April 2014

Protecting our prosperity series: How do we fix a tax system?

Fixing Australia's tax system requires the broader community to understand and embrace the need for change. This is how to do it.

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Fixing Australia's tax system

It is difficult to see reason for change when things are going well, but change is what this country needs.

With 22 years of largely continuous economic growth, a stable government and a diverse population, the need for tax reform is not obvious to many people.

However it is already clear that an ageing population, growing debt and declining international competitiveness mean that unless we do something different, the Australian promise of affordable housing and health care, a good job, a decent education for our children, and a comfortable retirement will soon become unattainable for many of us.

PwC has sought to raise awareness of the need for major tax reform, with advice from respected organisations such as unions, charities, research bodies and some of Australia's leading tax experts and business leaders. This began in 2013 with the release of our first report *Protecting prosperity: Why we need to talk about tax.*

The need for tax reform is widely accepted among many economists, tax experts, business and civil society leaders. Both the Secretary of the Treasury and the Governor of the Reserve Bank have affirmed the need for tax reform. A number of state and territory government leaders have spoken on the issue. Both sides of national politics have taken steps towards exploring reform – the previous Labor government commissioned a wide-ranging review by a team led by Ken Henry and the current Coalition Government has announced it will produce a white paper on tax reform with a view to taking this issue to the next election.

But change will not be possible until the Australian public understands the need for action and can endorse crucial changes.

Our first report highlighted the need for a smarter tax system to deliver on the growth, equity and fiscal sustainability that is required to underpin the Australian promise. This second report is about the actions governments, along with business, social welfare groups, unions, and the public policy community can take to help the public understand the need for change in a way that allows governments to act.

The report looks at several case studies of major transformational reforms, including how tax reforms have been achieved in the past in other countries and in Australia. It finds that while strategies have differed, a common theme is winning community understanding and trust. This can secure change even in the absence of initial bipartisan support.

Taking the necessary steps

The Commonwealth Government will need to take a stand and explain clearly to the Australian public why we need major tax reform and how they plan to do it.

This requires a grass-roots campaign, that explores both tax and transfer measures, and connects with the majority of constituents to earn buy-in from those impacted by the reforms.

To do this, as a first step, the Government should appoint a broadly representative and independent reference group of eminent Australians with a mandate to begin the tax reform conversation. This process must start now and be completed well ahead of any formal tax reform white paper.

This reference group should engage directly with a cross-section of stakeholders to understand the concerns and fears surrounding tax reform and then provide the Government with an insight on community views and the issues that should be explored in the white paper.

If instances of successful reform show us anything, it is that political and public will for reform is possible when the community understands why it is needed. This understanding will enable the Government, at the right time, to lead the debate by providing the Australian people with a clear, coherent set of proposals, and to seek a mandate for change.

Luke Sayers
CEO, PwC

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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.

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Why do we need tax reform?

Australia's current economic conditions and spending pressures do not give rise to an economic crisis… yet. But without changes in government spending and revenues, combined annual deficits of Commonwealth, state and territory governments are estimated to rise from $34bn in 2013-14, to $237bn in 2039-40 and $627bn by 2049-50 (Figure 1).

This trend highlights the precarious position we are in.

Governments have an obligation to do something before the economy slows and our living standards decline.

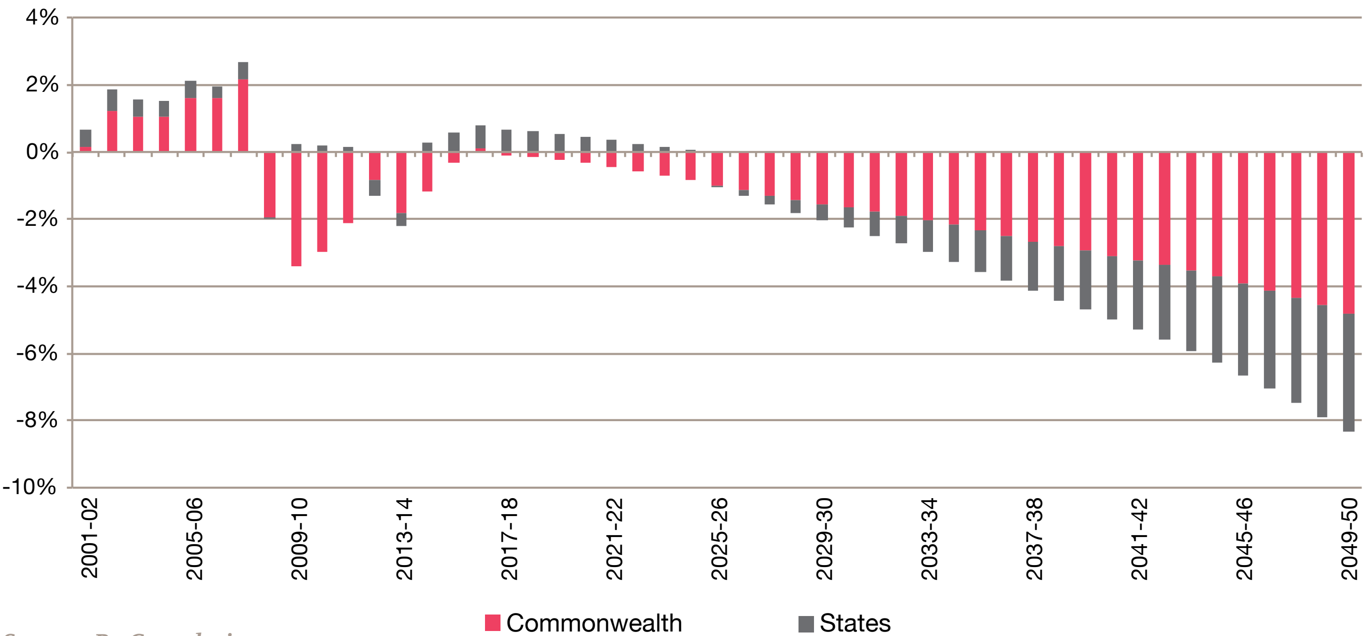
Comprehensive tax reform has been identified as one of the most achievable ways to contribute positively to productivity and economic growth, while stabilising our fiscal position. However, comprehensive tax reform is only part of the solution. It should be considered as part of a broader reform agenda to improve policy decisions and constrain inefficient expenditure growth.

Creating the conditions for change

The drive for comprehensive tax reform is not an easy one. But it has previously succeeded both here in Australia and overseas. And where it has been successful, those reforms were accompanied by the presence of the following key conditions, in no particular order:

- establishing the case for change
- driving community engagement
- securing a mandate
- developing a balanced package of reforms
- ensuring effective implementation and transition mechanisms.

Figure 1 Primary balances of Australian governments show annual deficits, as a percentage of GDP, growing over time



Source: PwC analysis

Our research shows that achieving political and public will for reform is possible. Across each of these successful reforms, while individual strategies have differed, a common theme is winning community understanding and trust – and this was achieved through various means, including partnering with credible experts, using open and wide-ranging engagement and ensuring sufficient analysis to underpin and reinforce messaging.

A mandate or at least tacit bipartisan support is also necessary, and while this can be difficult to achieve, effective and successful community engagement is likely to reinforce this end.

Reforms of the past often were initiated by a clear crisis, where change was unavoidable. Our challenge is to generate buy-in for reform before the crisis on the horizon materialises.

What we must do

The Commonwealth Government must take a stand and state what needs to be done to achieve tax reform in Australia. But the success of this step will hinge on the ability of the Government and the broader business, social welfare, union and public policy community, to help the public understand the need for change in a way that allows governments to act.

There are a number of must do's for the Government and the broader business and community sector.

Underpinning and inherent in these must do's is a need to engage with the community, well ahead of any formal white paper. The Government should appoint a broadly representative and independent reference group of eminent Australians with a mandate to begin the tax reform conversation.

The responsibility of this reference group would be to engage directly with a cross-section of stakeholders to understand the concerns and fears surrounding tax reform. It would be responsible for providing the Government with a view of community concerns and the issues that should be explored in the tax white paper.

Following this engagement and a comprehensive review that keeps all options on the table – both tax and transfer measures – the Government will need to provide the Australian people with a clear, coherent set of proposals and seek a mandate for change.

What we must do

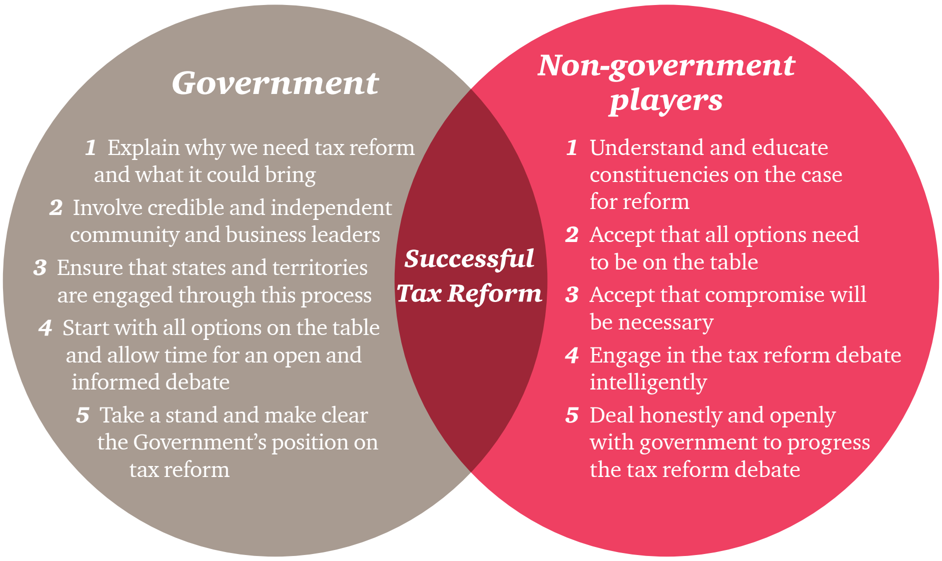


Table 1 Reforms which comprised these conditions were more successful

Condition	Henry Tax Review	Business Tax Working Group	A New Tax System	New Zealand Tax Reform	Denmark Tax Reform	Superannuation Guarantee Rate increase	ACT Land Tax
Establishing the case for change	✓	✗	✓	✓	✓	✓	✓
Driving community engagement	✗	✗	✓	✓	✓	✗	✓
Securing a mandate	✗	✗	✓	✓	✓	✓	✓
Developing a balanced package of reforms	✗	✗	✓	✓	✓	✓	✓
Ensuring effective implementation and transition mechanisms	✗	✗	✓	✓	✓	✓	✓

Why do we need tax reform?

Key messages

- *Australia has enjoyed over two decades of largely continuous growth in real income per person, albeit the distribution of gains has not been uniform. However, productivity growth has slumped since the millennium. This is a major threat to living standards as the population is ageing and our terms of trade are retreating from the historic highs of the mining boom.*
- *Without changes in government spending and revenues, combined annual deficits of Commonwealth, state and territory governments are estimated to rise from $34bn in 2013-14 to $237bn in 2039-40 and $627bn by 2049-50.*
- *Significant reform is required if Australian governments – state as well as Commonwealth – are to build fiscal resilience and maintain our living standards.*
- *While cutting inefficient expenditure is part of the solution, it is not going to be enough by itself.*
- *Comprehensive tax reform would significantly contribute to economic growth, while stabilising our fiscal position. It would also complement related measures associated with increasing workforce participation and boosting real income per person.*

Is Australia heading towards crisis?

Based on Australia's economic performance over the last two decades – which saw almost continuous growth in real income per person – the notion that the country is heading toward crisis can appear implausible.

Australia's economic strength was maintained over this period despite a number of external shocks, including the GFC, which left other OECD countries in a much less enviable position.

But Australia's resilience over this period was buffered by a range of economic factors which no longer exist (Table 2).

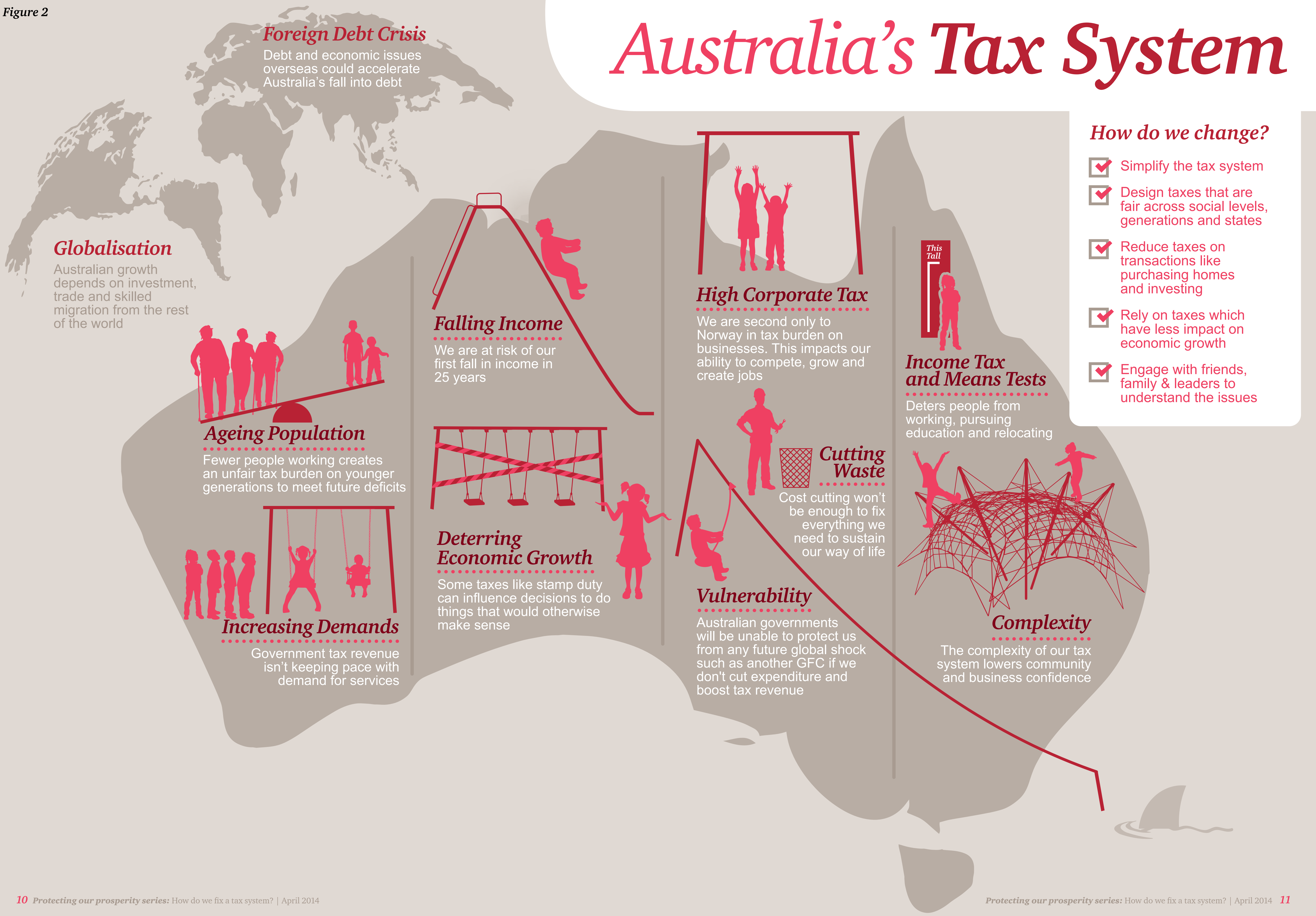
These changes in Australia's economic landscape coincide with a number of emerging spending pressures and challenges (Figure 2).

Current economic conditions and spending pressures do not give rise to an economic crisis… yet. They do however highlight the precarious position Australian governments are in.

Table 2: A change in Australia's economic landscape

Previously...	*Now...*
Productivity	
Strong productivity growth through the 1990s played a key role in driving growth in real income per person and was a direct result of microeconomic reform in the 1980s and 1990s.[1]	Our productivity levels have been low over the past decade. While they have improved somewhat recently, in the absence of further microeconomic reform poor productivity levels could put real wage and employment growth at risk.
Terms of trade	
Australia's terms of trade rose to record levels in the 2000s, fuelled by the industrialisation and urbanisation of China and its effect on commodity prices (especially iron ore and coal).[2] This helped maintain real income per person despite productivity levels falling below the long-term average.	Terms of trade levels have fallen from their peak and while China's growth will continue, it will be at a much slower rate.[3] This could see below average performance in investment and output per person, such as followed previous terms of trade booms.[4]
Government budgets	
During the 1990s and into the 2000s, Australia's governments built a strong fiscal position largely due to asset sales and strong tax revenues. This fiscal strength gave the Commonwealth Government the flexibility to respond to the GFC through discretionary stimulus.	The relatively strong debt position of the Commonwealth Government has eroded due to a reduction in tax revenues and the spending associated with the GFC. The Government is now facing the prospect of announcing a fifth consecutive year of budget deficits in May 2014 and is encountering increasing difficulties in returning the budget to surplus without significantly reducing the services it provides. GST revenues have also failed to keep pace with the spending responsibilities of state and territory governments, as the community saves more and spends an increasing share of its income on items not subject to GST (such as housing health care and education).
Workforce participation	
Workforce participation levels are an important factor underpinning economic growth. Participation rates have been rising over the last few decades, peaking in 2010.[5] This was driven by both increased workforce participation by women and older workers. Indeed, greater workplace participation by older workers resulted from improvements in health and higher education attainment levels.[6]	Since 2010, participation rates have declined.[7] While this can be partly attributed to the cyclical response to soft labour-market conditions, a trend to lower participation by older workers is also evident. Working age ratios – that is the number of working age people supporting every person aged 65 and over – has fallen from 7.5 in 1970 to 5 in 2010. By 2050, this ratio is expected to fall even further to 2.7.[8] The effects of an ageing population are significant, with the largest spending increases over the last decade associated with health (although more is spent per capita by all people) and the age pension.[9]

Figure 2


Australia's Tax System
Foreign Debt Crisis
Debt and economic issues overseas could accelerate Australia's fall into debt
Globalisation
Australian growth depends on investment, trade and skilled migration from the rest of the world
Ageing Population
Fewer people working creates an unfair tax burden on younger generations to meet future deficits
Increasing Demands
Government tax revenue isn't keeping pace with demand for services
Falling Income
We are at risk of our first fall in income in 25 years
Deterring Economic Growth
Some taxes like stamp duty can influence decisions to do things that would otherwise make sense
High Corporate Tax
We are second only to Norway in tax burden on businesses. This impacts our ability to compete, grow and create jobs
Cutting Waste
Cost cutting won't be enough to fix everything we need to sustain our way of life
Vulnerability
Australian governments will be unable to protect us from any future global shock such as another GFC if we don't cut expenditure and boost tax revenue
This Tall
Income Tax and Means Tests
Deters people from working, pursuing education and relocating
Complexity
The complexity of our tax system lowers community and business confidence
How do we change?
Simplify the tax system
Design taxes that are fair across social levels, generations and states
Reduce taxes on transactions like purchasing homes and investing
Rely on taxes which have less impact on economic growth
Engage with friends, family & leaders to understand the issues

The Commonwealth Government is also seeing a change in the composition of its tax base following the GFC. Receipts from key taxes such as company and capital gain tax are not expected to return to their pre-GFC levels and a number of indirect taxes, such as fuel excise and alcohol tax, are expected to fall because these taxes are not indexed or because of changes in consumption patterns, respectively.[10]

Personal income tax is expected to make up a larger share of total tax revenue as wage inflation moves individuals to higher average tax rates. If the Commonwealth Government does not adjust income tax brackets, average tax payers will move from paying around 21% of their income[11] in personal tax to 34% in 2039-40 and 38% in 2049-50.[12] This means that individuals will be giving the government around 40% of every additional dollar they earn in 2039-40 and 42% in 2049-50 – effectively moving average tax payers from the middle personal income tax bracket to the top tax bracket.

However, even with this bracket creep, tax revenues are not expected to be sufficient to address the spending requirements of governments.

Combined, continued expenditure growth and slowing, increasingly volatile revenue growth, are exposing an imbalance in the fiscal position of Australian governments. Without changes in government spending or revenues, combined annual deficits of Commonwealth, state and territory governments are estimated to rise from $34bn in 2013-14, to $237bn in 2039-40 and $627bn by 2049-50 (Figure 3).

Australian governments seek to maintain a modest budget surplus, on average, over the medium term.[13] Although budget deficits are not necessarily a bad outcome in the short-term, where these fiscal conditions extend over longer time frames, and show no signs of returning to surplus, they can have broader consequences.

In particular, government budgetary decisions should as far as possible maintain a degree of intergenerational equity such that today's spending decisions do not impose great costs on future generations. Failure to find sustainable ways to fund important social policies, or to address intergenerational inequities in current tax and transfer arrangements, may increase the economic burden on our children and our children's children.

Current economic conditions and spending pressures do not give rise to an economic crisis…yet. They do however highlight the precarious position Australian governments are in.

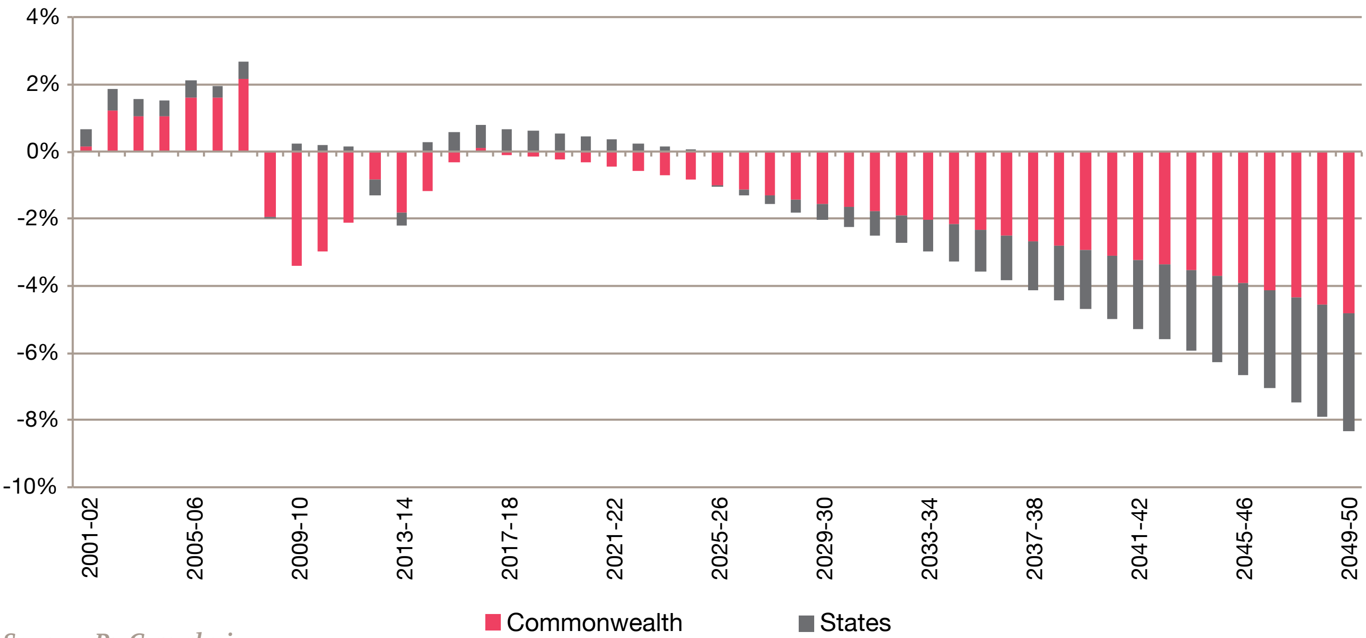
Making the hard decisions

Australia's continued economic well-being depends on all our governments fostering an environment that supports economic growth and maintains current living standards while also protecting the prosperity of future generations.

A range of measures will be required to meet Australia's economic challenges and continued prosperity. Comprehensive tax reform must be part of that solution as it has been identified as one of the most achievable ways to contribute positively to economic growth, while stabilising our fiscal position.[14] However, comprehensive tax reform is only part of the solution. It should be considered as part a broader reform agenda to improve policy decisions and constrain inefficient expenditure growth.

The drive for comprehensive tax reform is not an easy one. But it has been achieved both here in Australia, and overseas. Where it has been successful, present in these reforms were some key conditions. These are explored in the next chapter.

Figure 3 Primary balances of Australian governments show annual deficits, as a percentage of GDP, are growing over time



Source: PwC analysis

Creating the conditions for change

Key messages

- *Many obstacles can stand in the way of effective reform – particularly where those who may initially be adversely affected are vocal in their opposition and the long term benefits are not easy to explain to the broader community.*
- *However, examples of successful reforms, from Australia and overseas, highlight that political and public will for reform is possible.*
- *At the core of each of these successful reforms were a number of key conditions, which helped set the stage for reform. These conditions are, in no particular order:*
  - *establishing the case for change*
  - *driving community engagement*
  - *securing a mandate*
  - *developing a balanced package of reforms*
  - *ensuring effective implementation and transition mechanisms*
- *While individual strategies have differed, a common theme in those successful reforms is winning community understanding and trust – and this was achieved through partnering with credible experts, using open and wide-ranging engagement and ensuring sufficient analysis to underpin and reinforce messaging.*

Driving tax reform

Reform of any nature is difficult. Since the introduction of the GST in 1999, much has been done in investigating and identifying areas for tax reform. However, real progress has been limited (Box 1).

In part this can be attributed to the hard decisions associated with comprehensive tax reform. Decisions which while making way for the future growth and prosperity of our country may also lead to unavoidable short-term pain for individuals, families and businesses.

This reality highlights that successful tax reform needs more than just the right conceptual solution. It requires a broad and collective understanding of the problems tax reform should address, consensus on the way forward, and a recognition that it will not occur without adjustment pains.

Box 1: Recent attempts at tax reform have been unsuccessful

Australia's Future Tax System Review (the Henry Tax Review) (2009)

- Developed recommendations for reforming Australia's tax and transfer system with a view to moving our revenue base towards four robust and efficient broad-based taxes.
- The terms of reference excluded the specific consideration of GST and the review was undertaken with limited public engagement.
- While some recommendations of the review were pursued (eg resources tax), this was done in a piecemeal fashion, without taking into consideration the tax and transfer system as a whole.

Business Tax Working Group (BTWG) (established in 2012)

- Explored reforms to Australia's corporate tax arrangements, including broadening the corporate tax base with a view to fully financing a reduction in a corporate tax rate cut.
- Consideration of only one aspect of the tax system and an absence of political leadership.
- The inability to find significant additional savings meant that consensus for change could not be achieved.

Conditions of reform

Challenging reforms have been achieved in the past – both in Australia and overseas – which have brought about the significant transformation of a nation. At the core of each of these reforms were a number of key conditions:

- establishing the case for change
- driving community engagement
- securing a mandate
- developing a balanced package of reforms
- ensuring effective implementation and transition mechanisms.

Some of these conditions interact and reinforce each other. For example, effective community engagement is generally reliant on establishing the case for change and the effective sharing of analysis developed by government agencies and independent third parties.

Similarly, public opinion has a significant ability to sway political will; hence obtaining even tacit bipartisan support will rely on garnering sufficient buy-in across the electorate.

Establishing the case for change

The complexity of comprehensive tax reform is a given. Gaining agreement to any specific adjustment to the tax system – such as the removal of tax expenditures or a tax increase – can lead to an immediate negative response. But there are steps that can be taken to manage and potentially mitigate these outcomes.

This should start with articulating a compelling case for change:

- Why does the change need to happen?
- Is there a sense of urgency or crisis? If so, by whom or what?
- What are the benefits of the change – for today and for future generations?
- What will be the ramifications of 'doing nothing'?
- Is the result of the change 'worth the pain' of the change process?
- What are the potential risks of changing?

Because of individuals' personal responses, this case for change will require both rational elements, which highlight the technical impacts of reform, along with the emotional elements, which demonstrate how households and their family's way of life will be affected.

Figure 4 The case for change needs to address both the rational and emotional responses of the community

Facts

- Detail the impacts on government budgets, equity and income distribution.
- Model the long-term impacts on economic growth, employment and real income per person.
- Quantify the impact on the provision of government services today and into the future.
- Develop the proposed reform package, including the implementation road map.

Feelings

- Provide tangible examples of how tax reform will benefit households in terms of their core values:
  - job security and income growth
  - access to health care and education
  - retirement and quality of life.
- Demonstrate what inaction means for future generations.
- Build reform as a shared endeavour and set out the steps for achieving this.

Defining key design principles which can be used to evaluate individual proposals and the overarching reform packages (Box 2) may also support the goal of consistent and clear messaging throughout the reform process.

To a large extent the 'facts' of tax reform already exist. They formed part of earlier, government-initiated assessments, including the *Henry Tax Review*. The focus should now be on building a compelling case that moves beyond the rational aspects, and taps into the emotional drivers of change.

Driving community engagement

The broader community is often imperfectly informed or does not have the information or skills to assess and understand the effects of tax changes. While this can allow governments to drive the agenda, it can also provide scope for other influencers, such as special interest groups and opposition political parties, to derail progress.

Wide-ranging engagement with business, unions, special interest groups, charities, academics and the broader public is a key condition for realising successful reform. When this is done well, it can facilitate a broad social consensus that favours the introduction of the proposed reforms.

This is not a new concept. Australia's tax reforms of the past, including the Howard Government's plan for *A New Tax System*, involved stakeholder engagement through a series of summits attended by business, union and community leaders. Similarly, the Productivity Commission's review which led to the introduction of *DisabilityCare* involved comprehensive consultation with over 100 community and government stakeholders, along with a public submission process (Box 3).

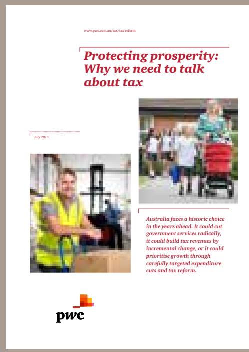
Box 2: Setting the scene for reform

Principles of tax reform

In 2013, PwC published *Protecting prosperity: Why we need to talk about tax*. In this we explored features of a 'good' tax system which were found to be:

- equity and fairness
- economic efficiency and simplicity
- fiscal sustainability, including the ability to support an effective operation.

However, these principles often compete. Achieving the economic objectives of a more efficient tax system may create challenges for the other two objectives.



It will therefore be necessary to balance these competing principles with the overarching objective of tax reform and the understanding that the role of the tax system is to fund key services for the Australian community.

Box 3: Effective engagement has been a key feature of other reform initiatives

National Disability Insurance Scheme (2010-2013) – Australia

The NDIS, or *DisabilityCare*, is a long-term disability care and support scheme funded by an increase in the Medicare levy from 1.5% to 2%, with reductions for those earning below certain income thresholds.

As a way to achieve public support, a public inquiry was established led by the Australian Government's independent research and advisory body, the Productivity Commission. Key features contributing to public acceptance and bipartisan support for the reform were:

- setting clear terms of reference regarding the objectives for the reform
- establishing an Independent Panel to advise the Productivity Commission during the course of the Inquiry
- conducting an evidence-based assessment of the long term problems including quantifying additional costs of $6.5 billion a year in the future
- conducting early and ongoing community consultation including releasing a discussion paper, considering over 1,000 written submissions, and holding over 20 public hearings across Australia with more than 100 community and government stakeholder groups
- undertaking detailed consideration of the costs and benefits of the scheme
- developing different versions of the Inquiry Report for different audiences, including a technical report, an overview booklet, and a 'plain and simple' English version.

Support for *DisabilityCare* from the broader electorate, including its promotion via social media, resulted in bi-partisan support for the initiative.

Establish an independent panel

People are influenced most by those they trust and view as credible on the subject. For community engagement to be effective, it is often helpful for governments to identify and partner with credible community and business leaders.

An example of where organisational leaders who are trusted by the public helped to shift public perception and government action is anti-smoking campaigns. A campaign began in America in 1961 with the American Cancer Society and other public health organisations addressing a letter to President Kennedy calling for a national commission on smoking.[15] These organisations had a clear investment in making change happen, but also were seen as having credibility in discussing health-related issues. The resulting government report highlighted the serious health consequences of tobacco use and had an impact on public attitudes and policy.

In the specific case of tax reform, the involvement of a range of specialists – including economists, lawyers, political scientists, academics and generalists – in the development and analysis of tax policy can help to reassure the public and verify data provided by governments concerning the benefits and case for change.[16] The strategy can be even stronger if leaders across community groups and the business sector are involved.

This approach was used by the New Zealand Government as part of its successful tax reform process in 2010 (Box 4).

A similar independent group should be established by the Commonwealth Government to support and guide the process of tax reform in Australia. It should provide independent and clear information that would be readily accessible to the range of Australian stakeholders. The mandate of this reference group should be meeting and consulting with Australians to explain the need for tax reform and the benefits that can be achieved by it.

Box 4: Open engagement and sharing of information

Tax reform (2010) – New Zealand

New Zealand's 2010 tax reform process saw a restructure in the tax mix towards a broad based and low rate tax system, as summarised below.

	Before 2010 Budget	*After 2010 Budget*	*Change*
Increased GST rate	12.5%	15%	+2.5%
Reduced income tax rates:			
• $0-$14,000	12.5%	10.5%	(2%)
• $14,001-$48,000	21%	17.5%	(3.5%)
• $48,001-$70,000	33%	30%	(3%)
• >$70,000	38%	33%	(5%)
Reduced corporate tax rate	30%	28%	(2%)

Note: Other changes were reducing the 'thin cap' rule for foreign owned companies (75% to 60%) and reducing the tax rate on portfolio investment entities, unit trusts and superannuation funds (30% to 28%).

Tax reform was underpinned by an effective and wide ranging consultation process characterised by:

- partnership with the Victoria University of Wellington which facilitated consultation on behalf of the Government and added credibility to the objectivity of the process
- the inclusion of leading private sector tax practitioners, business people and academics in the Tax Working Group led by the University and supported by Treasury officials
- early and ongoing engagement with the broader community in an open and transparent way, including conducting public conferences as well as publishing, on a dedicated website, the outcomes of all Tax Working Group workshops and other background papers considered by the group
- a plain English report able to communicate the technical subject matter to a wider audience, including any trade-offs.

Learnings from the change managers

We discussed the issue of how to motivate all Australians to adopt tax reform with some of our nation's most talented change managers and this is what they had to say:

Understand stakeholders' competing commitments

While living standards in Australia have improved in recent years, many Australians view the cost of living to be out of control. Any mention of tax reform, or the winding back of government services, is then viewed by the broader public as further eroding their living standards.

To overcome these concerns, it is necessary to:

- Undertake staged engagement – initially with community and business leaders, then with the broader population. This can help to tap into the competing commitments that get in the way of a better future. It might also bring to the surface underlying assumptions that may be incorrect about the reform.
- Initiate engagement early – rather than waiting for the start of a formal review, a conversation needs to start with Australians now. This is because as well as identifying likely sticking points, it can start to draw out the key messages and emphasise the role of the broader community in contributing to the debate.
- Demonstrate you listened – it is crucial to demonstrate how what stakeholders have said has been taken into consideration. This will validate that the engagement is meaningful and not just being done as a tick-the-box exercise.

Use multiple engagement platforms – including social media

A range of engagement methods is required to manage the tax reform conversation. Naturally, this includes traditional engagement methods such as consultation papers and submission processes, stakeholder forums and targeted advertising and education campaigns. These are necessary, but they do not guarantee engagement from the broader public. This is not to deny the continuing relevance of talkback ratio in the political dialogue.

Today the real opportunity for wide-ranging engagement is through the less traditional methods of social media channels, such as Twitter, YouTube and Facebook. These channels can be used to share and disperse commentary on policy issues and reform and have the ability to spread information quickly and globally with Facebook 'likes' and Twitter 're-tweets'. They can be an effective vehicle for sharing information and encouraging broader engagement.

There are, however, challenges associated with social media; in particular, it is harder to control. Hence governments need to take a proactive approach to ensure the robustness and authenticity of the message they are trying to communicate.

The same features that make social media valuable to governments also make it valuable to those individuals and special interest groups opposed to change. The expanding role of social media in opposing reform is much greater than even a few years ago. Even relatively recent reforms, such as New Zealand's 2010 tax reform process, did not have the same level of discourse via social media that we would take for granted today.

Indeed, the 'media storm' that whips up around a politically charged issue is now more likely to come from the social media sphere, and build momentum (through re-posts and re-tweets) at a significantly greater pace than it does through traditional media.[17]

In line with this, politicians are becoming acutely aware of and sensitive to the impact of social media. And this can have negative consequences – some politicians may be less likely to stand behind bold but necessary policies for fear of aggravating the electorate and incurring a social media backlash.[18]

There are however examples where governments and politicians now use these non-traditional methods to engage the community and inform the development of key policy initiatives – such as the UK Government's Red Tape Challenge (Box 5) and use of social media by US President, Barack Obama, during his campaign (Box 6).[19]

Box 5: Using social media as tool for stakeholder engagement

Red Tape Challenge (Current) – United Kingdom (UK)

The UK Government's Red Tape Challenge aims to promote open discussion of ways in which the objectives of existing regulation can be fulfilled in the least burdensome way possible. Every few weeks a regulation theme is notified through the UK Red Tape Challenge Twitter, Facebook and email feeds, and people are invited to comment online over a five week period.

There have been a number of innovative approaches to consultation as part of this reform, including:

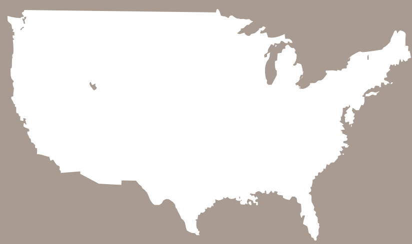
- crowdsourcing of reform options to reach a broader group of stakeholders in an easy and accessible way
- interactive consultation using facilitators to guide online discussions
- notifications of new themes for consultation and key achievements through a range of social and other media
- the reporting of information in a form that is accessible to a broad audience, including the use of plain English and infographics.

Box 6: Using social media to mobilise support

Barack Obama's presidential campaigns (2008 and 2012) – United States

Social media has been an increasingly important part of building a support base and mobilising action in American politics. In particular, it has been widely recognised that a major success factor in President Obama's 2008 victory was how his campaign used social media to raise money, and more importantly develop a groundswell of empowered volunteers who felt they could make a difference.[20] This social media campaign also meant President Obama had a database of supporters who could be engaged at a low cost throughout his term as President.

Applying a similar approach for his 2012 re-election campaign, President Obama talked directly with voters through online engagement, bypassing the filter of traditional media and expensive advertising to build momentum. The Obama campaign posted nearly four times as much content as the challenger, Mitt Romney's, campaign, and was active on nearly twice as many platforms.[21] Obama's digital content also engendered more responses from the public – twice the number of shares, views and comments on his posts than for Romney.[22]



Achieving a mandate

Reforms are rarely made simply because they are a good idea. They typically involve leadership from a change agent, with a mandate to pursue reform in the face of opposition.

Achieving a clear mandate, however, is not easy. Over the last decade there has been limited bipartisan support or engagement in the area of tax policy. Both sides of politics continue to characterise tax policy in negative terms and undermine the community's 'trust' in the basis of any government announcements in relation to tax changes.

Australia has pursued and succeeded at tax reform in the past with the implementation of *A New Tax System* by the Howard Government in 2000 (Box 7). The Howard Government made tax reform a central feature of its 1998 election campaign, and on winning the election continued to implement that reform package under the leadership of John Howard and the then Treasurer, Peter Costello.

But even with what was thought to be a clear mandate, prolonged negotiation with minority parties and subsequent adjustments to the package of reforms were required. Indeed, while the Howard Government saw itself as having a clear mandate for tax reform, the Australian Democrats, who had a majority in the Senate, believed they had their own mandate as a house of review.[23]

More recently, the Abbott Government has committed to a tax reform white paper in his first term, with any recommendations in the paper to be taken to the 2016 election.[24]

There are instances where a mandate for change has been secured in the absence of an election, such as the introduction of *DisabilityCare* by the Labor Government. The vocal support for this initiative by the broader community saw the Liberal Party eventually agree to this policy. Both Parties also took their commitment to implement this initiative to the 2013 election.

Box 7: Creating the mandate for change

A new tax system (2000) – Australia

Proposals for a broad-based consumption tax had been raised on a number of occasions without success. It was not until the 1998 election that the then Coalition Government announced its intention to reform Australia's tax system and was able to deliver this strategy. The reform involved the introduction of the GST, which replaced various local indirect taxes including sales taxes and duties on bank accounts. A reduction in income tax was also part of the reform package.

The introduction of the GST was not without challenges. Significant negotiation with the Australian Democrats was necessary to secure Senate support for legislation. Even with the political mandate achieved by the Government, negotiation was needed: with the minor parties seeking exemptions from GST for items such as food; and with the states pursuing compensation for the revenue lost through the abolition of state taxes.

Developing a balanced package of reforms

There is often debate regarding how best to structure reform measures – that is, whether 'big bang' or more incremental approaches are better.

Due to the inherent difficulties in pursuing larger reforms, governments often opt for more piecemeal attempts, such as making small changes to specific taxes, on the basis that this might be easier to progress.

Recent examples of this piecemeal approach in the Australian context include the introduction of the Carbon Tax and the Resources Super Profits Tax (RSPT) which was subsequently replaced with the Minerals Resources Rent Tax (MRRT).

Our research indicates a big bang approach has a higher chance of success:[25]

- A comprehensive approach to tax reform can be used to mitigate the potential adverse effects of the proposed changes. For example, measures which seek to broaden or increase consumption taxes can generate additional revenues which can be used to provide targeted compensation to those most in need. This does not mean all those adversely affected by the reform require compensation. It does however acknowledge that objectives in equity and income distribution can be managed as part of any reform process.
- Inherently political in nature, any reform entails mutual adjustment among diverse and often conflicting stakeholders, through a process of negotiation, bargaining and consensus building.[26] But taking a comprehensive approach provides the government with greater flexibility to shape and modify reforms with a view to balancing outcomes so that any additional burden is borne by those most able to bear it. This approach of balancing outcomes to ensure electoral support formed a key part of Denmark's successful tax reform agenda in 2010 (Box 8).

Ensure all options are on the table

The Government should set broad terms of reference for any review into the reform of Australia's tax system. All taxes should be on the table, along with tax concessions and scope to consider the interactions between the tax and transfer systems.

While any detailed assessment of reform should be approached on a comprehensive basis, in practice any implementation is likely to be pursued through a set of packages that deal with the specific reform elements and also their interaction, trade-offs and timing.[27] Effective transition arrangements to allow time to adjust to changing requirements may also be needed.

Box 8: Driving comprehensive tax reform

Comprehensive tax reform in Denmark (2010)

The success of comprehensive tax reform in Denmark in 2010 was based on an approach of balancing cuts among groups of similar taxpayers. The marginal income tax rate for the highest income bracket was decreased by 5.5%, coupled with a decrease of 1% for the bottom bracket and an increase to the tax free threshold. These cuts were primarily financed by reducing the tax value of interest deductions on personal income tax.

Public support for the necessity of comprehensive tax reform was generated by appointing a Tax Commission in early 2008 with a former minister for taxation as chairman, and broadcasting the Commission's results on live television.

Gaining electoral support for the reduction in the tax value of interest deductions was a significant challenge to the reform, requiring the Danish government to incorporate a number of safeguards into the proposal:

- gradual implementation of the reduction in the value of interest deductions between 2012 and 2019, with tax reductions coming into immediate effect in 2010
- a minimum threshold to minimise impact on low-income groups
- a compensation scheme to ensure no individual could lose more from the financing measures than they gained from the cuts to personal income taxation.

Although these safeguards dampened the effectiveness of the initial proposal, they also made the reform publicly and politically acceptable, thereby creating enough revenue to allow tax cuts in other areas of the economy to generate positive structural changes.

Ensuring effective implementation and transition mechanisms

Taxes, tax concessions and broader welfare arrangements affect incentives and decisions relating to consumption, employment, innovation and investment. Any changes to these arrangements – such as those brought about through reform – are then likely to affect these decisions.

Develop a phased implementation plan

Governments should therefore take a phased implementation approach to allow time for businesses and the community to implement new processes and adapt without destabilising activity. This should also aid social acceptance.

Transition arrangements are often associated with tax reform initiatives. For example, following the decision to adjust the compulsory superannuation guarantee rate, a transition arrangement was introduced to give businesses time to adjust to the new requirement (Box 9).

Box 9: Staged implementation spreads costs and enables refinement

Superannuation Guarantee Rate (SGR) – Australia (2012)

Changes to the rate of compulsory employer contributions to employee superannuation (as a proportion of gross income) received bipartisan support in 2012 to incrementally raise the rate from 9% on 30 June 2013 to 12% by 1 July 2019.

The proposal to repeal the Minerals Resources Rent Tax (MRRT) and a slower than expected global recovery from the financial crisis have resulted in the staged implementation of this reform being deferred by two years as outlined in the table below.

Date of change	*Pre-MRRT repeal*	*Post MRRT repeal*
2012	9%	9%
2013	9.25%	9.25%
2014	9.5%	9.25%
2015	10%	9.25%
2016	10.5%	9.5%
2017	11%	10%
2018	11.5%	10.5%
2019	12%	11%
2020		11.5%
2021		12%

Similarly, in light of the inefficient and distortionary nature of stamp duty on property transactions, the Australian Capital Territory announced in 2012 that it would progressively reduce the rates of stamp duty and replace this revenue through higher land taxes (Box 10).

Box 10: Transitioning strategies for tax reform

Transition from stamp duty to land taxes – ACT (2012)

In recognition of the highly distortionary nature of stamp duties on property, the ACT began the process of replacing its existing stamp duty tax with land taxes.

A key concern with changing from stamp duty to land taxes is ensuring that homeowners who have recently paid stamp duty are not then forced to pay land tax – essentially being taxed twice.

The Government proposed a 20 year transition process to minimise these potential effects. This produced the additional benefits of spreading transition costs to government, giving taxpayers ample time to adjust to the changes, and allowing the reform to be refined over time to suit economic conditions.

In addition to spreading transition costs, a staged approach to implementation enables the reform to be more easily refined to suit changing economic conditions (eg deferred implementation of changes to the SGR in response to a slower than expected global recovery and repeal of the MRRT).

Caution should be exercised when designing transition arrangements to ensure that any economic disruptions are balanced, while at the same time ensuring the transition period is not so long that it jeopardises or undermines the reform itself. An overly long time frame exposes the reform to fluctuations in the political cycle, and a change of government could lead to a reversal of policy. It may also unnecessarily restrict the economy from realising the full benefits of reform, and may result in a loss of momentum if progress is relatively slow.

Undertake a post-implementation review

A post-implementation review of all significant tax changes is valuable to ascertain whether the measures are achieving their policy objectives, with the scope and timing set out in relevant legislation.[28] Such a review process can allow for refinement of the reform in line with changing economic conditions. Announcing a formal review in advance may also increase public acceptance given that there is flexibility to abandon or refine the reforms if they are not achieving their objectives.

For example, a contributing factor to comprehensive reforms in the Netherlands in 2001[29] was up front agreement that the reforms would be re-evaluated after four years.[30]

Summary

Examples of successful reforms, from Australia and overseas, highlight that political and public will for reform is possible.

Across each of these reforms, while individual strategies have differed, a common theme is winning community understanding and trust – and this was achieved through various means, including partnering with credible experts, using open and wide-ranging engagement and ensuring sufficient analysis to underpin and reinforce messaging (Table 3).

A mandate, or at least tacit bipartisan support is also necessary, and while this can be difficult to achieve, effective and successful community engagement is likely to reinforce this end.

Many reforms of the past were initiated by a clear crisis, where change was unavoidable. The situation in Australia is very different. Indeed the fact that we have managed to escape largely unscathed from both the Asian Financial Crisis and the GFC has led to a degree of complacency and a view that any future economic risk is likely to be equally easily resolved. However, there is mounting, and in our view compelling, evidence that Australia's crisis is on the horizon if clear action is not taken now, and we do not have the same flexibility to deal with it.

When there was no immediate crisis, reforms have sometimes occurred when governments had strong revenue flows and could provide generous compensation to all those adversely affected. In our current climate, offsetting the costs of reform for all those adversely affected would be irresponsible. But some form of targeted compensation will be required. Such compensation should be directed to those who are most in need – such as low income and welfare dependent households.

The absence of these conditions – an immediate crisis or full coffers to pay for change – does not mean that reform is not possible. It highlights that driving effective tax reform in Australia will require determined and respectful engagement across the Australian community.

Table 3 Reforms which comprised these conditions were more successful

Condition	Henry Tax Review	Business Tax Working Group	A New Tax System	New Zealand Tax Reform	Denmark Tax Reform	Superannuation Guarantee Rate increase	ACT Land Tax
Establishing the case for change	✓	✗	✓	✓	✓	✓	✓
Driving community engagement	✗	✗	✓	✓	✓	✗	✓
Securing a mandate	✗	✗	✓	✓	✓	✓	✓
Developing a balanced package of reforms	✗	✗	✓	✓	✓	✓	✓
Ensuring effective implementation and transition mechanisms	✗	✗	✓	✓	✓	✓	✓

What we must do

The Commonwealth Government must take a stand and state what needs to be done to achieve tax reform in Australia. Fixing Australia's tax system will hinge on the ability of the Government, other political leaders and the broader business, social welfare, union, and public policy community to help the public understand the need for change in a way that allows governments to act.

This is what we must do.

The Commonwealth Government

While a range of institutions and stakeholders influence reform, it is governments that set the stage for change. The key 'must do's' for the Commonwealth Government are:

1 Explain why we need tax reform and what it could bring

Much has been written regarding the objectives for tax reform from a theoretical and policy perspective. But as the Government pursues reform it is necessary to turn these more abstract concepts into simple objectives that resonate with all Australians. At the heart of Australia's tax reform process should be a desire to:

- ensure the fiscal sustainability of our governments – including the Commonwealth, states and territories – and enable them to provide the services that Australians require
- strengthen the economic fundamentals on which our country is based – including ensuring that all Australians can enjoy affordable housing and health care, a good job, a decent education for their children and a comfortable retirement
- enable governments to continue to provide a safety net to those most in need
- ensure that the budgetary decisions of our government today do not put at risk the ability of our children, and our children's children, to enjoy a similar or better standard of living.

It is these key objectives, set out in a clear and simple way, which can be used to set the scene for tax reform in Australia.

2 Involve credible and independent community and business leaders

While the Government needs to take the lead on tax reform, it is necessary that it partners with a credible and independent group of community and business leaders throughout the reform process. The inherent value of these partnerships is the verification they can provide regarding the message for reform.

This engagement should start well ahead of the release of any detailed review of tax reform, such as the proposed white paper, as these parties will be necessary to reinforce the objectives for tax reform and support the conversation about why change is necessary.

The Commonwealth Government, with input from states and territories, should appoint a broadly representative and independent reference group of eminent Australians with a mandate to develop the tax reform conversation. This initiative should be promptly commenced. The responsibilities of this group would include:

- explaining the link between future living standards, the delivery of government services and our tax system and the challenges which create the need for tax reform
- engaging directly with a cross-section of stakeholders – unions and welfare groups, businesses and industry groups, community groups and individuals – to understand the concerns and fears surrounding tax reform
- providing the Government with a view on the key options, issues and concerns that should be explored in its tax white paper.

Its responsibilities would not include:

- Repeating the detailed assessments of the past – this analysis already exists as part of the earlier *Henry Tax Review*, the Business Tax Working Group and reports by other governments, academics and the OECD
- Coming up with detailed recommendations for change – its role would be to reach out to the broader community through meetings, community forums, market research and social media to inform the tax reform debate and understand the public's concerns.

3 Ensure that states and territories are engaged through this process

Changing only Commonwealth administered taxes will not be enough to realise the full benefits of the reform. Many of the taxes that have the most adverse effects on growth, such as stamp duties, are levied by states and territories and form a significant component of the total revenue base. Equally, many of the services enjoyed by Australians such as health care are delivered by the states.

State and territory governments need to be fully engaged in any reform process. Many changes will require their buy-in and the assurance that any lost revenues associated with improving the efficiency of the tax system will be replaced with alternative, sustainable sources. State and territory governments should have a say regarding the composition of any reference group and receive the benefit of their findings.

4 Start with all options on the table and allow time for an open and informed debate

Throughout the history of tax reform in Australia it is clear that some sectors or special interest groups do not readily accept a process that puts all options on the table or potentially some options *back* on the table. The status quo often has a number of beneficiaries – intentional or unintentional – that do not want to relinquish any gains they have previously secured, even if the status quo is unsustainable over the longer term.

Unless all measures – taxes, tax concessions and their interaction with the transfer system – are able to be scrutinised, the extent of reform that can be achieved may be limited. Having all options open to the Government provides greater scope to identify measures which may counterbalance any undesirable consequences, such as ensuring sufficient compensation for those most in need.

With all options open for consideration, the Government can then undertake a considered process of community engagement to educate the broader population and make clear the options and benefits of reform. Unlike our more recent attempts at reform, this attempt should avoid an approach where tax policy is decided behind closed doors; the process should be transparent and open to the views of the broader public.

The process should also explore the non-traditional methods of engagement – via social media and the release of simplified, easy-to-understand materials that answer the practical questions which the broader community might fail to understand (or define by themselves). Such material should set out what the reform will mean today, tomorrow and into the future.

5 Take a stand and make clear the Government's position on tax reform

Following this process, the Government must make clear its position on tax reform. This should include providing the Australian people with a clear, coherent set of proposals for reform that demonstrates that it has listened to the views of the community. The findings from the reference group, which will include the concerns and issues raised across the broader community and business sector, will be useful in informing this process.

The non-government players

While government effectively leads the process of reform, there is still a critical role for a number of non-government players, including welfare organisations, unions and industry bodies, academics and businesses and our non-government political representatives.

While in general these organisations tend to target a specific area of reform from a narrow constituency viewpoint, something new is required for tax reform. These organisations will need to get behind the case for reform as well.

1 Understand and educate constituencies on the case for reform

The case for tax reform requires an understanding of a range of issues related to fiscal sustainability, growth, equity and the federation. These are challenging concepts and for many constituents it can be difficult to see how these fundamentals affect living standards, their expectations regarding the role of government, and the Australia they will deliver to their children.

A key part of the debate therefore is not just informing the community of the objectives of tax reform, but making sure the leaders of unions, welfare groups, industry bodies and the business sector reinforce these messages to their constituencies.

2 Accept that all options need to be on the table

Over the years many organisations have fought for the interests of their constituencies in a range of issues, including tax reform. While conceding previously gained positions may seem counter-intuitive, it is only through doing this that true reform will succeed. All tax and transfer arrangements should be on the table for consideration as part of any detailed review of Australia's tax system. This will allow for the development of a reform solution that can balance the competing requirements of equity and fairness, efficiency and fiscal sustainability.

3 Accept that compromise will be necessary

As with any reform process, the benefits may be realised over time. It is necessary to accept that some compromise will be needed to facilitate and ensure the long-term prosperity of Australia.

4 Engage in the tax reform debate intelligently

There needs to be an open debate about tax reform, where all views are canvassed. Such a debate will provide the opportunity for all stakeholders to discuss the issues and consequences of the status quo and determine what reform will bring in terms of benefits and costs.

The result of the stakeholder discussion will reveal opportunities to guide and influence the design of any reform measures and identify the most palatable way to implement the chosen reform measures.

5 Deal honestly and openly with government to progress the tax reform debate

While compromise may be a pragmatic necessity, the reform process should not be approached as an exercise in ambit claims and exaggerated downsides. There is simply too much at stake for Australia as a nation, and for all our communities, to not approach reform with a genuine commitment to deliver a successful outcome. All stakeholders have this obligation.

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