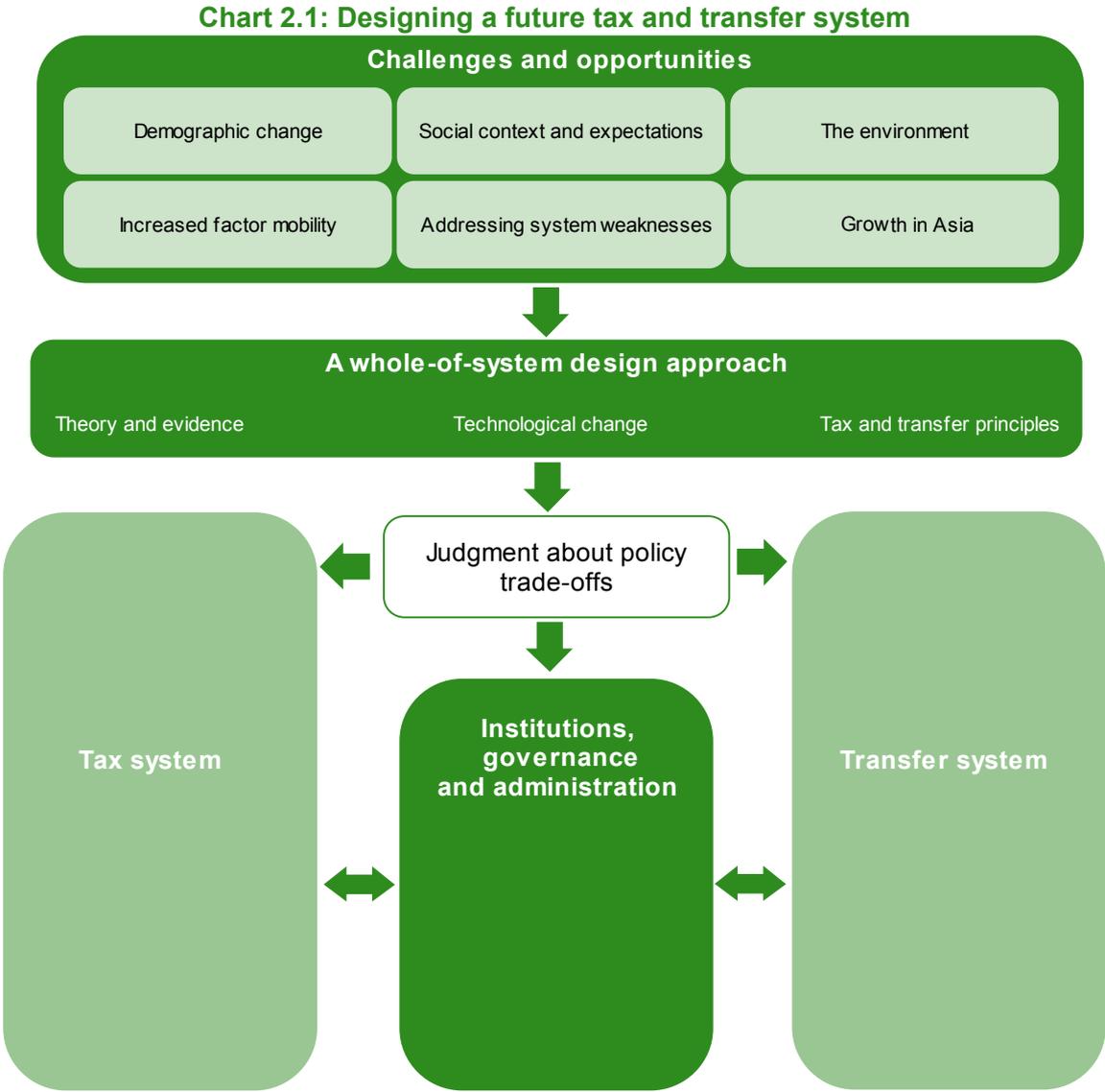


2. Designing a future tax and transfer system

Consistent with its broad terms of reference, the Review has taken a systemic approach in redesigning the tax and transfer system (see Chart 2.1). That is, the Review has evaluated specific taxes and transfers from the perspective that each is a part of a single national tax and transfer system. Recommendations on the implementation of reforms as they affect the system’s administration, the client interface and the assignment of revenue within the federation also reflect this perspective.



In forming its recommendations the Review has drawn on the latest developments in economic theory and rigorous evidence-based analysis of the impact of taxes and transfers (see Section 2.1 below). Translating this information into policy design has, of necessity, required the Review to make judgements about its relevance in the Australian context and about the trade-offs that arise between the goals of fairness, efficiency, simplicity,

sustainability and policy consistency (see Box 2.1). In evaluating these trade-offs, the Panel has been guided by the following broad objectives:

- The tax system must be capable of raising sufficient revenue to fund the expenditure required of future governments.
- Revenue should be raised from taxes that are least detrimental to economic growth and that support a diverse economic structure.
- The transfer system, together with progressive personal taxation, should be the predominant means through which the government influences the distribution of income in the economy.
- People in similar circumstances should be treated in a similar way under the tax and transfer system.
- The transfer system should provide assistance to those in need in accordance with intended distributional outcomes, while retaining a strong incentive for people to work and improve their lifetime opportunities if they are able.
- Policy settings should be coherent and reflect a greater emphasis on simplicity and transparency than is presently evident.
- Policy design should be integrated with technology to raise revenue efficiently, enhance social outcomes through tax design and improve the experience of people and business in interacting with the system.
- The design of the system and the assignment of revenue within the federation should support effective government and clear accountability of governments to citizens.
- The design and governance of the system should ensure that the benefits of reform are enduring.

2.1 New insights about the design of taxes and transfers

In redesigning the tax and transfer system, the Review has taken advantage of better and stronger understandings developed recently about the way taxes and transfers affect people's behaviour and the economy. The international consensus on these matters has moved some way since the last major reviews of the tax and transfer systems, the Asprey review of the tax system in 1975 (Asprey 1975) and the *Social Security Review* initiated in 1986 (Cass 1986).

Box 2.1: Design principles for the tax and transfer system**Equity**

The tax and transfer system should treat individuals with similar economic capacity in the same way, while those with greater capacity should bear a greater net burden, or benefit less in the case of net transfers. This burden should change more than in proportion to the change in capacity. That is, the overall system should be progressive. Considerations about the equity of the system also need to take into account exposure to complexity and the distribution of compliance costs and risk.

Efficiency

The tax and transfer system should raise and redistribute revenue at the least possible cost to economic efficiency and with minimal administration and compliance costs. All taxes and transfers affect the choices people and businesses make by altering their incentives to work, save, invest or consume things of value to them. The size of these efficiency costs varies from tax to tax (see Chart 1.5 in Box 1.1) and from transfer to transfer, reflecting, in part, the extent to which they affect behaviour. Instability in policy settings can reduce economic efficiency by increasing uncertainty about the expected payoffs to long-term decisions such as investing in education, choosing retirement products, investing in long-lived productive assets and the choice of business structure. These costs represent a net loss to society as a whole, whereas revenue raised through a tax is redistributed among members of society through government expenditure, including transfer payments.

Simplicity

The tax and transfer system should be easy to understand and simple to comply with. A simple and transparent system makes it easier for people to understand their obligations and entitlements. People and businesses will be more likely to make the most beneficial choices for themselves and respond to intended policy signals. A simple and transparent system may also involve lower compliance costs for taxpayers and transfer recipients.

Sustainability

A principal objective of the tax system is to raise revenue to fund government programs, including transfer payments. The tax system should have the capacity to meet the changing revenue needs of government on an ongoing basis without recourse to inefficient taxes. To be sustainable the tax system, together with the transfer system, must contribute to a fair and equitable society. The cost of the transfer system needs to be predictable and affordable in the light of demographic change. Sustainability also means that the structural features of the system should be durable in a changing policy context, yet flexible enough to allow governments to respond as required. Legal and administrative institutions and frameworks should also be robust to maintain the effectiveness of the system and underpin the legitimacy of the system. Policy settings should also contribute to environmental outcomes that are sustainable.

Policy consistency

Tax and transfer policy should be internally consistent. Rules in one part of the system should not contradict those in another part of the system. To the extent possible, tax and transfer policy should also be consistent with the broader policy objectives of government. However, the primary objectives of the tax and transfer system, to raise revenue and provide assistance to those in need, should not be compromised by other policy objectives.

The impact of taxes and transfers on economic growth

Encouraging strong economic growth is one of the most effective ways of dealing with the fiscal pressures that are likely to be associated with the ageing of Australia's population. Recent empirical studies suggest that economic growth is affected by the structure of the tax system. Company income tax has been found to have the largest adverse effects on economic growth, followed in rank order by taxes on personal income, consumption and land (assuming all these taxes are on suitably broad bases) (see Table 2.1). This ranking reflects the higher efficiency costs of a tax levied on a base that can be moved or changed. For this reason, there should be a lighter tax burden on more mobile bases, particularly investment.

Table 2.1: Long-run percentage change in GDP per capita from a revenue-neutral shift of 1 per cent in tax revenues — selected OECD countries^(a)

Shift in tax mix	Estimated change in GDP (per cent)
From income tax to consumption taxes	+ 0.74
From income tax to recurrent taxes on immovable property	+ 2.47
From consumption and property taxes to personal income taxes	- 1.13
From consumption and property taxes to corporate income taxes	- 2.01

(a) Johansson et al. (2008) note that while the size of the estimated effects are large compared to what would be reasonably expected, the tax base rankings are robust to a large number of robustness checks and alternative specifications. Further, other studies have found similarly high point estimates.

Source: Johansson et al. (2008).

Tax and transfer policy should support productivity through the efficient allocation of investment and productive resources to their most highly valued uses. When products are taxed at the same rate, relative prices will be unaffected and there will be less impact on the decisions of individuals and businesses. A broad base also enables a lower rate of tax for a given revenue objective, which results in smaller distortions to people's and businesses' choices. Broadly-based taxes are, therefore, more consistent with an allocation of resources in the economy that supports a high rate of economic growth and individual satisfaction. Narrowly-based taxes can, however, improve resource allocation where they address cases of market failure or support improved social outcomes.

People's choices about participating in the workforce are affected by both taxes and transfer payments. International and Australian research has highlighted the different ways in which tax and transfer rules impact on the workforce participation of men, single and partnered women and women with children. In particular, partnered mothers and single parents are quite sensitive to the impact of taxes, transfer withdrawal rates and the level of transfer payments in deciding whether to undertake paid work.

Associated with increased female workforce participation and the growth of two-income households, there is now also a greater awareness of the importance of policies that enable primary carers of children to make workforce participation choices that are in the best interests of their children and themselves. Studies generally confirm that in the period immediately following childbirth, both the mother and the baby benefit from the mother being at home. However, extended absences from the labour market tend to affect a person's longer-term labour market prospects, with detrimental effects on longer term outcomes for both children and their parents, especially women. However, the potential for improved family wellbeing as a consequence of the primary caring parent returning to work while children are young depends on the availability of high quality affordable child care.

The tax and transfer system also affects people's choices to save and invest. Recent theoretical and empirical research has brought a new perspective to the long-standing debate about the relative merits of comprehensive income taxation, under which savings income is taxed at a taxpayer's marginal rate, and expenditure taxes, under which savings income is exempt. This work strengthens the argument that while there are potential benefits from taxing savings income, it should be taxed at a lower rate than labour income.

Designing transfers to improve lifetime wellbeing

In framing policies to alleviate disadvantage, a simple focus on the adequacy of income, judged against criteria such as the Henderson Poverty Line,⁴ has been replaced by broader goals that focus on lifetime income and the capacity of people to engage in work and other social activities. In particular, there is greater awareness that assistance should not encourage short-term choices which compromise the development of capabilities that offer potential medium to long-term improvements in a person's wellbeing. For example, government assistance, and its interaction with taxation, should not lock people into welfare dependency by discouraging them from working, working longer hours, studying or retraining. This has seen increased emphasis on requiring people to work, actively seek employment or participate in training. Similarly, housing assistance should not lock people into geographical disadvantage.

The distributional implications of taxes

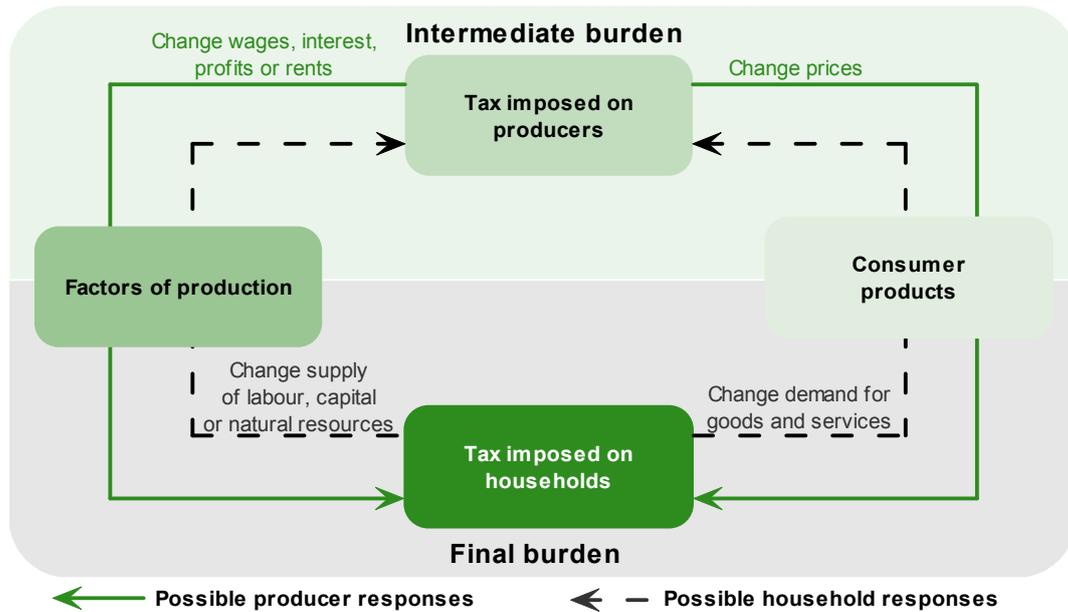
All taxes ultimately bear on or benefit people, not businesses or other entities. It is the distribution of the economic burden of taxes that is important for equity, not who remits a tax. Different community perspectives about the merits of a specific tax setting often reflect a difference of view about who ultimately bears the burden of a tax.

It has long been understood that the person or entity legally obliged to remit a tax may not be the person, or the only person, whose income or consumption opportunities are altered. For example, taxes are shifted from businesses to households through higher prices for products or through lower returns to the use of domestic factors of production such as reduced wages, reduced rent or reduced prices for the use of natural resources (see Chart 2.2). The distribution of the burden of a tax can also vary over time as markets adjust. It is generally accepted that the burden of a tax will fall to a greater extent on:

- a person consuming a product or owning a factor of production for which the demand or supply is unresponsive to a change in its price;
- a person consuming a product with no ready substitutes; or
- a person owning a factor of production that is relatively immobile.

4 The Henderson poverty line defines the amount of income below which a particular household would be considered to be in poverty. The benchmark level relating to 1973 was established by the Henderson Commission of Inquiry. This level is adjusted by per capita household income and is therefore a relative, rather than absolute, measure of poverty (Henderson 1975).

Chart 2.2: How taxes are shifted



There has been less agreement about the extent to which tax shifting occurs in practice and where the burden of most taxes ultimately rests. It follows, however, that in a small open economy like Australia's, where capital and products can move relatively freely between Australian and overseas markets, the burden of most taxes ultimately is likely to fall largely on Australian residents. It also follows that the extent to which this occurs is likely to be higher in the longer term, as there is greater capacity for resources to be reallocated across the economy in response to changes in prices or the return to investment. Recent empirical work using economic models is shedding greater light on this issue.

At least some of the burden of company income tax is shifted onto labour. This is because investors can avoid the tax by moving their capital abroad. Less capital in the economy means lower productivity of labour and land and this means lower wages and lower rents for the owners of land. These effects are less pronounced where a tax is levied on profits that arise because of the specific location of an investment, as is often the case with non-renewable resources.

Taxes (such as payroll tax, insurance tax and GST) on the factors of production and other business inputs tend to be shifted to households through lower returns to those factors or higher product prices. Taxes that appear to be borne by the business owner end up being borne by them either as a supplier of labour or as an owner of specific capital. In contrast, the burden of a broad-based uniform tax on land will fall primarily on existing landowners. The fixed supply of land limits the ability of landowners to pass the tax onto others. Instead, the price of land would adjust to restore the market rate of return to holding land as an asset.

Policy measures that compensate people for the indirect impacts of taxes, such as changes to the rates of transfer payments by indexation or other compensation measures and increases to first home owner grants, effectively shelter the recipients from the burden of those taxes. A consequence of such indexation is that it adds a degree of progressivity, even to broadly based indirect taxes that are fully passed on through consumer prices. The principle underlying compensation measures in this context is that where taxpayers have arranged their affairs on the basis of the existing arrangements or are poorly placed to rearrange their financial affairs (either because they are not able to do so, or because it would be

unreasonable to expect them to absorb the cost of doing so), it is necessary to effectively shelter them from the burden of those taxes. Compensation measures have also reflected judgements about the distributional impact of taxation changes.

However, compensation measures can be complex. Grandfathering arrangements can result in service delivery agencies administering two sets of rules. Measures to insulate income support and family assistance recipients from the price changes of major shifts in the tax base can also result in complex arrangements. A payment indexed only to the CPI will automatically adjust to changes in prices (though in some circumstances special measures will be needed to bring forward the payment of the CPI increase). However, if it is important that payments benchmarked to community living standards do not reduce in real value, other changes in addition to normal indexation are necessary.

The Report does not outline specific compensation measures for the recommended changes to taxation. The design of any such measures will depend on government decisions about policy reform packages. However, in this context it should be noted that if payment or taxation rates are effectively adjusted to compensate low and middle income households for changes that are often regarded as regressive (such as flat rate taxes and consumption taxes), such taxes can have an overall progressive effect. Consistent with the principles articulated in Part Two, the personal income tax and transfer system is the most appropriate mechanism for compensating low- and middle-income households for major tax changes.

The costs of complexity

The complexity of the tax system and the costs of complying with it are perennial concerns, particularly of the business community. Recent research suggests a range of costs associated with this complexity. It reduces transparency, impeding optimal decision making by businesses and individuals and their ability to respond to intended policy signals. It can cause people inadvertently to pay the wrong amount of tax or claim more or less than they are entitled in transfer payments. It is regressive in its impact, affecting mostly those people with the least capacity to deal with complexity and the least access to professional help.

Significant among the causes of complexity are the pursuit of finely calibrated equity and efficiency outcomes, instability in policy settings and people's incentives to maximise their after-tax and transfer incomes or after-tax business profits. The provision of choice in determining a tax liability can increase complexity and result in higher compliance costs where taxpayers seek to discover the best tax outcome. Complexity may also be compounded where policy settings within the system do not draw on 'natural' taxpayer systems or are inconsistent with broader policy objectives of government.

Related to the issue of complexity are the costs of administering and complying with the tax and transfer system. These costs represent a net loss to the economy, because the resources engaged in these activities could otherwise be put to more highly valued uses. Recent research suggests there is an optimal level of system complexity and operating costs, one that balances administration and compliance costs with improved efficiency and distributional outcomes.

