

## 11. Macroeconomic and fiscal impacts

Australia's tax and transfer system needs to raise and redistribute revenue efficiently, equitably and in a fiscally sustainable manner. In doing so, it should be fair, support increases to national income through higher productivity and workforce participation and be consistent with environmental sustainability.

To evaluate the economic and fiscal impact of the reforms, the Review has assessed the macroeconomic implications of the recommendations and their overall fiscal impact using indicative policy parameter values. The findings from this high-level analysis are that the recommendations would significantly increase overall national output, increase real wages, contribute positively to macroeconomic stability and add to national savings. They would also be fiscally sustainable.

Many of the recommendations of the Review have focused on enhancing distributional outcomes. However, the way the recommendations might be implemented, the specific values of their key policy parameters, their timing and the prevailing economic environment in which they are implemented would influence how they affect individuals and businesses. For this reason, the Review has not undertaken detailed quantitative distributional analysis of the impact of the recommendations.

### 11.1 Implications for economic growth

The reforms outlined in this Report have the potential to significantly increase the productive capacity of the economy by reducing the extent to which the tax and transfer system interferes with the decisions of individuals and businesses, including investment and workforce participation decisions.

The economy-wide impacts of the Review's primary recommendations have been analysed using the MM900 economic model of the Australian economy, developed for the Review (see Box 11.1). Unlike other general equilibrium models of the Australian economy, the MM900 model incorporates considerable detail about the Australian tax system. Its predecessor, MM600, is a widely used and well-respected Australian economy model.

The economy-wide analysis has included the following reform directions:

- reducing company income tax;
- improving the taxation of Australia's non-renewable resources and land;
- replacing a range of narrow product taxes with a broad-based cash flow tax; and
- improving the structure of other taxes aimed at improving social outcomes.

Other recommendations have not been modelled, either because there is insufficient policy detail to perform the simulation or the policy detail could not readily be modelled within MM900.

The potential overall gain to output has been estimated to be in the order of 2 to 3 percentage points, the major contributors to which are state tax reform and improved business taxation, including a reduced company tax rate and increased reliance on more efficient resource taxation. The increase to GDP is broadly equivalent to around \$25 to \$40 billion in 2010–11 values. The real wage rate (the wage rate adjusted for the change in consumer prices) has been estimated to increase in the range of 3 to 5 per cent.

Significantly, the estimated increases to national output and to real wages do not include potential gains to economic efficiency from: improved transport pricing; improved workforce participation incentives arising from personal taxation and transfer payment reform; a higher level, and more efficient allocation, of savings and investment; and increased entrepreneurial activity. They also exclude the efficiency gains from lower system administration and compliance costs.

The estimated increases would be expected to arise over an extended period, in part because reforms are likely to be implemented progressively over many years, but also because it takes time for people and businesses to respond to changes in prices, particularly where this involves changing employment, changing business operations or replacing existing assets. Consequently, the gain to national income would be expected to accrue through a higher rate of annual economic growth over the transition period.

## 11.2 Macroeconomic stability and national savings

Elements of the tax system can affect macroeconomic stability. For example, tax distortions such as the asymmetric treatment of debt and equity can encourage excessive leveraging and other financial market problems, which have been evident in the recent global financial crisis (IMF 2009b).

While reductions in the company income tax rate would reduce this bias, the business level expenditure tax (identified by the Review as meriting further consideration) would substantially reduce it or eliminate it altogether.

The existing tax system is also likely to encourage excessive leveraging in pursuit of tax-preferred income. Where capital inflow is used to finance less productive assets, this can also affect long-term macroeconomic stability. In this regard, recommendations to provide a more neutral tax treatment of savings, to reduce the benefits from negative gearing and eventually abolish stamp duties on housing would also help improve macroeconomic stability.

Overall, a more efficient and flexible economy is likely to be able to respond more easily to macroeconomic shocks. A more transparent and accountable tax and transfer system would improve this flexibility and perceptions of Australia's economic prospects.

The likely widening of Australia's current account deficit coming out of the global recession might refocus public debate on the level of Australia's national saving.

The Review's recommendations for the taxation of superannuation would have a positive effect on national savings. The proposed changes to the taxation of superannuation would provide a significant increase in private savings mainly driven by the proposed elimination of the superannuation contributions tax and the halving of the earnings tax, both of which would significantly increase superannuation assets.<sup>8</sup>

In addition, the Review Panel has noted that for areas of policy where community needs are likely to increase due to the ageing of the population (such as aged care and disability), some form of compulsory insurance to meet the costs of seniors might be appropriate. While these reforms would be important in their own right, they would also enhance national savings and help pre-fund fiscal risks.

### **Box 11.1: Computable general equilibrium models**

An understanding of the impact of taxes and transfers on the allocation of resources in the economy is crucial to tax policy design. A general equilibrium economic model of the Australian economy is the only viable means of assessing the economic effects of reform of the scale outlined in this report. Such models represent the economy, the way it operates and the way people and businesses respond to changing price signals, using a consistent economic framework. They enable the economy-wide effects of a policy change to be observed, including so-called second-round effects in markets not directly affected by the policy under consideration.

While they provide a sophisticated means of assessing the impacts of policy change, these models have limitations. They are an approximation, or simplified version, of the real world. They are usually highly aggregated, reflecting both data limitations and the need to make the models tractable. Consequently, these models will not provide insight into all the possible effects of a policy change. For example, the actual impact of a policy change may vary between individual firms in a particular industry, due to differences in their business structure, but such effects will not be captured in an aggregated model.

Importantly, the results obtained from such a model are influenced by the structure of the model itself and its underlying assumptions about producer and consumer behaviour. There are also limitations to the precision with which individual taxes and transfers can be represented in such models.

The model used to analyse the economic effects of the recommendations in this Report is the KPMG Econtech MM900 computable general equilibrium model of the Australian economy. This model has a high level of tax detail, which has enabled a broad range of the existing Australian taxes and recommended policy changes to be modelled. It estimates the long-run impacts of a policy change, usually taken to be about 10 years. An overview of the MM900 model is provided in KPMG Econtech (2009) (available at [www.taxreview.treasury.gov.au](http://www.taxreview.treasury.gov.au)).

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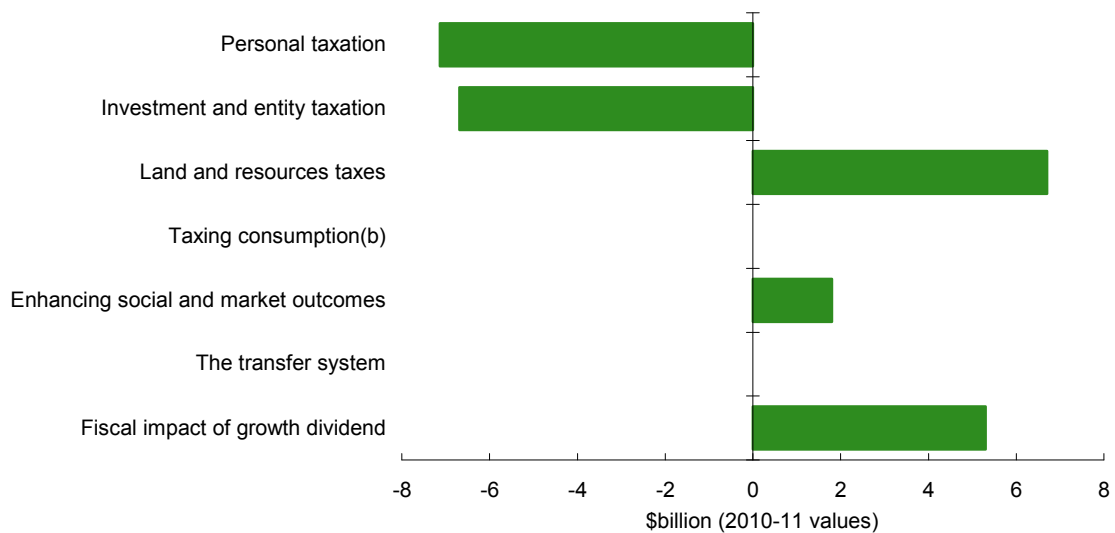
<sup>8</sup> The overall effect on national savings, however, also depends on the effect on the government's fiscal position (that is, public savings). Superannuation affects public savings by reducing future Age Pension outlays, but the cost of concessions (such as halving the earnings tax) reduces government revenue, thereby decreasing public savings. However, based on the assumptions set out in Part Two, the superannuation tax proposals are estimated to result in a net increase in national savings.

### 11.3 Fiscal sustainability

Indicative estimates of the national fiscal implications of the reform vision are summarised in Chart 11.1. The estimates reflect the potential fiscal impact of the recommendations when mature, that is, when any transitional arrangements or transitional revenue effects are complete. In each case, the mature measure has been costed using 2010–11 as a reference year. Further detail about how the estimates have been derived and their limitations is presented in Box 11.2.

The recommendations in this Report are designed to improve the structure of the tax and transfer system, not to raise additional revenue. Overall, the reform vision is estimated to be broadly fiscally neutral, after taking into account the net fiscal gain from the estimated increase in national output. This 'efficiency dividend', is estimated to be equivalent to around \$5 billion in 2010–11 values.

**Chart 11.1: Indicative impact of the recommendations on the shape of the system<sup>(a)</sup>**



(a) Indicative costings are provided on a mature measure basis (expressed in 2010–11 values) for recommendations indicating clear policy outcomes. Recommendations calling for further review, or that outline tax and transfer design principles or very broad directions, are not included.

(b) The changes to taxes on consumption have been assumed to be revenue neutral.

Source: Treasury and FaHCSIA estimates.

The recommendations would, however, change the shape of the system by shifting the tax mix from taxes on capital income, both at the business and personal levels, toward land and resources.

- The recommendations relating to the taxation of investment and business entities are estimated to reduce revenues by around \$7 billion in 2010–11 values, when fully mature. Most of this reflects the recommended reduction in the company income tax rate to 25 per cent.
- The recommendations relating to the taxation of resources and land are estimated to lead to a gain to revenue of around \$7 billion in 2010–11 values, when fully mature. This estimate reflects the impact of the proposal on the tax treatment of resource rents. Consistent with the recommendations, changes to taxes on land are assumed to be fiscally neutral.

- The recommendations relating to the taxation of personal income are estimated to reduce revenues by around \$7 billion, most of which is accounted for by the changes to retirement savings (around \$5 billion).
- The recommendations relating to government assistance payments are estimated to be approximately fiscally neutral.
- The changes to taxes on consumption have been assumed to be revenue neutral.

**Box 11.2: The basis of the fiscal estimates**

The estimates in Chart 11.1 reflect the potential fiscal impact of the recommendations when mature. They are measured against the expected fiscal position in 2010–11 and announced policy settings for that year. The estimates are not comparable to conventional Budget estimates, as they include recommendations that might not be implemented for many years and exclude the fiscal implications of phasing in some recommendations.

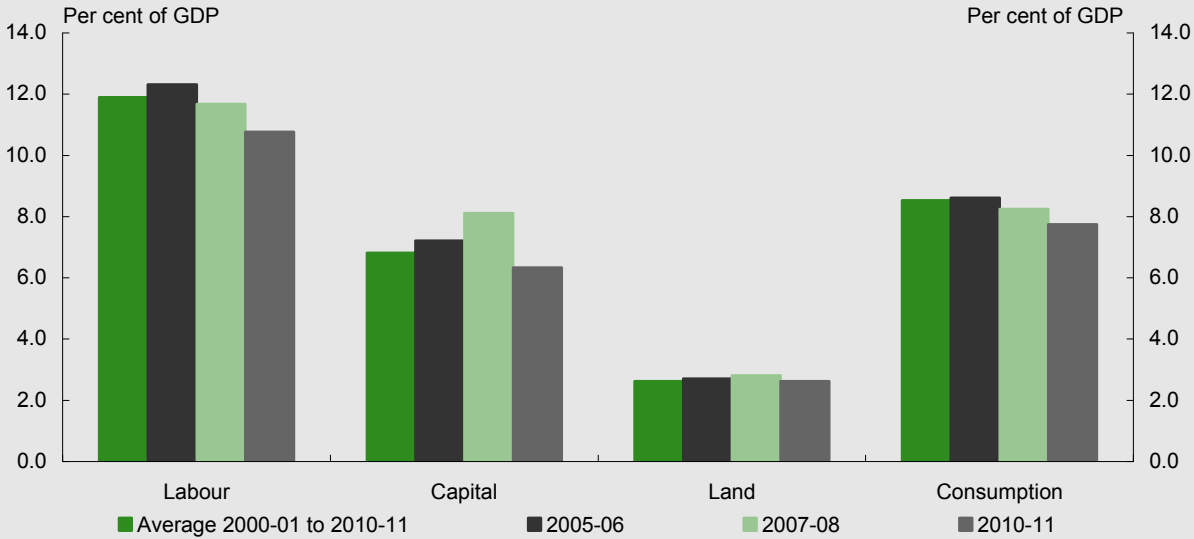
The fiscal impact is the net impact of the policy change on total Australian, state and local government revenue or expenditure, and generally include interactions with other recommendations, expected behavioural responses by people and businesses, and direct flow-on effects to other items of revenue or expenditure. The estimates do not take into account second-round revenue effects arising from the economy-wide effect of a change in a tax or transfer. These effects are reflected in the growth dividend.

Not all recommendations have been costed. Those that are very broad, that set out tax and transfer design principles or that call for a further review have been excluded. Administrative expenses or savings have been excluded on the basis they are unlikely to be material in the context of the policy change being recommended.

An important consideration in the choice of reference year is whether it is representative of the future fiscal context. The tax mix in 2010–11 is broadly representative of the average tax mix since 2000–01, when the GST was introduced (see Chart 11.2). A more notable difference is in the share of revenue attributable to taxes on capital, mainly company income tax, between 2007–08 and 2010–11. Even so, a higher level of company income, similar to that in 2007–08, would have only a minor impact on the overall fiscal feasibility of the vision.

Similarly, transfer payments are estimated to be above average in 2010–11, implying a slightly higher fiscal cost of the recommendations concerning the level of income support payments than might be expected assuming a stronger economy. Nevertheless, the overall fiscal impact of recommendations concerning the transfer system is estimated to be broadly neutral.

**Chart 11.2: Sources of tax revenue**



Source: Treasury estimates.