

# Executive summary

## The task

This Review considers how Australia can best structure its tax and transfer system to meet the challenges of the 21st century and to enhance its economic and social outcomes.

Australians face far-reaching change. As we navigate that change, our challenge is to maintain our strengths, sustain our values and fulfil our promise.

The Review looks forward over the next 40 years to mid-century. Through these decades we expect:

- a new world economic order based on ever-deepening international integration, with new centres of competition and opportunity increasingly located in close proximity to us;
- the transformation of business, commerce and personal lives by technological advances, especially in digital electronics and communications;
- ageing of the population, reducing some tax bases and raising the costs of health, aged care and dependency;
- strong growth and cultural diversification of our population, with high demands for economic infrastructure, education and social infrastructure spending;
- deepening stresses between human activities and wider ecosystems, globally and locally; and
- further stresses on housing affordability and pressure on urban amenity.

Unfortunately, we must also assume that the world will continue to present high risks of conflict imposing high security costs.

Our task is to define a tax and transfer system that anticipates and responds to those expectations. We find that much of the key architecture of the existing tax and transfer system, built last century, reflects sound policy frameworks and Australian social values and will still serve us well.

But not all of it will – a range of key reforms would even better equip us for the changing era ahead.

## The setting

Through this period, we expect that the Australian economy can continue its well-established high rate of economic expansion, provided policy reforms continue to support growth and structural change. This is vital for us. It will ensure that Australians can continue to deliver all of the things they most value — including improving living standards, support for the needy, fairness, social advancement, security and protection of the environment.

Policy reforms over the past quarter century, particularly those that have made the economy more flexible and responsive to price changes, have contributed to a remarkably resilient economy. Australia's strong growth continued through the Asian financial crisis of 1997–98 and the recession in the industrialised world in 2001, and Australia has been the strongest performing developed economy through the 2008–09 global financial crisis. Since the early 1990s, our per capita incomes have moved up the OECD rankings and we have maintained an equitable pattern of overall income distribution.

We expect that Australians will find their futures best secured by much the same overall balance of complementary public and private activity that has prevailed for many years, though its style and structure should continue to respond to changing needs and opportunities. We do not expect total tax burdens will rise in the next few years, but some increases in later times may be unavoidable. The combination of ageing and high population growth will contribute to a considerable increase in public investment needs, and in spending on services, and it will be important that this be funded in ways that improve public saving over time so that our national saving effort is increased and our fiscal strength maintained. We need a tax system that is robust and efficient, and that can adapt to changing future circumstances.

Most of all we need a tax and transfer system that is oriented to supporting strong and sustainable economic growth. We need policies that not only redistribute income but also promote the growth of incomes at all levels, including through high-quality investment in the nation's infrastructure. This means more capital per worker, more workforce participation and higher creativity and skills.

Our anticipated high population growth and continuing economic growth will also put pressure on our increasingly fragile ecosystems. To ameliorate this pressure a suite of policy interventions will need to be considered, including environmental taxes where appropriate, along with targeted stewardship and statutory duty of care programs.

We also want a tax system that fully exploits the opportunities of the new digital age and integrates neatly with the new ways we live our lives and conduct business. As far as possible, we want to enmesh the tax and transfer systems into our economy and society in ways that, while transparent, are simple and unobtrusive. This means simplifying, coordinating, making transparent and automating the operating elements of the tax and transfer systems.

## The vision

A 21st century tax and transfer system should meet its purposes efficiently, equitably, transparently and effectively. Critically, it would support per capita income growth rates at the upper end of developed country experience by encouraging high workforce participation, a more efficient pattern of saving, and stronger investment in education and physical capital. It would be robust, capable of supporting large structural change, dealing with unforeseeable external shocks and encouraging patterns of economic activity that prove fiscally and environmentally sustainable. It would support economic dynamism and diversity. Through both its direct and indirect effects, it would support the commitment to Australian values of fairness, and support for those who are disadvantaged. It would exploit opportunities to reduce compliance costs and make interactions with the tax and transfer system easier, more certain, and more understandable. It would enhance the accountability of governments to their citizens.

## The future architecture

The Review has identified a wide range of reform opportunities that can deliver this vision. The main directions and proposals are presented here in nine broad themes. A full listing of recommendations appears at the end of this Part, and their supporting analysis is provided in Part Two.

### 1. Concentrating revenue raising on four efficient tax bases

Australia has too many taxes and too many complicated ways of delivering multiple policy objectives through the tax and transfer systems. The capacity of the legislative and operating platforms of these systems, and their human users, to deal with the resulting complexity has been overreached. The tax and transfer architecture is overburdened and beginning to fail in dealing efficiently and effectively with multiplying policy goals and demands. Rationalisation of the tax and transfer architecture should now be a strategic priority.

#### Key directions

- Revenue raising should be concentrated on four robust and efficient tax bases:
  - personal income, assessed on a more comprehensive base;
  - business income, with more growth-oriented rates and base;
  - private consumption, through broad, simple taxes; and
  - economic rents from natural resources and land, on comprehensive bases, noting that revenue from rent taxes will likely be more volatile than from the existing resource royalties it will replace.

- Other taxes should be maintained only if they efficiently address social or economic costs — such as taxes on tobacco, alcohol, gambling and environmental costs, and efficient road user taxes or charges.
- In time the following taxes should be abolished and their revenues replaced by taxes applying to the four robust and efficient tax bases:
  - insurance taxes;
  - payroll tax;
  - property transfer taxes;
  - stamp duties on the purchase of motor vehicles;
  - resource royalties, replaced by the rent tax;
  - luxury car tax;
  - the tax on superannuation contributions in the fund;
  - income taxes on all government pensions, allowances and benefits; and
  - fuel and vehicle registration taxes, if replaced by more efficient road user charges.

## **2. Configuring taxes and transfers to support productivity, participation and growth**

The continued strength of long-term economic growth is vital for Australia, and will determine future incomes and living standards at all levels. The reforms in this Report could potentially increase national output by around 2 to 3 per cent, or around \$25 billion to \$40 billion in 2010–11 values over the long term. Long-term growth is supported by increasing workforce participation and by increasing productivity, including through stronger investment. Both tax theory and research evidence strongly suggest that the architecture of taxes has a major impact on each of these. Workforce participation is strongly influenced by incentives in the tax and transfer system, and by the affordability of quality child care. Productivity is increased by more efficient tax bases, support for skill acquisition and ensuring the efficient and timely supply of infrastructure. Investment is particularly supported by lower company income tax rates. Higher economic growth promotes higher wage growth, and provides revenue growth to fund income transfers and community services. A number of other countries with strong social support policies have at the same time increasingly adopted strongly pro-growth tax structures. Accordingly, Australia should configure its tax and transfer architecture to promote stronger economic growth through participation and productivity.

## Key directions

- Maintain the company income tax rate towards the lower end of the small to medium OECD economy average, with a reduction to 25 per cent over the medium term. This aims particularly to increase the level of business investment in Australia across all sectors, including foreign direct investment; promote more entrepreneurial activity; and reduce incentives for profit-shifting offshore.
  - A business-level expenditure tax could suit Australia in the future and is worthy of further consideration and debate, along with a reconsideration of dividend imputation's place in an internationally integrated economy.
- Promote higher workforce participation through:
  - improving support for quality child care;
  - building clear work incentives into the levels of income support payments; and
  - targeting means tests to facilitate higher workforce participation by groups with differing participation opportunities and expectations. Steeper means test withdrawal rates should anticipate full-time participation by those fully able to work, now or in the near future, but they should anticipate, through gentler withdrawal rates, part-time work for others, including pensioners and students.
- Within practical limits, lift productivity through more efficient and neutral taxes:
  - for business risk, an improved treatment of business losses, with a one-year carry-back of company losses;
  - for investment in productive assets, streamlined and enhanced capital allowance arrangements, including allowing low-value assets to be written off, with a high threshold for small business, and streamlined small business capital gains tax rules; and
  - for investment of personal savings in the presence of inflation, a common 40 per cent discount for interest, net residential rents and capital gains.
- Increase the efficiency of use and investment in roads by a program of road reforms that includes greater use of road user charges, including congestion charges.

## 3. An equitable, transparent and simplified personal income tax

The personal income tax system will remain Australia's largest source of tax revenues. The personal tax structure should be the sole means of delivering progressivity in the tax system, supporting the even more direct distributional role of the transfer system. Personal tax compliance has become inordinately complex, and complexity hides its policy intent from citizens. An opportunity exists to greatly simplify personal tax, to make its policy more transparent, and to use 21st century technologies to make it fairer, easier to comply with, and more robust. At the same time, personal tax can be better coordinated with the transfer system.

### Key directions

- A much higher personal tax-free threshold, around \$25,000, should replace the current complex array of thresholds and offsets.
- All pensions, allowances and other transfer payments should be tax-free.
- A simple transparent two-step tax scale should apply.
- Deductions and offsets should be rationalised — with most work-related deductions replaced by a standard rate of deduction linked to the level of income from work.
- Progressivity of the tax system should be enhanced by including all forms of work remuneration in personal tax returns — including employer superannuation contributions (see below for new concession framework) and the main fringe benefits.

## 4. A fair, adequate, and work supportive transfer system

The overall architecture of Australia's transfer system is well founded — it is focused on poverty alleviation, clear targeting and sustainability. The Pension Review developed adequacy benchmarks for age, disability and carer pensions paid to those where there is limited or no expectation of work. Adequacy benchmarks are also required for other government payments, but these must also address incentives to work. In the 21st century, given both changing social expectations and increasing age dependency, there will be a greater expectation that those who are able to support themselves through work will do so. This Review provides strategic directions for these arrangements, relating to income support, student assistance and assistance for children and parents. Once established, the adequacy of payments should be maintained by common indexation arrangements. While full integration of the tax and transfer systems is not practicable given their different objectives, better coordination between them is possible.

### Key directions

- Three levels of primary support payment should be established — pensions for the aged, disabled and carers; lower-rate participation allowances for those of working age; and assistance payments for young people and students — each with means test withdrawal rates reflecting different work expectations.
- Once adequacy benchmarks are reached, they should be preserved by common indexation arrangements applied to each of the main payment types.
- Following the Pension Review changes, the relativity between single and couple payments should be improved across other payment types.
- The assets test should be abolished, and a comprehensive means test base established for the main pension and allowance payments (including for Rent Assistance to prevent additive withdrawal rates). Income from savings would take the form of deemed returns from assets.
- Family assistance should be paid through a single program principally based on the assessed additional costs of children, in general increasing with age, and means tested in accordance with family taxable income on the same base as for income tax.

## 5. Integrating consumption tax compliance with business systems

Consumption spending, if broadly defined, is potentially an efficient and robust tax base. The introduction of the GST made Australia's consumption tax base more efficient because it replaced a range of narrowly based Commonwealth and State taxes. However, the GST is itself an operationally complex tax, designed on tax invoice concepts more suited to the documentary standards of the 1960s than the digital potential of the 21st century. Moreover, Australia retains some other inefficient State taxes on consumption (such as insurance taxes) and a narrow payroll tax. It would be possible to replace the current narrow State taxes base (including payroll tax) with a low-rate, broad cash flow tax that exempts business export sales, more effectively utilising the consumption base. By using existing tax reporting mechanisms, the new tax could more readily be based on the automated systems increasingly used by businesses.

### Key directions

- Inefficient State taxes (including the current payroll tax) could be replaced by a low-rate destination cash flow tax, with revenues allocated to fund State services.
- Replace the current inefficient input taxation of financial services under the GST with a more efficient financial services tax, developed in consultation with the industry.

## 6. Efficient land and resource taxation

The returns to immobile factors of production constitute an efficient tax base. A rent-based tax would ensure the right levels of exploration and extraction and provide sufficient encouragement for private sector participation. A tax on high-value resource rents would on average over time likely raise higher revenues than existing output-based royalties. There are several alternative mechanisms for applying a rent-based tax, and transitional arrangements are critical.

A land tax is efficient if it is broadly based. Existing land taxes are quite inefficient because they are not broadly based, and rates vary according to land use and landholding aggregation rules. An efficient land tax would apply equally to all land uses and aggregate holdings, but could have a threshold and different rates based on the value per square metre of land. In practice this could mean that most land in lower-value use (including most agricultural land) would not face a land tax liability and the tax would apply moderate rates to most other land. Transitional rules will be critical in changing the basis of land taxes, to smooth valuation effects and to allow ample time for those affected to make adjustments to their investments in land.

### Key directions

- Except for low-value commodities, existing resource royalties should be replaced by a project-based uniform resource rent tax set at 40 per cent.
  - Resource taxation should include a symmetric treatment of losses and be based on the capital allowance rather than cash flow method of assessment.

- With appropriate transition rules, the new tax should apply to both new and existing projects.
- The Australian and State governments should negotiate an appropriate allocation of the revenues and risks of the tax.
- Existing land tax arrangements should be replaced, subject to a long transition to slow valuation effects and facilitate landholding adjustments, by a land tax applying to all land regardless of use. The rate scale would be based on the value per square metre of land.
  - A unit value threshold would effectively exempt most land in agricultural use.
  - Most residential land could be subject to tax of about 1 per cent. A higher rate may apply to the highest value land (per square metre).
  - Land tax revenue would also replace stamp duties on land transfers.

## 7. Completing retirement income reform and securing aged care

The Review's interim report on retirement incomes was released in May 2009. It supported the basic framework of the current system, and made a range of recommendations for improvements. However, the Review did not address all issues because it wanted to consider many of these in the context of other proposals. There is scope to improve the equity and simplicity of the superannuation arrangements, and in doing so it is also possible to increase the effective rate of savings delivered by the superannuation system. The Review proposes that these changes be made and sees them as taking Australia's superannuation system towards its logical design conclusion — as a subsidised expenditure tax. This is important, because there has been concern that superannuation has undergone constant change.

Aged care is a major challenge for Australia with rapidly increasing demand. The Review proposes some reforms in this area. It notes that this may be an area requiring compulsory levies, on all taxpayers.

### Key directions

- The tax on superannuation contributions in the fund should be abolished, increasing saving from currently taxed contributions by 17.5 per cent.
- Instead, employer superannuation contributions should be included in employee taxable income. Subject to annual limits, all contributions would attract a tax offset payable to contributors.
- All income and gains of superannuation funds should be taxed at a rate of 7.5 per cent, further increasing savings.
- The \$50,000 transitional cap for contributors aged 50 or older should be continued indefinitely.

- Superannuation balances should be included in Age Pension means tests on the same basis as other savings.
- The development of longevity insurance products should be encouraged and the government should consider offering such products itself.
- Care services for the aged should in general be separated from accommodation choices and provided on a means tested basis – preferably, any future compulsory funding levies should apply to all personal taxpayers and not be linked only to the superannuation guarantee.

## 8. Toward more affordable housing

Over the past decade, large parts of Australia have experienced worsening housing affordability problems. Rising housing prices have been underpinned mainly by rising residential land values (with high construction costs contributing in some cases, particularly in remote areas). While the overall demand for housing is increased by favourable tax and transfer provisions particularly for owner-occupied housing, these provisions are of very long standing and have deep community support. The sharp deterioration in affordability in recent times is more likely to reflect demand and supply factors such as high rates of immigration and household formation and government land use policies. The Review anticipates continued strong population growth and continued overall favourable tax-transfer treatment of owner-occupied housing. On that basis it has considered whether other features of the tax and transfer systems are appropriately configured to maintain fairness and efficiency in housing markets. It proposes a series of changes that would improve equity and market efficiency – but policy changes outside the tax and transfer systems will be necessary to better match aggregate housing supply and demand if overall housing price pressures are to be alleviated.

### Key directions

- Maximum rates of Rent Assistance for income support recipients should be substantially increased and linked to movements in market rents.
- Subject to transition arrangements, public housing rent concessions should be replaced by Rent Assistance and a new form of assistance for high-needs tenants, to improve equity and work incentives.
- Over a long transition period, a land tax should be introduced on all land on a more efficient and uniform basis linked to unit land values, removing disincentives for institutional investment in rental property and integrated over time with property rate assessments.
- Over a similar period, transfer taxes on property should be reduced, and ultimately removed, with revenues replaced by efficient taxes, preferably annual land tax.
- Subject to transitional provisions, and following action to improve the current shortfall in housing supply, a more neutral personal income tax treatment of private residential rental investment should be introduced, with less volatile market effects, through a 40 per cent discount on all net residential rental income and losses, and capital gains.

## 9. A more open, understandable and responsive tax system

Both tax policy-making and administration should be as responsive as possible to problems experienced by taxpayers. This requires a more transparent and understandable system, with citizens having clear rights to information on the tax system and their experience with it. It also requires more effective mechanisms to respond to both policy and administrative issues as they arise. Further, it is critical that the integrity of the tax system be maintained and that threats be promptly dealt with as they emerge.

### Key directions

- In time, citizens should be able to access, through a suitable choice of channels, comprehensive and timely information on their tax and transfer affairs, and be able to see and interpret how their tax and transfer outcomes have arisen and may be affected by choices they may make.
- The Board of Taxation should be empowered to initiate its own reviews of how current tax policies and laws are operating.
- A board should be established to advise the Commissioner of Taxation on the general organisation and management of the ATO.
- The government should ensure that sufficient resources are devoted to the Inspector-General of Taxation, the Australian National Audit Office and the Commonwealth Ombudsman, and clarify that the role of the Inspector-General of Taxation is to examine systemic tax administration issues that affect businesses.
- Governments should make available data and publish analyses of taxes and transfers to inform and encourage community debate about the performance of the tax and transfer system. High standards of transparency and accountability should apply to all taxes, transfers and government spending.

### Pathway to reform

This Review has aimed to set the strategic directions for the future architecture of the Australian tax and transfer system. It has not produced a one-off tax policy package, and it has not advanced the detailed design or timing of measures. Indeed, it is neither possible nor desirable to make all of these changes too quickly.

There are several reasons for this approach:

- First, taxes and transfers are instruments of government policy — they rarely provide a full expression of the underlying policy itself in isolation from other policies. There are critical links between tax and transfer policies and the other policies of government — mainly regulatory and expenditure policies. The future implementation of many tax and transfer policies depends on developments in this broader fabric of policy. For example:

- retirement income policies must take account of expected future policies for funding the rapid escalation of costs of health and care for the aged;
  - transfer system support for child care depends on the development of the capacity and regulation of the quality of child care services;
  - the effectiveness of tax arrangements for housing, and of housing assistance transfers, depends critically on future land and housing regulatory policy;
  - road tax and charging reform depends critically on reform to the institutional and reporting framework of road providers; and
  - the best assignment of taxes by level of government depends on models for future funding of major programs in areas like health, education, welfare and transport.
- Second, as the Review has addressed a vast field of policy, it is inevitable that some changes will be timed differently than others. This creates the need for future policy-makers to ensure that desired balances are maintained on an ongoing basis, but it is not practical for the Review to anticipate or prescribe in advance all of those sequencing challenges.
  - Third, policy reforms are usually aimed at changing market or other behaviours and outcomes, but such responses are rarely instantaneous. Markets, businesses and households need adjustment time. Many reforms will need further consideration closer to the time of implementation.
  - Fourth, the Review has been asked to look at taxes and transfers at all levels of government. Clearly, implementation will require agreement at the intergovernmental level, and will require detailed assessment of financial implications – likely in more than one step.
  - Fifth, tax reform should not be pursued independently of fiscal and macro-economic circumstances. Australia, and perhaps more importantly the rest of the world, is not currently experiencing typical economic times. Policies that suit the long run, which is the focus of the Review, may not necessarily be best implemented in these atypical times. Governments need the flexibility to pursue changes in accord with fiscal and other macroeconomic conditions, and the Review has not attempted to predict or anticipate that future pathway.
  - Sixth, policy changes that affect the distribution of income and benefits always confront the fact that many people have arranged their affairs on the basis of prior or existing policies. Adjustment itself has costs and requires time, and sometimes help is essential. Where adjustment is costly for the welfare of those affected, other provision may need to be made. The Review has not attempted to define every one of these possibilities and recognises that future policy decision-making will need to take these issues into account.

In drawing attention to all of these issues, however, the Review is by no means advocating a slow boat to reform. A number of the recommendations in this Report, if they were to be implemented immediately and without compensating changes elsewhere, could be represented as leading to losses of real disposable incomes (or real wealth) for some people in the community. Recognising the implementation challenges posed by such recommendations, the Panel has nevertheless decided to state clearly its views on what a future tax and transfer system should look like. The Panel sees no value in ignoring those features of the present system it strongly believes have no place in a 21st century architecture, for no better reason than some Australians currently gain more than others from those features.

The Panel appreciates that reform packages constructed on its recommendations will take some account of static distributional impacts, but considers that such accounting should not result in a failure to implement recommendations that would produce a tax and transfer system of enhanced durability, integrity and equity.

Australia's future success depends vitally on a robust approach to an ongoing reform agenda, and this will rely on support from all sections of the community. To maintain strong forward momentum, the Review recommends that all governments, and institutions such as the Council of Australian Governments (COAG) and the Productivity Commission, should be charged with the task of pressing ahead with reform implementation on an open, transparent basis.