3. A tax and transfer system for the 21st century

The broad architecture of Australia's tax and transfer system provides a good starting point for meeting the challenges and opportunities that Australia faces in the 21st century. There is, however, a need for reform to better align the design of the system with Australia's future economic, social and environmental conditions.

3.1 Existing strengths

The existing tax system comprises several relatively efficient taxes capable of providing a sustainable flow of revenue over the long-term, as well as a number of specific taxes that, properly applied, could enhance social outcomes or market efficiency.

The overall framework of the tax and transfer system rests on the broad principle that levels of taxation should reflect ability to pay, and that support should be provided when needed. Australia's personal income tax system is relatively progressive and the transfer system is highly targeted and broadly supports workforce participation. The retirement income system, based on a unique mix of public and private provision, shares the burden and risks in providing retirement incomes.

These features provide a foundation for achieving socially acceptable distributional outcomes in a fiscally sustainable manner. Indeed, largely because of these structural features, Australia is better placed than many OECD countries to deal with the challenge of an ageing population.

Australia also has a high standard of administration of both taxes and transfers, with an increasing emphasis on exploiting opportunities offered by emerging technologies to improve tax processes.

3.2 Opportunities for improvement

Although Australia is better placed than many other countries to deal with an ageing population, the sustainability of our current system is not assured.

The States raise a significant proportion of their tax revenue from some of the least efficient taxes in our system. The more efficient of the taxes available to the States are poorly designed and, as a result, are currently limited in their capacity to generate revenue.

The least efficient taxes undermine Australians' living standards, reducing productivity and incomes by discouraging investment and workforce participation or by directing investment and resources to less valued activities.

The level of some transfer payments, and the basis on which relativities between payments are set, is not sustainable in the medium to long term. The projected growth in the proportion of people aged 65 years or older will test the capacity of the retirement income system.

Living standards are also undermined by tax settings that discourage people from making choices that would yield greater lifetime wellbeing. The transfer system, and its interactions with personal taxation, can also discourage workforce participation and lock people into welfare dependency through short-term choices that compromise their lifetime wellbeing.

Australia's tax and transfer system is too complex. Complexity in the tax system is a primary reason why Australians rely on tax agents to complete their personal tax returns to a far greater extent than in other OECD countries. There are too many taxes, many of which apply to the same activity, and too many administering authorities for a country with Australia's population. It is difficult and costly to comply with the requirements of the tax system, which is a major source of dissatisfaction in the business community. Policy inconsistency across the tax and transfer system has eroded the underlying principles in some areas.

The potential opportunities for simplification offered by new digital technology suggests a considerably larger payoff now than in the past from reassessing the weight given to equity and efficiency relative to simplicity when designing policy.

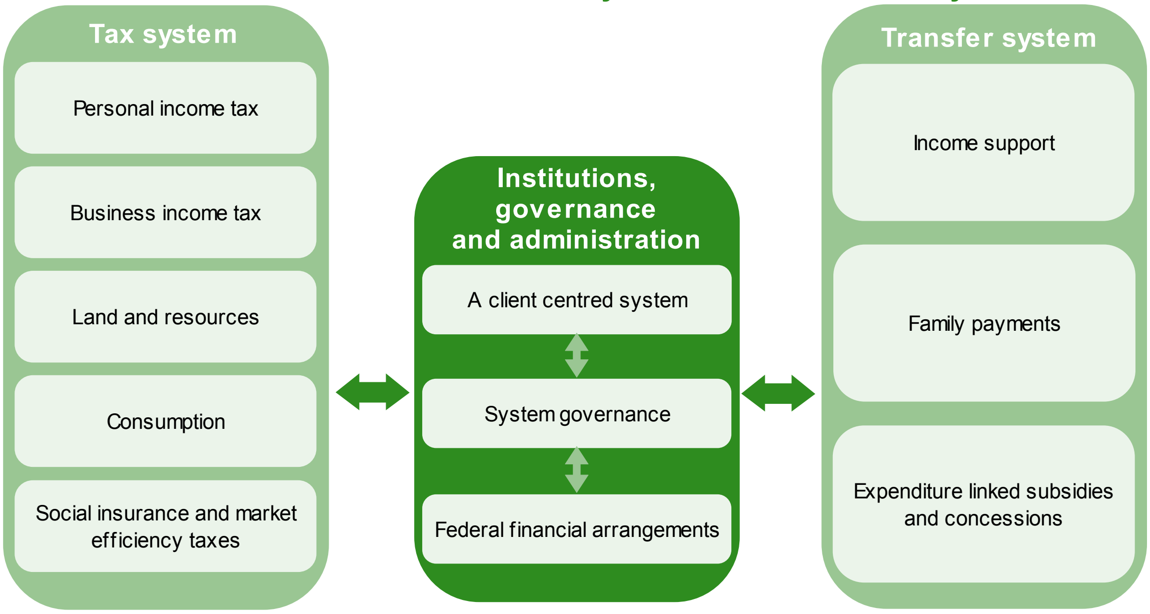
3.3 The future architecture

The architecture of Australia's future tax and transfer system is represented schematically in Chart 3.1.

The architecture is designed from a national rather than jurisdictional perspective. That is, taxes and transfers have been designed primarily to meet national revenue and income redistribution objectives.

The existing structural separation of the tax system from the transfer system should be retained. The extent to which the two systems might be integrated has been considered in some depth and the Review has concluded that integration is neither achievable nor desirable because of their different purposes. The tax system should raise revenue based on individual capacity to pay, while support through the transfer system should be based on household need. Nevertheless, the design of policy settings in each system has taken into account their interactions with the other system and the overall implications of taxes and transfers for the choices people make.

Chart 3.1: A tax and transfer system for the 21st century



A key recommendation for reform is that revenue raising should be concentrated on four robust and efficient, broad-based taxes:

- personal income, assessed on a more comprehensive base;
- business income, designed to support economic growth;
- economic rents from natural resources and land; and
- private consumption.

Narrow-based taxes, such as those on specific goods and services, should only be levied where they improve social outcomes or market efficiency through better price signals. Such taxes would only be used where they are a better means of achieving the desired outcome than other policy instruments. With these taxes, the rate would be set in accordance with the marginal spillover cost of the activity. User charging should play a complementary role, as a mechanism for signalling the underlying resource cost of publicly provided goods and services.

In the case of both specific taxes and user charges, revenue would be a by-product of the tax or charge, not the reason for it. Other existing taxes should have no place in the future tax system and over time should be abolished.

Recommendation 1: Revenue raising should be concentrated on four robust and efficient broad-based taxes:

- personal income, assessed on a more comprehensive base;
- business income, designed to support economic growth;
- economic rents from natural resources and land; and
- private consumption.

Additional specific taxes should exist only where they improve social outcomes or market efficiency through better price signals. Such taxes would only be used where they are a better means to achieve the desired outcome than other policy instruments. The rate of tax would be set in accordance with the marginal spillover cost of the activity.

User charging should play a complementary role, as a mechanism for signalling the underlying resource cost of publicly provided goods and services.

With both specific taxes and user charges, revenue would be a by-product of the tax or charge, not the reason for it.

Other existing taxes should have no place in the future tax system and over time should be abolished.

Transfer payments would remain highly targeted through eligibility criteria and means testing based on a person's circumstances. Transfer payments would continue to be targeted through a range of mechanisms — eligibility criteria, payment rates and withdrawal rates. The rates and conditions of payment would reflect community expectations about people's standard of living and their obligations to become self-reliant.

There would be clear incentives for people to improve their lifetime opportunities through workforce participation, investing in education or saving. Payment categories in the income support system would clearly define social expectations about the responsibilities of people to look for work. Once established, rates of payment would be maintained through consistent indexation arrangements.

The assessment of a person's means for transfer purposes would take into account their income, including that derived from assets, generally at a deemed rate, with capped exemptions for the home and personal effects. Reflecting community expectations about the role of partners in couples in caring for one another, it would also take into account the income and assets of a person's partner.

The tax and transfer system would be designed with a focus on improving the experiences of individuals and business in interacting with the system and improving the effectiveness and accountability of government. Reducing the number of taxes and transfers, and improving the effectiveness of those that remain, is necessary but not sufficient to achieve this goal.

The administration system would allow people to engage with the tax and transfer system through a single, individualised portal that draws on natural business systems to automate business interactions with government. Governance arrangements would support a more responsive system and ensure the benefits of reform are preserved and enhanced over time.

The reforms required to achieve this vision are outlined in Sections 4 to 10 and in greater detail in Part Two of this report. Section 11 discusses the implications of the reforms for economic growth and other macroeconomic outcomes and fiscal sustainability. A consolidated list of the recommendations is provided in Section 12.