1. The need for reform

Over the past 30 years, Australia's tax system and transfer system have undergone an almost continual process of reform in response to a changing policy context and as problems have been identified with existing policy settings. These reforms have underpinned Australia's fiscal position and the fairness of the tax and transfer system and contributed to Australia's strong economic performance over the past two decades.

In particular, this reform process has contributed to the remarkable resilience of the Australian economy, which has experienced uninterrupted growth through the Asian financial crisis of 1997–98 and the recession in the industrialised world in 2001. Australia has been the strongest-performing developed economy through the 2008–09 global financial crisis. Since the early 1990s, Australia's per capita income has moved up the OECD rankings, while an equitable pattern of overall income distribution has been maintained.

But Australia is now facing a different set of economic, social and environmental circumstances to those that have shaped tax and transfer policy since federation. Emerging demographic, health and other pressures on budgets at all levels of government, and expected challenges to our economic circumstances, call into question the durability of the tax and transfer system. The re-emergence of the Asian region as a centre of world economic activity together with increasing globalisation, characterised by increasing mobility of capital and to a lesser extent labour, will have a further profound effect on how investment is taxed and will increase the need for tax and transfer policy settings that support productivity growth.

In addition, changes to tax policy are required as part of the concerted response to help mitigate emerging environmental pressures. Developments in technology are also transforming the way businesses operate and people live, as well as opening new opportunities in the administration of taxes and transfers. Further, there is a need to create a more sustainable tax structure.

The breadth of this Review, spanning taxes and transfers at all levels of government, has provided a unique opportunity to consider how Australia can best structure its tax and transfer system to anticipate and respond to these challenges and opportunities. Policy settings that support economic growth and structural change will ensure that the living standards of Australians continue to rise and that they can continue to live in a society that supports the needy, is fair, enables social advancement and values the environment. Maintaining strong growth will require increased workforce participation, higher levels of capital per worker and support for entrepreneurial creativity and skill formation.

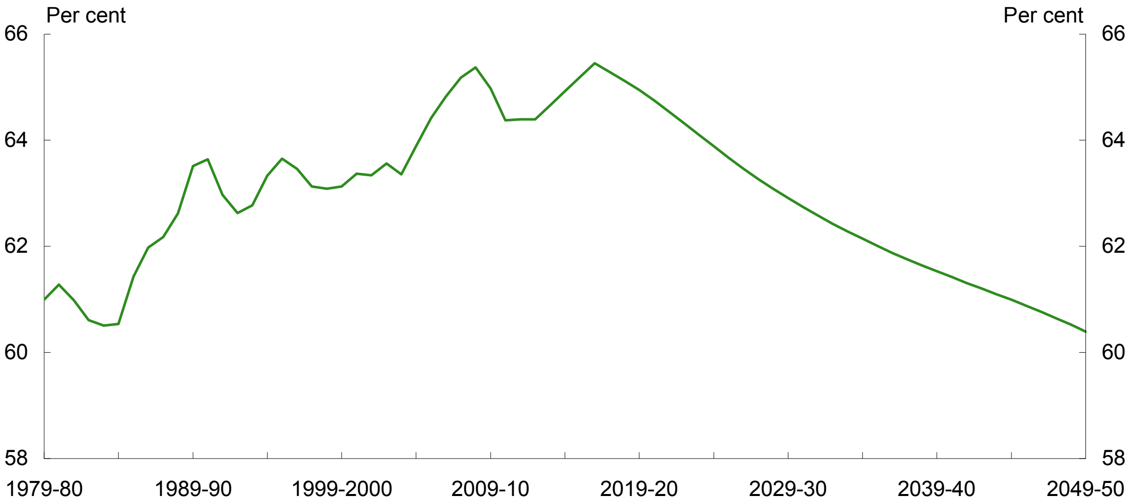
1.1 Demographic change in Australia

By the middle of this century, Australia's population is projected to rise to around 35 million (Treasury projections), an increase of around 60 per cent from today. The proportion of

Australians aged 65 years[1] or older is projected to increase to 22 per cent, from 13 per cent today. Even more remarkably, the proportion of Australians aged 85 years or older is projected to treble to 5 per cent.

The proportion of Australians in work or looking for work is projected to stabilise and then decline significantly over this period. This is in stark contrast to the rising participation trend over the past few decades (see Chart 1.1). It means that demographic change will shift from being a positive influence on income growth per person to a negative one. Coupled with this, the old age dependency ratio (people aged 65 years or older as a proportion of people of working age) is projected to double by the middle of the century. In 40 years time there could be just 2.7 people of working age for each person aged 65 years or older, compared with 5.0 people today and 7.5 people 40 years ago.

Chart 1.1: Participation rate[(a)]



(a) The participation rate is the proportion of the population aged 15 years or older in work or looking for work.
Source: Treasury projections.

The projected increase in the population and the higher proportion of older Australians bring rising costs of new economic and social infrastructure, health and aged care and dependency. The *Intergenerational Report 2007* (Australian Government 2007) projected that over the subsequent 40 years, Australian government expenditure requirements would increase by more than 4 per cent of gross domestic product (GDP). The Productivity Commission (2005) has projected that, in addition, State spending requirements could increase by around 0.8 per cent of GDP. Demographic change, and in particular the ageing of the population, is expected to account for a sizeable part of the projected increase in government spending. Health expenditure is also projected to increase significantly over the next 40 years, due in part to the ageing of the population, but also because of increased demand for health services in the broader community.

The demand for affordable aged care services is expected to increase significantly as the proportion of older Australians increases and so too does their average life expectancy. Ensuring equitable access to care will be an important challenge, as the availability of

1 In response to the Review's recommendation in its report to the Treasurer on retirement incomes, the Australian Government announced in the 2009–10 Budget the phased introduction of an increase in the Age Pension age, from 65 to 67 years.

affordable, quality aged care has the potential to affect the lives of Australians of all ages through its effects on government spending and the availability of people to work.

Our ageing population will also test the adequacy of the retirement income system. With the fastest rate of population growth projected to be among Australians aged 85 years or older and increasing life expectancies, there will be more interest in mechanisms to enable people to finance a higher level of income and services throughout their retirement.

If these projections prove correct, government budgets will need to change. One option would be to reduce other areas of government spending. Another would be to increase revenue. The latter would present particular problems for the States, whose existing taxes are relatively inefficient and have limited revenue-raising capacity. It would therefore be prudent to design a tax system now that would be capable of delivering higher tax revenues efficiently in future decades, should that prove necessary. Increasing the revenue-raising capacity of the tax system would require a greater emphasis on broad-based taxes.

To highlight the scale of the fiscal challenge, financing the projected increases in Australian and State government spending would be equivalent to the entire revenue raised by the GST.

Timely policy responses, including through the tax and transfer system, to boost workforce participation and lift productivity could ameliorate some of the projected impacts of demographic change. For example, in response to the Review's recommendation in its report to the Treasurer on retirement incomes, the Australian Government announced in the 2009-10 Budget the phased introduction of a higher Age Pension age, of 67 years. More generally, opportunities exist to reduce the cost that the tax and transfer system imposes on growth through disincentives for people to work and distortions to the allocation of investment and productive resources. This would increase productivity, raise incomes and make the task of financing future government expenditure less burdensome.

1.2 A changing social context and expectations

Changes in the structure of the Australian economy and attitudes toward workforce participation by women have resulted in greater diversity in work patterns. Australians are also expecting better community living standards over time. In addition to the rising demand for health, aged care services and disability support and services, there is pressure to increase spending on child care, housing and education.

A changing labour market

Over the past 30 years the predominance of full-time male workers in the labour force has given way to increased part-time work by men, increasing workforce participation and employment periods of women, and increasing numbers of older workers. These trends may continue for some time. The composition of the workforce is likely to continue to change, given that the participation rates in Australia of prime-age men, women of child-bearing age and older people are still below those in many other OECD countries. Australia ranks 6th lowest of 30 OECD countries in terms of the participation of prime-age males; 8th lowest for women of child-bearing age; and 13th for older men and women in the OECD (Abhayaratna & Lattimore 2006).

Changes have resulted in a more flexible labour market, but have increased the complexity in people's lives as they balance work with education, caring responsibilities and preparation for retirement. There are fewer single-income family households, and more dual-income family households as well as those without any private income. The increasing prevalence of part-time work has increased the role of income support as an income supplement for people in work. As a consequence, high effective rates of tax, due to the cumulative effect of personal income tax and the withdrawal of income support and family assistance, affect a large number of people.

Increasing female workforce participation has also focused attention on the balance between nurturing children and paid work. The introduction of a paid parental leave scheme will enable almost all primary caring parents to stay with their infants for the first six months.

However, extended labour market absences become more critical to the longer-term employment prospects of carers, which may be detrimental to their and their children's longer-term wellbeing. The interaction of tax and transfer rules can create disincentives for women of child bearing age to re-enter the workforce. Another issue is access to affordable high-quality child care, which has a major impact on family wellbeing, particularly in the case of the primary caring parent returning to work while children are young.

Rising expectations about community living standards

Over the past decade, housing affordability and vacancy rates for rental accommodation have declined over large parts of Australia. The sharp deterioration in affordability reflects an emerging housing shortage due to rising demand and constraints in supply. The housing market is expected to remain tight over the next few years. Concern is also being expressed about the existing arrangements for accessing public housing. Rationing of public housing can lead to inequitable outcomes, result in a poor alignment between housing and need, and discourage tenants from working or moving.

Individuals and the business community are demanding higher standards of education at all levels and greater access to higher education. Retraining can be an important step in re-entering the labour market during periods of economic adjustment.

While many policies affecting these issues are beyond the Review's terms of reference, the design of the tax and transfer system is relevant to them all. At a minimum the tax system will need to fund community access to these services. The design of the tax and transfer system may also influence how people pay for these services and the level of assistance they receive to acquire them, or assist people to save so they can afford them.

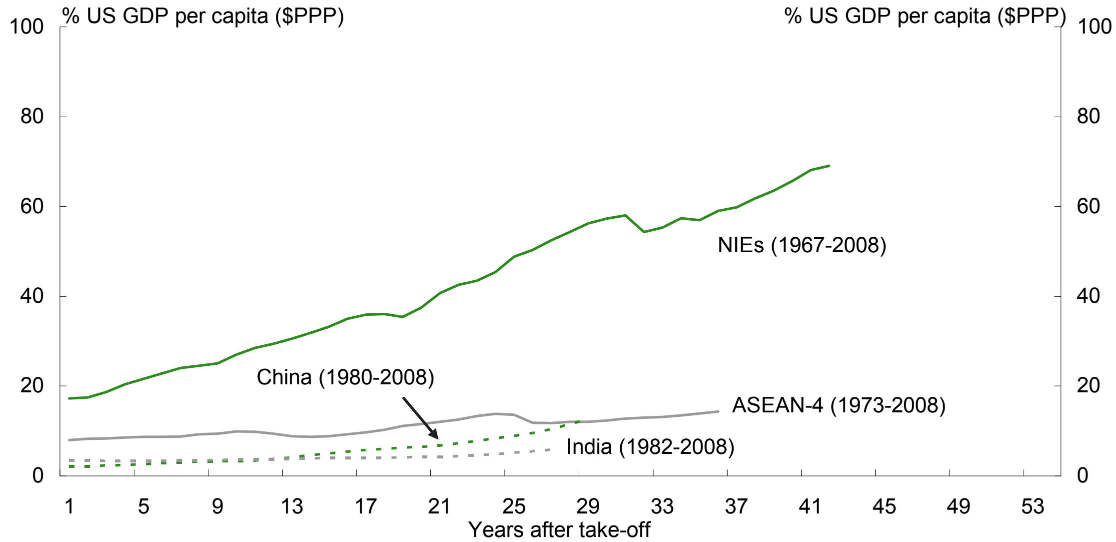
1.3 The rise of Asia and the shifting centre of world economic activity

The Australian economy is being transformed by the emergence of new centres of competition and opportunity in the region. The shift of the centre of gravity in the world economy towards Asia is reducing the distance between Australia and its export markets, adding considerable value to our natural resource wealth and opening new investment, trade and employment opportunities. However, growth in Asia will also attract globally mobile capital. Australia will need to respond if it is to remain an attractive place to invest and do business. Part of this response should be to ensure that the tax system supports investment, allocates resources to their most valued uses and does not inadvertently add to the cost of production through taxes on business inputs or excessive complexity and compliance costs.

With much of China and India at an early stage of catching up with the living standards of the developed world, strong growth in these countries could continue for a long time (see Chart 1.2). It is therefore likely that demand for non-renewable resources will remain strong and underpin, for some time and possibly for decades, a structurally higher terms of trade[2] than existed for much of the past 50 years. This view appears to be shared by investors, as evidenced by strong international interest in investing in the Australian resources sector.

It would be a mistake to conclude that the prospect of a continuing high terms of trade would translate into increased wealth for all or underpin a broad employment base. The expansion in the resources sector and a stronger exchange rate will continue to draw productive resources from other parts of the economy. Policy responses that expand the supply of productive resources in the economy may ameliorate this adjustment and support a more broadly based economy. Tax and transfer policy settings can influence the effective supply of labour and capital through their effects on the incentives to save, invest and work, and by improving the productivity of labour and capital.

Chart 1.2: Per capita GDP convergence for selected Asian countries



Note: The lines show the paths of GDP per capita relative to the United States in selected Asian countries, commencing at the time of 'take-off' in their economic growth. The first year of take-off for economies, excluding China and India, is the year when the three year moving average of constant price export growth first exceeded 10 per cent. The first year of take-off is 1980 for China and 1982 for India. The ASEAN-4 consists of Indonesia, Thailand, Malaysia and the Philippines. The newly industrialised economies (NIEs) consist of Hong Kong, Korea, Singapore and Taiwan.
Source: The Conference Board Total Economy Database (2009), IMF (2009a) and Treasury estimates.

2 The terms of trade represent the relationship between export and import prices. Australia's terms of trade are calculated by dividing the implicit price deflator for exports by the implicit price deflator for imports (ABS 2000).

1.4 Increasing globalisation

With continuing globalisation, tax settings will be of increasing importance for decisions about where capital will be invested, especially for small open economies like Australia.

Many countries are reducing tax rates on business and capital income relative to labour income and consumption. There has been a clear downward trend in statutory company income tax rates, particularly among small open economies (Table 1.1). Empirical evidence indicates that company tax rates matter for investment decisions, particularly investments for which location is not critical, and decisions by firms about where to declare profits and pay tax.

Table 1.1: Statutory company tax rates by size of economy

	Average statutory corporate income tax rate[a]		
	2000	2004	2008
Large-sized OECD countries	39.5	36.0	33.1
United States, Japan, Germany, United Kingdom, France, Italy			
Medium-sized OECD countries	35.7	33.1	29.1
Canada, Spain, Korea, Mexico, Netherlands, Australia (30%)			
Small-sized OECD countries	30.9	26.6	23.6
Belgium, Switzerland, Turkey, Sweden, Austria, Poland, Norway, Greece, Denmark, Ireland, Finland, Portugal, Czech Republic, Hungary, New Zealand, Slovak Republic, Luxembourg, Iceland			
OECD total	33.6	29.8	26.6

(a) Unweighted averages.
Source: Heady (2009).

Australia reduced its company tax rate over the period from the late 1980s to 2000. This adjustment was an important element of policy reforms that have led to strong growth. A continuation of this responsive adjustment would underpin further growth.

Increasing capital and labour mobility will result in strong competition for capital, especially direct investment. Foreign direct investment in Australia as a share of GDP is low in comparison to many developed countries. The significant growth in the stock of foreign investment in Australia over the past 20 years has been largely in the form of portfolio equity and debt. This is likely to reflect our tax settings, at least to some extent. While it is likely that the strength of our financial sector will continue to ensure access to debt financing, and that the resources sector will have little difficulty in attracting foreign direct investment, the relatively high costs imposed on foreign direct investment by Australia's 30 per cent company income tax rate may make it harder for other sectors of the economy to secure capital.

With increasing globalisation, people's choices about where to work may also become more sensitive to tax. Several submissions to the Review have highlighted the increasing international mobility of people, particularly of the more highly skilled. The flow of skilled workers into Australia has generally exceeded the outflow. However, in the future, population ageing in Australia and many other countries could lead to increased competition for skilled labour and more opportunities for Australians to work abroad.

National savings

Australia has benefited enormously from running current account deficits to finance levels of investment that are high by OECD standards. However, the global financial crisis highlights the potential risks associated with high levels of economic integration between countries, particularly where there are prolonged and large global macroeconomic imbalances. Due to a combination of sound regulation, a flexible economy, responsive policy and a generous endowment of natural resources, Australia has fared relatively well, despite its history of relatively large current account deficits. Coming out of the global recession, Australia's current account deficit is likely to continue to widen and possibly stay at historically high levels for some time — but due to continued high investment rather than low national savings.

Nevertheless, the potential risks and vulnerabilities arising from a high current account deficit can be mitigated by ensuring a strong national savings effort. There appear to be three important points of intersection between a strong national savings effort and the tax and transfer system.

- The first and the most critical is for Australia to maintain its strong public sector balance sheet, which more recently has enabled governments to fund both public investment and recurrent spending. It has also provided flexibility for the government to respond to the global financial crisis without exposing Australia to undue credit risk. Maintaining a strong balance sheet reinforces the need for broad and robust tax bases.
- Second, some additional forms of insurance might be appropriate to enhance national savings and help pre-fund community needs arising from ageing and disability, but the mode and delivery would need to be carefully considered. Ideally, it should be universal, applying to all taxpayers.
- Third, other private savings such as superannuation, and a more balanced tax treatment of household borrowing and saving, should continue to assist the national savings task.

It will also be important that investment financed by current account deficits is allocated to its most productive uses and that the choice of equity or debt financing reflects sound commercial considerations. A more neutral tax treatment of investment and financing choices would encourage this outcome.

1.5 Growing environmental pressures

Awareness of the fragility of Australia's natural environment is increasing — especially environmental pressures emerging in areas such as land degradation, species decline, water use and climate change. The projected increase in Australia's population over the next 40 years, together with continued economic growth, will put pressure on our increasingly fragile ecosystems. It will also place pressure on our cities and their supporting infrastructure.

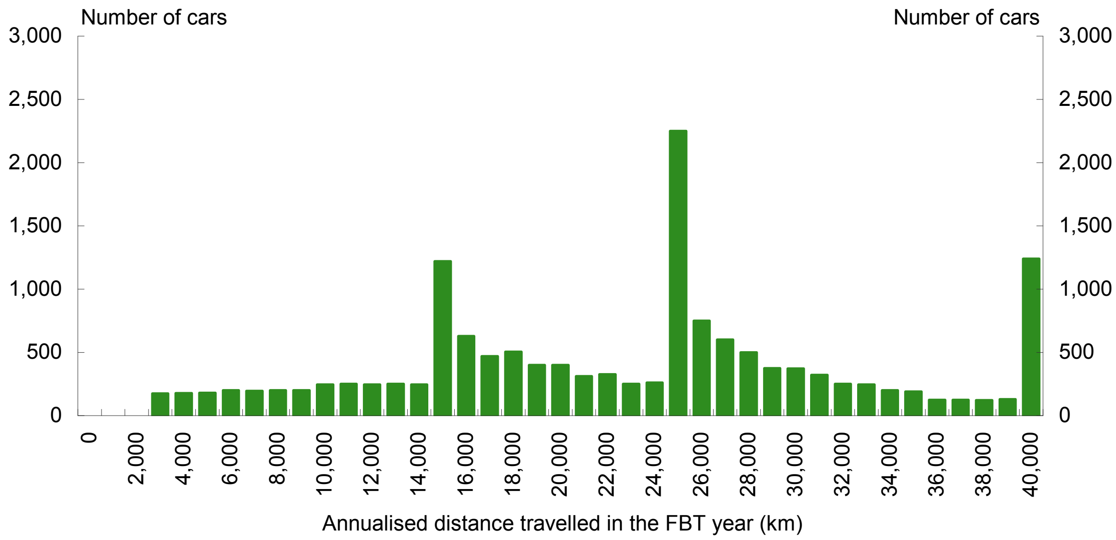
Quite apart from the intrinsic importance that many people ascribe to a healthy environment, our economic growth prospects are strongly linked to environmental sustainability. The environment provides natural resources essential to Australia's productive capacity, and ecosystems that absorb and assimilate the waste generated by people and industry. Sound land and water management practices are essential to maintaining agricultural production; biodiversity enables technological progress, particularly in medical and pharmaceutical applications; and low atmospheric pollution is essential to climate stability. Moreover, as people's incomes and wealth increase, so too will their demand that government policy is consistent with maintaining environmental amenity.

People and businesses make decisions on a daily basis that affect environmental quality. In many cases they are not fully aware of their impact or do not value those impacts as highly as others do, particularly future generations. Accordingly there is a role for government to influence decision-making with a view to achieving better environmental outcomes. The Carbon Pollution Reduction Scheme aims to make businesses and households face a price in relation to generating carbon associated with their production and consumption choices.

Potentially, the tax system can play a greater role in promoting sustainable policy outcomes, by influencing the incentives that lead to environmental degradation. An equally important consideration is to ensure that settings within the tax and transfer system do not unintentionally produce adverse environmental incentives or conflict with the broader environmental goals of regulatory and other policy measures. In some cases, existing tax and transfers settings are inconsistent with broader environmental objectives (see Part Two, Section E2 Taxes to improve the environment).

For example, the statutory formula for valuing car fringe benefits applies so that the taxable value of a car's fringe benefit falls as total kilometres driven per annum increases. At the margin, this may create an incentive for individuals to travel additional kilometres to reduce the taxable value of their car (particularly at the points at which the statutory fraction falls — 15,000, 25,000 and 40,000 kilometres per annum, as shown in Chart 1.3). In turn, this increases pollution and road congestion.

Chart 1.3: Number of vehicles by kilometres travelled
2007–08 fringe benefits tax (FBT) year



Source: Based on SG fleet submission to the 2009 Review of Australia's Automotive Industry, as cited in the AFTS submission of the Federal Chamber of Automotive Industries.

1.6 Technology

Business, commerce and people's lives are being transformed by technological advances, especially in digital electronics and communications.

In a competitive global environment, technological change can create both opportunities and challenges. Maintaining high levels of investment will support the adoption of new and emergent technologies and foster value-creating activity in Australia.

New technologies will enable greater use of user charging to address social spillover[3] costs (the cost to society as a whole of a transaction) and improve environmental outcomes. For example, electronic tagging of vehicles and GPS technology could allow congestion charging in cities and road-use charges for heavy vehicles. This would lead to a much more efficient use of road networks and investment in transport infrastructure.

The new digital age could dramatically alter how government and citizens interact in the tax and transfer system. It provides the opportunity to enmesh the tax and transfer system into the economy and society in ways that are transparent, simple and unobtrusive. For example, better use of technology could enable tax administration to increasingly utilise 'natural' business systems rather than requiring people to operate separate systems for tax purposes. People's engagement with the system may also be transformed through the use of internet-based technology and greater automation of the tax and transfer compliance process.

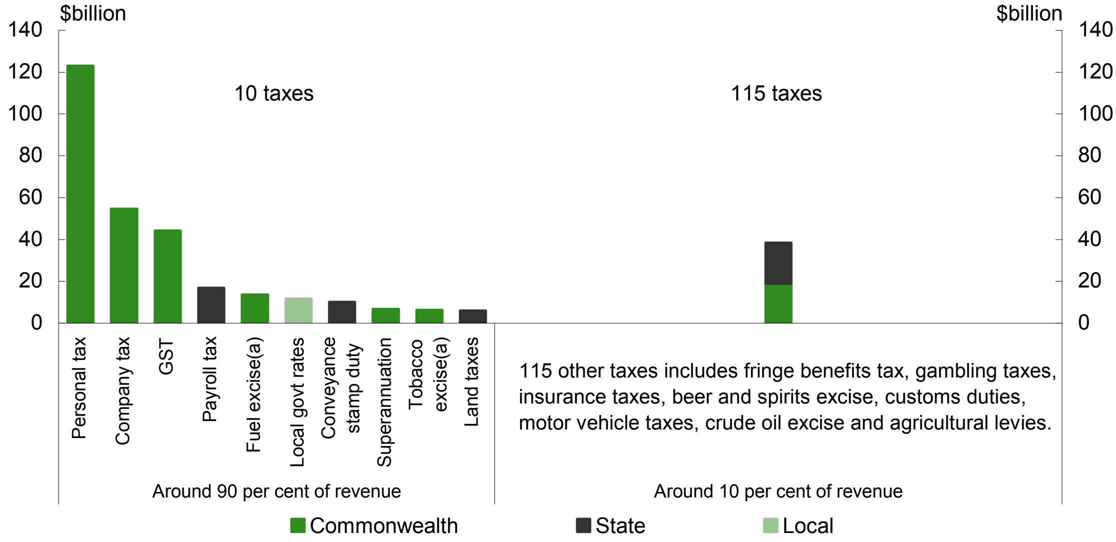
1.7 An unsustainable tax structure

Australia has too many taxes and too many complicated ways of delivering multiple policy objectives through the tax system. The capacity of the legislative and operating platforms of these systems, and their human users, to deal with the resulting complexity has been overreached. To a large extent this is a reflection of a compartmentalised and incremental approach to tax policy that has been weighted toward achieving finely calibrated equity and efficiency outcomes at the expense of simplicity.

Around 90 per cent of Australian tax revenue is raised through only 10 out of some 125 different taxes that are currently levied on businesses and individuals (see Chart 1.4).

3 A spillover occurs when a person's actions impose involuntary costs (or benefits) on others. That is, in addition to the private costs and benefits that accrue to the decision-maker, some costs and benefits can 'spill over' on to others.

Chart 1.4: Ranking of Australian taxes by revenue in 2009–10



(a) Fuel excise and tobacco excise includes excise equivalent customs duties for these products.
Source: Treasury estimates.

Many taxes detract from the overall efficiency of the system (see Box 1.1), with many of the least efficient taxes being levied by the States. Years of incremental policy change have eroded the bases of even potentially efficient taxes. It has also led to a relatively low degree of policy consistency among the States, and across levels of government, in terms of the way taxes are levied and administered. Consequently there have been repeated calls, particularly by business groups, to improve the structure of the tax and transfer system. These calls were echoed in submissions to the Review.

Improving the structure of the tax system, by replacing inefficient taxes with a rationalised suite of taxes and streamlining administration, has the potential to increase government accountability, reduce system complexity and business compliance costs, and make the Australian economy more productive.

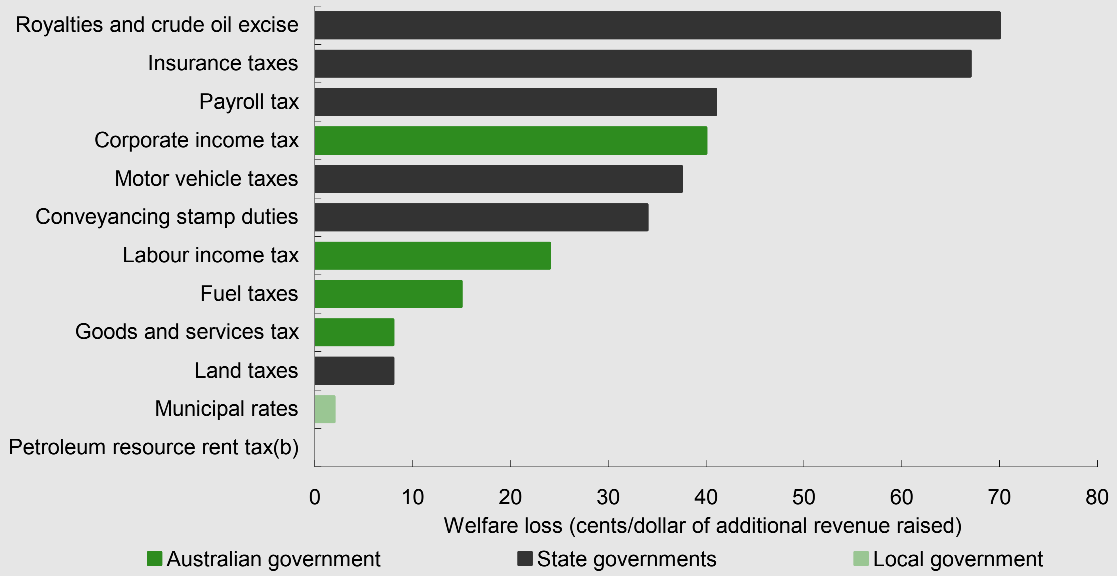
Box 1.1: The economic efficiency of Australian taxes

Most taxes result in some loss of economic efficiency. For example, a tax may reduce incentives for people to work or invest or induce them to alter their consumption patterns. This leads to losses in consumer welfare, which can be expressed relative to the amount of revenue raised. An efficient tax system involves taxes that result in relatively low losses in consumer welfare per dollar of revenue raised.

Chart 1.5 compares the marginal welfare loss arising from a small (5 per cent) increase in each of a range of major Australian taxes (marginal excess burden), estimated using the KPMG Econtech MM900 model. This model contains a high level of tax detail, enabling estimation of the efficiency impacts of a broad range of existing taxes. However, as with all such models, the results are only indicative due to limitations in the way taxes and the economy are represented. For example, the full range of efficiency costs associated with conveyance stamp duties, the complexity of the personal and company income tax bases, and some potential spillover effects of taxes cannot be measured with this type of model. Also, the relative welfare loss associated with a small change in one tax may not be representative of that associated with the removal of that tax or where multiple taxes are changed together.

The estimated welfare losses of municipal rates and land tax are lower than, or similar to, those of the GST, and a lot lower than for personal tax on labour income and company income tax. This ranking is consistent with empirical work by the OECD (Johansson et al. 2008). The existing payroll tax is estimated to have a relatively high welfare cost, reflecting the effect of the tax-free threshold on business size. A payroll tax with no tax-free threshold is estimated to have a welfare loss similar to the GST. For a more detailed discussion see KPMG Econtech (2009).

Chart 1.5: Marginal welfare loss from a small increase in selected Australian taxes[(a)]



(a) The welfare effect of varying each tax has been assessed using the KPMG Econtech MM900 general equilibrium model of the Australian economy. The welfare loss is the loss in consumer welfare per dollar of revenue raised for a small (5 per cent) increase in each tax, simulated individually. It is measured as the amount of lump sum compensation required to restore the representative consumer's level of satisfaction to its original level, after returning the revenue raised by the tax to the consumer as a lump sum transfer. The extent of such compensation reflects the distorting effect of the tax on the economy.

(b) The petroleum resource rent tax is modelled as a pure rent tax giving rise to a zero welfare loss. In practice, a small increase in this tax could be expected to induce some welfare loss. However, it would be expected to rank as one of the more efficient taxes in the chart.

Source: KPMG Econtech (2009).