G — Institutions, governance and administration

G1. A responsive and accountable tax system

Key points

Australia needs modern and sophisticated tax policy and administration processes that can deliver a tax system to meet the demands of the 21st century. The tax system will face a range of challenges over the next few decades that will affect how tax policies are developed and administered. It is imperative that the tax system can meet these challenges and respond to the needs of the community.

The operation of Australia's tax system is fundamentally sound and there is general confidence in the system. The level of voluntary compliance is high, reflecting positive perceptions about the fairness and integrity of the system and how it is administered. Many of the current institutional arrangements will continue to perform well. However, a number of changes would further the system's ability to meet future challenges.

The nature of any tax system means there will always be some tension between taxpayers and tax authorities. The tax law is complex and there are inevitable uncertainties in its development and application to complex commercial arrangements or in novel situations. This can create tension about the authorities' interpretation of the law and efforts to improve certainty through amendments to the law. A more transparent and accountable system has the potential to ease these concerns.

We should further develop open and inclusive processes by which the community can raise issues and have them considered by government. Building on its existing strengths, the Board of Taxation could act as a 'circuit breaker' in the system — to quickly identify problems in the system, particularly those that arise at the boundary between policy and administration.

An advisory board would contribute further external views into the management of the Australian Taxation Office (ATO). These external views will help the ATO meet the considerable demands of the coming decades. Other changes would improve the effectiveness of external scrutiny of the system.

G1-1 A responsive tax system

The tax system is a fundamental part of Australia's social and economic infrastructure. The operation of the system should reflect the type of society Australians want and the role of government in that society. It will not be feasible for the tax system to be reformed in a single step to accord with the vision laid out in this Report. And even once it has been reformed, the objectives for the tax system may need to be adjusted in response to changes in understanding, priorities, technology or the economy.

The tax system needs to keep pace with these developments so that it does not unnecessarily impede Australian businesses in competing internationally, and supports the nation's capacity to attract overseas investment.

The tax system operates through a number of institutions that together design and implement tax policy and govern administration of the system. These include parliamentary, executive and judicial bodies. In combination, these institutions, and the relationships between them, influence how taxpayers experience the system. As in other areas examined by the Review, it is clear that the institutional architecture of the tax system has been developed incrementally, and in some respects it does not operate in a fully coherent and effective whole. The Review has examined these arrangements from a whole-of-system perspective to see whether they are capable of meeting the demands of the coming decades.

Principles for responsive policy and law

The tax system needs to reflect and support Australia's social and economic objectives because it exerts a powerful influence on social and economic outcomes.

While timely changes are necessary to ensure that the system remains relevant, change is a costly process and can create significant uncertainty. The higher the rate of change, the more difficult it is for people to understand their rights and obligations. Changing the system can involve significant upheaval. These costs need to be taken into account when changes are under consideration. So, while the system needs to adapt to changing circumstances and expectations, the features that work well should remain stable. In practice, this is a difficult balance to achieve.

Somewhat perversely, the desire for certainty can also be a significant source of instability in the system. A high level of precision in the tax law can provide the certainty needed to make the best decisions at lower cost and with lower risk. However, while prescriptive rules can provide immediate certainty to anticipated issues, they are usually not flexible enough to cover other similar cases that arise later. They also risk producing unintended consequences.

Without careful management, tax changes can have significant unintended impacts on individuals, businesses and the wider economy. At times, policies are developed without fully anticipating their impact, such as when they inadvertently disrupt longstanding arrangements or cause uncertainty. Policy-makers need to recognise the potential consequences of changes in policy and law, particularly when complex business arrangements are involved.

The system needs effective mechanisms for identifying and addressing uncertainty. A transparent and accountable process, by which users of the system can raise issues with government and receive feedback on their representations, is necessary for the ongoing health and maintenance of the tax system.

A consultative approach to developing policy and legislation can help ensure the system responds to the needs and expectations of the community. It provides stakeholders with an opportunity to inform policy-makers about the impact of the tax system on their different circumstances. It allows governments to benefit from the practical experience, skills and knowledge of stakeholders and incorporate this into policy design. This helps generate better

targeted and more practical solutions. It also gives governments more information about the range of options available and the benefits, costs and risks associated with those options.

Principles for responsive administration

It is important for the tax authority to administer the tax system in a way that builds community confidence. The way taxpayers interact with the tax authority affects public perceptions of the system and the degree of voluntary compliance with the tax law. The tax authority should help people understand their rights and obligations and make it as easy as possible for them to comply with their obligations.

While the tax authority should support people who are trying to comply, it has a responsibility to apply the law firmly to people who do not. The community needs to have confidence in the fairness and integrity of the system — that everyone is paying their fair share. When taxpayers perceive that others are avoiding or evading taxes, they are less inclined to pay taxes themselves.

The administration of the tax laws can have a significant bearing on the level of certainty taxpayers have about their obligations. A challenge for the tax authority is to be responsive to the individual circumstances of taxpayers while at the same time being fair and consistent. Timely and consistent advice and self-help products that taxpayers can rely on reduce the uncertainty associated with complex laws. However, complexity in the tax system can be as much of a challenge for the tax authority as it is for taxpayers.

The administration of the tax system can benefit significantly from experiences and perspectives developed in the private sector. A consultative approach can contribute greatly to the tax authority's ability to understand the position and perspectives of taxpayers. In particular, consultation can help the tax authority take compliance costs into account when designing and implementing its administrative systems. Consultation also promotes a common understanding of the role and responsibilities of the tax authority, which helps build community trust and respect for the system.

Principles

The tax system needs to be flexible enough to respond to economic and social change in a timely way, while offering stability and certainty. The system needs effective mechanisms for identifying and addressing areas of uncertainty. In particular, the tax system should have an open and inclusive process by which the community can raise issues and see itself as having a responsibility and interest in doing so.

Tax policy, legislation and administration should be developed using a consultative, transparent approach to help achieve better targeted and more practical solutions, reduce unintended consequences and support community confidence in the system.

Taxpayers should be able to organise their affairs with good information about the tax consequences. While the tax authority should support people who are trying to comply, it has a responsibility to apply the law firmly to people who do not.

How responsive is the current system?

The operation of Australia's tax system is fundamentally sound and there is general confidence in the system. Voluntary compliance is at a high level, reflecting positive perceptions about the fairness and integrity of the system and the way it is administered. A relatively transparent and participatory approach to the development of policy and legislation has helped establish and maintain a sound framework that has served Australia well. The vast majority of taxpayers (86 per cent of individuals and 90 per cent of businesses) consider that the ATO is doing a good job (ATO 2009b). The ATO has developed a positive reputation internationally and is widely regarded as one of the leading tax authorities (JCPAA 2008). Much of the institutional architecture of the existing tax system will continue to perform well. However, a number of changes should be made to increase our ability to meet future challenges.

An increasingly open approach to designing and administering the system

An increasingly open, inclusive and consultative approach to the development of policy, legislation and administration is helping to identify, develop and implement changes needed in the system. These approaches can reduce the number of unintended consequences, as well as helping to recognise and address the ones that do arise.

The ATO has developed extensive consultation arrangements to help it administer the tax system fairly and efficiently. It has around 50 consultative forums for taxpayers, businesses and tax professionals (ATO 2009b).

Extensive consultation arrangements also exist in the tax design process. Since 2002, there has been formal consultation on most substantive tax measures. In 2008, the Government announced changes to the consultation arrangements for tax policy and legislation. These focused on making consultation more accessible, inclusive and transparent, to improve the contribution that the private sector makes to the development of the tax system. The key change was to increase the involvement of the private sector at the initial policy design stage to reduce the likelihood of unanticipated consequences.

In addition to the range of consultative forums (such as the ATO's National Tax Liaison Group) that enable organisations, businesses and tax professionals to raise views about the operation of the tax system, the community can raise issues through a number of avenues.

- People can write directly to ministers at any time. However, neither the letters nor the Minister's responses are generally published.
- Each year the government invites the public to submit ideas for the Budget, including ideas for tax changes. Submissions are not published and detailed responses are not routinely provided.
- People, including professional bodies, can also raise minor policy and administrative issues relating to the care and maintenance of the tax system through the Tax Issues Entry System, a website jointly operated by the Treasury and the ATO. It includes a register of issues raised and details on whether, and how, each issue is being addressed.

So, while there are several ways in which the community can raise problems with the tax system, it is sometimes unclear which is the best way. It can also be unclear whether an issue

has been previously considered by the government. The same issue may be raised a number of times by different parties, because the government's position is not publicly known.

The impacts of complexity on the system

The tax system is excessively complex. The current tax law is a morass of technical detail — for example, the income tax law now extends to almost 6,000 pages, despite the repeal of more than 4,100 pages of inoperative income and other tax law in 2006. It has reached a point where any change to the law is as much about dealing with the interactions between the change and the existing system, as it is about the change itself. This generates uncertainty about the way the system operates and the way it should operate. This uncertainty tends to reduce trust between stakeholders in the system. At worst, this can undermine confidence in the integrity and legitimacy of the system.

Complexity reduces the system's transparency, makes it harder for taxpayers to understand their obligations, increases the risk of non-compliance and hinders the making of properly informed decisions. It creates uncertainty and risk, which taxpayers spend time and money dealing with. Some taxpayers arrange their affairs to take advantage of the complexity and its unintended consequences.

To some extent, the complexity of the tax system reflects the complexity of the wider world. Over time, policy objectives have also tended to become more sophisticated, including many different treatments for specific groups of taxpayers. Cultural issues are also an important cause, as well as a symptom, of complexity and uncertainty. The culture of the tax system is a subset of the wider national culture. It reflects the community's recognition of the connection between taxes and the supply of government services. It has emerged from the historical approach to imposing taxes together with the way taxpayers and government interact according to prevailing values like trust and a sense of obligation. The vast majority of taxpayers recognise and accept their tax obligations, but the nature of the tax system means there will always be some tension between taxpayers and the tax authorities. The challenge is how to moderate the impacts of these inherent tensions in the system.

The administration of the income tax system follows a process of self-assessment. Self-assessment was introduced in the 1986–87 income year to improve system efficiency — it shifted the ATO's focus from processing returns to helping taxpayers to comply with the law and taking enforcement action against those who do not. The introduction of self-assessment shifted the distribution of cost and risk between the government and taxpayers. It exposed taxpayers to more risk by removing some of the finality of the assessment process. As the tax laws have become more complex, self-assessment has also exposed some taxpayers with more complicated affairs to greater compliance costs.

To address concerns about the imbalance of cost and risk created by self-assessment, a system of binding rulings was introduced in 1992 to give taxpayers greater certainty about the application of the law and to reduce penalties. Further refinements have been undertaken since. Treasury's 2004 review of self-assessment led to changes that made even more ATO advice binding; it also reduced the periods in which the ATO can amend assessments, and reduced the interest payable in some cases. More recently, the ATO has entered into Advance Compliance Agreements with some large businesses to provide them with the real-time certainty they need. The ATO also offers a priority rulings process for commercially significant and time-sensitive transactions.

Under the system of income tax self-assessment the ATO advises and guides taxpayers about their obligations and applies the law to collect revenue. More broadly, the ATO also seeks to create an environment that is increasingly conducive to high levels of compliance. This involves helping people to understand their rights and responsibilities, making it as easy as possible for people to comply with the law, and providing an effective deterrence to non-compliance to support honest taxpayers. In addition, the ATO plays a role in safeguarding Australians' retirement income through its administration of significant aspects of the superannuation system. It also promotes online dealings between government and business through its stewardship of the Australian Business Register.

Self-assessment places great importance on taxpayers having a good understanding of the tax law and voluntarily complying. As the tax system has become more complex, ATO advice has taken on a more significant status, as taxpayers (and advisers) in more complex matters may not have the capacity to understand the tax law.

Paradoxically, the pursuit of certainty about tax obligations and entitlements has itself become a source of the complexity. Some larger businesses are increasingly looking for the comfort of prescriptive legislation or rulings to give them certainty about the tax treatment of their particular arrangements. This has increased the size and complexity of the law and of ATO rulings.

The complexity of the system also affects the way the Treasury develops policy and legislation, and the ATO approach to interpreting the law. Often taxpayers criticise the laws for being too comprehensive and taking a disproportionate approach to addressing the revenue risks of tax avoidance. Accepting some degree of greater risk in this regard could ease complexity and make it easier to change the law when necessary. However, in an environment where some taxpayers actively use the complexity of the tax system for tax avoidance, the Treasury and the ATO are cautious about establishing precedents that could compromise the integrity of the system.

Submissions to the Review by some segments of the large business community have suggested that the level of uncertainty in the tax system is creating excessive compliance risks. In particular, these submissions have argued that the ATO does not always meet the need for timely, consistent and reliable advice. The ATO has also been criticised for not recognising the commercial impact of its decisions. In particular, these taxpayers argue that the ATO has sometimes undermined certainty by revisiting long-settled interpretations of the law or changing its established administrative practices — the Inspector-General of Taxation is currently reviewing these issues.

A further dynamic is the relationship between the Treasury and the ATO. The Treasury is responsible for advising the government on tax policy and the ATO is responsible for administering the law. However, there is unavoidably a grey area at the boundary between these responsibilities. It is sometimes unclear whether a solution to a problem lies in policy or administration. A lack of transparency and accountability for issues at the boundary means that the tax system is not as responsive as it could be. Before 2002, the ATO was responsible for designing, as well as administering, tax legislation. In 2002, this function was transferred to the Treasury, which already had policy responsibility. This change was made to bring accountability for tax policy and legislative design more directly under ministerial control and to reinforce the need for a whole-of-government perspective in tax law design. While this goal has largely been achieved, some perceive that the change has reduced the

ability of ATO to administer the law purposively since it is less intimately involved in the development of tax policy. However, while the Treasury has responsibility for designing the tax laws, in most cases the ATO continues to participate in all stages of the tax policy and legislation design process. The Government formalised this involvement in 2008, deciding that tax measures should be developed by a tri-partite team comprising Treasury, the ATO and the private sector. This arrangement allows the ATO to contribute to, and understand, the policy objective of new laws. Beyond this, the ATO can also consult with the Treasury in forming its view on the interpretation of law. While Treasury views are not determinative, the ATO considers them along with the views of other stakeholders in arriving at a purposive interpretation of the law. However, as these have been treated as confidential communications within the government, the arrangements lack transparency.

Findings

The operation of Australia's tax system is fundamentally sound and there is considerable evidence of general confidence in the system. There is an increasingly open, inclusive and consultative approach to the development of tax policy and legislation and the administration of the system. While there are several ways in which the community can raise problems with the tax system, the best way is sometimes unclear.

The complexity of the current system imposes considerable costs on the community. It has exposed both taxpayers and government to higher levels of risk and uncertainty. This has led to behaviours that add to the cycle of increasing complexity. The level of complexity is such that considerable attention is needed to ensure that the system is operating as intended. There is a need for a process to identify and resolve problems quickly and transparently. There is also a need for greater transparency about the policy objective of the tax laws.

Making the tax system more responsive

Some complexity and uncertainty in a tax system is inevitable. In particular, large business taxpayers that have sophisticated arrangements and that operate in a vibrant globalised economy will always face significant complexity. In these cases, there is a need for a process to identify and resolve the areas of greatest uncertainty quickly.

To stem the growing complexity and uncertainty experienced by large businesses, there needs to be greater collaboration, trust and understanding between them, the Treasury and the ATO. This ultimately depends on the values and behaviours exhibited by both taxpayers and government. While consultation arrangements can help, other institutional reforms may be needed to rebalance the dynamics of the system to support the desired cultural changes. In particular, a more transparent system has the potential to build the confidence needed to support a system where there is less complexity and uncertainty and an increased willingness to accept the risk that does exist.

Recommendation 111:

The government should establish a more transparent means of dealing with community ideas about the tax system by extending the Tax Issues Entry System website and further developing its use.

Recommendation 112:

The government should commit to a principles-based approach to tax law design as a way of addressing the growing volume and complexity of tax legislation, and as a way of helping those laws to be interpreted consistently with their policy objectives.

Recommendation 113:

The Board of Taxation should be empowered to initiate its own reviews of how current tax policies and laws are operating, in consultation with the government. This would be in addition to reviewing matters referred to it by the government, though it should not engage in substantive policy development unless requested by the government.

In giving effect to these changes to the nature and functions of the Board, the government should ensure that the Board has adequate resources (including its own permanent secretariat). The government should also consider:

(a) how to manage the increased workload for the Board, including whether the Board would require further members and/or members who can devote more time to the Board;

(b) whether the Secretary to the Treasury, the Commissioner of Taxation, and the First Parliamentary Counsel should be appointed as advisers to the Board, rather than as members; and

(c) whether the Inspector-General of Taxation, the Auditor-General, the Commonwealth Ombudsman and the Chair of the Tax Practitioners Board should be appointed as advisers to the Board.

Recommendation 114:

Information or advice provided by Treasury to assist the ATO in determining the purpose or object of the law, or materials used by the ATO to determine policy intent (other than correspondence with or from government) should be made public.

A more transparent approach to community ideas for tax changes

The community can already raise ideas for changes to the tax system in number of ways, but there needs to be a more transparent approach to dealing with those ideas. This would increase community understanding of, and participation in, the tax design process.

Greater transparency would be achieved by extending the Tax Issues Entry System website so that it records community suggestions about substantive tax policy issues, as well as minor policy and administrative issues (see Recommendation 111).

This would offer another easy way for people to raise issues with government, but it would not replace the existing avenues. In particular, people could continue to write directly to

government raising concerns and suggesting ways to redress those concerns (including making Budget submissions).

A more principles-based approach to designing the tax system

As discussed above, a major source of complexity in the current system is the way policies are designed. Over time, policy objectives have tended to become more sophisticated. Policies have also tended to be changed in isolation, and without a coherent framework for the whole system. This has complicated the tax laws and made tax compliance and administration more difficult.

While policy design needs to place a premium on reducing complexity, this alone is not enough to ensure that taxpayers will experience a more certain system. The way in which the laws are designed, and the administrative approach taken to implementing those laws, also influence the level of complexity experienced by taxpayers.

As one way of addressing the growing volume and complexity of tax legislation and to reduce unintended consequences, the drafting approach used for recent tax legislation reflects a preference for more principles-based rules — which emphasise the policy objective the law is trying to achieve, rather than simply describing the legal mechanisms and concepts for producing that objective.

A principles-based approach to designing the tax laws has the potential to stem the cycle of increasing complexity by building a more stable platform on which to base the system. By making the policy objective of the laws clear, the approach can help the laws to be interpreted consistently with the policy objective and reduce the incidence of unintended consequences. The approach can also produce rules that apply properly to the changing arrangements of taxpayers without the need for constant amendment. In these ways, the principles-based approach can make our tax laws more certain and sustainable in the long-term. The government should continue to pursue a principles-based approach to tax law design (see Recommendation 112).

As noted above, the length and complexity of the tax laws impose considerable costs on the community. All participants in the tax system — taxpayers, government, Parliament and the courts — bear and contribute to these costs. A better understanding of the costs associated with the traditional black-letter approach to designing tax laws (particularly the cumulative long-term costs) will put into perspective the short-term risks and costs of moving to a principles-based approach. The institutional changes recommended elsewhere in this section will improve transparency in the system, which should help support the levels of trust needed to accept the risks of a changed approach.

A ‘circuit breaker’ in the system — an expanded role for the Board of Taxation

Policy and administrative issues need to be resolved in a more timely way to provide taxpayers with greater practical certainty. Independent views of the system help to identify and resolve these issues. To some extent the Australian National Audit Office (ANAO), the Ombudsman, the Joint Committee on Public Accounts and Audit (JCPAA), the Board of Taxation and the Inspector-General of Taxation perform this kind of role in different areas. The Board undertakes tax policy and legislation reviews at the request of the government, though it can also suggest areas of review to the government. The Inspector-General can initiate reviews of systemic tax administration issues. To date, neither the Board nor the

Inspector-General has had a role in initiating reviews of policy and legislation, although the Board does undertake post-implementation reviews if asked by the government.

Box G1-1: Board of Taxation

The Board of Taxation is a non-statutory advisory body that contributes a business and broader community perspective to improving the design and operation of the tax laws. The Board advises the Treasurer on improvements to the general integrity and functioning of the tax system and commissions research on tax matters approved or referred to it by the Treasurer.

The Board comprises ten members, seven of whom have been appointed from the private sector. There are three public sector members — the Secretary to the Treasury, the Commissioner of Taxation and the First Parliamentary Counsel. The Board is supported by a secretariat drawn from the Treasury, the ATO and the private sector. The Board also makes extensive use of consultants from the private sector and academia.

The Board does not make tax policy — that is the responsibility of the government. Similarly, the Board has no authority to direct the Commissioner of Taxation on how to administer the tax laws. Nevertheless, the Board has a wide role in advising the Treasurer on the development, implementation and ongoing operation of the tax laws. In particular, one of the functions of the Board is to conduct post-implementation reviews of legislation to assess its quality and effectiveness in achieving its intended effect.

The Board has made a valuable contribution to improving the tax system. One measure of that success has been the very high rate at which its recommendations have been accepted and implemented by successive governments.

Since its inception in 2000, the Board has produced 16 reports on tax issues that affect individuals, welfare organisations, and small and large businesses. Some of the significant events that have followed the Board's recommendations include: the repeal of over 4,100 pages of inoperative tax law; the reform of international tax arrangements; the establishment of the office of the Inspector-General of Taxation; and the government commitment to consult on substantive tax measures. The Board's advice also informed government decisions not to codify the common law definition of a 'charity', not to proceed with the taxation of trusts as companies, and not to proceed with the tax value method for calculating taxable income.

The Board is well positioned to understand stakeholders' concerns about, and priorities for, the tax system. It has advised the government in the interests of all Australians — it has not acted as a lobby group for special interests, nor has it been a rubber stamp for government proposals. The Board has arrived at its advice and recommendations independently, though it has worked closely with the Treasury and the ATO. These are considerable strengths of the Board, which have supported its achievements to date. The Review considers that the Board could make an even greater contribution if it was given an expanded role. However, this should be done in a way that preserves the features that have made the Board successful in the past.

The Board should be able to initiate its own reviews of lower order tax policy issues, in consultation with the government (see Recommendation 113). In this way, the Board would

be positioned to act as a 'circuit breaker' in the system — to quickly identify and propose solutions for lower order policy issues relating to problems experienced by taxpayers given their varying and complex circumstances. However, the Board should not engage in substantive policy development unless requested by the government.

While the Board already can, and does, suggest areas of review to the government, it requires a formal reference from the government. The Board should be expressly permitted to initiate its own reviews, albeit in consultation with the government. Consultation would ensure that the government is aware of the Board's activities and ensure that the Board is conscious of the government's priorities. This would balance the need for a timely review of issues against the desirability that this review is relevant and effective.

This would improve transparency and accountability for issues that remain unresolved due to uncertainty about whether a legislative remedy is required. These delays, and the lack of transparency about their cause and the process for resolving them, can generate considerable uncertainty for taxpayers.

The Board should continue to be an advisory, not a decision-making, body. While it should continue to recognise the government's responsibility for determining policy, it should provide the government with advice about community concerns and priorities for tax policy and legislation.

The Board should not have access to taxpayer information and should not consider the ATO's administrative decisions that relate to specific taxpayers. Nor should the Board audit matters of administrative efficiency or effectiveness, which is a role performed by the Auditor-General.

A focus for the Board should be to examine unintended consequences that arise in the application of tax policy to the varying and complex circumstances of different taxpayers. While a consultative approach to developing policy, law and administration should reduce the incidence of unintended consequences, the complexity of the system makes it inevitable that there will be some. For instance, laws will sometimes be designed or administered in a way that causes unnecessary complexity, uncertainty, compliance costs or inconsistency with the intended policy.

While the Board would not be in a position to direct the government to amend the law, its independent advice would highlight which issues are most important to taxpayers. This would be a valuable input into the government's work program, though it would still need to consider proposals in the context of its overall legislative priorities. The Board would publish its findings and recommendations.

The recommended changes to the nature and focus of the Board would increase the opportunity for taxpayers to voice concerns about the operation of the system. In addition to receiving submissions directly from taxpayers, the Board would be expected to monitor the government's Tax Issues Entry System website (see Recommendation 111). Another source of issues would be those the Board uncovers while reviewing matters referred to it by the government.

It is likely that the community will raise many more issues than the Board can examine, particularly when these are added to the other matters referred to it by the government. In consultation with the community, the Board should develop an annual work program to

outline its planned activities for the coming year. While the Board should examine issues that are important to taxpayers, it should focus on areas that are also priorities for the government, so that its advice continues to be relevant and effective.

The government should ensure that the Board is adequately resourced to undertake these additional responsibilities. It might be necessary to appoint further members and/or members who can devote more time to the Board, while ensuring the Board retains its strong links to the business and broader community. The Board should also be resourced to attract and retain a permanent secretariat that can draw from the private and government sectors.

The Board needs to be seen as independent of both the Treasury and the ATO, with its own direct access to the government. The Review of Business Taxation (1999) recommended that the Board be established as a statutory body, though the government of the day decided to establish it as a non-statutory body. Formally establishing the Board by an Act might emphasise its independence, establish a more substantial ongoing status, and make its functions and powers clearer. However, with greater independence comes the risk that the Board might lose some of its ability to work in partnership with the Treasury and the ATO to make constructive suggestions to the government. These are strengths of the current arrangements, which have enabled the Board to have considerable influence. While it is desirable to emphasise the independence of the Board, this should not be at the expense of its relevance and effectiveness. On balance, the Review does not favour establishing the Board as a statutory body.

The Board includes three public sector members — the Secretary to the Treasury, the Commissioner of Taxation, and the First Parliamentary Counsel — though these members are not bound by the Board's recommendations. The government should consider whether these public sector officials should be advisers to the Board, rather than members. This change could reinforce that the Board is independent of the public service, but ensure that the Board is still appropriately connected to the functionary arms of government.

There is some potential for overlap between the Board's expanded role and the review functions currently performed by the Inspector-General of Taxation, the ANAO and the Ombudsman. As one way to ensure that there is no inadvertent duplication of effort, there should be consultation between them. This could be assisted by appointing the Inspector-General, the ANAO and the Ombudsman as advisers to the Board. In addition, appointing the Chair of the newly established Tax Practitioners Board as an adviser to the Board of Taxation could bring a further perspective about the practical operation of the system.

An objective and purposive approach to interpreting tax laws

Taxpayers and practitioners have a legitimate expectation that the advice they receive from the ATO should be accurate and unbiased. Some submissions to the Review have alleged that the ATO's advice is motivated by a pro-revenue bias and that the ATO has inadequate incentive to administer the law consistently with its policy intent. The Inspector-General and the JCPAA have found no objective evidence to support this claim. Further, according to surveys, the ATO's private rulings for large business received a 95 per cent satisfaction rating, with another 2.5 per cent neither satisfied nor dissatisfied. Of the rest, 2 per cent were dissatisfied, and 0.5 per cent very dissatisfied. The ATO's class rulings to large businesses received similarly high ratings, with 91 per cent of respondents satisfied and 9 per cent

neither satisfied nor dissatisfied. Nevertheless, some have suggested that the ATO's ruling and revenue-collection roles should be separated.

In Sweden, private binding rulings are given by a body independent of the revenue-collection agency (OECD 2008). This separation differentiates tax collection and legal interpretation and attempts to introduce greater independence in the interpretation of the law. This arrangement came about as a result of criticisms that the revenue collector was not objective and independent. A difficulty with the Swedish system is the delays that applicants experience in receiving ruling decisions, of which there are relatively few (IGT 2008). If a similar system were implemented in Australia, this problem might be overcome with adequate resourcing of the rulings body. The government could redirect some of the ATO's current budget to fund the new agency. If needed, this could be supplemented by charging application fees for more complex rulings.

Of greater concern than potential delays would be the risk that an independent rulings body might reduce the flexibility and responsiveness taxpayers want from the ATO. An independent rulings body would be detached from the practical consequences of its interpretations (because it would not be responsible for either changing the law or for implementing it), and there is the prospect that it would take an overly legalistic approach. While the ATO is sometimes criticised for applying tax laws too literally, it often exercises discretion to help taxpayers comply. Arguably, a more independent body may have less of an appreciation of the impacts of its decisions. To some extent, these institutional incentives could be corrected by having the right governance and accountability arrangements in place. In particular, the rulings body could be established under a charter that sets out an expectation that it should promote voluntary compliance.

While the rulings function could be moved to an independent body, the ATO would still have to interpret the law in order to fulfil its administrative role. In the absence of the ATO's 'in-house' binding rulings regime, taxpayers would have a reduced understanding of the ATO's view of the law and a reduced capacity to bind the ATO to those of its views that were known. Even if the independent body had issued a ruling that bound the ATO, there could be doubt about the ATO's view on whether or not it applied in a given case.

Rather than creating a separate institution to issue tax rulings, the Review Panel considers that the ATO should continue to execute that role in a way that builds community trust in the fairness of its approach. The ATO should continue to bring a practical administrative perspective to the purposive interpretation of tax laws. Greater transparency about the policy objective of the tax laws will support a purposive approach to interpretation. A principles-based design of the law will help make the policy objectives more explicit (see Recommendation 112). Transparency would also be enhanced by publishing information or advice provided by Treasury to assist the ATO in determining the purpose or object of the law, or materials used by the ATO to determine policy intent (see Recommendation 114).

G1-2 An open and accountable tax administration

Principles for an open and accountable tax administration

The tax authority is responsible for decisions that affect millions of taxpayers, often having a direct impact on their financial position. The resources of the tax authority mean that there is

a significant imbalance of power between it and most taxpayers, especially individual and small business taxpayers. Disputes between the tax authority and taxpayers are resolved through the tribunals and the courts. However, this is often a costly and time-consuming process, despite improvements such as the small claims division of the Administrative Appeals Tribunal, and alternative dispute resolution mechanisms.

The tax authority should be independent in its administration of the law. This independence is founded on strong equity and integrity arguments — namely, that it would be undesirable for the administration of the tax laws to be influenced by political forces. Although independent, the tax authority performs a critical function of government, which means effective monitoring and scrutiny are essential.

Public confidence in the tax authority is particularly important in a system of self-assessment. This system relies substantially on voluntary compliance, which is more likely to be forthcoming when taxpayers have confidence that the tax authority is administering the law fairly and efficiently.

Principles

The tax authority should be independent in its administration of the tax laws. However, the independence of the tax authority, together with its considerable responsibilities and powers, means that it should have extensive and clear accountabilities, to help ensure that it administers the system fairly and efficiently.

The ATO — its current role and accountability

The role of the ATO

The ATO will recognise its centenary of service to Australia in 2010. It has been part of enormous changes in the tax system over this period. The ATO originated in an era when the design of the tax system was determined largely by the feasibility of basic administration. Over time, the size and sophistication of ATO operations have grown in response to policy changes that expanded the revenue base, as well as seeking to achieve a range of economic and social objectives.

Tax policy goals have become more sophisticated, reflecting the increasing complexity of our society. For example, a growing number of Australian taxpayers now own equity investments, are involved in complicated business structures, and invest or work overseas. Increasing globalisation, e-commerce and financial innovation have also prompted more sophisticated tax rules. As a consequence, the tax laws have needed to become more complex — as noted previously, the income tax laws have grown from 526 pages in 1975 to be almost 6,000 pages in 2009. This complexity makes it hard for taxpayers with more complicated affairs to have the certainty they need to comply with the law.

At the same time, the ATO has assumed a greater role in administering non-tax policies, which themselves have become more complicated to administer. The ATO administered transfers totalling almost $17 billion in 2008–09 — including paying around $8 billion to over 8.5 million taxpayers as part of the Government's economic stimulus package. Even apart from the one-off stimulus package, there has been a significant growth in the payments and transfers administered by the ATO in recent years. The ATO administers transfers to families

and individual taxpayers such as the private health insurance offset and superannuation co-contribution payments. It also administers a variety of fuel schemes that affect businesses, and provides industry assistance via the research and development tax offset and large-scale film production tax offset (ATO 2009b). The ATO is one of only a handful of tax administrators in the OECD that also has responsibility for administering student loans and valuations (OECD 2008). The ATO also administers significant aspects of Australia's retirement income systems, as well as the Australian Business Register.

In the course of meeting these demands, the ATO has grown into an organisation of more than 20,000 staff. It is the second-largest government agency, employing around 15 per cent of staff in the Australian Public Service (APSC 2008). The ATO's operating budget for 2008-09 was $3 billion (ATO 2009b).

Globalisation, technological progress and international competitiveness will influence how the system operates in the future and will add to the pressure on the ATO to perform at a high level. Taxpayers will continue to demand more tailored assistance and personalised services from the ATO (see Section G3 Local government). At some point, it might make sense to have a single national body, such as the ATO, collect and administer all the taxes in the federation (see Section G2 State tax reform). Such changes will increase the significance of the ATO, and increase the importance of its accountability and transparency.

Accountability of the ATO

The Commissioner of Taxation has a statutory independence to administer the main federal taxes. Independence means that the Commissioner makes the decisions about how to implement and apply the tax laws. Of course, disputes between the Commissioner and taxpayers are arbitrated through the legal system, with the courts providing authoritative interpretation of tax laws.

The ATO is an agency in the Treasury portfolio. Therefore, Treasury ministers are accountable to the Parliament for the performance of the ATO under the principles of responsible government. However, the Commissioner's statutory independence means ministers have limited involvement in the governance of the ATO. In particular, ministers have no power to direct the Commissioner's administration of the tax laws and exercise limited control over the management of the ATO.

The high-level management of the ATO is the responsibility of the Commissioner, three Second Commissioners and senior executives appointed by the Commissioner who are responsible for finance, operations, information and communications technology and human resources. They are supported by a number of consultative and internal committees that include members drawn from outside the ATO to contribute external perspectives (ATO 2009b).

- The ATO's Audit Committee oversees the internal governance and assurance policies used to monitor and evaluate its internal controls. The committee also ensures that recommendations of external scrutineers are implemented, including those of the Australian National Audit Office, Inspector-General of Taxation and Ombudsman. The committee includes external representatives who bring high-level public and private sector experience and relevant financial expertise.

- The ATO's People Committee supports the ATO Executive on people, culture and integrity issues. The committee includes representation from the Australian Public Service Commission, the Ombudsman's office and private sector companies. Other external advisers attend meetings on invitation.

- The Change Program Steering Committee sets the direction, outcomes and priorities for the ATO's change program. It includes the ATO's information technology consultants and independent assurers.

The ATO also has a number of advisory panels that include external representation, such as the Public Rulings Panel, the General Anti-Avoidance Panel, the new Offshore Voluntary Disclosure Panel and the Wide Settlements Panel. In addition, there is an independent Integrity Advisor reporting to the Commissioner, and a Special Revenue Advisor seconded from the Treasury.

The Commissioner is required by law to report annually to Parliament on the operation of the ATO. The Commissioner also appears before parliamentary committees to explain the ATO's administration of the tax laws. In addition to the normal Senate estimates hearings, the ATO has attended biannual hearings of the JCPAA since 2007 to answer questions about the ATO's administration and to outline its future plans. While many stakeholders support these arrangements, the complexity of the tax system makes it difficult for parliamentarians to examine the operations of the ATO effectively. If Parliament had a better understanding of the difficulties experienced by taxpayers and the ATO it would also be in a better position to critically examine the tax laws it makes.

A number of agencies complement these parliamentary accountabilities by scrutinising different aspects of the Commissioner's work. The Australian National Audit Office conducts financial, performance and business support process audits on the ATO. The Ombudsman and the Inspector-General of Taxation both have review functions, each with differing perspectives but with some potential for overlap.

The Ombudsman's main role is to investigate and resolve taxpayer complaints about the ATO. It sometimes examines systemic administration issues. In 1995, the position of the Taxation Ombudsman was established to give a special focus to the handling of tax complaints. While the Ombudsman is available to assist businesses and individuals equally, in practice mainly individuals and owner-operated small businesses approach the Ombudsman.

The Inspector-General of Taxation reviews systemic tax administration issues. The office was established in 2003 to strengthen the advice given to the government about tax administration. The Inspector-General reports to the government on the way the ATO administers the tax system. Like the Ombudsman, the Inspector-General is able to investigate systemic tax administration issues that affect individuals or businesses. However, the Inspector-General has come to focus his activities on issues that affect mainly businesses, in part reflecting the Ombudsman's focus on individual taxpayer concerns.

The Ombudsman and the Inspector-General liaise with each other to avoid duplicating effort. However, there remains the potential for taxpayers to be confused about which body is the appropriate one to deal with a complaint about the ATO.

When compared with the resources of the ATO (more than 20,000 staff and an annual budget of around $3 billion), the resources committed to review the ATO by the Ombudsman and the Inspector-General are not substantial. The Ombudsman had an annual budget of around $20 million in 2008–09 and employed 152 staff, though this was to investigate all Commonwealth agencies, not just the ATO. In 2008–09, 1,422 complaints (7 per cent of all complaints) to the Ombudsman related to the ATO (Ombudsman 2009). The Inspector-General had an annual budget of around $2.2 million in 2008–09 and employed seven staff. During 2008–09, the Inspector-General completed four reviews and, as at the end June 2009, had five reviews under way (IGT 2009).

In the United States, relatively more funding is directed to the scrutiny of the Inland Revenue Service (IRS). The IRS has around 90,000 staff (IRS 2009) and is subject to scrutiny by the National Taxpayer Advocate, which has about 1,150 case advocates (NTA 2009). However, there are a number of explanations for this apparent disparity between Australia and the United States. To a great extent it reflects the more proactive role of the Taxpayer Advocate, especially in representing the interests of individual taxpayers in disputes with the IRS. In other comparable countries, such as the United Kingdom, the resources dedicated to scrutiny of the tax administration are similar to that in Australia.

Findings

Over the nearly 100 years of its existence, the ATO has assumed considerable responsibilities and powers. It has grown to become a large and modern organisation. Throughout this evolution it has recognised the value of engaging external perspectives into its management. The need for this expertise is likely to become greater as the ATO faces a range of future challenges.

The ATO is scrutinised by many bodies, including the Parliament, the Commonwealth Ombudsman, the ANAO and the Inspector-General of Taxation. However, the effectiveness of this scrutiny is dependent to some extent on the resources and other responsibilities of these institutions.

While the Ombudsman and the Inspector-General of Taxation perform valuable roles, they would be more effective if their roles were clarified to remove the potential for overlap between them.

While the Commissioner of Taxation is ultimately accountable to Parliament, the complexity of the tax system makes it difficult for parliamentarians to perform an active role in the cycle of public accountability of the ATO.

Independent surveys continue to find that Australians have a high level of confidence in the ATO. This was recognised by the JCPAA in its recent extensive review of the ATO.

Improving the accountability of the ATO

Recommendation 115:

A board should be established to advise the Commissioner of Taxation on the general organisation and management of the ATO. The board would not be a decision-making body and would have no role in interpreting the tax laws or examining individual taxpayer issues. The government would appoint members to the board.

Recommendation 116:

The government should clarify that the role of the Inspector-General of Taxation is to examine systemic tax administration issues that affect businesses.

Recommendation 117:

The government should ensure that sufficient resources are devoted to the functions of the Inspector-General of Taxation, the Australian National Audit Office and the Commonwealth Ombudsman, recognising their importance in maintaining a fair and efficient tax system.

Recommendation 118:

The Joint Committee of Public Accounts and Audit should examine reports of the Inspector-General of Taxation and the Commonwealth Ombudsman, and monitor the ATO's implementation of the recommendations in those reports.

An advisory board for the ATO

The independence of the ATO, together with its very significant powers and responsibilities, means that it should be subject to very high levels of public accountability and transparency. While the independence of the Commissioner needs to be preserved, governance arrangements need to strike a balance between maintaining that independence and getting the best performance from the ATO.

In the course of its consultations, the Review heard suggestions that the ATO should be overseen by a board of directors drawn from the wider community. These submissions pointed out that the revenue authorities in Canada, the United Kingdom and the United States are overseen by boards that include representatives with backgrounds outside the bureaucracy. A key function for these oversight boards is to inject a range of experience and perspectives into the management of those tax authorities. In line with this objective, all of these boards have a role in developing corporate strategies and plans. Significantly, though, none of them are involved in the interpretation of the tax laws or in the affairs of particular taxpayers. This limitation preserves the independence of the tax administrators in relation to the application of the tax laws. In the United States, the IRS oversight board was established in response to a general crisis of taxpayer confidence in tax administration (US Congress 1997). This is not the situation in Australia, where the vast majority of taxpayers are satisfied with the performance and approach of the ATO.

The suggestions for an oversight board also draw on the experience of governance arrangements in the private sector. Private sector models can provide some insights about appropriate arrangements for the public sector, but significant limitations apply in the public sector context. These considerations were canvassed in the 2003 Uhrig review of the

corporate governance of public sector authorities which found that executive management, rather than a board of management, is likely to be the most effective governance arrangement for an organisation that essentially delivers government services (Uhrig 2003). The Uhrig review found that the presence of an oversight board often obscured the accountability of a statutory authority to a minister. These were considerations in the government decision in 2005 to wind up the governing boards of Medicare Australia and Centrelink and to introduce executive management.

While the ATO is not subject to the same day-to-day ministerial direction and control as many other government agencies, it is subject to many other accountabilities and lines of reporting. The Commissioner also has very specific personal responsibilities under the tax laws and other laws such as the *Financial Management and Accountability Act 1997* and the *Public Service Act 1999*. The Review does not consider it appropriate to disturb these existing accountabilities and has concluded that the ATO should continue to be led by the Commissioner as an executive manager directly accountable for the performance of the organisation.

However, the Uhrig review found that the accountabilities of a statutory authority could accommodate an advisory board that advises the chief executive in a non-binding manner. This Review considers that such an advisory board should be established for the ATO (see Recommendation 115). This would usefully add to, formalise and elevate the existing consultative arrangements that support the Commissioner's management of the ATO — such as the participation of externals in the ATO's Audit Committee, People Committee and Change Program Steering Committee. This should not be seen as a criticism of the current management of the ATO. Rather, the Review's aim is to put the ATO in the best possible position to meet the significant challenges of the future. Though the current management arrangements have served the system well in the past, the pace and significance of changes to the ATO's work mean that it could benefit from additional management arrangements that offer an even greater range of expertise and perspectives.

The creation of an advisory board would increase the ability of the ATO to benefit from external experiences and perspectives. The discipline of a regular external review of the ATO's corporate reports and plans, in addition to that already carried out by the JCPAA, would also ensure the ATO is suitably focused on the strategic challenges of the future. It would also contribute to a more open and transparent environment, which would promote greater trust and confidence in the operation of the system.

Responsibilities of the ATO advisory board

The advisory board would not be involved in the interpretation of the tax laws or in the affairs of particular taxpayers. This limitation would preserve the Commissioner's independence in relation to the administration of the tax laws.

The advisory board would provide the ATO with more high-level strategic advice and apply private-sector experience and expertise to improve the ATO's performance. It should also review the ATO's management practices to ensure the highest standards of corporate governance continue to be maintained. It would bring an additional diversity to the mix of expertise, experience and skills available to the ATO, including in areas such as information technology, human resources, finance and communication.

The board would not be a decision-making body and is intended to assist the Commissioner to exercise his existing role, rather than to interfere with the Commissioner's responsibility

for running the ATO. While ultimate responsibility would remain with the Commissioner, the role of the advisory board would be to advise the Commissioner about the general organisation and management of the ATO, including advising on the ATO's:

- strategic plans;
- financial performance and budget;
- corporate values;
- human resources strategies; and
- management of significant resources and contracts.

The advisory board would complement the executive management arrangements that already exist in the ATO. As noted above, the ATO Executive is currently supported by many committees and forums that include external representatives. The advisory board would bring together other external representatives into another body. This board would provide advice to the ATO Executive, drawing on the information generated by the ATO's management committees. For instance, the advisory board could be expected to complement the ATO's People Committee in advising the Commissioner on strategies to increase the diversity of skills and experiences held in the ATO.

The advisory board will add to the JCPAA's review of the ATO's governance reports and corporate plans. However, whereas the JCPAA meets the Commissioner twice a year, the advisory board would be a standing source of advice for the Commissioner.

Composition of the ATO advisory board

The size of the advisory board would need to take into account the size and complexity of the ATO's operations and the board's proposed role. A board of between six and nine members would be consistent with current thinking about the most effective number of members for boards (Uhrig 2003). However, over time the size of the board might change in line with changes in the responsibilities of the board and of the ATO.

In line with the responsibilities of the board, the government should appoint members with regard to the need for the board to have practical expertise in finance, information and communications technology, and human resources. Of course, the ATO should continue to access these skills and experience through other avenues as it does now, although over time it might look to rationalise these in the context of new arrangements. Board members would not be selected to represent the interests of particular organisations or interests and would not necessarily be tax experts. Instead, the government should select board members according to their personal ability to contribute to the good management and organisation of the ATO.

As noted above, the ATO could have a greater role in administering State taxes in the future (see Section G2 State tax reform). If so, it might be appropriate for the States to have a closer relationship with the ATO. One way to achieve this would be to give the States a role in the selection of some advisory board members.

Clarifying the roles of the Ombudsman and the Inspector-General of Taxation

As outlined above, the responsibilities of the Commonwealth Ombudsman, the ANAO, the JCPAA and the Inspector-General of Taxation overlap considerably. This has the potential to cause confusion and uncertainty and to involve a wasteful duplication of effort.

One approach to this problem would be to merge the tax investigation functions of the Ombudsman and the Inspector-General into one organisation, and limiting the scope of scrutineers, including the ANAO and the JCPAA, from reviewing matters otherwise covered. Potentially, this would provide a more complete overview of the issues faced by taxpayers in their dealings with the tax system. In particular, it would improve the ability of the organisation to identify systemic issues arising from individual taxpayer complaints. This could help to resolve problems before they impact on many taxpayers. Taxpayers could also benefit by being able to seek assistance on tax administration issues from a single agency. Finally, there might be modest administrative efficiencies in amalgamating the two functions into one agency, and in reducing the impact on the ATO of overlapping scrutiny.

Having the Ombudsman perform the Inspector-General's role would involve the Ombudsman reporting to Treasury ministers on tax administration issues as well as generally reporting to the Parliament. Some taxpayers may see this as reducing the Ombudsman's independence. Another potential concern is that resources intended for the review of systemic issues might be diverted to addressing individual taxpayer complaints.

Another option is that the Ombudsman's responsibilities for investigating tax issues could be performed by the Inspector-General. However, this might lead to confusion since it would mean tax complaints are dealt with differently from complaints against other government agencies. Importantly, such a change would remove the ability of the Ombudsman to apply the lessons learnt from investigations of other areas of government administration to tax issues (and vice versa), which is a significant advantage of the current arrangements. Another consideration is whether transferring the complaint-handling function to an Inspector-General within the Treasury portfolio may result in a perceived loss of independence in reviewing taxpayer complaints. A final consideration is whether tax administration issues would have a sufficient profile within an Ombudsman's office that is responsible for reviewing complaints against all government agencies, but which has a specific role of Taxation Ombudsman focusing on the ATO. The separate office of the Inspector-General has established a strong profile with taxpayers, especially within the large business community. It has allowed for a specific focus on tax administration issues and encouraged regular interaction with taxpayers, tax professionals and the community.

So, there are considerable advantages to maintaining the separate offices and roles of the Ombudsman and the Inspector-General of Taxation. However, as noted above, both have a role in examining systemic tax administration issues and there is a need to clarify these responsibilities to reduce the risk of overlap. Much of the potential for overlap could be removed by directing the Inspector-General to investigate systemic tax administration issues that affect businesses (see Recommendation 116). This would formalise the current practice, an arrangement that has developed through consultation between the Ombudsman and Inspector-General, and in response to the business community's concerns with systemic tax administration issues. Similar arrangements could apply to address the potential duplication arising from reviews by the ANAO and the JCPAA.

Resourcing the Ombudsman, the ANAO and the Inspector-General of Taxation

It is imperative that the Ombudsman, the ANAO and the Inspector-General are sufficiently resourced to adequately perform their important roles.

It is not clear whether there is an unmet demand for reviewing tax administration issues in Australia. In relation to taxpayer complaints, there has been a downward trend in recent

years, which the Ombudsman attributes to the ATO's improved handling of complaints and efforts to improve dealings with taxpayers. In relation to systemic reviews, the Inspector-General appears to have met community expectations for the number, scope and detail of investigations. However, these are important matters and the government should examine the resource needs of the Ombudsman, the ANAO and the Inspector-General in more detail to ensure that they are able to perform their roles effectively (see Recommendation 117).

Improving accountability to the Parliament

As noted above, the ATO is ultimately accountable to Parliament. The Review has not sought to disturb these accountabilities, but considers that improvements can be made to make Parliament more effective in holding the Commissioner to account for the performance of the ATO.

An important way in which Parliament operates is through its committees. The JCPAA holds Australian government agencies to account for the lawfulness, efficiency and effectiveness of their operations. In 2008, the committee concluded a major review into the operation of the tax system. Following that report, the ATO has attended biannual hearings of the JCPAA and provided it with a significant range of performance information. The Review has considered ways in which the JCPAA might provide more active oversight of the ATO on behalf of the Parliament.

Some submissions to the Review have expressed concerns that the ATO is not sufficiently accountable for its responses to recommendations of the Inspector-General of Taxation and the Ombudsman. These submissions suggested there should be a power to compel the Commissioner to accept and implement these recommendations. However, the Review does not consider it appropriate for these recommendations to be binding on the ATO, which is ultimately responsible for the administration of the tax laws. Nor is it appropriate that these recommendations be binding on the Treasury or the government.

Instead, the Review considers that the JCPAA should take a role in monitoring the ATO's actions on these recommendations (see Recommendation 118). This would be similar to the role the JCPAA currently performs in examining government responses to reports of the Auditor-General. Like the Auditor-General, the Inspector-General and the Ombudsman perform roles for which Parliament itself is not well suited. The Inspector-General and the Ombudsman have the expertise needed to assess whether the ATO is administering the law in a fair and reasonable way. In reviewing the reports of the Inspector-General and the Ombudsman, the JCPAA could require the ATO to explain whether it has implemented the recommendations made in those reports and its reasons for disagreeing with any of those recommendations.

The JCPAA's primary purpose in reviewing these reports would be to assess whether the ATO has responded appropriately to those reports. In most cases the JCPAA would be expected to avoid going over issues covered during the Inspector-General's and the Ombudsman's inquiries and would focus instead on any disputed issues and on whether the ATO has acted on its responses to the recommendations.

G2. State tax reform

Key points

The States need to have revenue to fund their expenditure and should have autonomy over how some of this revenue is raised. Because of factor mobility across States and the desire to have a less complex tax system across the federation, some taxes are more appropriately assigned to the States than others.

Although the States currently have access to significant taxes, there are problems with either the quality of these taxes or the way they are levied. Increasing the rates of tax on existing State taxes would not be a sustainable way of funding services in the future.

The States would be better placed to meet cost pressures in the future if they received the revenue from a broad-based cash flow tax. This could fund the abolition of a number of State taxes. The States could also raise some revenue from tax base sharing of the personal income tax, with the Australian government keeping a share of the consumption tax revenue.

Reforms to State taxes should be implemented over time through an intergovernmental agreement to allow for revenue stability as taxes are reformed and to facilitate good policy outcomes across the federation.

G2-1 Principles for assigning tax responsibility in a federal system

The tax system spans the three levels of government in Australia — the Australian government, State governments and local governments. Individual governments separately administer their own taxes, but there is much interaction between the policy objectives and the administration of taxes levied by different governments.

Improving the structure of the tax system should begin with recognising that the wellbeing of the Australian people is affected by the taxes of the entire federation. A poorly performing tax affects people no matter which government is responsible for it. People also respond in their work and savings decisions to taxes as a whole, regardless of which level of government administers them. For example, the States' payroll taxes and the Australian government's personal income tax both affect the post-tax wages available to workers, which in turn impact on workforce participation decisions.

In this respect, recommendations for the design of a future system have been based, in the first instance, on the quality of particular taxes. The assignment of tax responsibility to a particular level of government is then a secondary, but important, consideration. The role of the States in the tax system and the implications of reform directions for State taxes are discussed in this section.

It is worth noting that many issues within the federation relate to governments' spending and other responsibilities and the way different levels of government deliver services. While these issues are largely beyond the Review's terms of reference, reforms to taxes across the federation can also provide a platform for future reforms that seek to improve the performance of governments more broadly.

The role of different levels of government in the tax system

For a number of reasons, including history, institutional arrangements and differences in the size and scope of their operations, the different levels of government in Australia raise tax revenue in different ways. Both the way that governments raise taxes and the proportion of tax revenue raised by each level of government have changed significantly since federation. They will inevitably change in the future as well, as each level of government will be affected by the drivers of change in different ways. Three of these drivers — increasing mobility of economic resources, demographic change and technology — are particularly relevant when considering the future roles of each level of government in the tax system.

- Increasing mobility of productive resources, particularly the mobility of capital, will tend to favour tax systems with lighter taxation of mobile factors and fewer complex or unpredictable taxes levied on business. Factor mobility is generally higher within a country than between countries. This calls into question the capacity of sub-national governments to raise revenue from taxes that fall on highly mobile factors.

- Demographic change will affect different tax bases and types of government expenditure in different ways. Given the current allocation of tax and expenditure responsibilities in Australia, governments will face fiscal pressures at different times. Population ageing means that taxes (and transfers) will need to be designed to encourage workforce participation and to not impede people moving around Australia to work where they are most productive.

- Technological change will provide opportunities for governments at all levels to finance expenditures in different ways. For example, technology may allow roads to be more efficiently priced from direct charging (see Section E3 Road transport taxes).

Although Australia will retain its three levels of government, at least for the foreseeable future, there will likely be changes in their roles and responsibilities. It is therefore difficult to be definitive about tax assignment in the federation: as circumstances change, the ideal allocation of taxes to levels of government may also change. However, principles can be developed to help define the role of different levels of government in the tax system; that is, how much revenue they should raise and the type of taxes they should levy. Further, institutions can be set up to allow flexibility in these arrangements so that governments can adapt more easily to changing circumstances.

The amount of tax revenue for each level of government

Traditional fiscal federalism theory provides two benchmark models for how much taxing power should be available to each level of government in a federation. Musgrave (1959) and Oates (1972) argue that national governments are better placed to raise most taxes as sub-national taxation of potentially mobile factors tends to be distorting. Under this benchmark, the tax system in a federation would be largely centralised, even if sub-national

governments have significant expenditure responsibilities. In contrast, Tiebout (1956) suggests a greater role for sub-national governments in the tax system. His view rests on the assumption that competition for mobile taxpayers ensures that each sub-national government will offer residents their preferred mix of taxes and government services.

In practice, these benchmarks are not found in a pure form. A comparison of federations reveals diversity in how much taxing power is given to sub-national governments relative to their expenditure responsibilities. As Bird and Smart (2009) note after comparing a number of developed federal countries, neither standard fiscal federalism theory nor the differing economic circumstances of different countries appears to offer a ready explanation for the substantial differences observable in the level and structure of State finances in different federations. They argue that this is because federations are largely a product of their history, rather than a desire to structure the tax system according to a particular model. In Australia's case, these historical factors include how the federation was set up (that is, the powers that the Constitution gave to different levels of government) and the way that Australian governments have responded to various crises, events and long-term pressures since federation.[1]

It is clear, however, that because of the practical difficulty of exactly matching revenue and expenditure at each level of government, all federations operate with some degree of 'vertical fiscal imbalance'. In the overwhelming majority of cases, it is the national government that collects more revenue than it spends. Usually this is due to the desire to have a more centrally coordinated tax system combined with decentralised provision of government services. Vertical fiscal imbalance has existed in Australia since federation, although the level has changed over time.[2]

More recent theory on fiscal federalism has focused less on benchmark models and more on the incentives and institutions that would best serve federal systems. In summarising the recent theory of fiscal federalism, Oates (2005) notes that the challenge for federations is:

> one of determining the kinds of institutions that can accommodate fiscal decentralisation so as to realise the political advantages and economic gains from local control, while avoiding the potentially distorting and destabilizing effects that can result from soft budget constraints.

Under a 'soft budget constraint', a government can receive additional revenue without being accountable for how that revenue is raised. This can occur when a sub-national government is provided with additional grants from the national government, or when a national government withdraws grants to a sub-national government, to fill a revenue gap that, for example, has arisen due to poor fiscal planning. If a government is not accountable for the revenue it raises, it may not face the full cost of how it spends revenue and may have less incentive to be disciplined in how it spends that revenue.

A sub-national government could, in theory, face a hard budget constraint without raising any of its own revenue if there was a fixed agreement with the national government about the amount of revenue it received. In practice, such an arrangement would not be sustainable

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1 The most notable example of this was during the Second World War when the Australian government assumed control of income tax (in exchange for grants to the States) to finance and coordinate the war effort.

2 See Chart 10.5 in the Australia's Future Tax System Architecture Paper.

or desirable as it would deny sub-national governments flexibility to make spending decisions. A better way to ensure that sub-national governments face hard budget constraints, while allowing them the flexibility to change the amount of revenue they receive, is for sub-national governments to have access to taxes they can increase (or decrease) to finance spending decisions. Bird and Smart (2009) note that a government will face a hard budget constraint if it is able to increase or decrease spending only by increasing or decreasing its revenue in such a way that it is publicly responsible for the consequences of its actions. In other words, if a government chooses to spend extra money on a particular program, that government must raise the revenue required to fund that program rather than burden another level of government and it needs to be clear to people they are paying tax to fund the extra spending.

This does not necessarily mean, however, that sub-national governments have to fund all their spending from their own taxes. In a developed federation, it can be expected that there is some base level of goods and services that all sub-national governments will provide and that requires a commensurate amount of revenue. This revenue can be provided by the national government. Because of differences in preferences between jurisdictions, individual sub-national governments will want to provide different sets of goods and services. So that they can meet the preferences of their citizens, sub-national governments should have the capacity to raise tax revenue to fund significant marginal expenditure beyond the base level.

In applying this principle to the Australian federation, the question becomes how much of their own tax revenue State governments need in order to fund significant marginal expenditures. To a large degree, this is dependent on their expenditure responsibilities — both in terms of size (their total amount of expenditure) and nature (how different types of expenditure change over time). It is also a question that cannot be answered with a great deal of precision, as significant marginal expenditure is difficult to quantify. A general principle, however, is that as long as State governments have significant expenditure responsibilities, they should have access to significant and sustainable tax revenue. Furthermore, to enforce a hard budget constraint, they should also have some autonomy over (and responsibility for) the amount of revenue they raise.

Principle

The assignment of tax responsibility in a federation should take into account the revenue needs of each level of government. Each level of government should have access to tax revenue it can use to finance significant marginal expenditure decisions.

The type of taxes each level of government should levy

Because of differences in their size and their interaction with each other, different levels of government in a federation may have more or less capacity to raise revenue from a given tax on a sustainable basis. For example, it is unlikely that local governments in Australia could raise revenue sustainably from company income taxes as it would be relatively easy for businesses to move to a different local government area where they paid a lower amount of tax. All local governments would then have an incentive to keep lowering their taxes, either by lowering their tax rates or providing concessions to specific businesses. The likely end result is that they would not raise enough revenue to fund their expenditures.

Principles of tax assignment have been developed with the aim of ensuring that each level of government has access to a sustainable tax base while maintaining the coherence of the whole tax system. Principles developed by Musgrave (1983) suggest that if tax bases are highly mobile or distributed unequally across sub-national jurisdictions, they should be levied by national governments. Further, if taxes are used for redistribution or macroeconomic stabilisation, they should be levied by the national government, as it is better placed to coordinate these functions. These principles then suggest that appropriate tax bases for sub-national governments are ones that are immobile, are more equally distributed across jurisdictions and have limited inter-jurisdictional interaction.

The nature of a government's expenditure responsibilities may also be relevant to the question of tax assignment. For example, Warren (2006) includes in his benchmarks for tax assignment the principle that tax revenues should be able to expand in line with expenditure. That is, if a government has expenditure responsibilities that are expected to grow over time, then this expenditure should be financed from a tax base that is expected to grow.

While assignment rules are relevant to all federations, they will result in different outcomes in different federations. This is because federations are structured differently to begin with. There may be constitutional restrictions, as there are in Australia, on the taxes that different levels of government can levy. Further, the size of sub-national governments and the preferences of their citizens will influence the mobility of productive resources between them.

Principle

To the extent that there is a choice about the assignment of taxes in the federation, the Australian government should have control of taxes with more mobile tax bases and taxes used for redistribution and macroeconomic stabilisation. The States should have control of taxes on more immobile bases.

Own-source taxation is not the only way that sub-national governments can raise revenue autonomously. Autonomy is dependent on the extent to which governments can change the tax base and the tax rate. For tax bases that are more mobile between jurisdictions, the tax base may be more sustainable if it was uniform across all jurisdictions and not able to be changed by any individual government, as governments would not be placed under pressure to introduce tax exemptions or concessions. Revenue autonomy could still be achieved by allowing individual governments to change the rate of tax they apply to the uniform tax base.

Governments in a federation can coordinate in a number of different ways to raise tax revenue, including:

- Individual governments may choose to apply a similar policy, or the same policy, as applies in other jurisdictions. For example, in recent years, a number of Australian States have harmonised most aspects of their payroll tax legislation.

- Governments at one level may arrange for a higher level of government to undertake the collection and administration of a particular tax on their behalf (this would be easier if the tax base was uniform across the lower level of government).

- Tax base sharing arrangements can involve two (or more) levels of government taxing the same base. Each jurisdiction can set its own rate and receive the revenue raised in, or derived from, that jurisdiction. Tax base sharing arrangements are used in a number of federations. For example, in Canada, all provinces (except for Quebec) have a base sharing agreement with the federal government for personal income tax that allows them to set their own rates and thresholds that apply in addition to the federal rates and thresholds. Tax collection agreements enable federal and provincial taxes to be administered centrally with the relevant revenues provided to provinces. Individuals need to file only one set of tax forms each year covering their federal and provincial tax.

To the extent that these arrangements provide the States with revenue from broader based taxes, they can also help the States avoid using less efficient and less equitable taxes.

Principle

Tax base sharing or centrally administered State taxes can provide the States with the capacity to raise revenue sustainably and with some autonomy.

Implementing the principles outlined above may come at the expense of other principles for the tax system as a whole. For example, if there is a tax that individual sub-national governments have full control over (that is, they can adjust the tax base and the tax rate) and they can raise tax revenue from this sustainably, the fact that the same tax is levied by different governments may create complexity for businesses that operate in different jurisdictions.

Taxes that are harmonised across jurisdictions and cannot be changed by an individual government may avoid this complexity. However, locking in the tax base may reduce the flexibility needed for policy to adjust to changing circumstances. For example, a change to the tax base may be necessary to ensure that a new type of good, service or transaction (which was not envisaged when the tax base was designed) is treated consistently. If institutional arrangements do not allow changes to be made easily, inconsistencies may accumulate and the efficiency of the tax may be impaired.

Principle

The assignment of tax responsibility should take into account how different arrangements affect the complexity of the tax system and its capacity to respond to changing circumstances.

Intergovernmental grants

If a government is to face a hard budget constraint, it must have access to taxes it has the autonomy to increase (or decrease) to finance its spending decisions. Sub-national governments are also likely to receive intergovernmental grants. It is important that these grants are provided in such a way that they maintain the need for sub-national governments to rely on their own taxes to finance their marginal expenditure decisions. If intergovernmental grants are excessive, then sub-national governments may use them as substitutes for raising their own tax revenue.

A particular issue associated with intergovernmental grants is the bailout problem. The national government may have a tendency to provide higher grants to sub-national governments facing difficult financial circumstances. While such grants provide a form of insurance, they can also create a moral hazard problem — that is, if governments know they will be bailed out, they have less incentive to exercise fiscal discipline (Inman 2003).

Intergovernmental grants will support a hard budget constraint if they are transparent; that is, if people can understand how much grant money is received and under what conditions. Grants should also not be subject to discretionary change in a way that allows sub-national governments to seek additional ad hoc funding.

These conditions are also relevant to ensure that the national government maintains a hard budget constraint. If a national government exercises poor fiscal planning, it may seek extra revenue through withholding previously agreed grants to sub-national governments. If intergovernmental grants cannot be subject to discretionary change, national governments could be restricted from withholding grants.

A revenue-sharing arrangement, under which sub-national governments share a fixed proportion of the revenue from a tax over which the national government has policy control, is consistent with these requirements. Such revenue effectively becomes 'infra-marginal'; that is, it has little bearing on sub-national governments' ability to deliver marginal services. Revenue-sharing arrangements can make clear exactly what sub-national governments are receiving. Further, because the revenue sub-national governments receive cannot exceed its share of what is being raised, if the share amount is adhered to the amount of revenue cannot be subject to grant seeking (or cutting) behaviour.

The revenue from a revenue-sharing arrangement could be distributed to sub-national governments in a number of ways. For some taxes it would be possible for revenue to be returned to the jurisdiction in which it was generated. This would provide sub-national governments with greater ownership over the revenue they receive. However, for other taxes, there are practical difficulties in determining the jurisdiction where the revenue was generated and distributing the revenue on a derivation basis is not possible. For example, for a business that operates in a number of jurisdictions, it may be difficult to determine where profits, and hence company income tax revenues, are generated. In such cases, alternatives for distributing revenue include allocating on the basis of population share or weighting revenue shares based on the relative fiscal capacities of sub-national governments.

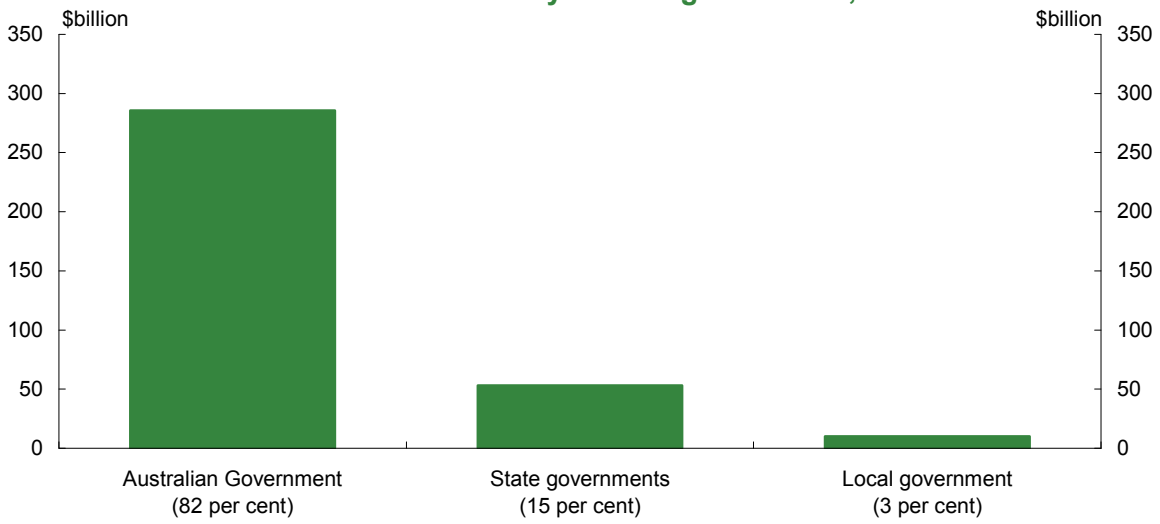
Principle

To ensure that governments face a hard budget constraint, any intergovernmental grants should be transparent and not easily subject to discretionary changes.

G2-2 Current State taxes are not well placed to fund services in the future

The Australian tax system is highly centralised. Chart G2-1 shows that in 2007–08, 82 per cent of total tax revenue was raised by the Australian government.

Chart G2-1: Tax revenue by level of government, 2007–08



Source: ABS 2009, *Taxation Revenue, Australia, 2007–08*, cat. no. 5506.0, ABS, Canberra.

The Australian government raises the majority of tax revenue in the federation and levies the largest taxes: personal income tax, company income tax, the goods and services tax (GST) and excises. To some degree, this accords with the principles for tax assignment: the company tax base is relatively more mobile while the personal income tax base is used for redistribution.

The high degree of centralisation in the Australian federation is also a function of the Constitution. In relation to taxing powers, the Constitution prohibits the States from imposing certain taxes, including:

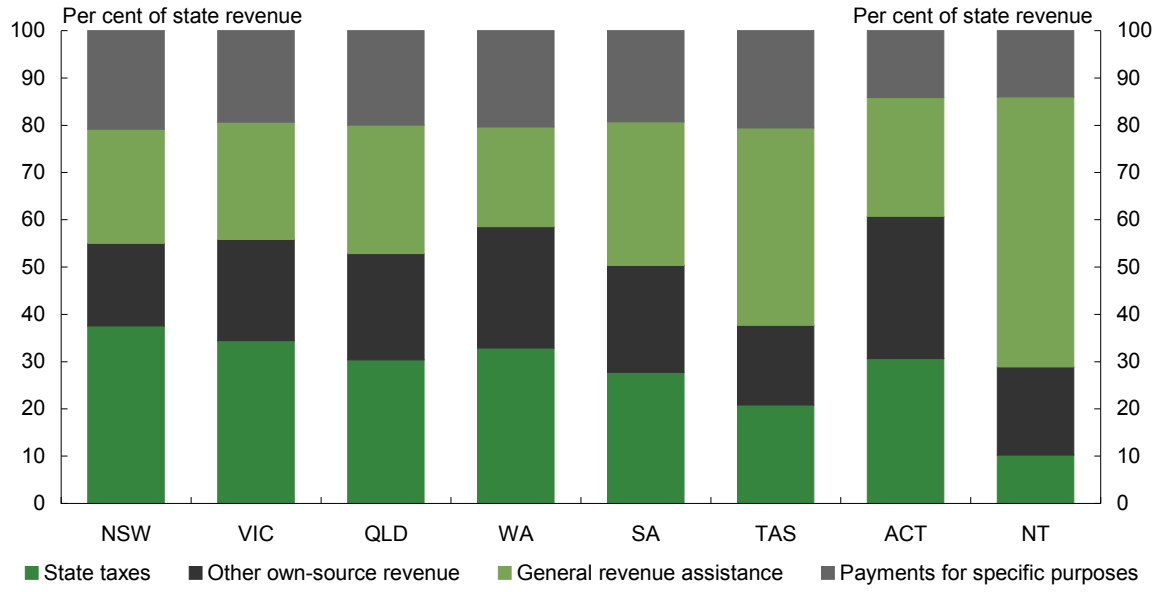
- customs and excise duties under section 90;
- taxes that conflict with the provision in section 92 that 'trade, commerce and intercourse among the States … shall be absolutely free'; and
- taxes on Commonwealth government property under section 114.

While section 90 provides the Commonwealth with exclusive power to impose customs and excise duties, it does not clearly define what these are. Successive High Court interpretations of the Constitution have restricted the States from imposing taxes on the production, manufacture, sale or distribution of goods. Australia's broad-based consumption tax — the GST — is therefore levied by the Australian government, although under present

arrangements, all the revenue from the GST is distributed to the States under the principle of horizontal fiscal equalisation.[3]

In 2007–08 the States raised $53.1 billion in tax revenue, which comprised around one-third of their revenue. A significant proportion (46 per cent in 2007–08) of the States' total revenue comes from the Australian government as either general revenue assistance (primarily GST revenue) or payments for specific purposes. As Chart G2-2 shows, the proportion of revenue that each State receives from the Australian government ranges from 39 per cent for the ACT to 71 per cent for the NT.

Chart G2-2: Sources of State revenue, 2007–08

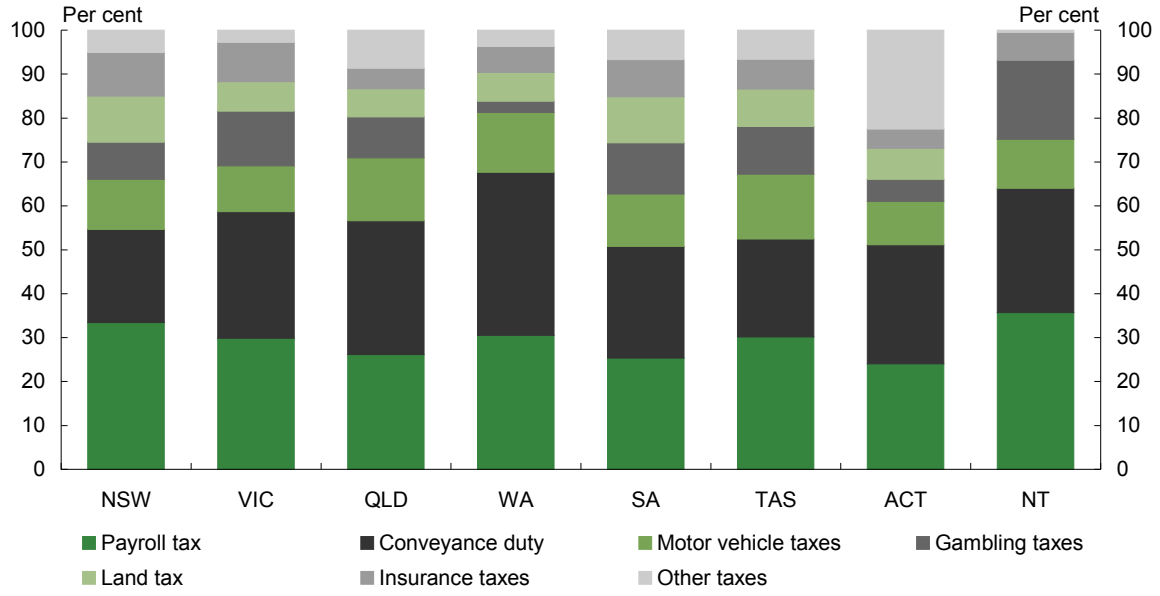


Source: ABS 2009, *Taxation Revenue, Australia, 2007–08*, cat. no. 5506.0, ABS, Canberra; Australian Government 2008b, *Final Budget Outcome 2007–08*, Australian Government, Canberra; ABS 2009, *Government Finance Statistics, Australia, 2007-08*, cat. no. 5512.0, ABS, Canberra.

The main sources of State tax revenue are payroll tax, conveyance duty and land tax, as well as taxes on motor vehicles, gambling and insurance contracts. In total, the States levy around 25 different types of taxes. While there are similarities in the main taxes used in each State, the thresholds, rates and range of exemptions often differ between States. As Chart G2-3 shows, there is variation in how much each State relies on different taxes, reflecting differences in revenue-raising capacities as well as differences in policy.

3 Horizontal fiscal equalisation has been defined as follows: 'State governments should receive funding from the Commonwealth such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standards.' (Commonwealth Grants Commission 2002 p. 5)

Chart G2-3: Sources of State tax revenue by State, 2007–08



Note: As the ACT does not have local councils, 'Other taxes' for the ACT includes revenue from rates (around 15 per cent of their total revenue).
Source: ABS 2009, *Taxation Revenue, Australia, 2007–08*, cat. no. 5506.0, ABS, Canberra.

The States are facing increasing cost pressures

The suitability of current State taxes is closely related to how well they can contribute to the funding of future expenditure. As noted in Section G2-1, demographic change will affect different tax bases and types of government expenditure in different ways. In the only comprehensive assessment of the fiscal pressures facing both Australian and State governments, the Productivity Commission (2005) estimated that in the absence of policy responses, expenditure for all levels of government in Australia would increase by 6.5 percentage points of GDP between 2003–04 and 2044–45, resulting in a fiscal gap of around 6.4 per cent of GDP by 2044–45.

While the Productivity Commission's base case found that the States would bear a relatively small increase in cost pressures (0.8 percentage points of GDP), this was predicated on the assumption that specific purpose payments (SPPs) to the States grew in line with service needs. Under the alternative assumption that SPPs grow in real per capita terms, the gap the States face would be over three times as large (2.3 percentage points of GDP). Given that the States' own tax revenues currently account for around 4.3 per cent of GDP, these cost pressures are significant.

Narrow-based and complex State taxes hamper revenue sustainability

Assuming no change in expenditure responsibilities between levels of government, the States will need better access to sustainable tax revenues to deal with these cost pressures. Although the States currently have access to some significant taxes, the analysis of individual State taxes (or groups of taxes) throughout this report has shown that there are many problems with current State taxes.

Narrow-based taxes are not desirable

A significant proportion of State tax revenue comes from stamp duties, which are narrowly based transaction taxes on the value of conveyances, insurance contracts, motor vehicles (on the transfer of ownership) and other financial transactions. These taxes can impose significant costs. For example, taxing property only when ownership is transferred discourages people from buying and selling. Individuals and businesses may choose to continue to hold property instead of a preferred alternative simply to avoid the tax. Transaction taxes can also be inequitable as people with similar incomes may pay different amounts of tax because they buy and sell a taxed good more frequently.

Transaction taxes can also be volatile sources of revenue because the tax base is determined not only by the value of the good but also how often it is bought and sold (the volatility of conveyance duty revenue is discussed in Section C2 Land tax and conveyance stamp duty).

Tax bases should be broader

A broad consensus that has emerged from reviews of State taxes is that the States currently have two potentially very efficient taxes, payroll tax and land tax.[4] To the extent that the burden of a broad-based payroll tax will fall on workers and a broad-based land tax on landowners, the immobility of these resources (relative to capital) make them good taxes for the States.

However, the current State payroll taxes and land taxes are not levied on the ideal broad bases. Payroll tax applies only to businesses with payrolls above a certain threshold and certain groups of employers and types of payments are exempt (see Section D3 Payroll tax). As a consequence, fewer than 100,000 of Australia's 2 million businesses are liable for payroll tax and around 95 per cent of businesses are exempt for one reason or another. Land tax is levied on land used only for certain purposes and its rate often differs between taxpayers according to the use of the land and the scale of landholdings. These features affect who bears the burden of these taxes. For example, because the land tax does not apply to all types of land, some of the burden of the tax is likely to be passed from landowners to renters (see Section C2).

Differences between States can create complexity

While the mix of taxes levied by each State is similar, there are many differences in the details of individual taxes from State to State. These relate to what is taxable, who is exempt from paying the tax, the rates and thresholds of the tax and when the tax must be paid.

Some of these differences are desirable because they allow State governments to modify their taxes to account for differences in geography, climate, industry structure and revenue needs. However, differences can also create complexity for individuals and businesses that operate in more than one State, or that move between States. Even though the burden of a tax may not fall on businesses, it is businesses that will often have to deal with the complexity of the tax system. More complex and uncertain tax arrangements across the federation can

4 For example, Gabbitas and Eldridge (1998) note that these taxes are relatively efficient, equitable and stable and have broad bases capable of raising substantial revenue. In its review of NSW taxes, IPART (2008) found that payroll tax is the highest ranking State tax in terms of performance against standard taxation principles while land tax is a relatively efficient tax, with substantial scope to improve its efficiency.

discourage business investment — affecting the sustainability of tax revenues more generally.

Without reform, increasing the rates of tax on existing State taxes would not be a sustainable way of funding increased cost pressures in the future.

Finding

Many of the current State taxes are inherently of poor quality while other State taxes need to be reformed. Increasing the rates of tax on existing State taxes would not be a sustainable way of funding services in the future.

G2-3 Reform directions for State taxes

The reform directions for individual State taxes or groups of State taxes are detailed in various parts of this Report. Table G2-1 provides a summary of these reform directions and references to the relevant sections of the Report.

Table G2-1: Reform directions for State taxes (including resource royalties)

State tax	Reform direction	Reference
Payroll tax	Payroll tax should be replaced by a tax that better captures the value-add of labour. This could be a broad-based wages tax or, preferably, a cash flow tax.	Section D3
Conveyance duty	The removal of stamp duty should be achieved through a switch to more efficient taxes, such as those levied on broad bases (including consumption and land).	Section C2
Land tax	Land tax should be levied using an increasing marginal rate scale applying to the per-square-metre value of the land. The tax should be calculated per land holding, not on an entity's total holding. There should be no specific exemption for principal place of residence or primary production.	Section C2
Insurance taxes	All specific taxes on insurance products, including the fire services levy, should be abolished.	Section E8
Motor vehicle taxes	State taxes on motor vehicle use and ownership, including motor vehicle registration transfer (stamp) duty and taxi licence fees, should be replaced with efficient user charges where possible.	Section E3
Gambling taxes	Explore options for reducing conflicts in policy-making between regulation and revenue-raising.	Section E7
Resource royalties	Most existing output-based royalty and resource rent tax arrangements imposed on non-renewable resources should be replaced by a single rent-based tax. The Australian government and State governments should negotiate an appropriate allocation of the revenues and risks from the resource rent tax.	Section C1

The long-term reform directions for State taxes would mean that the States rely less on transaction taxes and more on the efficient and immobile land tax base. The abolition of a number of taxes would contribute to a more coherent tax system across the federation.

Providing the States with better revenue sources

The States would need access to alternative sources of revenue to fund the abolition of a number of existing taxes. While the broadening of the land tax base is expected to yield additional revenue, it is envisaged that this reform would principally replace the revenue from conveyance duty.

Providing the States with more efficient and sustainable revenue sources is to some degree contingent on the reforms to consumption taxes, including payroll tax, outlined in Section D. Over time, revenue from a broad-based cash flow tax could provide a sustainable revenue base for the States to meet future cost pressures.

Different variations of consumption tax reform will have different implications for the role of the States. For example, the States currently levy their own payroll taxes, setting both the base and rate and could continue to set their own rates on a broad-based wages tax. In contrast, as a cash flow tax would be applied to business cash flows across Australia, to avoid significant complexity, and possible constitutional issues, the rate of the cash flow tax would need to be uniform across Australia.

Tax base sharing options

While the reforms to State taxes outlined above would provide the States with better revenue sources, the States would lose some discretion over how they raised their revenue (particularly if payroll tax was absorbed into a new cash flow tax). This calls into question whether the States would have sufficient revenue-raising autonomy — that is, whether they would have the capacity to raise revenue to finance significant marginal expenditure. How the States raise or receive revenue may also impact on how large cost pressures are over time. In Germany, for example, a reliance on intergovernmental grants in some German states have been linked to weakened fiscal discipline (Stehn & Fedelino 2009). If the States are not responsible for raising any of the revenue to fund increased spending, then there may be less incentive for them to provide services in more cost-effective ways.

While the States would have control over a reformed land tax, there may be some practical limitations on how this tax could be used to fund changes in expenditure. Although a reformed land tax base would be an appropriate revenue source for the States, the relative variability in land values may mean that changes in land tax rates may not always be a responsive mechanism for the States to use to fund expenditure decisions. Further, the revenue from the land tax may not be enough to allow States to have control over a significant amount of revenue (relative to their expenditure responsibilities).

If the States require further revenue-raising autonomy, then this could come through a tax base sharing arrangement. The Australian government currently raises significant amounts of revenue from two broad tax bases: the company tax base and the personal income tax base. It is possible that the States could share one of these bases, by applying a State-based surcharge.

While company tax has a broad base, as capital is highly mobile, it is expected that in the future the proportion of company tax revenue to total tax revenue will be lower than it is now (see Section B1 Company and other investment taxes). Further, as capital is mobile, States are likely to face pressure to reduce rates and they may be forced in to a 'race to the bottom' as they compete to maintain investment in their State. It is likely that these pressures are magnified (compared to international competition) in the case of States as the other characteristics that may attract investment (such as skilled labour and strong governance structures) are similar in each State. This would make the rate of the surcharge in each State a relatively more important factor in businesses' decisions about where to locate within Australia. At the same time, a State surcharge on company tax could not satisfactorily be integrated with the dividend imputation system.

The personal income tax base, which largely comprises the labour income of individuals, is less mobile between the States (as people move less freely than capital investment). Even where the personal income tax base includes some return to capital (for example, income from savings), the base is relatively immobile as the surcharge rate of tax would be based on where the person lives, not where the investment is undertaken.

Tax base sharing of income tax operated in Australia before the Second World War, although there was little coordination between the two levels of government. In 1976, the Australian government introduced the possibility of the States levying a personal income tax surcharge to replace financial assistance grants. No State took up the option.[5] A key reason for this was that the Australian government did not reduce its own tax rates to make room for the States (Carling 2007).

For a tax base sharing arrangement to work, therefore, it would be necessary for the Australian government to reduce its tax rates to allow room for the States. The revenue from tax base sharing that the States raised (and the Australian government gave up) should be offset by a reduction in grants from the Australian government or by the Australian government keeping a share of revenue from an existing revenue sharing arrangement. The revenue that the Australian government kept should be commensurate with the amount of revenue it gave up from the personal income tax base.

Administrative arrangements

While sharing of the personal income tax base appears to be constitutionally possible, there would be a number of administrative issues that would need to be considered, including the necessary State legislation. The administration and collection of the tax would need to allow for the revenue derived in each State to be returned to that State. It would also be necessary for taxpayers to be able to identify the Australian government and State government components of the tax that they pay, even though both would be administered centrally. This would allow people to link the additional tax they pay to the State government with the benefit that expenditure delivers in that State.

Key design elements of a tax base sharing arrangement are how much scope the States would have to change or influence the tax base and rate thresholds that applied in their State. As the personal income tax would continue to be centrally administered, the tax base should be uniform for all jurisdictions, and the Australian government would maintain policy control over changes in the tax base. One option could be that changes in the tax base would have to be agreed by the States — similar to the way the GST currently operates. However, this could compromise the flexibility that the Australian government needs to ensure that the tax base can remain coherent with changes in the economy and business practices. Further, as the Australian government would still raise the majority of revenue from personal income tax, it should maintain policy control of the tax base, and the States can be assured that the Australian government has the incentives that the tax base is managed appropriately.

In terms of setting the rate thresholds, as the Australian government is the appropriate level for determining distributional policies, one approach is for the Australian government to retain policy control of tax thresholds and the structure of the rate scale. While the structure

5 The legislation allowing the States to impose a surcharge was repealed in 1989.

of the personal income tax would be nationally uniform, the States could levy a flat rate surcharge on total income tax payable to the Australian government (with the surcharge payable based on the individual's place of residence). For example, if an individual's liability for Australian government personal income tax was $20,000, a State surcharge of 10 per cent would add $2,000 to the taxpayer's liability (which would be returned to the relevant State government).

Alternatively, the States could levy a tax rate (or rates) on the uniform tax base, potentially providing the States with more scope to change the structure of rates and thresholds. However, this could lead to a proliferation of marginal tax rate structures across the different States. Accordingly to ameliorate interaction with distributional policies and to limit complexity, it would be sensible under this approach to have some restrictions on the choices States had over rates and thresholds. A suitable approach may be the States being restricted to levying a flat rate of tax on income above the tax-free threshold.

If a personal income tax base sharing arrangement was desired, consideration would need to be given to how alternative approaches would impact on the complexity of the personal income tax structure and the administrative arrangements for returning revenue to the States. The personal income tax is also a key mechanism for the Australian government to influence workforce participation. The rate that States could levy in addition to the Australian government's personal income tax rates would need to be determined with careful consideration of participation objectives, particularly the relationship between the personal income tax and the transfer systems.

Finding

If the States required additional fiscal autonomy, they could raise revenue from sharing the personal income tax base. This could be done by the States levying a flat rate surcharge on income tax payable to the Australian government or a flat rate of tax on income above the tax-free threshold. The Australian government would need to reduce its rates of personal income tax and the States would receive lower revenue from grants or an existing revenue sharing arrangement. Any tax base sharing arrangement would need to be designed so that it was consistent with national objectives for redistribution and workforce participation and avoiding additional complexity.

Administration of State taxes

The reform directions suggest a reduced role for the States in the administration of taxes in the future. The abolition of a number of State taxes with the replacement revenue largely coming from centrally administered taxes would mean that the States could devote fewer resources to tax administration.

There is a possibility in the future that a single national body — the ATO or a successor organisation — could collect and administer all the taxes in the federation. This would reduce the costs of having separate administrations for each State and provide an opportunity to further reduce complexity in the overall tax system. However, if all State taxes were centrally administered, it would reduce the autonomy that States enjoy in raising their revenue. The States would need to decide if differences in taxes across the States are sufficient to warrant separate administrations. If in the future there were substantial

convergence in the way States levied their taxes, the costs of maintaining separate administrations may outweigh the benefits.

Longer-term reforms to the administration of taxes and transfers and changes in the way that people interact with the tax and transfer system are also relevant to State taxes. For example, an online client account could be used by all levels of government to give people up-to-date personalised information, including information about liability for State taxes and charges (for more on the online client account, see Section G4 Client experience of the tax and transfer system).

G2-4 Intergovernmental agreements and federal financial relations

Recommendation 119:

Reforms to State taxes should be coordinated through intergovernmental agreements between the Australian government and the States to provide the States with revenue stability and to facilitate good policy outcomes.

Intergovernmental agreements to achieve State tax reform

The implementation of a number of recommendations related to State taxes would require cooperation between the Australian government and the States. Further, some recommendations related to Australian government taxes would also impact on State taxes; for example, the recommendations relating to company income tax (Section B1) and resource taxes (Section C1). Depending on when some of the recommendations are implemented, the States may also be subject to losses in revenue that could not easily be made up from other revenue sources. Funding from the Australian government may at times be necessary to ensure that the financial position of a State is not adversely affected.

It is also important that reforms are sequenced in a way that allows people to understand the reason for change and how they will be affected. In many circumstances, changes will occur not only to taxes but also to transfers and other types of expenditures. For example, the reforms to the road transport sector outlined in Section E3 would require action by all levels of government — both in the way taxes and user charges are levied, and how services are delivered. Similarly, there is a high level of interaction between reforms to housing assistance and reforms to taxes that impact on the housing market (including conveyance duty and land tax). The process of State tax reform should not be seen only as an exercise of replacing poorly performing taxes with more sustainable taxes. It should also be seen as a mechanism to deliver better policy outcomes across the federation.

One way to coordinate and implement reforms over time is through an intergovernmental agreement between the Australian government and all the States. Examples of such agreements include the agreements related to the implementation of National Competition Policy, the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, which accompanied the introduction of the GST, and the recent *Intergovernmental Agreement on Federal Financial Relations*. Although the objectives of each of these agreements

were different, experience suggests that intergovernmental agreements tend to be more effective if they have the following characteristics:

- The objective of reforms is clearly outlined and agreed to by all parties.
- Reforms involve a commitment from all governments and the roles and responsibilities of each government are clearly defined.
- Timelines linked to outcomes are clearly agreed. To allow for flexibility, it is preferable for reforms to be undertaken by a specified date, rather than on a specified date. In some circumstances, reforms may be contingent on certain events occurring, for example, the availability of cost-effective technology for road user charging.
- Performance reporting by all jurisdictions is transparent and enhances public accountability.
- If provided, any incentives and penalties associated with reform are clear and binding so that good performance is rewarded and poor performance is penalised. Any rewards and penalties for all parties are based on an independent review of performance.

Other aspects of federal financial relations

As noted in Section G2-1, reforms to taxes across the federation should provide a platform for improving the performance of governments more broadly. The existing institutions for federal financial relations, however, need to support reforms to State taxes. Key aspects of these institutional arrangements are horizontal fiscal equalisation and payments for specific purposes.

Horizontal fiscal equalisation

Horizontal fiscal equalisation (HFE) is designed to provide GST revenue to the States so that if each State made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each State would have the capacity to provide services at the same level. Part of this process is to assess the revenue-raising capacities of each of the States.

A change in tax mix adopted by all States will change their relative revenue-raising capacities, therefore affecting the distribution of GST revenue. A change in tax mix might be revenue-neutral to the States in an aggregate sense, but an individual State might have one of their relatively stronger bases replaced with a relatively weaker base, such that revenue from their own taxes is lower. However, this loss in revenue could be made up through the HFE process, as the loss of their relatively stronger tax base means that their revenue needs are higher. In theory, if all States apply the same revenue-raising effort, no State would have a financial incentive to resist or favour a revenue-neutral reform of State tax base composition on the basis of the local strength or weakness of particular tax bases.

In practice, however, the States will be affected differently because they apply different policies to their existing tax bases and are likely to continue to do so in regard to tax bases they have access to in the future. The redistribution of GST revenue will not take into account the impact of changes to tax bases on a State where it does not apply the average policy. That is, if a State is raising more than the average revenue off a base that is abolished, HFE will not compensate for revenue lost above the average, just as if a State was making a

below-average effort that State would not be penalised. This may cause difficulties for some States, particularly if the States do not have the same ability to raise marginal revenue from the new tax base as they did with the old one.

As such, the States will need to consider whether, and to what extent, such differences should be reflected in replacement taxes.

While GST revenue is currently used as the pool for implementing HFE, HFE could currently be achieved with a smaller pool of revenue. The amount of revenue needed to achieve HFE changes over time with changes in revenue-raising capacities, the costs of providing services, population shares and the way that other grants from the Australian government are distributed. Changes to tax and expenditure responsibilities would also affect the size of the pool that is needed to achieve HFE.

Payments for specific purposes

The *Intergovernmental Agreement on Federal Financial Relations* introduced significant reforms to payments for specific purposes from 1 January 2009. The new framework involves providing the States with National Specific Purpose Payments (National SPPs) for five key service delivery sectors (healthcare, schools, skills and workforce development, disability services and housing) and National Partnership payments designed to support the delivery of specified projects, to facilitate reforms or to reward States that deliver on nationally significant reforms.

While it is too early to assess the impact of the new arrangements, the reforms have generally improved the transparency of specific purpose payments. The National SPPs are provided as a contribution to the States' funding of key services, so the States can be seen as having the responsibility for funding marginal expenditure associated with the delivery of these services. Depending on the level and growth of these payments, they should be consistent with a hard budget constraint.

National Partnership payments can be a good mechanism to coordinate the delivery of national public goods; that is, goods and services the States are in the best position to deliver, but which produce benefits that extend beyond an individual State. If National Partnership payments are used too much for discretionary purposes, however, there is a risk that the payments will become more complex and will lead to the States will having softer budget constraints.

Expenditure responsibilities

While changes to expenditure responsibilities are largely beyond the review's terms of reference, changes to the way that services are funded and provided across the federation are likely to be ongoing. As there is a strong relationship between the expenditure responsibilities of each level of government and the taxes and revenue sources that it needs, the assignment of taxes and revenues may need to change over time to reflect changes in expenditure responsibilities. The institutions in the federation will need to be flexible to respond to any significant changes.

A number of goods and services provided by governments are increasingly thought of in national terms. While the States provide health, education and community services, they often do this within a framework of national objectives and targets, often agreed through

COAG. There is also an increasing desire to create national economic and regulatory frameworks to support the efficient and equitable provision of goods and services. These trends suggest that there may be pressure for the Australian government to assume greater responsibility for funding the provision of, or access to, a number of goods and services currently funded by the States. For example, the National Health and Hospitals Reform Commission (NHHRC) recommended that the Australian government assume some additional responsibility for the funding of health services, including public hospitals, public dental services and community health services (NHHRC 2009).

The appropriate response of tax and revenue assignment to significant changes in expenditure responsibilities will depend on the type and amount of expenditure involved. In general, the following approaches could be adopted:

- Changing the proportion of revenue for each level of government from a tax base sharing arrangement. For example, if one level of government takes over some expenditure, it can increase the rate of tax it levies on the uniform tax base, while the level of government that no longer has to fund the expenditure can reduce its rate of tax. This can be done so that the total tax burden does not change.

- Changing the shares of each level of government under a revenue-sharing agreement. The level of government undertaking more expenditure would receive a greater share of revenue.

- Changes to intergovernmental grants. If the Australian government undertakes more expenditure, it could keep some of the grants it currently provides to the States.

- Changes to taxes. One level of government could raise more in own-source taxes and the other level of government would raise less. The increase in revenue should come from a better (or, at least, no worse) tax than the tax being reduced.

A number of these options are currently possible and if personal income tax base sharing was introduced, then changing the proportion of revenue for each level of government from a tax base sharing arrangement would be an option in the future. If there were any changes to taxes and revenue to reflect changes in expenditure responsibilities, these changes should also be consistent with the principles outlined in this section.

G3. Local government

Key points

Local governments are generally established under State and Territory legislation. They have access to one tax — local government rates levied on properties within the municipality. The majority of local government expenditure is funded through own-source revenue (83 per cent in 2005–06), with rates making up around 45 per cent of that own-source revenue.

The immobility of land makes local government rates based on land value an appropriate tax base for local governments to use to fund local public goods and services. States should allow local governments a substantial degree of autonomy to set the tax rate applicable to property within their municipality.

Over time, State land tax and local government rates should be more integrated. This could involve moving to a joint billing arrangement so that taxpayers receive a single assessment but are able to identify the separate State and local components. This could also mean that land tax and local government rates use the same valuation method to calculate the base (with this method being consistent across the State).

When implemented correctly, user charging is an appropriate funding mechanism for local governments to deliver private goods and services.

Grants to local government made up 17 per cent of total local government revenue in 2005–06. The distribution of untied financial assistance grants to local governments should be reviewed.

G3-1 Local government's roles and revenue sources

The roles of local governments vary across Australia

There are around 560 local governments in Australia, the majority of which are statutory bodies constituted under State and Territory legislation.[6] Although they are not formally referred to in the Constitution, local governments have come to play an important role in the delivery of government services in Australia.

The revenue-raising mechanisms of local governments across Australia are similar, but there is much variation in the roles individual local governments play. Often this variation is driven by characteristics of each type of local government. For example, to meet their community needs, some rural and remote local governments operate aerodromes so that fly-in medical assistance can be accessed (Productivity Commission 2008).

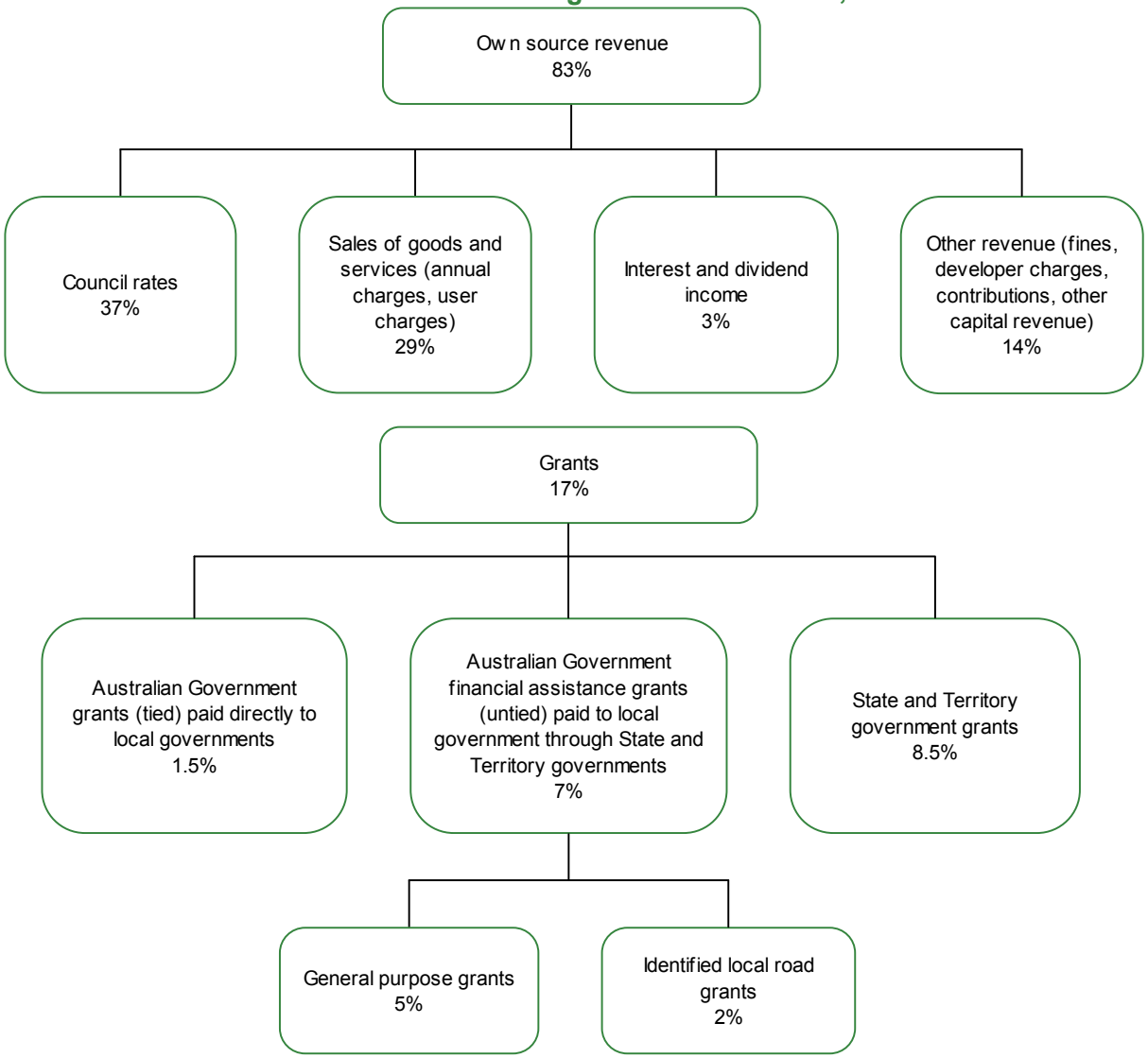
6 There are no local governments in the ACT. The ACT Government performs many of the functions that local governments perform in other jurisdictions.

Local governments typically provide a range of goods and services, some of which are public in nature, such as a local park that provides benefits to the wider community and is consumed at a low per-unit cost. Other goods and services local governments provide are more private in nature. For example, some local governments provide child care services. For some goods and services, the delineation between public and private is not always clear and can depend on circumstance (see Section E1 User charging). For instance, a car park provided by a local government in a major city is likely to be private in nature as more people will want to park their car there than the number of places available. But in less populated areas, the good is likely to have more public good characteristics as car parks are more likely to remain available for the public at large (hence one person using the car park does not stop another using it). The diversity of goods and services local governments provide suggest they should raise revenue from a mixture of taxes and user charges (consistent with the principles in Section E1).

Local governments raise most revenue from their own sources

Local governments (in aggregate) raise the majority of their revenue from their own sources. Chart G3-1 shows that in 2005–06 local governments raised 83 per cent of revenue from their own sources with 17 per cent of revenue received as grants from other levels of government. For individual local governments these percentages can vary significantly, reflecting differences in revenue-raising capacity.

Chart G3-1: Sources of local government revenue, 2005–06



Source: Adapted from Productivity Commission (2008).

Rates

Local governments have access to just one tax base: local government rates (often referred to as municipal rates). In 2007–08, local governments (and the ACT Government) raised around $10.2 billion from rates.

Local government rates are a tax charged on the value of property, with most types of land included in the tax base. The tax rate, however, can vary according to the type of land. For example, land for residential use may be charged a different tax rate from land for commercial use. Local governments generally have autonomy in setting the tax rate although there may be restrictions on how rates can be varied. In New South Wales, for example, the Minister for Local Government determines the maximum percentage by which general income from rates and charges may vary from the previous year.

The average tax rate varies significantly across jurisdictions. Jurisdictions with lower average land values tend to charge higher tax rates for a given property value. This may reflect that if

one area has lower land values than its neighbour, it must charge a higher tax rate to raise the same level of revenue so it can provide the same level of services.

The tax rate applied by a local government can also vary from year to year, as local governments generally set the rate to achieve a revenue target. A significant rise in land values from one year to the next can lead to a lower average tax rate if the local government's revenue target does not change significantly.

Local governments use a variety of valuation methods (although differences between some of them can be minor). Unimproved value, site value, capital improved value (that is, the total value of the property) or rental value are all possible valuation methods. Some States allow local governments a choice in the valuation method, while others do not (Productivity Commission 2008). The merits of different valuation methods are discussed in Box G3-1.

Box G3-1: Land valuation methods for local government rates

Local government rates can be levied on the improved or 'property' value or on the unimproved land value. There are at least two competing theories about which of these are more efficient — the 'benefits tax' view and the 'capital tax' view (see Zodrow 2007). The benefits tax view argues that improved or property value taxes are efficient, as they simply recover spending on local public goods that benefit the property owner. However, people are less likely to improve their property if that leads to an increase in taxes, and improved-value taxes therefore provide a disincentive to invest. Nor is it easy to see why the ratepayer who improves a property gains more benefit from the council's spending on public goods than a ratepayer who does not.

In contrast, the capital tax view argues that improved or property value taxes distort the use of capital within a jurisdiction. That is, taxing the capital used to develop land is likely to be less efficient than taxing more immobile bases, such as the land itself. Zodrow (2001) found that the empirical literature in the United States provided limited support for this view.

The fact that capital can move between councils more easily than it can move between countries suggests that council rates should be levied on unimproved or site value. Using unimproved or site value would still reflect the beneficiary principle, as local government spending that improves a local area is most likely to be reflected in land values.

However, taxes on improved value are only inefficient to the extent that they impact on marginal investment decisions — as is the case with stamp duties on property — and therefore act as a disincentive to invest. In regard to local government rates, the consensus is that the distortions and efficiency costs of using improved value are small (Productivity Commission 2008). If the tax liability depended on the improved value of all houses in the area, rather than an individual assessment of a specific house, then the inefficiency is likely to be substantially reduced. However, some ratepayers may regard this as inequitable.

Exemptions (such as land owned by other levels of government) and concessions (such as for pensioners and other income support recipients) from local government rates are prescribed in State legislation. State governments usually rebate local governments for revenue losses due to pensioner concessions (although in New South Wales local governments only receive a partial rebate) (Productivity Commission 2008).

Because local government rates are generally a tax on land, which is a highly immobile tax base, they are a relatively efficient tax (see Section C2 on land taxes). Further, given that land is immobile, local government rates are an appropriate tax base for local governments to use to fund the provision of local public goods (see Section G2 State tax reform).

Finding

The immobility of land makes local government rates based on land value an appropriate tax base for local governments to use to fund local public goods and services.

User charges

Local governments charge fees for many goods and services — such as sporting grounds, and water and sewerage services — that are private in nature. As Chart G3-1 shows, around 29 per cent of total local government revenue comes from user charges. Provided these charges accurately reflect the cost of provision (see Section E1 User charging), they are an appropriate revenue source for local governments.

Local governments also receive revenue from developer charges, often known as infrastructure charges. Infrastructure charges can operate as either user charges or taxes, depending on the level at which they are set. They are user charges when they reflect the cost of providing the additional infrastructure needed for the development, but operate as taxes when they exceed such costs. The supply of infrastructure and the associated charging are important factors in the supply of land suitable for housing and they can have significant consequences for affordable housing. Infrastructure charges are discussed further in Section E4 Housing affordability.

Finding

User charging, when implemented correctly, is an appropriate funding mechanism for local governments to deliver private goods and services.

Local governments receive tied and untied grants

In 2007–08, local governments received more than $2.3 billion in grants from the Australian government. This consisted of $1.78 billion in untied financial assistance paid through the States and $554 million paid directly to local governments and 'tied' to specific purposes. State governments also provide grants to local governments for specific purposes or services, as well as to reimburse rate concessions.[7]

Australian government untied financial assistance is provided under the *Local Government (Financial Assistance) Act 1995* and consists of general purpose assistance and an identified road component. The road component is identified but untied and can be spent according to local government priorities.

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7 It is difficult to determine the total amount of State grants to local government as some State governments also provide contract payments to local governments to carry out some State functions. The Productivity Commission (2008) estimated that in 2004–05 State government grants to local government were $1.831 billion. As a comparator, the Productivity Commission estimated Australian government grants to local government were $1.813 billion in 2004–05.

Each year the Australian Treasurer determines an escalation factor to be applied to the untied financial assistance grants. It is set by reference to population growth and the consumer price index.

The untied financial assistance is paid to the States on the condition that it is fully passed on to local government. The general purpose assistance is distributed to States on a per capita basis, while the road component is based on fixed historical shares. The distribution within States is in accordance with recommendations made by State grants commissions. These recommendations are required to conform to a set of national principles (See Box G3-2).

Box G3-2: Principles for distributing untied revenue assistance to local governments

State grants commissions are required to distribute untied revenue assistance provided under the *Local Government (Financial Assistance) Act 1995* in accordance with the following principles:

- Horizontal equalisation: each local government should be able to function, through reasonable self-effort, at a standard not lower than the average of other local governments in that State.
- Effort neutrality: actual revenue or expenditure policies should not impact on the grant received by local councils.
- Minimum grant: no local government can receive less than 30 per cent of its per capita share of the untied revenue assistance provided to its State under the *Local Government (Financial Assistance) Act 1995*.
- Other grant support: any grants received by local governments in respect of assessed expenditure needs should be accounted for in the assessment.
- Aboriginal and Torres Strait Islander people: assistance should be provided to councils in a manner that recognises the needs of Aboriginal and Torres Strait Islander people within the local government area.
- Identified road component: this funding should be allocated on the basis of road expenditure needs.

There seems little reason that local governments with large fiscal capacities should receive a guaranteed minimum grant (which allows them to tax their residents less than they otherwise would) at the expense of local governments with relatively small fiscal capacities (which result in them taxing their residents more than they otherwise would). The current requirement that each council receives 30 per cent of its per capita share of untied financial assistance grants may prevent State grants commissions from redistributing to councils that require greater assistance.

G3-2 Reform directions for own-source and grant revenue arrangements

Recommendation 120:

States should allow local governments a substantial degree of autonomy to set the tax rate applicable to property within their municipality.

Recommendation 121:

Over time, State land tax and local government rates should be more integrated. This could involve:

(a) moving to a joint billing arrangement so that taxpayers receive a single assessment, but are able to identify the separate State and local component; and

(b) using the same valuation method to calculate the base for local government rates and land tax (with this method being consistent across the State).

Own-source revenue: towards more autonomy, accountability and integration

If local governments are to be accountable to ratepayers for their expenditures, it follows that they should have full (or at least greater) autonomy over the setting of the tax rate applied to properties in their jurisdictions (see Recommendation 120).

Unless there are genuine policy reasons for doing otherwise and these reasons provide greater benefits than the associated costs, land-based taxes should make use of the same valuation method as this is likely to reduce administration costs. Therefore, as State governments make more use of the land tax base over the long term (see Section C2 Land tax and conveyance stamp duty), there should be one valuation method across the State used to calculate the base for both rates and land tax (see Recommendation 121). That is, land valuation would be the same for both taxes. However, local governments could continue to charge a fixed charge to ratepayers and there should not be a low land value threshold for local government rates, as even those who own land with a low per square metre value receive benefits from local government services.

If land tax and council rates can be better integrated with landowners receiving one bill per year covering both, it may be possible to have a single point of contact for enquires, debt management and compliance of both taxes.

Such a reform could see taxpayers receive one tax assessment notice for both taxes, with each tax rate and tax liability clearly identified. In some States this change would substantially alter some rate assessments — a long transitional arrangement may be appropriate in these cases.

Integrating and sharing this tax base may also facilitate a reassignment of tax responsibilities within the federation, as it is relatively simple to alter the rate of tax charged by each level of government (leaving overall revenue collected unchanged) to alter the amount of revenue received by each level of government. This may be necessary if there are major changes to

user charging. As outlined in Section E1, governments in Australia should contemplate opportunities to expand user charging for the provision of private goods. This is highly relevant for local governments and may offer the opportunity to lower local government rates and other charges.

The road and transport reforms outlined in Section E3, for example, may offer local government a significant opportunity to recover from heavy vehicles the maintenance costs they impose on local government road assets. In its May 2009 submission to the Review, the Australian Local Government Association highlighted that local governments own and manage around 80 per cent of Australia's road network, and roads expenditure is the largest expenditure for most local governments. If road reforms result in heavy vehicle road-wear charges flowing to the owner of the road, local governments are likely to receive significant amounts of additional revenue from these reforms (as they presently do not collect motor vehicle taxes). Of course, substantial parts of the local road system would not be fully funded from road-wear costs and would continue to require funding assistance. Consideration would need to be given to the revenue and grant implications at the appropriate time.

Reviewing the minimum grant principle

Local governments are generally established under State legislation and deliver services that would otherwise be delivered by State governments. As such, it may be more appropriate for State governments, rather than the Australian government, to be responsible for ensuring that local governments have access to enough revenue — including through untied financial assistance — to provide local services. The ability of the States to fund untied financial assistance is contingent on the States themselves having access to sustainable tax revenue.

Whichever level of government is responsible for funding untied financial assistance, there is a strong case to review the principles for the distribution of untied financial assistance, particularly the minimum grant principle. If the minimum grant principle was removed, the overarching principle for untied assistance could simply be horizontal equalisation within the relevant jurisdiction. The other principles could be considered when determining the distribution needed to achieve horizontal equalisation.

Payments to local government for specific purposes — either from the Australian government or State governments — are likely to have an ongoing role, as intergovernmental cooperation involving local government is often necessary to deliver reforms of national or State significance. Other levels of government can use these payments to purchase the delivery of goods and services from local government. Given the expertise that local governments have in the delivery of some goods and services, these payments can represent value for money for higher levels of government.

G4. Client experience of the tax and transfer system

Key points

People's interactions with the tax and transfer system tend to be complex and fragmented.

A 21st century tax and transfer system should allow individuals to engage with it in ways that meet their needs and preferences — a citizen-centric design. It should help people make informed decisions that are in their best interests. It should be transparent and trusted in its operation, and aligned with the 'natural systems' of individuals and businesses (the things they do anyway).

While improvements to individuals' experiences of the present system have been pursued by delivery agencies, policy and program complexity has continued to increase, such that the system remains confusing, costly and risky for people. Tax and transfer administrative and technology systems do not have unlimited capacity to absorb this complexity while maintaining a simple interface for citizens.

Significant improvements in client experience require a new approach to policy design that gives far greater weight to the experience of the system by users. This goal has underpinned many of the recommendations of this Review. If achieved, it will be possible to employ modern technologies far more effectively to deliver programs and enhance client experience and outcomes.

Greater use of technology, improved coordination and management of information, plus better design and integration of processes will enable more automation of reporting. It will also empower clients to better understand and engage with the system through online, up-to-date access to their own tax and transfer accounts.

Current government strategies such as the Standard Business Reporting Program will improve businesses' experience of the system, including through reducing compliance costs. Such strategies have the potential to generate further improvements in the business experience of the system and bigger compliance cost reductions if extended to cover further business interactions with other government regulators.

A high-level taskforce should be established to progress, oversee and regularly report on a whole-of-system reform of the policy, administrative arrangements and technologies that deliver the client experience of the tax and transfer system.

G4-1 Simplicity and client experience

The current tax and transfer system is complex. It combines individual-basis annual tax assessment with household-basis 'real-time' means testing of income, family and other assistance.[8] It requires detailed client information to deliver finely tailored results, with different programs using different measures of client circumstances. It involves income-linked arrangements for child support, tertiary education funding, superannuation, health insurance and other programs. Not surprisingly, individuals may have very complicated experiences in dealing with the system.

In many different ways and at various times, the tax and transfer system affects every person in Australia. For example, almost all individuals interact with the income tax system (11.8 million individuals lodged a return in 2006–07), and many individuals deal with the transfer system (in June 2009 for example, around 1.77 million families received Family Tax Benefit A in respect of 3.44 million children, 1.36 million families received Family Tax Benefit B, while 356,000 people received Youth Allowance). Other interactions with the system are less frequent; for instance, 55,199 Australian government disaster recovery payments were granted to provide assistance and support to survivors of the Victorian bushfires, while 85,065 grants had been paid under the Australian government's LPG Vehicle Scheme (as at 30 June 2009, for the 2008–09 financial year).

Submissions provided to the Review and meetings with the general public have highlighted concerns that the tax and transfer system is difficult to understand, laden with inaccessible jargon and inconsistent in its use of terms. Complex rules and the different ways in which various elements of the system are administered create costs and risks for people.

The Review has recommended policy reforms that would lead to a simpler system, such as abolishing many State taxes, and rationalising tax offsets and tax deductions. Simplification will have many benefits for clients, including greater transparency, less information to collect, and forms and processes that are easier to understand.

Nevertheless, the complex objectives of the tax and transfer system, the world in which it operates, and the desire to tailor its impacts to the diversity of people's lives mean that even a simpler system has the potential to be complex, costly and risky for the people interacting with it. The Review has referred to this interaction as the client experience of the system and believes that improved client experience is an important element of Australia's future tax and transfer system.

G4-2 Desirable features of client experience

A citizen-centric design

Over the past decade, concerted efforts have been made in a number of countries to improve the relationship and interactions between government and citizens. A consistent theme in these reforms has been a move to more citizen-centric government (Briggs 2009). 'Old'

8 Eligibility for transfers is means tested in 'real time' because recipients have to provide up-to-date income information on a fortnightly basis.

government service delivery has been characterised as transaction-based service delivery systems built around, and aligned with, program boundaries. Citizen-centric government instead matches services delivery to the needs and preferences of the individual. The government would come to be regarded as approachable, services would be easy to locate and understand, and citizens would be able to choose from a range of service models based on their particular needs, without having to understand which agencies deliver what services (Briggs 2009). Authentication and personal information would need to be provided only once in order to access government services, and diverse transactions would be grouped and completed together (Briggs 2009).

In a European Commission report titled *A vision of public governance in 2020*, the characteristics of this new citizen-centric environment were outlined as fully joined-up open government administrations which are responsive to user needs and which empower citizens to participate in a democratic government (EC 2008). In Europe, this new environment has manifested itself in services such as web portals that allow people to access a range of government services in one place (for example the United Kingdom's Customer First Programme and the Netherlands e Citizen Programme). In Canada, Service Canada was created in 2005 to bring together a range of federal and local government services to make things easier for clients.

In Australia, improvements to client experience have included service delivery reforms to co-locate and combine services. Examples include the ongoing development of online government portals, such as australia.gov.au, vic.gov.au and brisbane.qld.gov.au (Brisbane City Council is the largest local government in Australia). Examples of co-location of services include making a range of municipal services available in local government shopfronts and making Centrelink services, particularly family assistance, available in Medicare offices.

Being more citizen-centric requires a better understanding of what people want and need. Results from surveys of peoples' attitudes and preferences indicate that Australians want streamlined, integrated service delivery. They are frustrated by interactions with many different agencies that require them to assimilate complex information from multiple sources and by the need to communicate with lots of people and fill out lots of forms to get their issues resolved (AGIMO 2008). For most simple transactions, they want an efficient service they can access at a time and using a channel convenient to them. This service should provide accurate, comprehensive information appropriate to their personal circumstances, and the service should be consistent regardless of how or by whom it is delivered (AGIMO 2008).

There are many opportunities to further streamline and integrate services by reducing duplication in websites, telephone lines and communication materials within and across agencies. However, rationalisation is only effective up to a certain point — people also value dealing with someone who is knowledgeable enough to handle their issues effectively. Rationalisation of all government call centres into a single number could result in reduced quality and increased levels of referral or escalation. Consolidation of too many government services in government shopfronts can lead to reduced responsiveness because counter staff cannot maintain expertise over a very broad range of services. So a critical issue for servicing clients is determining the right balance of service provision, integration and appropriate service channels.

In many cases people prefer to access services over the web, but they also value face-to-face interactions where they have complex needs or where they are in situations of risk.[9] In those interactions, people want to be treated fairly and politely by competent and sympathetic staff. People would also like to provide their information to government only once, that is, they want to complete one application (or ideally pre-populate one form) and have it dealt with by any of the relevant agencies or service providers rather than sending separate completed forms to each agency or service provider.

The trend towards citizen-centric government has implications far beyond the Review's focus on the tax and transfer system. Nevertheless, citizen-centric design of the tax and transfer system implies that individuals should be presented with 'real-time' information about their whole relationship with government on taxes and transfers. People would interact at a time and in a way that suits their preferences and needs (but not always over the internet). They would provide their information once or have it provided by third parties such as employers, other government agencies or financial institutions. This information would be used to update their details with all agencies and to pre-populate forms, generate liabilities and confer entitlements.

Box G4-1: Example of citizen-centric design

Citizen-centric design starts with understanding the needs of citizens rather than the problems of service providers. Canada is often described as a leader in citizen-centric services.

Service Canada officially began operations in September 2005 but its origins date back to 1998 when the Government of Canada began developing an integrated citizen-centred service strategy based on detailed surveys of citizens' needs and expectations. Service Canada aims to provide a one-stop, single-window, multi-channelled service network, centred on the needs of Canadians. It provides a wide range of welfare services relating to families, employment and retirement as well as providing services on behalf of other agencies such as passport and boat licence applications.

Governments commonly use service integrators, but a design that merely connects citizens to services does little to resolve difficulties citizens have in dealing with multiple government organisations built around program or jurisdictional boundaries. Service Canada also has a mission to integrate services over time to minimise overlaps, reduce duplication and fill gaps in service.

Helping people make informed decisions in their best interests

People should have a right to readily see what identifying and financial information (from any source) is held about them by tax and transfer agencies. They would benefit from being able to receive immediate feedback about the impact of actual or hypothetical changes (such as becoming unemployed, starting a new job or having a baby) on their whole financial relationship with government. Providing clients with quick and accurate information on how such changes could affect (or have affected) their financial position makes it easier for

9 For example, people may be in situations of risk because they are disadvantaged, vulnerable or in urgent need because their personal safety is at stake.

them to make decisions in their best interests. Currently, people can test changes in circumstances against specific parts of the system, but then need to assemble these pieces of information to get an overall answer. This process requires people to be quite knowledgeable about the system and is prone to client error.

Choice defaults for complex decisions can help people to achieve better outcomes (Dunstall & Reeson 2009). Behavioural studies have shown that the more complex a decision is, the less well equipped many people are to handle it. When faced with complexity or uncertainty, people procrastinate about or avoid making decisions, stick with (less than optimal) defaults, or if they are confused about a decision, they can be prone to follow misleading advice. As a result, people often make decisions that are not in their best interests (Dunstall & Reeson 2009). A more client-focused system would apply insights from behavioural economics, behavioural finance and psychology, facilitated by advances in information technology and improvements to service delivery, to alleviate the burden of this complexity for individuals making such decisions. A future system would adopt defaults for complex decisions that would leave clients in a reasonable position. Carefully designed, such choice 'nudging' could significantly assist people while still giving them full control over the choices in question so they can easily make different decisions if they wish.

Box G4-2: Use of defaults — 'uplift' of Family Tax Benefit income estimates

With the introduction of A New Tax System in 2000, fortnightly Family Tax Benefit payments were paid provisionally based on a family's estimate of their income for the financial year. The family's actual entitlement was determined only once their taxable income was assessed at the end of the financial year. Initially, the complexity and uncertainty of estimating income for the next period led many people to underestimate their income. Many others did nothing and their previous year's estimate automatically 'rolled-over' to the next year, even where the estimate was inaccurate in the year it was given. Reliance on estimates that were too low meant that many people incurred debts once their fortnightly payments were reconciled with their actual entitlement.

To assist people, in 2006 the government introduced a default income estimate. The default is the previous year's estimate 'uplifted' by reference to the increase in average wages. The default is specified in a letter sent before the start of each financial year to each family assistance customer, requesting an estimate of their family income for the following year. It is open to the customer to provide their own estimate, but in the absence of further communication, Centrelink uses the default to calculate fortnightly payments.

Transparent and trusted in its operation

Another desirable feature of the client experience of Australia's future tax and transfer system is that the system be transparent and trusted in its operation.

Information held in agency systems and the flows of information between them should be visible to clients. The protections applied to information about clients (obtained from them or third-party information systems) and the circumstances in which information can be provided to others also need to be clear.

People need to know what information provided by third parties has affected their taxation position or their transfer entitlements. If they wish, people should be able to see the

information from third parties that is being used. The calculations used to determine a client's position should also be available so they can easily understand the result.

To the maximum possible extent, third-party information should be obtained by agencies in advance of administrative decisions, for example to pre-populate tax returns, rather than as a check on the information provided by clients themselves. In order to assist clients, electronic systems should make it possible to minimise the risks of error or misunderstanding with them, and not test those clients' knowledge about, or the accuracy of, the records they provide.

Finally, creating client trust in the operation of the system requires a clear and effective review and complaints system. Where clients believe that a breach of their rights has occurred, they need a review mechanism which is convenient for them to use, efficient, inexpensive and which delivers results in which they have confidence.

Aligned with the 'natural systems' of individuals and businesses

Third parties have considerable obligations, risks and costs placed upon them in relation to providing information about people to government. For example, businesses need to provide information about their employees' Pay As You Go withholding details to the Australian Taxation Office (ATO) for tax purposes. They incur the cost of doing this, and must ensure the information is accurate and provided on time.

Therefore it is important that policy design is as simple and straightforward as possible, and that reporting obligations fit readily with established business systems.

'Natural systems' are those systems that individuals and businesses use, provide information to or interact with regularly for non-tax and non-transfer purposes. Examples of natural systems include payroll systems for businesses and bank accounts for individuals. By aligning with natural systems, the future tax and transfer system could operate seamlessly, drawing relevant information from the everyday processes and interactions of people and businesses. People and businesses would be able to comply with their obligations without doing anything additional that they would not have done in any case.

For example, a client receiving a family transfer (who currently needs to report changes in income to Centrelink as and when they occur) would no longer need to do this if information about their income (drawn from their employer's payroll system under the employer's control) were provided directly to Centrelink. This would avoid many problems for clients such as incurring a transfer system debt if they forget to report an increase in salary.

Another example would be the exchange of information between hospital systems, birth registries, Centrelink and Medicare on birth of a child. By drawing on information provided to the hospital at birth, the process of registering the birth, registering the child for Medicare and applying for family assistance could be automated.

Relying on the natural systems of business, such as their financial and payroll systems, can reduce compliance costs for business. These costs can relate to the assessment of tax liabilities for the business itself, as well as reporting and withholding requirements in respect of its employees. There would also be benefits for the integrity of the system as automated

exchange of data would likely improve business compliance, reduce errors and enhance confidence in the system.

Principle

The tax and transfer system should allow individuals to engage with it in ways that meet their needs and preferences (a citizen-centric design). It should help people to make informed decisions that are in their best interests. It should be transparent and trusted in its operation, and be aligned with the 'natural systems' of individuals and businesses.

G4-3 Building the future client experience

Moving beyond current approaches

Public meetings and submissions to the Review have raised significant issues about the difficulty of interacting with the tax and transfer system, and how this affects the experience of clients. Overall, the current way of interacting results in clients being exposed to cost, risk and inefficiency, as well as driving client disengagement.

There are numerous examples of innovative government service delivery aimed at improving the experience of clients, some using technology and others a more personal approach. The creation of Centrelink in 1997 was itself a reform aimed at improving the experience of clients. It aimed to deliver previously disparate social security payments and services, as well as government assistance, with a consolidated focus and a whole-of-government approach.

A more recent specific example, the Australian government drought bus, provides advice on tax, health and mental health issues in addition to specific drought and flood relief services. This initiative recognises that people in need rarely have problems that are confined to the responsibilities of one agency or service deliverer.

Over the past decade the ATO has dramatically reduced its use of paper forms by offering its clients internet-based options. In 2008, over 2.2 million individuals lodged their tax return using e-tax (ATO 2009c). Benefits include 24-hour availability, faster processing times and automatic estimation of the tax refund or debt. Taxpayers and agents preparing an electronic income tax return are able to utilise pre-filling. Pre-filling partially completes the tax return using information supplied by third parties such as employers, banks and other government agencies. The pre-filled information is the same as that sent to the ATO for information-matching purposes. This initiative has improved the client experience through reducing time and effort spent preparing and lodging tax returns, while improving accuracy and compliance.

While such initiatives will improve the experience of clients to varying degrees over time, most are still primarily organisational or portfolio-specific. Furthermore, the policy and program complexity of the system has continued to increase while these initiatives have been under way. Tax and transfer administrative and technology systems do not have unlimited capacity to absorb this increasing complexity while offering citizens a simple interface.

Without a change in current approach, Australia's tax and transfer system will continue to be designed and administered in ways that do not give primacy to the experience of users.

People will be confused about the overall impacts on them and continue to face frustrating processes to undertake basic transactions with government. Carrying out a simple task such as reporting a change of address or a change of partner might still involve being referred to multiple areas and agencies, providing the same information again and again.

A new approach that brings together policy design and implementation across agencies and portfolios is needed to achieve the kind of transformation summarised in Box G4-3 following.

Box G4-3: Transforming the client experience

Old system	New system
Limited range of transactions can be performed online.	All transactions (except those that need to be conducted in person due to a policy requirement) can be performed online.
Information has to be reported multiple times, sometimes in different ways.	Information such as a change in address or new employment details will be provided once and used across the system.
Account balance information for tax and transfers is not easy to access.	Totality of financial relationship with government will be accessible online with clients able to see historical data as well as real-time information.
Difficult to calculate how a change in income or circumstances such as having a child or retiring will affect a client's tax liability and transfer entitlements.	Clients will be able to see how their tax and transfer situation will change if their income or circumstances change.
Different processes for benefits and transfers administered by different policy departments.	Common processes so clients have a similar experience when transitioning between payments.
Many rebates, offsets and deductions providing welfare-type assistance in the tax system.	Greater use of standard deductions and outlays.
Information from third parties such as financial institutions and employers is pre-filled in electronic tax returns where available; other information is manually entered.	Tax and transfers reporting is designed so that most information can be pre-filled automatically.
Many clients get assistance to manage their tax and transfer affairs.	Most clients will feel confident to manage their own affairs because the process is simpler and more automated.
Clients use face-to-face and call centre services to make queries or provide information when they would be willing and able to use self-service applications if they were available.	Extensive self-service options are complemented by personalised assistance for those needing more intensive assistance.

Finding

While a range of recent and current initiatives will improve client experience, the system remains confusing, costly and risky for people. A new approach to policy design and implementation is needed which gives primacy to users' experience of the system.

A rapidly evolving environment

The precise trajectory for development of the new client experience and the speed at which it could be implemented, are not clear. Developments in technology and their use in delivering services are occurring very rapidly, creating new possibilities and expectations for government service delivery.

The continuing evolution of technology-based information and communication services is enabling a paradigm shift in delivering services. The world is moving beyond a 'cottage industry' model of technology-based service delivery in which organisations develop and deliver in-house services over the web. Instead the advent of global industrial models for technology-based service delivery is becoming apparent, under which entities

would store information and then provide technology-based service delivery on behalf of other organisations to those organisations' clients. Large global enterprises (such as Google and Amazon) are leveraging low-cost technology in sophisticated, disciplined ways to deliver high-quality services at very low cost. Not surprisingly, existing approaches to technology used by the Australian government cannot match this new approach in terms of cost or quality.

At the same time, a more sophisticated version of citizen-centric service delivery is emerging, which some have dubbed citizen-driven service delivery (Di Maio 2009). To date, citizen-centric service delivery models have been characterised by government agencies joining up services in ways they think people will value, rather than letting them do it themselves. New approaches emerging from the private sector would allow citizens to configure services or information directly or via intermediaries to match their needs. For example, citizens today are adopting new information technology that allows them to combine or 'mash-up' existing services and content in ways that fit their preferences. Using mash-ups allows a client to create entirely new services tailored to them. It also allows intermediaries to innovate and mash-up online services in ways they think people will want.

Box G4-4: New technology: Mash-ups

A mash-up is the integration of two of more web services from internal and external information sources (Bradley 2007). An example of this is the iGoogle service, which enables non-expert customers to select the set of services they want to access on a regular basis. Users can create a personalised homepage that combines live content such as news, weather and cinema guides with other tools such as foreign language translators and recipe finders.

Other examples include websites and mobile applications combining public transport timetables with mapping and event information from different sources.

Six enablers for improved client experience

Recommendation 122:

A tax and transfer client account should be developed, based on customer research and with customer input into its design. The account should include at least the following features:

(a) up-to-date presentation of income earned from all sources, taxes withheld, tax liabilities incurred, transfers received and information flows from third parties;

(b) complete information from past periods;

(c) an optional single point for updating personal information, undertaking transactions, and reporting information or making applications, with extensive pre-filling of forms based on information previously provided; and

(d) the ability to test the impact of hypothetical changes in circumstances.

Recommendation 123:

Pre-filled personal income tax returns should be provided to most personal taxpayers as a default method of settling their tax affairs each year.

Recommendation 124:

Existing tax and transfer provisions should be reformed to support improvements in client experience, including greater alignment of income definitions and reporting, rationalising of personal tax deductions and offsets, and streamlining of mandatory administrative requirements. Future new policy proposals should be subject to comprehensive, published expected impact assessments on client experience systems and outcomes.

Recommendation 125:

Where possible, information required for determining tax liabilities and transfer entitlements should be collected from third parties, including employers, government agencies, financial institutions, and share and property registries.

(a) Over time, electronic provision of this information by third parties should be made mandatory.

(b) To reduce current and minimise new compliance costs, reporting obligations should as far as possible be aligned with existing information concepts and systems of third parties, and facilitated through electronic interaction with information held in the 'natural systems' of those entities.

Recommendation 126:

Further approaches (extension to and approaches which build on Standard Business Reporting) should be pursued to reduce the compliance costs associated with business interactions with government.

Recommendation 127:

The government should assist small businesses to be 'business ready' when they begin business. This could be achieved through education and financial assistance, which may include assistance to small business to get ready for Standard Business Reporting (SBR).

Recommendation 128:

Common information standards, leveraging from the standards and governance put in place by the Standard Business Reporting Program, should be developed and adopted to support system interoperability between tax and transfer agencies, and between those agencies and third parties, such as employers.

Recommendation 129:

A modern privacy and secrecy framework should be developed and adopted that maintains and streamlines protection of personal information held by government agencies, and facilitates exchange of information (other than an individual's health information) between agencies to support improved client experience of the tax and transfer system.

Recommendation 130:

A method of linking records, for example by linking existing client identifiers, should be developed to facilitate development of a single client account for tax and transfer financial information. This would allow better service delivery by supporting interoperability and data exchange between the appropriate government agencies, and flows of tax and transfer information from third parties to those agencies. Information should not include individual health information.

Recommendation 131:

A high-level taskforce be established, under central agency leadership, to progress a whole-of-government approach to improving the client experience of the tax and transfer system, with:

(a) membership from relevant agencies, the private sector and client representatives;

(b) terms of reference requiring the taskforce to:

1 develop, consult, oversee and regularly report to government and Parliament on a whole-of-system reform of the administrative arrangements and technologies that deliver the client experience of the tax and transfer system;

2 position these reforms within the overall government initiative to improve the relationship between it and citizens; and

3 lead consultations with relevant stakeholders, including citizens, privacy advocacy groups, professional associations, financial institutions and employers.

(c) a mechanism for capturing feedback from citizens on government service delivery, including both current administration and new proposals.

Despite uncertainty about the pace and direction of these trends, a focus on six enablers will position Australia to deliver improved client experience of the tax and transfer system.

(i) Doing more for people

As noted previously, even a simpler tax and transfer system has the potential to be complex for some people who have to deal with it. Improving client experience will require smart service delivery that makes complexity easier for people to navigate.

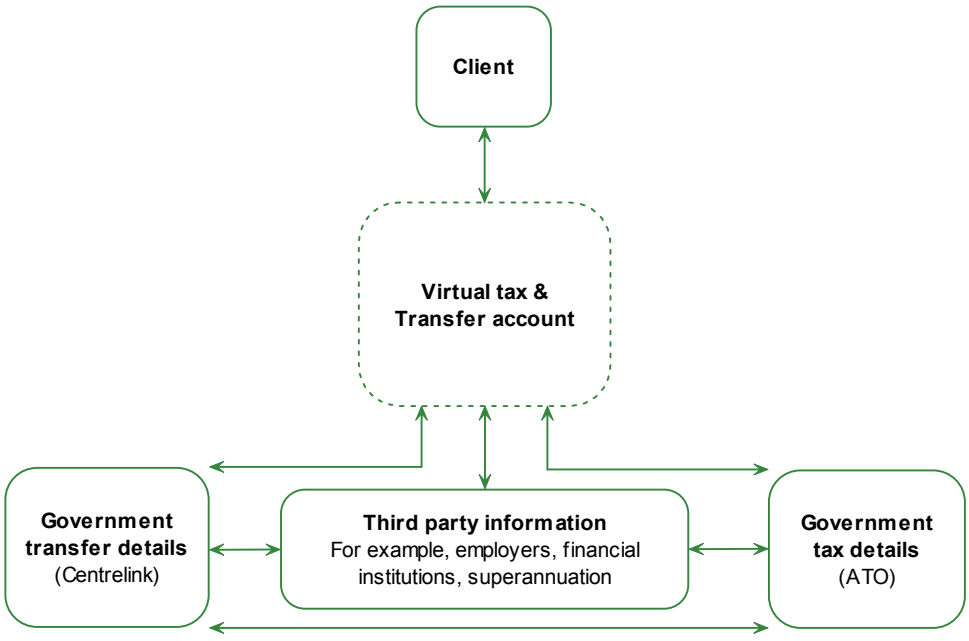
A client account

To provide convenient access to information about all their tax and transfer affairs, people should have a single client account (or possibly a structure of accounts) with government, which can be viewed and managed online (see Recommendation 122). The account would provide individuals with a single view of their financial relationship with government, including details of their personal income tax, transfers, repayment of education loans, child support and aspects of superannuation (see Section A2-4 Improving people's awareness of the retirement income system). With consent, the account would also present relevant information of other family members (for example, where entitlement to transfers depends on family income).

People would be able to view how their rolling balance with government is building up during the year, including income earned from various sources, taxes withheld and transfers received. Complete information from previous periods would also be available. The account would provide a single point for updating personal information that would then flow to all relevant agencies. For example, transactions could also be undertaken through the account, with information already provided being used to pre-fill forms. Information flowing from third parties affecting liabilities and entitlements would be visible in real time. Finally, the account would provide people with immediate feedback on the impact of changes in their circumstances (such as having a baby or increasing their hours of work) on their net tax and transfer position, as well as allowing them to test the impact of hypothetical changes in their circumstances to better inform their decisions.

The account is illustrated in Chart G4-1 below.

Chart G4-1: Client account



Developments in information technology and potential privacy concerns suggest that the account may not take the form of single government database. Instead a virtual account would be created whenever a client seeks to access it, drawing information in real time from relevant agency systems. Direct personal use of the account would be optional. People preferring to access information or transact directly with agencies through other channels (for example, by telephone or face-to-face) would still be able to do so.

The specific details and features of the account would be determined in light of research on client preferences and involvement of clients in its design.

Use of defaults and 'nudges', including pre-filled tax returns

As noted above, it is well recognised that many aspects of observed human decision-making differ from the so called 'rational' behaviour of individuals assumed in economic models. This has a major impact on decision-making behaviour. People are fearful of losses, handle risk inconsistently, dislike uncertainty, are prone to procrastination, tend to stick with the status quo and are easily swayed by irrelevant numbers. For all but the simplest of decisions, people generally do not attempt to find the optimal solution, but rather apply simple decision-making strategies rather than searching for the best outcome (Dunstall & Reeson 2009).

Insights from human behavioural research indicate how choices are presented to clients in complex systems, such as the tax and transfer system, can have significant impacts on the decisions those clients make (Dunstall & Reeson 2009). To help clients to make choices in their best interests and so to protect their wellbeing, the Review recommends the application of the results of this behavioural research to the administration of the tax and transfer system. This should include utilising assisted decision-making and choice 'nudging' in relation to complex decisions to alleviate the burden of complexity.

A focus of the application of behavioural research should be on providing people with assistance to comply with obligations they find the most difficult. The major one for most individuals is filing their income tax return. Completing income tax returns is a major reason for individuals seeking the assistance of intermediaries such as tax agents. Greater pre-filling of client information into income tax returns is a major way to alleviate this burden for clients, and to improve their experience of the system. With more information pre-filled, the ATO might be able to send returns directly to people. The ATO might still ask the taxpayer to confirm the information in the return and to add any additional information if the person has more complex affairs. But, for most people, the pre-filled return would be a reasonable default. Those who chose to accept it could avoid the complexity of the process of lodging a tax return, as well as the expense of a tax agent.

Recommendation 123 proposes that pre-filled personal income tax returns be provided to most personal taxpayers as a default method of settling their tax affairs each year.

Box G4-5: How pre-filling of tax returns could assist clients in the future

Providing clients of the future tax system with default pre-filled tax returns will be of great benefit to many people.

People with very simple tax affairs (for example, those with employment or bank deposit earnings that have been reported to the ATO) could be sent a pre-filled tax return by the ATO. If correct, these taxpayers could simply confirm the return's details and finalise their tax obligations for the year without resorting to a tax agent. Based on 2007–08 data, around 11 per cent of tax return filers (around 1,380,000 people) could benefit from this approach.

Again, based on 2007–08 estimates, a further 31 per cent of tax filers (3,820,000 people) with deductions for expenses such as work-related expenses and the cost of managing tax affairs would only need to decide whether to accept the standard deduction calculated and pre-filled by the ATO, or provide additional information where their expenses exceeded the standard deduction threshold. Beyond this, a further 14 per cent (1,790,000 people) of filers would need to provide details of gift deductions.

This means that up to 56 per cent of tax filers, or around 7 million people, could complete their annual tax obligations by accepting the standard deduction and specifying the amount of their eligible deductible gifts.

In addition to these people with fairly simple affairs, a further 25 per cent of tax filers (around 3,160,000 people) would have had only had one further label to complete on their tax return to finalise it.

(ii) Policy reforms to simplify the client experience

Policy changes to align definitions and processes in different parts of the system and to simplify rules for determining tax liabilities and transfer entitlements would make the system easier for people to understand and interact with. It would also assist the system being able to do more for them.

For example, there could be greater alignment of income definitions between the tax system and the transfer system. A large number of different income definitions are currently used for different purposes. Moves towards greater commonality of tax income definitions with the transfer system would reduce complexity and simplify the client experience. They would also facilitate streamlined reporting arrangements for clients.

Policy reform to rationalise the number of deductions and offsets for personal income tax would also simplify the experience for clients. As discussed in Section A1 (Personal income tax), the Review recommends that a wide range of deductions and offsets be rationalised and removed from the system, and that a standard deduction be adopted for work-related expenses and for the cost of managing tax affairs. Rationalising deductions and offsets would reduce record keeping requirements and simplify completion of personal income tax returns. It would also enable the ATO to provide a significant proportion of taxpayers with a substantially complete pre-filled personal income tax return as a default.

Streamlining mandatory administrative requirements for clients of the tax and transfer system would also simplify the client experience. Significant administrative requirements present themselves to tax and transfer clients (especially in relation to applying for transfers)

as a large number of forms require clients to physically sign and return them, either by mail or in person. Clients may also need to provide original or certified copies of documents, either by mail or in person, to establish their identity or support their application. These cumbersome requirements are a source of constant irritation for clients. To facilitate an improved client experience, the Review recommends such administrative requirements be reformed to relieve clients of unnecessary contact and administrative burdens and provide clients with more convenient service delivery channels.

To ensure these improvements to the client experience of the system are maintained, future tax and transfer policy proposals should be subject to comprehensive impact statements. The effect new policy proposals have on administrative systems (such as technology and administrative application processes) supporting the client experience, as well as on the overall experience of clients interacting with the system, should be determined. These impact statements should be published.

Recommendation 124 proposes that existing tax and transfer provisions be reformed to support improvements in client experience, and future new policy proposals should be subject to comprehensive, published expected impact assessments on client experience systems and outcomes.

(iii) Greater use of real-time third-party reporting

Recommendation 125 proposes that, where possible, information required for determining tax liabilities and transfer entitlements should be collected from third parties, including employers, government agencies, financial institutions, and share and property registries.

More extensive third-party reporting of information needed to determine tax liabilities and transfer entitlements would mean people would need to do less themselves. Real-time reporting of this information and visibility of these flows through a person's client account would enable the system to be more responsive to changes in circumstances and more transparent to individuals.

A wide range of information about clients is provided to tax and transfer agencies by third parties such as employers and financial institutions. This information is used for a range of tax and transfer (and other) purposes, including confirming entitlement to transfers, but is not generally provided to agencies in real time.

If wage and salary information from employers, information about interest paid into bank accounts and information from property and share registries were reported to tax and transfer agencies in real time, clients would be able to meet many of their obligations under the system without having to do anything further. If salary data were reported in real time to a transfer agency, for example, a client's transfers could be recalculated immediately.

A first impression may suggest that such changes could create (possibly significant) additional compliance burdens for third parties. However, aligning such information reporting requirements with natural systems of businesses (such as the payroll system which processes payment of fortnightly salaries of employees) through the use of current and emerging technology, means that after the transition to these changed requirements is complete, overall compliance costs for businesses may actually fall.

These approaches could build on the experience of the Australian government's Standard Business Reporting (SBR) Program (see Box G4-6). The SBR Program is streamlining reporting requirements for business by working with developers of business software to ensure reporting information is held in a consistent way and reports required by regulatory and revenue authorities can be automatically generated.

Box G4-6: Standard Business Reporting

The report of the Taskforce on Reducing the Regulatory Burden on Business, *Rethinking regulation*, released in April 2006, recommended a whole-of-government business reporting standard. In 2008, the Council of Australian Governments endorsed SBR as one of nine additions to the regulation reform agenda.

The main goal of the voluntary SBR Program is to reduce the regulatory reporting burden on business by developing a single set of reporting definitions in a single language. A further goal is for the information to be sent directly and electronically from the business' systems to participating agencies.

From July 2010, businesses and their intermediaries will be able to see complete or partially complete reports, edit and confirm the details, and send these reports electronically to the appropriate government agency directly from SBR-enabled accounting, financial and payroll systems. Financial reporting is the initial focus, since this affects most businesses. Forms in scope include the ATO's Business Activity Statement, ASIC's Financial Statement and payroll tax administered by State and Territory revenue offices.

SBR is expected to result in businesses and their intermediaries spending less time preparing reports for government, with savings expected to reach approximately $800 million per year when fully implemented (Madden 2009).

Strategies such as the SBR Program (and approaches that build on it) will not just facilitate improving the experience people have of the system, but will also help improve the experience businesses have of the system. Among other things, such strategies will alleviate business compliance costs that arise out of interactions with government (see Recommendation 126).

The capabilities provided by the SBR Program will produce significant improvements in relation to government reporting for businesses. The benefits to business of using SBR, however, are not limited to government reporting. The use of SBR's reporting definitions, and the process of mapping those definitions to the information held in businesses' accounting and financial systems, offers further potential for improving reporting both within and between business entities.

Box G4-7: Building on Standard Business Reporting — beyond 2010

The current scope of SBR focuses on the high volume and frequent financial reporting by businesses. Once the current scope and base capability of SBR is delivered and bedded down, work will begin on increasing SBR's scope.

The key design principles for SBR involve the development and implementation of a single set of definitions and language for government reporting; enabling business accounting and financial systems to become the portal for business to report to government; as far as possible, making reporting to government a by-product of natural business systems and processes; and applying open and international standards based approaches wherever possible.

These principles have been applied to the current SBR design and it is intended the principles will be applied to other forms of reporting from business to government where information in accounting and financial systems can be leveraged to satisfy reporting requirements.

Further areas of reporting that would quickly leverage the SBR approaches include extension of the use of the 'single SBR credential' to other government agencies; occupational health and safety and workers' compensation reporting; the not-for-profit sector to enable the development of the proposed single chart of accounts; Department of Human Services requirements in relation to employees (for example, those of Centrelink); the superannuation industry; the Carbon Pollution Reduction Scheme; and sustainability reporting.

Given the SBR business model (and possible approaches building on it) relies on reporting directly from the accounting or financial systems used by business, the benefit of such approaches will increase in line with the number of businesses that use them. Use and acceptance of SBR approaches to reporting will be further enhanced by encouraging and enabling small businesses to adopt these approaches wherever possible.

It is well accepted that compliance costs have a proportionally greater impact on small businesses than on larger businesses, and these costs appear to have been growing over time (Board of Taxation 2007). Governments have made progress to help small businesses reduce compliance costs through a mix of education, streamlining administration and tax concessions. A further approach government could adopt to support small businesses to comply with the tax system (and help them improve people's and their own experience of the system) is by assisting them to be 'business-ready' to meet their reporting and compliance obligations when they commence business (see Recommendation 127).

Such assistance would aid small business to cope with their tax compliance obligations and to make informed investment decisions from the outset. Such assistance could include supporting small businesses to obtain professional accounting and legal advice in establishing their record keeping and accounting processes/systems, or assisting them to acquire appropriate technology in order to manage the taxation and other regulatory systems.

Despite the value of existing programs designed to help small businesses with their taxation obligations, there may be opportunities to provide assistance beyond current education and

training, such as providing financial assistance to seek professional advice, or acquiring technology that enables electronic lodgement of forms and record keeping. Such an approach would provide an incentive to the software industry to develop products fit for purpose for small businesses but able to be scaled up to larger operations as the business grows. Such assistance, for example, could include providing support to small businesses to help them into (so to receive the benefits of) the SBR Program (see Recommendation 127). This assistance may consist of providing small businesses with a voucher that can be spent on software or technology to enable their business to utilise SBR.

As noted previously, relying on the 'natural systems' of third parties is also likely to improve the integrity of the system through more comprehensive and accurate provision of information.

Greater use of real-time third-party reporting would require legislative change to authorise it and, over time, make electronic reporting mandatory. Currently the rules about electronic reporting to government vary depending on the type of obligation. In some cases only large organisations are required to use electronic channels but many smaller organisations choose to deal with government electronically because of the convenience and efficiency offered. To enable individual citizens to access automated tax and transfer reporting, the third parties with which they have financial relationships will need to provide data to tax and transfer agencies that is accurate, timely and presented in a format that can be used by the client account.

(iv) Information standards to support interoperability

To take advantage of advances in technology and innovations in service delivery, urgent attention is needed to develop and adopt information standards that support interoperability of government and private sector systems. Specific initiatives, such as the client account and enhanced pre-filling, will not be possible without such standards.

Currently, government information management is fragmented. Client information and data are currently recorded in many different ways by various government and private sector bodies. Even simple things such as names and addresses are not recorded in a uniform way by such bodies. To facilitate a better client experience, it is important that information about a client can be recorded in a standard format that is easily interchangeable. Even with advances in information technology and data matching, verification of non-uniform client information can be a difficult and time-consuming process.

Development and adoption of standards is a substantial undertaking requiring a disciplined approach. The SBR Program provides a useful illustration of the processes and governance required to streamline and standardise information collection across multiple agencies and levels of government. The SBR Program has identified a potential reduction of 71 per cent in the number of unique pieces of data that business has to assemble, analyse and report to government — cutting it from 9,648 to 2,838 (Madden 2009).

Recommendation 128 proposes that common information standards, leveraging from the standards and governance put in place by the SBR Program, should be developed and adopted.

(v) A modern privacy and secrecy framework

People will be more willing to engage with a system that they trust and that is transparent to them.

Maintaining trust needs to be married with people's expectations that they should not have to provide government with the same information many times. Under the current tax and transfer system, where clients provide information to one government agency, that agency is sometimes unable to provide the information to other government bodies, due to privacy and secrecy laws. These laws limit the types of information that can be shared with other agencies and the circumstances in which it can be shared.

Having a modern privacy and secrecy framework that facilitates exchange of client information between government bodies would improve client experience of the system. Such a framework would, among other things, support the pre-filling of client information into application forms for transfers as well as the pre-filling of income tax returns.

The Commonwealth's secrecy and privacy laws are currently under examination.[10] In line with the general directions for change emerging from these processes, the future client experience will need a privacy and secrecy framework that obtains informed consent for broader use of information collected by any specific agency. This is likely to involve broadening the scope of the 'purpose for which the information is collected' to include supporting the management of a person's financial relationship with government.

Recommendation 129 proposes that a modern privacy and secrecy framework be developed and adopted.

A building block for facilitating information exchange is common authentication processes. For information to be exchanged easily between different types of organisations and entities, a reliable method is required for identifying records relating to a specific individual across different systems.

Currently many different client identifiers are used by federal, State and local government agencies. Private sector organisations use their own identifiers. A more efficient exchange of client information to facilitate improved client experience of the tax and transfer system requires either consolidation or linking of these identifiers (see Recommendation 130).

Linking records can have a number of benefits. These include increased administrative efficiency and enhanced data accuracy. It can also support evidence based policy development by facilitating drawing together administrative data into longitudinal cross agency sets. Academics and other external researchers could then access suitably confidentialised extracts.

On the other hand, linking records raises a number of privacy issues such as a possible change in the relationship between the individual and those they provide information to. Such a change in relationship could occur because the amount of client information available

10 The Australian Law Reform Commission is currently reviewing the Commonwealth's secrecy laws. The Government's response to the Australian Law Reform Commission report 'For Your Information: Australian Privacy Law and Practice' was released at the Australia and New Zealand Chapter of the International Association of Privacy Professionals conference in Melbourne on 14 October 2009.

to different government agencies may possibly be broader and much more detailed than what is currently available to those bodies.

Health information is especially sensitive because it is very personal to individuals. For the purposes of privacy law, health information includes details about a person's health, any disabilities they may have, and medical treatments they may have undertaken. Due to the sensitivity attached to this information, it attracts additional privacy protections. Reforms under way to the Commonwealth's privacy laws, as well as initiatives to improve service delivery to individuals, acknowledge the delicate nature of such information. Given this sensitivity, health records should not be linked to arrangements discussed above.

An alternative (or perhaps a stepping-stone) to either consolidation or linking of client identifiers by government could be for clients to choose to link their various identifiers. Where individuals wanted the improved service benefits such linking could provide, they could choose to link their identifiers. As a result, when an individual filed their tax return or applied for a benefit, they might be asked to provide (once) multiple identifiers (for example, their tax file number, Medicare number and Centrelink reference number). Thereafter, these numbers would be linked and their client service enhanced.

(vi) Institutional reform

The existing institutional framework for taxes and transfers makes it difficult to achieve reforms that improve client experience quickly or reliably. As noted earlier, this is because initiatives to improve client experience in the system are largely progressed on a portfolio or organisational basis. Portfolio priorities thus determine what improvements are made. Portfolio priorities also tend to be given greater weight than cross-portfolio objectives, such as improvements in the way clients experience the whole system. Further, new policy objectives adopted in either the tax system or the transfer system (or other parts of government) may compromise future client experience objectives. Improving the client experience of the tax and transfer system requires a whole-of-system approach to governance.

Canada is considered an international leader in integrated service delivery. It has coordinating councils and support organisations that contribute to the development of common standards and approaches to integrating services and technology between agencies and levels of government.

In Canada, the Public Sector Chief Information Officer Council and the Public Sector Service Delivery Council have been in existence since the late 1990s. They bring together federal, provincial/territorial and municipal officials to exchange information on best practices, conduct joint research, adopt common practices and collaborate on service delivery.

Further, the Institute for Citizen-Centred Service (ICCS) is a non-profit organisation with a board of directors made up of leaders in service delivery and information technology from municipal, provincial and federal public sectors across Canada. The ICCS undertakes research to identify citizens' service needs and expectations, to assist the public sector in identifying and applying innovative, best practice service solutions, and to respond effectively to citizens' service needs.

The above initiatives may well be worth considering in the Australian context, but go beyond reforms of the tax and transfer system.

To achieve the narrower objective of improving client experience of the tax and transfer system, the Review recommends that a high-level taskforce be established under central agency leadership with the task of progressing the recommendations contained in this section (see Recommendation 131).

The taskforce could take a similar form to the SBR Program. There would be a small expert secretariat charged with implementing the reforms. It would need members with a mix of skills, with membership drawn from relevant government agencies as well as the private sector, including tax and transfer client representatives.

Key functions of the taskforce would include developing, consulting and overseeing reforms of the administrative arrangements and technologies that deliver the client experience of the tax and transfer system. The taskforce would regularly report on its progress to the Australian government and to Parliament. Additionally, to achieve its aims, the taskforce would lead consultations with relevant stakeholders, including citizens, privacy advocacy groups, professional associations, financial institutions and employer groups.

As a range of government processes are currently exploring citizen-centric service delivery, the taskforce would also be responsible for positioning the client experience reforms within the government's overall initiatives to improve the interaction between government and people.

The Review has gained great value from its public consultations and supports citizens being given more opportunity to contribute to service delivery design of the tax and transfer system.

There are some interesting international examples of getting citizens involved in service delivery reform. In 2003 the Belgian Secretary of State for Administrative Reform was asked to reduce the 'rigmarole' experienced by citizens and businesses in dealing with government regulation. Contact points were set up where people could make remarks and suggestions about administrative simplification. Every day, www.kafka.be received about ten proposals on how to improve existing regulation. As a result, within four years more than 200 laws and regulations were abolished or simplified.

In Australia, the Gov 2.0 Taskforce has been formed to investigate how the Australian government can use new 'Web 2.0' approaches to expand the uses of Commonwealth information and improve the way government consults and engages with citizens. The taskforce will make recommendations on how to maximise the extent to which government utilises the views, knowledge and resources of the general community.

Similarly for the proposed taskforce, a mechanism for engaging citizens in service delivery reform and capturing feedback from citizens on government service delivery, including both current administration and new proposals, would be of benefit. The ability to confirm with citizens what their preferences for improved client experience are, and to test possible reforms before implementing them, would be of great value.

Box G4-8: A day in the life of clients of Australia's future tax and transfer systems

Abby and Hank are a couple with two children. Abby works full time and Hank will be starting a new job tomorrow, after taking a year off from work to care for the children.

Updating his personal details with regard to the new job, Hank logs onto his government client account and in one transaction is able to provide his updated details to all relevant private and public sector bodies. This includes advising his employer of his tax file number and withholding details, and advising Centrelink of his employment income that may lead to changes in family or other transfer payments.

A month later, Hank accesses his client account to see a summary of his whole relationship with government, including his running balance of tax liabilities and transfer entitlements in real time. Hank checks his salary details, tax liability and transfer payments to determine what impact his employment income has had on his transfer payments. He uses a link to his superannuation account to check that payments of superannuation by his employer have commenced. Abby logs onto her client account and verifies that her details about transfer payments are the same as Hank's.

At the end of the financial year, Abby and Hank log onto their client accounts to see what transfers they received and the tax-related information used to finalise their affairs for the year. Using the client account, Abby and Hank's tax affairs are straightforward. Neither has to fill in a tax return as all relevant information has been collected from third-party information systems. They are both provided with a statement of their annual tax result.

The experience of clients of the future tax and transfer system such as Abby and Hank is much simpler, more transparent, accessible and timely than it was for clients in 2009.

G5. Monitoring and reporting on the system

Key points

Monitoring the tax and transfer system is essential to its long-term performance. Without government action, too little information will be collected about the operation of the system. This information is necessary to identify areas where particular transfers or taxes are not meeting their policy objectives. It can support research that improves understanding of the effects of the system, and guide policy responses to emerging problems.

High standards of transparency and accountability should apply to all forms of taxation, transfers and government expenditure. However, despite their similarities, tax expenditures and spending programs are not created, maintained, reviewed or reported in the same way. This means that there is often less transparency and accountability in the use of tax expenditures. While this situation continues, programs should not be delivered as tax expenditures unless there is a clear countervailing benefit in terms of efficiency, equity, complexity, sustainability and policy consistency.

G5-1 Monitoring the performance of the system

Australia needs a tax system that is efficient, equitable, simple, consistent and sustainable in the long term. Monitoring the system is essential to judging its performance against these criteria. Where possible, the performance of specific taxes and transfers should be measured objectively to identify whether they are meeting their policy objectives or not. An objective evidence base can reinforce public and government support for successful economic reforms (Wilkie & Grant 2009), and helps to determine when existing policy settings are no longer appropriate.

The Review has undertaken widespread public consultation in forming its recommendations and has been presented with many conflicting points of view. The judgment of experts about what to tax, and how, departs markedly from current practice in many cases. Moreover, there is no community consensus about existing taxes. Very few taxes received consensus support in submissions; many attracted conflicting recommendations, while a few received both condemnation and praise.

Sometimes, differences in opinion about taxes depend on underlying values or ideology. However, viewpoints are sometimes based on theory or conjecture that can be proved or disproved by appeal to the evidence. Wherever possible, policy-makers should draw on empirical observations in Australian conditions (Leigh 2009).

This becomes more important as governments seek to use tax-like instruments for a range of purposes beyond raising general revenue. For example, quite detailed knowledge is required to set rates of tax to correct market failures. To ensure such taxes actually make society better off overall, they should be calibrated to reflect the latest evidence on marginal social costs and benefits of different activities (see Section E Enhancing social and market outcomes).

Box G5-1: Better evidence is needed to set the rate of alcohol tax

Some taxes, such as congestion taxes and alcohol taxes, are designed to correct spillovers (or 'externalities'), which occur when individual decision-makers fail to take into account the impact of their actions on others. These taxes, while theoretically sound, are hard to implement in practice because objective and reliable information on marginal social costs is often not available.

This makes it difficult to set rates that actually target spillover costs. In the absence of clear evidence, the public may perceive a conflict of interest between setting tax rates to target social problems, and raising revenue. An acute example is the taxation of alcohol (see Section E5 Alcohol taxation).

In submissions and in meetings with the Review, stakeholders stressed the need for data based on an impartial, transparent and open methodology. These data could then form the basis for determining tax rates. For instance, the National Drug Research Institute (NDRI) submitted that:

> The drinking culture and characteristics of countries vary, as does that of different demographic and psychographic groupings within countries. Trends, behaviour and disposable income change over time. It is necessary to develop relevant data and to continually update those data.
>
> To optimise tax settings designed to influence price points as a contribution to safer and healthier consumption of alcohol, continual empirical scientific study is needed on price elasticities, cross-elasticities and substitution effects in the Australian context (Stockwell & Crosbie 2001). Such research needs to be done independently of vested interests. NDRI urges the Government to provide substantial ongoing funding for such work.

The paucity of information on some specific taxes or transfers means that data designed for other purposes are often used for analytical purposes. For example, the Review has received many submissions from a range of stakeholders about the taxation of alcohol. In making their arguments, many submissions relied on evidence about the social cost of alcohol consumption, drawing on Collins and Lapsley's cost of illness studies (2008b) as well as survey data from the National Health and Medical Research Council. However, the findings in these studies cannot be directly imported into a tax policy context. In his research for this Review, Cnossen (2009) highlighted some of the methodological issues involved.

As a means of increasing the availability of evidence and informing debate, the Review Panel has commissioned a series of papers to explore significant tax and transfer policy issues.

Principles

Monitoring the system is essential to judging its long-term performance. Where possible, governments should objectively measure the performance of specific taxes and transfers to identify whether they are meeting their policy objectives or not. Data on the tax system should be freely available to the public.

Data on the tax system are a public good and should be freely available

Unbiased and systematically collected data on the tax system, based on widely accepted methodology and appropriate for tax policy purposes, are rare and often not available in the public domain. Because such information is a public good (see Section E1 on user charging), and even though society would benefit through improved tax policy based on it, incentives for individuals or businesses to produce it are weak. In addition, the capacity of non-government actors to generate this type of information is limited when government holds much of the data needed to conduct analysis.

Some data on the effect of taxes and transfers are already being produced. In many submissions to the Review, stakeholders have supported arguments with data that range from in-house survey results to more sophisticated economic modelling. The Review has considered this information in coming to its recommendations. However, if the underlying sources and methodology are not transparent, it is difficult to judge between competing claims.

There is a greater risk of biased evidence where the functions of data collection and analysis are not clearly separated. If data are gathered for the purpose of supporting a particular argument or interest group, they are unlikely to persuade those with competing interests.

In some cases, estimates are produced, but only as a snapshot at one particular point in time, and often only on a small or partial scale. For example, while there have been a few studies of compliance costs imposed by the tax system (such as Pope 1994 and Evans et al. 1997), there has been no aggregate study of compliance costs in Australia since 2000 and there is no system-wide study of compliance costs that can monitor, on an ongoing basis, the costs of complexity. Proxies, like the number of tax agents or the length of the income tax laws, are of limited policy use. Well-designed system-wide surveys are expensive, but they would provide valuable information on where simplification would yield the greatest returns.

There is also little published information about the extent of non-compliance with the tax laws. The Australian Taxation Office (ATO) does not currently attempt to derive aggregate estimates of non-compliance for key income and deduction items or publish detailed results of its non-compliance activities.

There is very little information on compliance costs incurred by clients in meeting their obligations in respect of transfer payments — for example, in claiming payments, reporting earnings or changes in income and participating in reviews of their entitlements. However, Centrelink and various policy agencies conduct a range of surveys and analytical exercises that could be extended to provide better, ongoing information about client compliance costs.

The reliability of information could be improved by adopting a consistent methodology, classifications, concepts and data collection approaches that could operate as a common standard for tax data, irrespective of who produces it. This would improve the capacity of business, academics and government agencies to produce evidence to inform the policy process.

The prime consideration for the collection of data is to ensure that collection is not biased. The Australian Bureau of Statistics might be best placed to conduct surveys on compliance costs, as well as the social costs associated with particular activities (for example, the consumption of alcohol, tobacco or transport).

Existing data sources could be better utilised

In the past, Australian tax unit record files have not been generally available for research purposes. However, in 2009 the ATO produced and released a confidentialised 1 per cent sample file containing individual tax return information. Over time, expanded availability of this, and similar data for other taxes, would allow deeper analysis of the individual-level effects of the tax system. These data should only be used for statistical purposes, and should never be provided in a form in which individual privacy could be compromised. The guarantee that data will be kept confidential produces better quality data and higher response rates. Further developing protocols for making such data available for research purposes would unlock valuable public information resources.

Data on the transfer system are more readily available than tax data. Confidentiality and privacy concerns are addressed by providing de-identified data under strict terms relating to its use and safe storage. Research undertaken using social security data has generated many insights that have fed into policy development, including information on the persistence of welfare dependence among specific groups, the 'transmission' of welfare dependence between generations, the responsiveness of different groups to policy changes, and the effectiveness of policies in achieving their intended outcomes. Linked datasets, especially longitudinal datasets, are a powerful tool for evidence based policy. The experience of the Department of Families, Housing, Community Services and Indigenous Affairs (FaHCSIA) has highlighted the considerable benefits that can be derived from making this type of data available to academic and other researchers.

Findings

Unbiased and systematically collected data based on accepted methodologies and appropriate for policy purposes are rare and often not publicly available.

While society as a whole would benefit through improved tax policy from this information, the incentives for individuals or businesses to produce it are weak. Also, the capacity of non-government actors to conduct analysis of the system is limited when much of the information needed to do this is held by government.

Periodic analysis is needed to judge the system's performance

Recommendation 132:

The government should, every five years, publish a Tax and Transfer Analysis Statement that analyses and reports on the overall performance and impact of the system, including estimates of efficiency costs and distributional impacts.

Recommendation 133:

The Australian and the State governments should systematically collect data on aspects of existing taxes and transfers — including compliance cost data — according to consistent and transparent classifications and concepts, and make this information — including confidentialised tax unit records — freely available for further analysis and research.

Recommendation 134:

The government should support one or more institutions to undertake independent policy research relevant to the Australian tax and transfer system.

Australia needs a tax and transfer system that is efficient and equitable in the long term. To see whether these objectives are being met, it is important to analyse and report on the system's performance objectively and comprehensively. Currently, no such assessment of the system is undertaken.

Instead of assessing the performance of the tax and transfer system as a whole, it has become customary to consider elements of the system separately. As a consequence it is difficult to get a sense of the system's combined performance and effects, and to determine whether the system is making a coherent contribution to our national objectives.

The tax and transfer system is subject to continual change, and operates in a constantly evolving environment. Periodic analysis is needed to ensure it continues to perform as intended, and to identify areas that require attention. In theory, it might be desirable to constantly review and assess the system, but this is not feasible in practice. Instead, the Australian government and the States should periodically report on the performance of the entire system in a 'Tax and Transfer Analysis Statement'. This assessment could be carried out at regular intervals, such as every five years, to balance costs and benefits of the exercise (see Recommendation 132). The Australian government should initiate this change, with the Council of Australian Governments to examine the ways in which the States could follow suit.

Among other things, the Statement could estimate the total and marginal efficiency costs of taxes, tax expenditures and means tests. It could include information about the economic burden and distribution of taxes and transfers, and about tax expenditures not possible to publish in the annual Tax Expenditures Statement (discussed below). The problem of tax evasion and avoidance could be monitored and assessed by publishing detailed estimates of the level of non-compliance. This would inform the policy and administration changes needed to maintain the integrity of the system.

The Tax and Transfer Analysis Statement would contribute to ongoing research and debate about the objectives and performance of the tax and transfer system. Academics, practitioners and the general public should be encouraged to contribute to, and contest, the analysis presented in the Statement. All data used in the analysis and a full description of methodologies should be available to the public and ideally subject to peer review.

Government agencies should ensure that data on all aspects of the tax and transfer system are shared as widely as possible (see Recommendation 133). Provided that confidentiality of individual records is guaranteed, as much data as possible should be freely available to researchers, universities, think-tanks, businesses, other agencies and the public at large. While the analysis of this data would clearly be contestable, it would help provide a common point of reference for discussions of the tax and transfer system.

Another approach would be to establish an academic institution or a partnership between institutions that could draw funding from public and private sources to undertake tax research and evaluation (see Recommendation 134). An arrangement like this exists in the United Kingdom, where an independent business tax research centre is funded by the

business community and has access to government data sources.[11] Similar bodies operate in Australia, in other areas of research.

On the transfer side of the system, the Department of Families, Housing, Community Services and Indigenous Affairs funds research organisations to provide it with independent, high-quality research services. The research allows social policy to be made on a strong evidence base and permits information, data and analysis to be disseminated for public use. Aside from ongoing formal arrangements such as these, there is also a role for conferences and other forums to facilitate open discussion between public officials and private sector experts.

Any government institution would need to be careful not to 'crowd out' analysis from universities, think tanks and peak bodies. However, it could identify and help fill gaps in analysis, or identify where there are holes in the data available to researchers.

G5-2 Managing, measuring and reporting on tax expenditures

The main objective of any tax system is to raise revenue to fund government activities. However, the system also provides a government with the opportunity to achieve objectives directly, by reducing taxes to encourage certain activities and to direct assistance to particular groups. These forms of assistance are known as tax expenditures.[12] They can be provided in many ways, including through exemptions from tax, tax deductions, tax offsets, concessional rates of tax, a change in the timing of a deduction or the deferral of a tax liability. Not all concessions delivered through the tax system are tax expenditures. For instance, some refundable tax offsets are classified as spending programs, even though they are administered through the tax system.

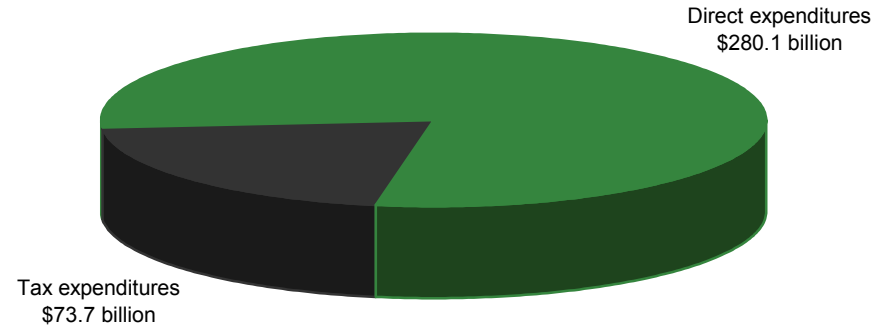
Tax expenditures provide many billions of dollars of relief from taxes, with significant effects on the budget and the economy. They reduce revenue that, if collected, would have been available to fund spending programs to meet similar objectives. Accordingly, their net effect on the budget is similar to that of spending programs. Assuming the case for government assistance has been made, a decision for policy-makers is whether to deliver that assistance by making a direct payment (such as a grant) or conferring a tax concession.

High standards of transparency and accountability should apply to all forms of government expenditure to engender greater community trust in, and therefore engagement with, the tax and transfer system.

11 The Centre for Business Taxation was established in 2005 as an independent research centre of the University of Oxford.

12 The focus of this section is on those tax expenditures that reduce tax liabilities. However, the tax expenditure concept is defined as being any deviation from the 'normal' tax benchmark, and so also includes aspects of the tax system that increase tax liabilities. These 'negative tax expenditures' might be thought as being equivalent to a fee or an additional tax.

Chart G5-1: Tax expenditures and direct expenditures in 2007–08



Source: Tax Expenditures Statement 2008.

Principles

Tax expenditures should ideally be subject to the same levels of transparency and accountability as equivalent spending programs. Without such transparency and accountability, programs should not be delivered as tax expenditures, unless there is a clear countervailing benefit in terms of efficiency, equity, complexity, sustainability and policy consistency.

Comparing tax expenditures and equivalent spending programs

Despite their resemblance, tax expenditures differ from spending programs in a number of ways. For instance, tax expenditures often receive Parliament's attention only at the time they are introduced, and they are subject to a less comprehensive management and reporting framework than spending programs. These differences, examined in more detail below, are often the source of concerns about the transparency of tax expenditures.

Tax expenditures and direct spending programs are often designed in quite different ways. In particular, the design of tax expenditures is often constrained in practice by the policy, legislative and administrative framework of the tax system. These constraints can significantly affect the efficiency, equity, complexity, sustainability and policy consistency of tax expenditures.

Efficiency

Like direct expenditure programs, tax expenditures can impose efficiency costs by encouraging taxpayers to undertake tax-favoured activities at the expense of other activities.

Some tax expenditures aim to correct market failures and so may improve efficiency by encouraging activities that would otherwise be underprovided. However, governments aim to encourage such activities without providing a windfall gain to people who would undertake them without the tax expenditure. It can be difficult for governments to set the level of a concession that encourages the favoured activities to the intended extent. This can also be true of spending programs. However, the fact that tax expenditures are typically claimed at the end of a financial year means there is less opportunity for the government to monitor the effect of the tax expenditure during the year to ensure it is having the desired effect.

On the other hand, use of tax expenditures rather than spending programs can reduce the need for direct government supervision of a policy, thereby saving administration costs. For example, there may be administrative savings from using the tax system rather than establishing a new bureaucracy to implement a spending program. However, in some cases the costs of a tax expenditure may simply not be as apparent. While establishing a new agency will have obvious budgetary and administrative costs, the extra costs borne by the tax administrator may not be as obvious.

In some cases, the tax system is a more administratively convenient way of delivering assistance than an equivalent spending program. However, the tax system may not be as efficient for the types of assistance that depend on characteristics not commonly reported in tax returns.

Finally, there is a question about the ability of the tax authorities to deliver non-tax programs efficiently. Naturally, tax authorities have built their expertise around the collection of taxes. The proliferation of tax expenditures has increased pressure on tax authorities to develop the ability to deliver other programs. It is important to consider whether the tax authority is properly equipped to perform this role, and also whether this impedes the ability of the tax authority to perform its core revenue collection function.

Equity

Many tax expenditures have been introduced to improve the fairness of the system. However, some tax expenditures actually reduce the equity of the system by directing benefits disproportionately to people on higher incomes.

For example, some tax expenditures directed towards individual taxpayers are delivered through income tax deductions. Progressive rates of the personal income mean these tax deductions have a greater value for those on higher incomes.

This is not an inherent weakness of tax expenditures as a policy tool. Rather it is a consequence of delivering particular tax expenditures as personal tax deductions, when they could have been provided as tax offsets (which have the same value to all recipients).

Complexity

Tax expenditures can add complexity to the tax system. They complicate the law and create additional choices for people. They can generate unintended opportunities for tax planning.

While providing a benefit through the tax system may reduce program administration costs, in practice it may impose extra compliance costs on taxpayers who need to understand how the concession applies. It may also impose costs on taxpayers who do not benefit from the tax expenditure, particularly in a system of compulsory filing. Moreover, as new tax expenditures are added, complexity increases because taxpayers need to understand the compounding number of interactions between the many rules.

Most tax expenditures could be delivered as direct expenditures. This would improve the tax system but would not necessarily reduce the overall level of complexity imposed on society. In the end, the focus should be on total complexity, regardless of whether that complexity arises within or outside the tax system.

Sustainability

Tax expenditures should be considered in light of revenue sustainability. Policies need to be affordable over the longer term, particularly in light of the demographic challenges facing Australia.

Tax expenditures can be difficult to contain. They can lead to erosion of the tax base as different groups put their case for further concessions. Once the system features a number of tax expenditures, the case for further tax expenditures is strengthened. In other words, the special treatment of one sort of taxpayer or activity tends to weaken the benchmark treatment against calls for similar concessions for other taxpayers or activities.

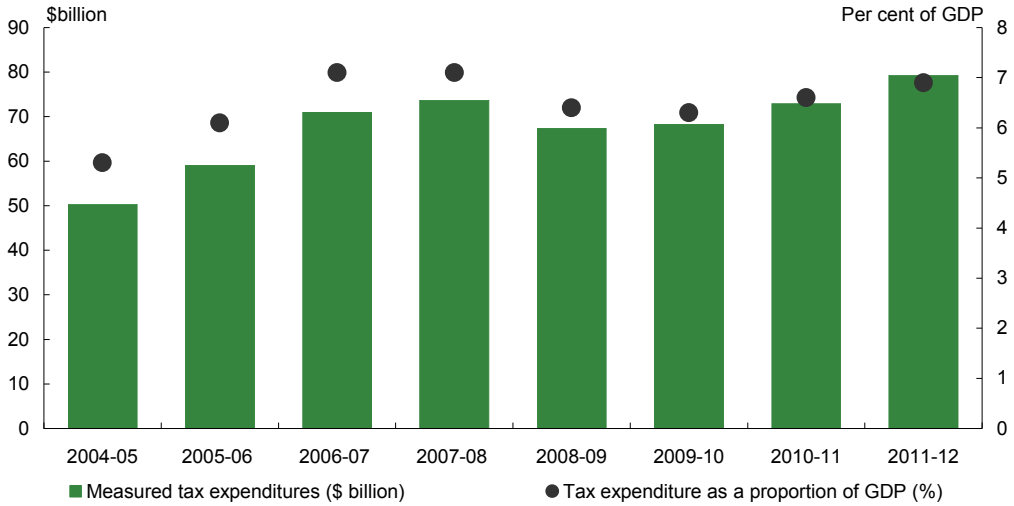
Tax expenditures can make it difficult to appreciate the extent of government intervention. For instance, they can reduce both tax collections and direct expenditures, making government appear smaller than it would if the same policies were pursued through direct expenditures. Once a tax expenditure is established, it can be politically difficult to remove it because that can be portrayed as a tax increase.

The proliferation of tax concessions may also threaten the integrity of the system. Voluntary compliance of taxpayers is a valuable aspect of our tax system. In particular, the collection of income tax under a system of self-assessment depends heavily on the community's trust in, and commitment to, the system. Tax expenditures can undermine this trust, especially when they are seen to be unfair or complex. As noted above, the design of many tax expenditures, and their lack of transparency and accountability, can contribute to these perceptions.

Around 320 tax expenditures were identified in the *Tax Expenditures Statement* 2008. In the past five years, around 50 new tax expenditures have been added to the federal tax system. A similar number have been identified as tax expenditures for the first time during this period. The value of tax expenditures has risen from an estimated $50.2 billion (5.3 per cent of GDP) in 2004–05 to an estimated $73.7 billion (7.1 per cent of GDP) in 2007–08.[13] While tax expenditures are not projected to continue to grow at this pace, the figures highlight the significance of tax expenditures and the restrictions they impose on the government's ability to fund services.

13 Tax Expenditures Statements, various years.

Chart G5-2: Australian government tax expenditures



Source: Tax Expenditures Statement 2008.

Policy consistency

A final design principle is that the tax and transfer system should be consistent with broader policy objectives. This suggests that all policies should be considered in an integrated way, and that it is their combined impact that matters. This is particularly relevant when assessing the role of tax expenditures, since the justification for many of them lies in other economic and social policy objectives.

Findings

While tax expenditures and direct spending programs are conceptually similar they are often designed in quite different ways. The design constraints on tax expenditures can significantly affect their efficiency, equity, complexity, sustainability and policy consistency.

Determining whether the benefits of tax expenditures justify their costs depends on effective monitoring and scrutiny. Tax expenditures are currently subject to less comprehensive management and reporting than spending programs. This hampers the effective supervision of individual tax expenditures and means that, in many cases, it is not possible to work out whether objectives are being achieved.

Making tax expenditures more transparent and accountable

Recommendation 135:

The Australian government should ensure that the rules governing the development of the Budget encourage trade-offs between tax expenditures and spending programs. Budget decision-making processes should measure and treat tax expenditures and spending programs symmetrically, to ensure that there is no artificial incentive to deliver programs through one mechanism rather than another.

Recommendation 136:

The government should introduce legislation to amend the *Charter of Budget Honesty Act 1998* to recognise the publication of detailed information about tax expenditures in a Tax Expenditures Statement separate from the Mid-Year Economic and Fiscal Outlook (MYEFO). However, the Tax Expenditures Statement should continue to be released by the end of January in each year, or within six months of the last Budget, whichever is later.

Recommendation 137:

The government should ensure that reporting standards are independently developed for the identification and measurement of tax expenditures in the Tax Expenditures Statement. In addition, the standards should establish a basis for reporting the broader economic and distributional effects of tax expenditures in the periodic Tax and Transfer Analysis Statement (see Recommendation 132).

Recommendation 138:

The Council of Australian Governments should examine the ways in which the States could uniformly report tax expenditures annually according to the independent standards developed under Recommendation 137.

Encouraging trade-offs between tax expenditures and spending programs

The Budget is the government's key decision-making process for revenue policy. It is therefore the most important process by which new tax expenditures are created and existing tax expenditures can be reviewed.

Under the Budget process, tax expenditures are settled after spending measures. The two are not usually examined together. This means that tax expenditures are not directly compared with other policy priorities and new spending proposals. There are no formal processes to ensure that tax expenditures are prioritised against other spending or to assess the efficiency of a tax expenditure in achieving outcomes. This increases the risk that tax expenditures are not properly coordinated with spending programs in the same policy area.

Ministers may, in conjunction with the Treasurer, propose new tax concessions on the basis that the reduction in revenue is offset by savings from within the Minister's portfolio. In this way tax expenditures can be controlled at the policy development stage by ensuring that the cost of any new concession is counted against the relevant portfolio budget and that offsetting savings are required in the same way as for spending programs.

However, ministers are not usually able to claim as savings any increases in revenue that might flow from the removal of an existing tax expenditure. In the past, this has tended to discourage the replacement of tax concessions with equivalent spending programs.

A more symmetrical treatment of tax expenditures and spending programs as part of the Budget process would encourage trade-offs between them and would help to ensure that policy objectives are pursued at least cost (see Recommendation 135). To do this, however, requires that expenditures and tax expenditures are measured on a consistent basis.

The establishment of 'spending rules' that limit the size or growth of government spending can have the perverse incentive of encouraging new tax expenditures, unless there is a similar constraint on revenue policy. Such rules create incentives to use tax expenditures as substitutes for government spending. This was a problem Sweden experienced when it imposed a spending cap with no restriction on tax expenditures (OECD 2009a). Australia should be mindful of this example and ensure that the restraint applied to spending proposals is also applied to tax expenditures.

Reporting tax expenditures more effectively

In contrast to direct government spending, which is generally scrutinised during the annual Budget process, tax expenditures often receive attention only at the time they are introduced. Systematic reporting of tax expenditures is therefore necessary to ensure they receive a similar degree of scrutiny as direct expenditures. This also makes it easier to compare tax expenditures and direct expenditures.

Australian governments have published annual estimates of tax expenditures since 1980, initially as an appendix to the Budget. The first separate Tax Expenditures Statement, providing detailed estimates of tax expenditures and the associated benchmarks, was published in 1986. The publication of this information became a legislative requirement under the *Charter of Budget Honesty Act 1998*.

An element of the framework established by the Act was that the Mid-Year Economic and Fiscal Outlook (MYEFO) would include detailed estimates of both tax expenditures and spending programs, thereby enhancing the scrutiny of both forms of expenditure. However, MYEFO estimates of tax expenditure have not yet been presented in a disaggregated form. Instead, this information is published separately in the Tax Expenditures Statement. MYEFO is released by the end of January in each year, or within six months of the last Budget, whichever is later. The separate Tax Expenditures Statement has also been released within this timeframe.

The purpose of MYEFO is to update key information in the most recent Budget. It provides an update on the government's fiscal and revenue strategy, rather than a comprehensive account of all measures. So, even if detailed estimates of tax expenditures could be produced for MYEFO, it would be difficult to compare them against spending programs in any detailed way.

Including fully detailed tax expenditure estimates in MYEFO would significantly change its focus as an update to the government's fiscal and revenue strategy and could delay its release. A better means for managing tax expenditures is by ensuring they are examined in the same way as spending programs in the Budget process. Detailed estimates of tax expenditures need to be prepared far enough ahead of the Budget to allow them to inform

government decisions. The Tax Expenditures Statement should continue to be released within the same timeframes as MYEFO, though not necessarily at the same time. The *Charter of Budget Honesty Act 1998* should be amended accordingly (see Recommendation 136).

Identifying tax expenditures

In order to identify a tax expenditure, the tax treatment that would normally apply (the benchmark) needs to be identified.

Not all concessional elements of the tax system are classified as tax expenditures. This is because some concessions are considered to be structural elements of the tax system and are incorporated in the benchmark. For example, the personal income tax system includes a progressive marginal tax rate scale, which results in individuals on lower incomes paying a lower marginal rate of income tax than those on higher incomes. This arrangement is a structural design feature of the Australian tax system and is therefore not identified as a tax expenditure. There may be different views on which structural elements to include in the benchmark. These benchmarks can vary over time and can sometimes be perceived as arbitrary.

The original concept of a tax expenditure includes only some of the concessional features of the tax system provided under the law. However, many tax benefits arise as a consequence of administrative practice or through non-compliance with the law. Some consider that these 'benefits' should be reported in the same way as other tax expenditures (ANAO 2008).

The purpose of reporting tax expenditures is so the community can understand how the tax system affects the economy and society more broadly. Benchmarks should allow an objective evaluation of the effects of government policy, rather than represent that policy. For example, if a tax concession is set up to assist a particular industry the benchmark should not incorporate this objective, but should provide a basis for identifying and valuing the concession. This allows the community to judge whether this form of assistance is appropriate.

Currently, many of the most important economic and distributional effects of taxes are incorporated in the benchmarks and so are not reported in the Tax Expenditures Statement. As noted above, a separate and broader Tax and Transfer Analysis Statement could include this kind of information about structural tax features. Even if this information is not reported annually in the Tax Expenditures Statement, the benchmark should be defined according to transparent and independently established standards.

The *Charter of Budget Honesty Act 1998* requires budget reporting to be undertaken against a set of external standards. External standards are also supposed to apply to the reporting of tax expenditures, but no such standards exist. The development of these standards would improve the integrity of the process. They would provide greater consistency in the identification and measurement of tax expenditures, which would allow more reliable examination of trends over time.

Consideration needs to be given to whether an existing body should develop these standards or whether a new body should be established. One option the government might wish to consider is the establishment of an academic advisory panel that could independently develop standards for identifying and measuring tax expenditures. Whichever option is

adopted, the body charged with the task should be equipped with the necessary skills and experience and should operate independently (see Recommendation 137).

Measuring tax expenditures

Unlike direct spending by the government, tax expenditures represent the *notional* cost to government of not collecting revenue that would otherwise be collected. These notional costs can be difficult to estimate, and the estimates can sometimes be misinterpreted as the amount of revenue that could be raised if the tax expenditures were abolished. For these reasons, tax expenditure estimates need to be treated with some caution.

The Tax Expenditures Statement estimates the value of tax expenditures using the 'revenue forgone' approach. This method is seen as the most reliable approach for estimating the level of assistance the tax system provides to taxpayers. Most other OECD countries also use this approach.

The revenue forgone approach calculates the benefit of a tax expenditure to taxpayers, rather than the budgetary cost of the expenditure. Estimates calculated by the revenue forgone approach identify the financial benefit to taxpayers of receiving a tax expenditure relative to taxpayers that do not. It does not necessarily follow that there would be an equivalent increase to government revenue from abolishing the tax expenditure. This is largely because of changes in taxpayer behaviour that removing the tax expenditure would cause (for example, removing one concession may result in increased use of others).

The 'revenue gain' approach has sometimes been proposed as an alternative to the revenue forgone approach in order to produce tax expenditure estimates that are more comparable to budget revenue estimates (ANAO 2008). This would directly measure how much revenue would increase if a concession were removed. It involves making assumptions about the way taxpayers would respond to policy changes. It also requires assumptions about the order in which tax expenditures are removed. This means there are considerable difficulties in preparing such estimates for all tax expenditures in the Tax Expenditures Statement. However, the Tax Expenditures Statement 2008 included revenue gain estimates for some major tax expenditures.

The revenue gain approach does not necessarily reflect the value of the concession to taxpayers. For instance, where an activity is highly sensitive to a concession, the increase in revenue from removing the tax expenditure could be very small. In these cases, revenue gain estimates give the impression that the tax expenditure has little impact, when in reality the recipients derive significant benefits. However, the revenue gain approach is useful when reviewing a tax expenditure since it indicates the revenue that could be realised for government if the expenditure were abolished. Revenue gain estimates for significant tax expenditures should continue to be published in the Tax Expenditures Statement.

A third approach to measuring tax expenditures is the 'outlay equivalence' approach. This approach estimates how much direct expenditure would be needed to provide a benefit to a recipient — assuming the payment is subject to the usual tax treatment for that type of income —that is equivalent to the tax expenditure.

The outlay equivalence method has the advantage of estimating tax expenditures on the same basis as spending programs, which may allow a better assessment of their comparative

merits. Outlay equivalence estimates are likely to be most useful when policy-makers are considering whether to deliver a program as a tax expenditure or a spending program.

These estimates can differ significantly from estimates produced under a revenue forgone approach, which focuses on the annual effect of a concession on revenue collection. The Tax Expenditures Statement shows the annual effects of tax expenditures and so makes no distinction between concessions that defer tax and those that reduce tax. In effect, a tax deferral is a loan made by the government to a taxpayer and the value of the loan is the interest concession. For instance, the effect of accelerated depreciation is to allow taxpayers to claim larger deductions in the early life of an asset, and lower deductions in the latter part of the asset's life. Accelerated depreciation does not increase the size of the deductions that can be claimed overall, but it does bring them forward. This bring-forward represents an interest-free loan made by the government to taxpayers. Using the revenue forgone approach, the Tax Expenditures Statement shows the lower taxes paid in early years and the higher taxes paid later, rather the interest value of the deferred taxation. In contrast, the outlay equivalence method would estimate the value of the interest-free loan. This type of information about tax expenditures should be presented in the periodic Tax and Transfer Analysis Statement (see Recommendation 132).

Reporting State tax expenditures

In order to give a comprehensive sense of the level of government assistance provided through the entire tax system, tax expenditures need to be measured for all taxes. The Australian government currently reports tax expenditures across its main taxes. However, there is no comprehensive or consistent reporting of tax expenditures by the States. In particular, the benchmarks used by States differ significantly, so it is not possible to make a direct comparison of tax expenditures between jurisdictions.

To remedy this, reporting standards should be developed and applied across the range of State taxes in a uniform and thorough way. The Council of Australian Governments should examine the ways in which the States could uniformly report tax expenditures annually (see Recommendation 138).