Australia has seen an easing of fiscal policy in response to COVID-19 disruption that will drive a deterioration in the Commonwealth budget from being broadly in balance in 2018-19 to a projected deficit of about 7 per cent of GDP in 2019-20 and somewhere in the vicinity of 8-12 per cent in 2020-21.⁴⁴ Significant deficits are also expected by the states and territories.⁴⁵

Past experience shows that short-term public expenditure rises during recessions and has a habit of becoming locked in (see figure 3.1), meaning that the process of budget repair tends to be a long one. Hence, repairing the tax base early is important. Indeed, as noted in section 2.3, maintaining Australia's existing tax system in light of projected population, participation and productivity growth (the 'three Ps') means the nation will not get back to a neutral budget position until 2039.



FIGURE 3.1

Australian government general government sector receipts and payments⁴⁶



Should existing budget deficits extend over long timeframes – or show no signs of returning to a sustainable balanced budget over the economic cycle – they can have broader consequences. This is particularly the case when budget deficits are driven by structural rather than cyclical factors. Large deficits focused on funding the requirements of today’s citizens, rather than investment for the future, may mean future generations will face a higher tax burden. Instead of accepting this outcome, Australia should aim to get government budgets back into a neutral position over the economic cycle. The above circumstances create the impetus for governments to implement an appropriate policy response.

However, the purpose of tax reform should not be to generate surpluses to pay back the \$140 billion expected to be directly incurred by the Australian government as part of the COVID-19 support package. Such an objective is not immediately necessary because:

- there is little risk of increased government spending ‘crowding out’ the private sector any time soon given the collapse in demand, low (and even negative) inflation, and low interest rates
- the potential cost of increased government spending is limited given that the interest rate the Australian government pays on new debt is at a historic low (i.e. just 0.8 per cent for money borrowed for 10 years). As a result, if the Australian economy resumed its long-run average growth rate after the current crisis, any increase in debt as a percentage of GDP will halve within 20 years
- the cost of increased government spending is unlikely to destabilise financial markets. Even with the stimulus provided by the Australian government (see figure 1.3), the nation will continue to have low levels of government net debt relative to comparable countries and will continue to be seen as a safe haven by financial markets (see figure 2.1).



Tax reform is necessary to shore up Australia’s federal budget position by finding reliable and sufficient sources of revenue to meet required spending needs.



3.2 Equity

The health and economic responses to COVID-19, put in place to protect older populations that are more susceptible, have resulted in a significant intergenerational transfer of wealth. This has manifested in a couple of ways:

- shutting down significant portions of the economy has exposed working-age people, and particularly those in casual employment (i.e. the young), to unemployment. The persistence of unemployment after economic crises (see figure 2.2) suggests that this will impose personal costs for years.
- almost 900,000 Australians have already applied for early withdrawal from superannuation. The Commonwealth Government expects this number will rise to 1.6-1.7 million, equating to about \$27 billion coming out of the superannuation system. While this may be important in sustaining the living standards of those accessing their superannuation, it potentially diminishes living standards in future years directly (i.e. through lower savings) or indirectly (i.e. because more burden is taken up through the pension, and so entrenches inequality in the community and makes budget repair harder).⁴⁷

In effect, the economic sacrifice of The Great Lockdown represents a loss of wealth from young/working-age people to protect the health outcomes of those over the age of 60.

It may be that the beneficiaries of that protection should repay that support (at least in part).⁴⁸ This could be achieved by addressing tax advantages that disproportionately benefit the relatively well-off over the age of 60. For example:

[W]here the next generation has a justified grievance is the costs of the tax breaks that support the build-up of these nest eggs. Your superannuation gets special tax treatment – a flat 15% tax on the way in, and no tax at all on earnings once you’re retired, except on very large balances.

These tax breaks, combined with refundable franking credits and the Seniors and Pensioners Tax Offset, have resulted in the share of households over 65 paying tax almost halving over the past two decades. Older Australians now pay on average about half as much income tax as younger households on the same income.

*Many of these tax benefits were introduced in the past 20 years and their generosity is now starting to bite: the cost is a growing tax burden on working-age Australians. Younger Australians have always supported services to older Australians through their income taxes, but the size of this transfer is much bigger now and growing quickly.*⁴⁹



Tax reform is necessary to address some of the equity issues associated with the distribution of costs and benefits associated with Australia’s response to COVID-19.

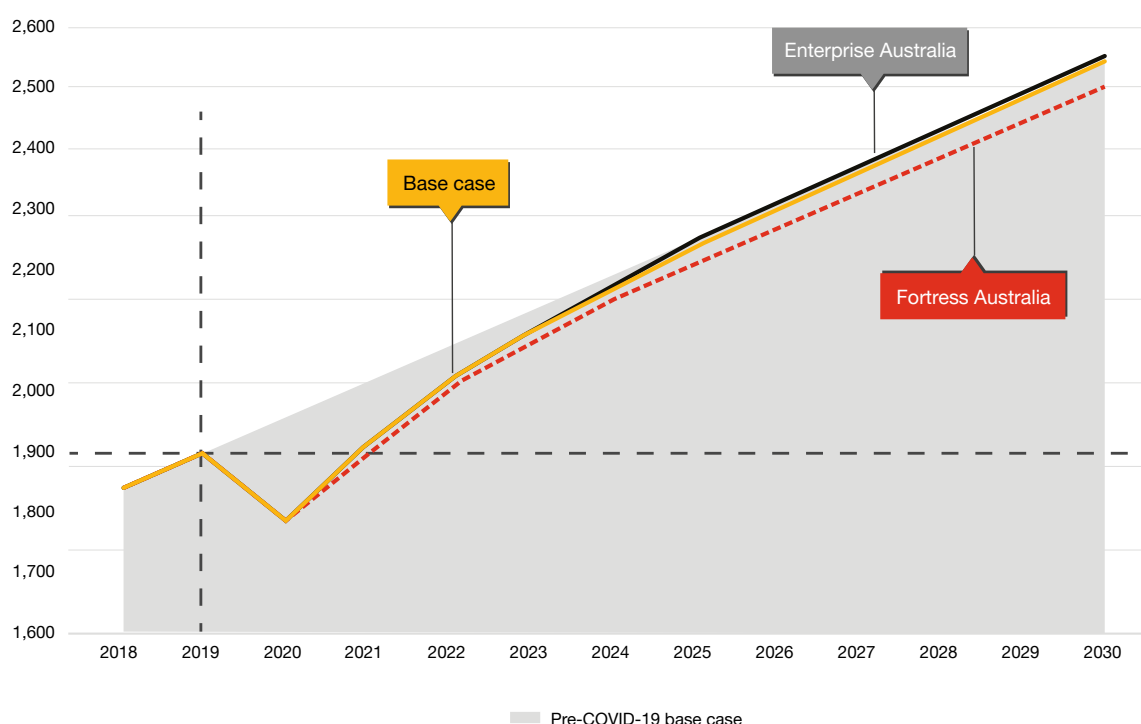


3.3 Economic growth

PwC's recent *Australia Rebooted* report, identified that economic growth should be the priority for Australian governments. This reflected modelling outcomes that showed that, compared to a passive 'no-change' approach, a high-growth model ('Enterprise Australia') would create \$64 billion over the period 2022-2030 and get the nation's economic growth trajectory back to (and in fact slightly exceed) the pre-COVID-19 growth trajectory.

FIGURE 3.2

Forecast real GDP (\$2019-20 billion)⁵⁰



Even if policies are adopted that establish different objectives (e.g. greater self-sufficiency), this should be done in a broader policy environment in which no-regret steps are taken to maximise economic growth.

Key to raising economic growth is raising Australia's productivity levels, given that labour productivity growth has been weak and slowing compared with previous years.⁵¹ The major factor driving this poor performance in recent years has been the fact that the capital-labour ratio (i.e. the quantity of capital inputs used per unit of labour input – referred to as 'the contribution from capital deepening') has progressively weakened. So much so, that Australia has seen the economy-wide capital-labour share fall (i.e. 'capital shallowing'). Tax reform has a role in addressing business' incentive to invest in new capital.

As noted in section 1.2, Australia's tax system is riddled with economic inefficiencies that have been highlighted by successive reviews (discussed in section 4.1). This is a 'luxury' that the nation cannot afford if it is to grow from COVID-19.



Tax reform is necessary to reduce distortions and other inefficiencies that are a handbrake on Australia's economic growth.

4.1 Hasn't this been tried before?

Fundamental tax reform has been one of those problems put in the 'too hard basket'.

Successive independent reviews of Australia's tax system⁵² have highlighted a myriad of systemic problems, yet the politics of reform have generally proven insurmountable. Tax reviews have included, for example:

- in 1998, the Liberal-National Commonwealth Government appointed John Ralph AO to conduct a review of the Australian business taxation system.⁵³ The review took place in the context of the Howard government exploring the introduction of a GST
- in 2008, the freshly elected Rudd ALP government directed former Treasury Secretary Ken Henry AC to conduct a 'root and branch' review of Australia's business and non-business tax systems (the Henry Review).⁵⁴ The review took place in the context of the Rudd/Gillard governments exploring the introduction of a mining tax
- in 2011, the Gillard ALP government convened a tax forum at the behest of cross-bench members of Parliament.⁵⁵ This tax forum took place in the context of the Gillard government's introduction of a carbon price
- in 2015, the Abbott LNP government started a review of the Australian tax system under the auspices of the tax white paper.⁵⁶

In each case, the broad purpose of the reviews was to promote economic growth, equity, simplicity and certainty, and to support Australia's fiscal position.⁵⁷ In each case, the review led to the identification of a range of problems or gaps in Australia's tax law, and to a set of recommendations that would fix or mitigate that problem or gap. In most cases (with the possible exception of the Ralph Review), the proposed reforms were largely or partly left unenacted, and the goals of the review went unrealised.





Plainly, recent years have not been free from reform. The Howard government introduced the GST, and the Rudd/Gillard governments introduced the carbon price and mining tax (each subsequently repealed). In the aftermath of the Ralph Review, the Board of Taxation was formed, which has produced regular and important reports and recommendations on a range of tax reform issues. Furthermore, in recent years there has been a flood of both unilateral and multilateral actions to mitigate base erosion and profit shifting (BEPS), including the introduction of the Multinational Anti-Avoidance Law (2015), the Diverted Profit Tax (2017), and the anti-hybrid rules (2018). However, there has not been sufficient political will or public interest to undertake holistic and structural tax reform, where such tax reform might not align with the preferred outcomes of key domestic stakeholder groups.

While Australia has achieved these very targeted and specific reforms, in the same period there has been significant tax reform to grow economies in other jurisdictions. These include, for example:

- the gradual lowering of the corporate tax rate in the UK from 30 per cent to 19 per cent over the past decade
- changes introduced by the Trump administration in the US, including:
 - a significant reduction in the corporate tax rate (from 35 per cent to 21 per cent)
 - tax cuts for pass-through businesses
 - capping interest deductibility at 30 per cent of EBITDA (after four years, EBIT)
 - immediate expensing of some capital investments
 - efforts to effectively tax foreign earnings, including a Base Erosion Anti-abuse Tax (BEAT) and a levy on a company's (creatively named) Global Intangible Low-Taxed Income (GILTI)
- the introduction of patent box regimes in many European countries, which encourage the development and utilisation of homegrown intellectual property by providing concessional tax rates on revenue generated by that intellectual property, thereby enabling those countries to attract science, technology, engineering and maths (STEM) jobs and compete for transfer pricing margins.

Even with such changes overseas, there has not been a sufficient 'burning platform' to ignite the willingness of stakeholders to embrace reform that may not align with each stakeholder's preferred outcomes, and so some form of *status quo* has continued.

However, the economic shock experienced in responding to COVID-19 provides such a 'burning platform' that might encourage policy decision-makers today to necessarily challenge the *status quo*.

That Australia has tried comprehensive tax reform previously and largely failed should not be a reason for not proceeding.

Governments have been given a 'pass' to do what is right in these unusual circumstances, often defying traditional stereotypes and entrenched positions. This opportunity to step outside convention should be used to overcome the barriers to tax reform that have existed over the past two decades.



4.2 Seize the moment?

If Australia has a unique opportunity, should it push for reform as fast as possible?

The answer is ‘no’.

Tax reform should not be a knee-jerk reaction to the immediate COVID-19 crisis. Indeed, the International Monetary Fund (IMF) cautions governments to:

Refrain from introducing bespoke or knee-jerk fundamental reforms or overhauling existing tax law systems during crisis, so as not to compromise the integrity of the system, and risk undermining tax certainty after the current crisis abates. In this respect, a premium should be placed on measures that move the tax system in desirable directions. Specifically: **refrain from tax holidays; keep environmental taxes; do not cut corporate income tax rates.**⁵⁸

Emergency and temporary taxation and spending measures are already in place to deal with the immediate COVID-19 challenges. They are not ‘tax reform’ in the traditional sense.

Australia should be planning comprehensive tax reform, but right now is not the time to implement wholesale change.

Rather, Australia needs to triage and stabilise the economy. Only then will there be capacity to consider imposing change. Tax reform in the middle of an economic shock will pose another level of disruption to businesses already being asked to change in so many ways, and it will risk the introduction of reforms that will need to be recalibrated once some stability returns.

However, this does not mean that Australia’s leaders shouldn’t act . Now is the time to plan for reforms as the nation emerges from the immediate crisis.

Reforms are rarely made simply because they are a good idea. Reform involves change, and change requires trust in governments, politicians, and bureaucratic institutions to explain, design and implement reform.

Surviving the COVID-19 pandemic has involved a new openness in dealing with the public; a bargain was made that required the public to 'buy in to' the temporary dismantling of the economy to ensure the public's safety.

Australia cannot go back to tax reform as a secret process.

Hence, the tax reform process needs to be seen as fair and equitable. Excluding certain taxes or tax concessions from assessment will undermine trust and affect the acceptability of any final package of reforms. For government to build trust and achieve meaningful tax reform, the public must be on board with the need for change. Clear principles are also required to guide the reform process, along with an effective plan which has community acceptance, and timeframes which allow for proper engagement and transition. Australia must not rush to solutions until trust and understanding are established. Leaders must also be wary of one-size-fits-all approaches and be prepared to challenge the status quo.

As such, a series of subsequent PwC Australia papers during June and July 2020 will identify tax reform options that will be exposed to scrutiny and comment by a range of stakeholders from different walks of society (e.g. union and business representatives, academics, and broader civil society representatives). The next papers in this series are expected to examine intergenerational equity and options to reform the GST.





- 1 These estimates are highly uncertain and need to be refined as more information becomes available on: the path of the COVID-19 pandemic; the near-term hit to the economy; the shape of recovery; and the take-up of key stimulus measures
- 2 Lowe (2020a)
- 3 Lowe (2020a)
- 4 Frydenberg & Cormann (2019)
- 5 OECD (n.d.). General government consists of central, state and local governments and the social security funds controlled by these units
- 6 Coates et al (2020)
- 7 OECD (2019)
- 8 GST tax growth would have been higher, but for the current exemptions which mean that GST does not apply to fresh food, health and education, along with some internet purchases (see section 2. for further discussion)
- 9 ABS (2019)
- 10 OECD data presented in Australian Institute of Health and Welfare (2017) *Australia's welfare in brief: 2017*
- 11 ABS (2018)
- 12 See Treasury (2020) *Tax Benchmarks and Variations Statement*
- 13 The payroll tax exemptions provided for small and medium-sized businesses and special one-off discounts/exemptions provided to some larger firms as a form of investment attraction are the most significant tax expenditures at the state level - see Australian government (2015, p.144)
- 14 PwC analysis of Treasury (2020)
- 15 2019-20 MYEFO, Table D1. As a point of comparison, in the United States the Congressional Budget Office 'estimates that in fiscal year 2019, the more than 200 tax expenditures in the income tax system will total more than \$1.6 trillion, including their effects on individual income, payroll, and corporate income taxes. That amount would equal 7.8 per cent of GDP — almost half of all federal revenues received in that year' - Congressional Budget Office (2019, p.88)
- 16 2019-20 MYEFO, Table 3.2
- 17 Tyson (2014, p.3)
- 18 Frydenberg & Cormann (2019)
- 19 NSW Review of Federal Financial Relations (2020)
- 20 OECD (2019)
- 21 OECD (2014, Figure 15)
- 22 'Fiscal illusion' refers to the possibility that citizens may not appreciate the actual cost of the services they receive, due to the tax raised to fund the services not being fully visible to them. In relation to transfers, this illusion may occur if citizens do not link their payment of tax to one level of government with the provision of services by another level of government
- 23 Daley et al (2018)
- 24 These costs are largely attributed to boundary issues that arise from the exemptions from the GST. One such example as was pointed out by Justice Richard Edmonds of the Federal Court is to decide whether Italian mini ciabatta is a 'cracker' (and therefore subject to GST) or 'bread' (and therefore exempt from it). See Eslake, S, 2011. *The Tax Reform Challenge*, Australian Parliamentary Library Lecture
- 25 Treasury (2020, p.10)
- 26 Treasury (2020)
- 27 PBO (2018)
- 28 ATO (2019)
- 29 Black Economy Taskforce Report (2017, p.1)
- 30 Black Economy Taskforce Report (2017, p.1)
- 31 Black Economy Taskforce Report (2017, p.36)
- 32 Google (2020) *Community Mobility Reports*
- 33 Lowe (2020b)
- 34 This is a short-term impact. The experience of the Spanish flu demonstrated that earlier and stronger interventions to limit contagion reduced the mortality rate, and consequently enabled higher economic growth in subsequent years (i.e. in comparison to places with slower interventions and higher mortality) - Correia et al (2020)
- 35 ABS (2020)
- 36 ANZ Research (2020)
- 37 ABS (2020)
- 38 PwC (2020)
- 39 PwC, drawing on ANZ Research (2020) and Treasury (2020). Does not include stimulus component of 'Supporting the Flow of Credit'
- 40 Cormann (2020)
- 41 See, for example, the call for suspension of shareholder class actions in relation to COVID-19 profit downgrades (Durkin 2020).
- 42 PBO (2020, p.1)
- 43 These estimates are highly uncertain and need to be refined as more information becomes available on: the path of the COVID-19 pandemic; the near-term hit to the economy; the shape of recovery; and the take-up of key stimulus measures

- 44 These estimates are highly uncertain and need to be refined as more information becomes available on: the path of the COVID-19 pandemic; the near-term hit to the economy; the shape of recovery; and the take-up of key stimulus measures
- 45 Wright (2020)
- 46 Treasury (2019, p.10)
- 47 See Coates & Nolan (2020)
- 48 See discussion in Tillett (2020)
- 49 Emslie (2019)
- 50 PwC (2020)
- 51 PC (2019, p.9-10)
- 52 See descriptions of reviews in Kenny (2010)
- 53 Ralph, Allert & Joss (1999)
- 54 Henry et al (2008)
- 55 See Shorten & Swan (2011)
- 56 See Hockey (2015)
- 57 Ralph, Allert & Joss (1999, p.13); Henry et al (2008, Terms of Reference points 1-2)
- 58 IMF (2020). Emphasis in original

Abbreviations

ABS	Australian Bureau of Statistics
COVID-19	Coronavirus disease 2019
GFC	Global financial crisis
GST	Goods and services tax
GDP	Gross domestic product
IMF	International Monetary Fund
LITO	Low income tax offset
LMITO	Low and middle income tax offset
OECD	Organization for Economic Co-operation and Development
PBO	Parliamentary Budget Office
RBA	Reserve Bank of Australia
VFI	Vertical Fiscal imbalance



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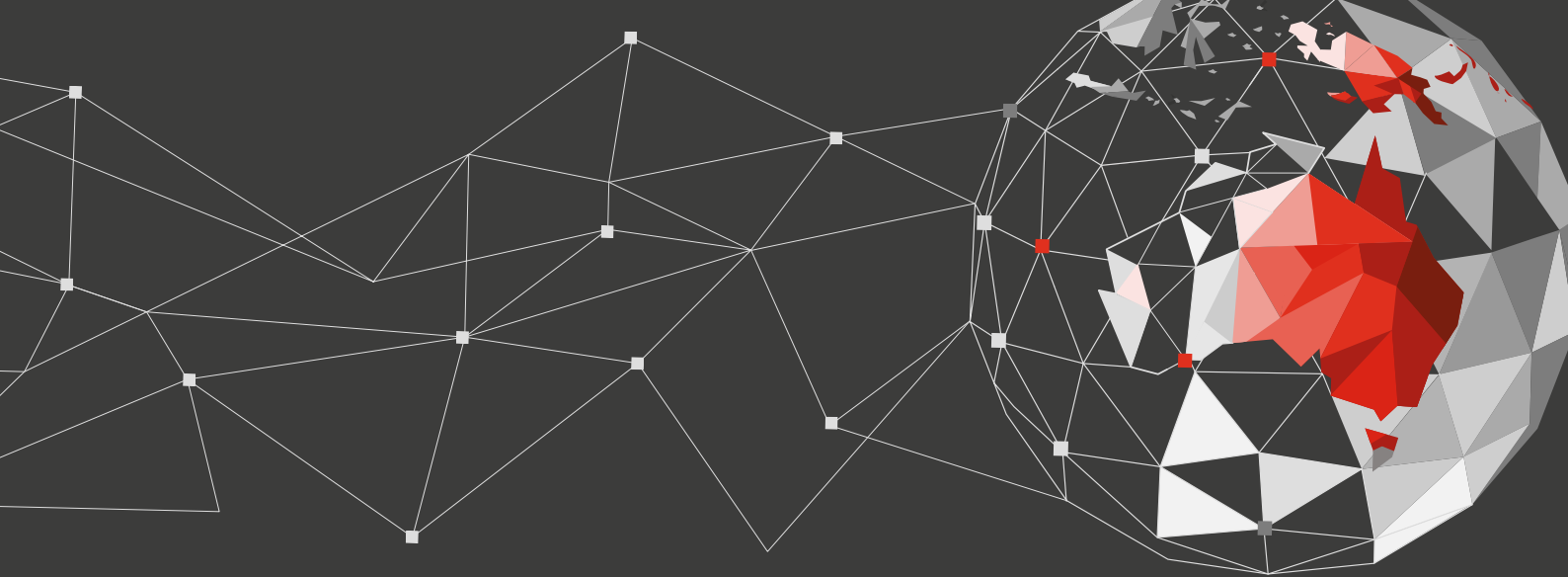
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