

# Executive summary

## Context of the review

The subject of this review – the tax-transfer system – is a fundamental part of Australia’s social and economic infrastructure.

The ‘tax-transfer system’ refers to the combination of Australia’s tax systems and transfer systems, and how they interact. It reflects the demands and expectations of Australians, about the level of income redistribution that should occur and the balance between private and public provision of goods and services.

All taxes and all transfers affect behaviour in some way. They change how much money people have and the incentives they face.

The design of the tax-transfer system also impacts on the distribution of income and opportunity, both between different social groups and between generations. The overall level of taxation and public expenditure, the level and targeting of transfers and the design of both these systems, influence the distribution of income across the Australian community.

A complex and inefficient tax-transfer system imposes costs on society and those more vulnerable in society will bear a disproportionate share of these costs.

## Emerging challenges and opportunities

The review is being conducted at a time of significant social, environmental and economic challenges. Some of the challenges are driven by international circumstances, some domestic.

Climate change is likely to generate significant costs, affecting the lives of all Australians. As the world moves towards a low-emissions economy, Australia’s response to climate change will impact upon, and make use of, the tax-transfer system.

Given Australia is a small, open and developed country operating in an increasingly globalised world with freer flows of ideas, investment and labour, there is increasing pressure for Australia’s tax-transfer system to remain internationally competitive.

The demographic challenge of an ageing population is also profound. As our population ages the proportion of people in the workforce will fall. This has significant implications for economic growth and our future standards of living.

Intrinsic to the policy responses to these issues is the nature of our federation. Coordinated action across governments is imperative.

These challenges are substantial and interact in complex ways with the tax-transfer system. The review provides an opportunity for shaping the tax-transfer system in ways that position Australia to address these challenges, so as to modernise the economy and secure Australia’s future prosperity.

## **An opportunity for reform**

Australia's economic position provides an ideal opportunity for reform. The boost to national incomes from the significant increase in the terms of trade due to the resources boom, together with Australia's strong fiscal position, provides a platform on which to base a reform agenda. Given the challenges that lie ahead, it is important to have a tax-transfer system that enhances incentives and rewards effort.

In improving the way the tax-transfer system operates, a key focus will likely be to secure expanded opportunities for those who remain disadvantaged. However, it will be important to ensure that reforms to the tax-transfer system are durable, should the recent strength in the terms of trade abate.

The breadth of this review provides an opportunity to step back from the day-to-day processes and historical events that have shaped the tax-transfer system and consider how it might best be shaped to complement, and even facilitate, the reforms needed to address the challenges facing Australia as we move through the 21st century.

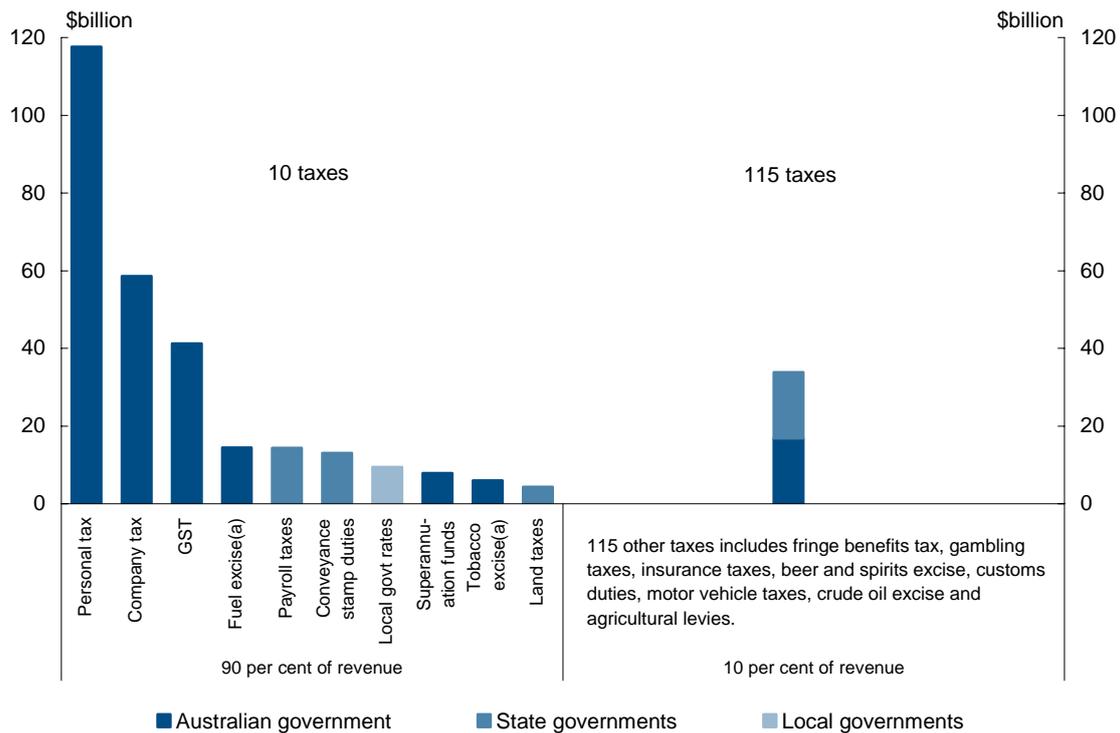
## **Overview of the tax-transfer system**

### **Taxes**

There are at least 125 taxes paid by Australians every year. Of these, 99 are levied by the Australian government, and 25 by the States and 1 by local government.

Of the total tax revenue collected by Australian governments in 2006-07, 90 per cent was derived from 10 taxes. These 10 taxes accounted for 95 per cent of Australian government revenue and over 70 per cent of state tax revenue (including 100 per cent of local government tax revenue). Ten per cent of tax revenue in 2006-07 was contributed by the remaining 115 taxes.

### Ranking of Australian taxes by revenue in 2006-07



(a) Fuel excise and tobacco excise includes excise equivalent customs duties for these products.  
Source: Budget Paper No. 1 2008-09, Budget Statement 5; ABS 2008a, Australian Treasury estimates.

Many taxes are levied on essentially similar transactions by different Australian governments with little consistency across jurisdictions.

In 2006-07, the Australian government collected \$262.5 billion through income tax, GST, taxes on fuel, alcohol and tobacco, customs tariffs and a range of other indirect taxes.

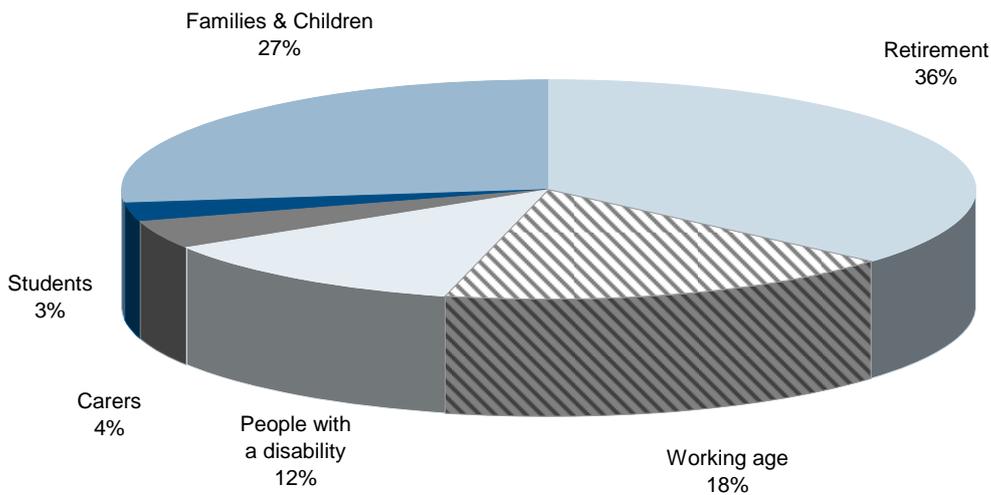
In the same year, the States collected \$48.9 billion (with a further \$9.4 billion raised through local government taxes) through their own taxes, including those on property, payroll, motor vehicles, gambling and insurance contracts.

## Transfers

There are around 40 cash transfers paid to Australians by the Australian government, costing over \$70 billion in 2006-07 and representing more than a quarter of Australian government spending.

The main Australian government transfers are income support payments and payments to families, including all Age and other pensions, Newstart Allowance and other allowance payments, Family Tax Benefit and supplementary payments.

### Australian government program expenditure by payment group in 2006-07

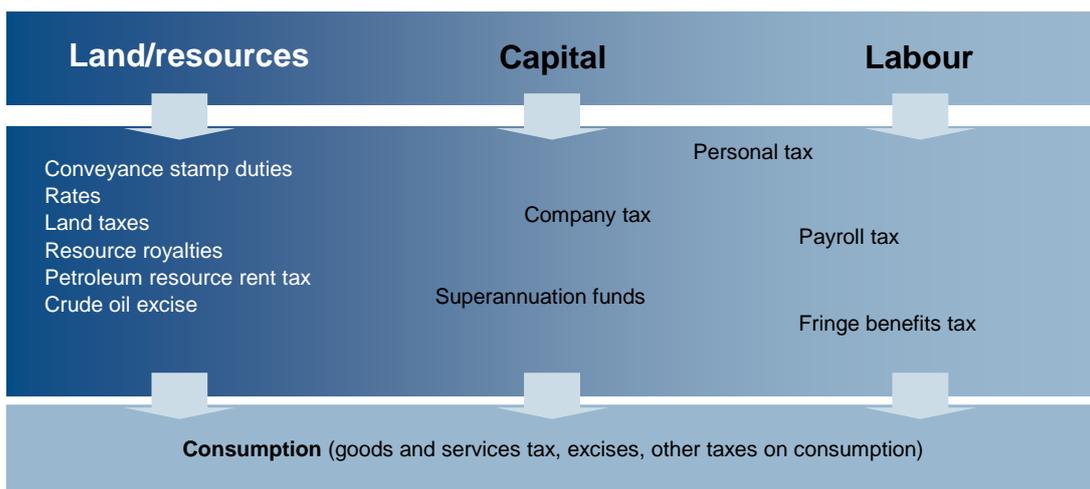


The States make very limited use of direct payments, relying mainly on indirect transfers, such as concessions.

### The economic structure of the tax-transfer system

There are many taxes in Australia, all of which are ultimately borne by individuals on the earnings from only three factors of production: labour, capital and land (including natural resources). Individuals end up paying taxes in a range of ways, including as consumers through higher prices, as employees through lower wages, or as shareholders or investors through lower profits.

#### Relationship between economic bases and taxes



All taxes affect choices by encouraging individuals to shift from higher taxed to lower taxed goods and services or activities, and by lowering their available income. Similarly, transfers can impact on people's choices by increasing available income in certain circumstances. The costs of the tax-transfer system include its impacts on these choices (economic efficiency) and the costs of administering and complying with the system. These costs are significant.

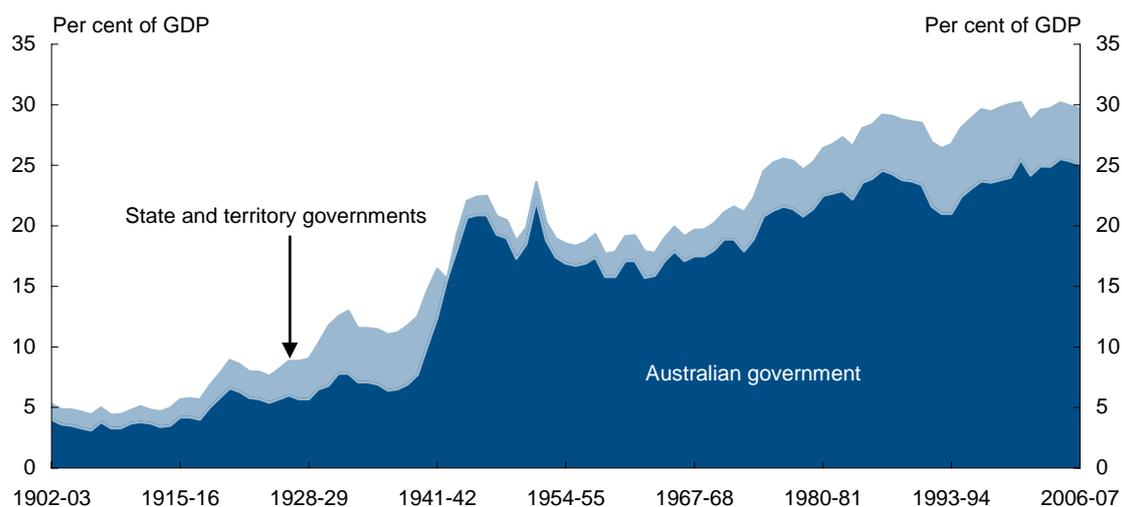
## History of Australia's tax-transfer system

There have been two distinct periods in the historical development of Australia's tax system.

From federation to the mid-1970s, the focus was mainly on ensuring there were adequate levels of revenue to fund the increasing social provision of goods and services.

Since the mid-1970s, the focus has been on improving the equity, efficiency and simplicity of the tax system.

### Australian government and state taxation (1902-03 to 2006-07)



Source: Budget Papers; ABS (2008a); ABS (2007a).

Transfers have evolved from basic payments linked to war service and old age (with a pension age well above average life expectancy) to a more extensive system of social support.

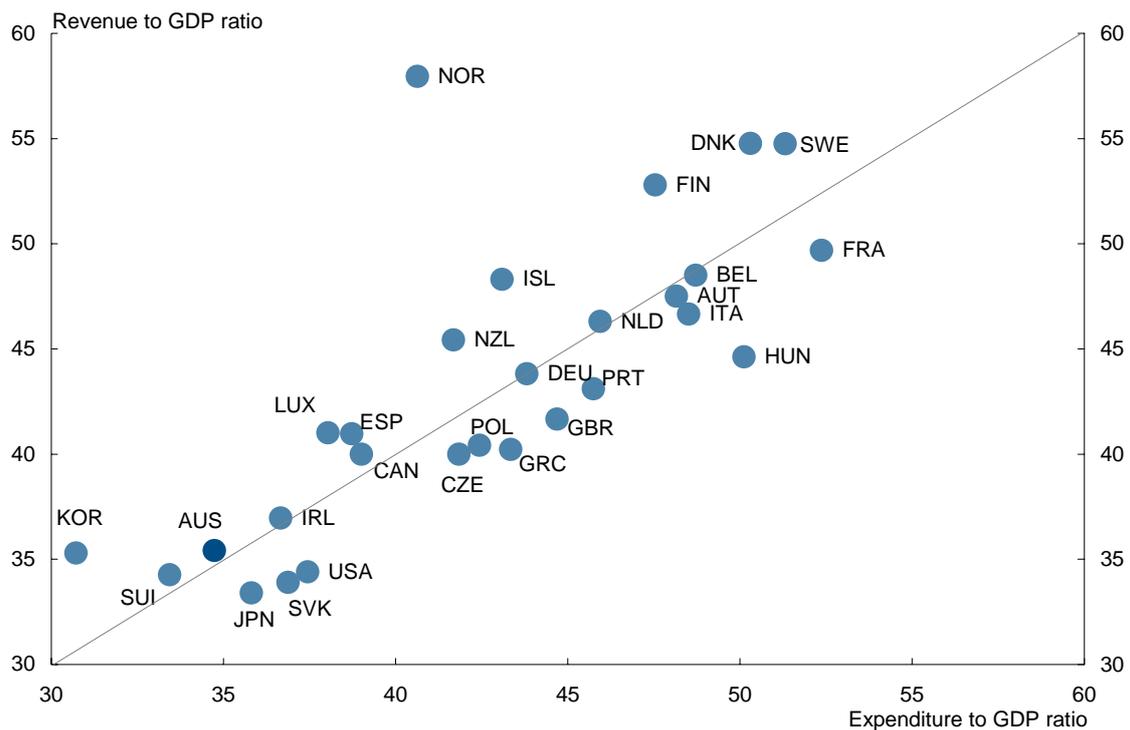
The principles of early transfers set the social support scene for the future – funded from general government revenue, based on circumstances rather than past earnings, and means tested to target assistance.

Since federation, the Australian government has been the predominant revenue raiser and revenue has been redistributed to the States.

## Australia's tax-transfer system — an international comparison

By OECD standards Australia is a low tax country – the eighth lowest. Australia is also a low expenditure country – the third lowest in the OECD.

### Size of government — OECD 2007<sup>(a)(b)</sup>



(a) Data for Mexico and Turkey not available.  
 (b) Revenue refers to receipts of tax and non tax revenue.  
 Source: OECD (2008a).

Our tax to GDP ratio is higher than that of our immediate neighbours, but this reflects the greater role of government in Australia's economy.

Australia's mix of direct and indirect taxes is broadly comparable to other OECD countries, but the composition differs.

Australia and New Zealand are the only OECD countries that do not levy a social security tax and have a dividend imputation system.

By OECD standards, Australia's:

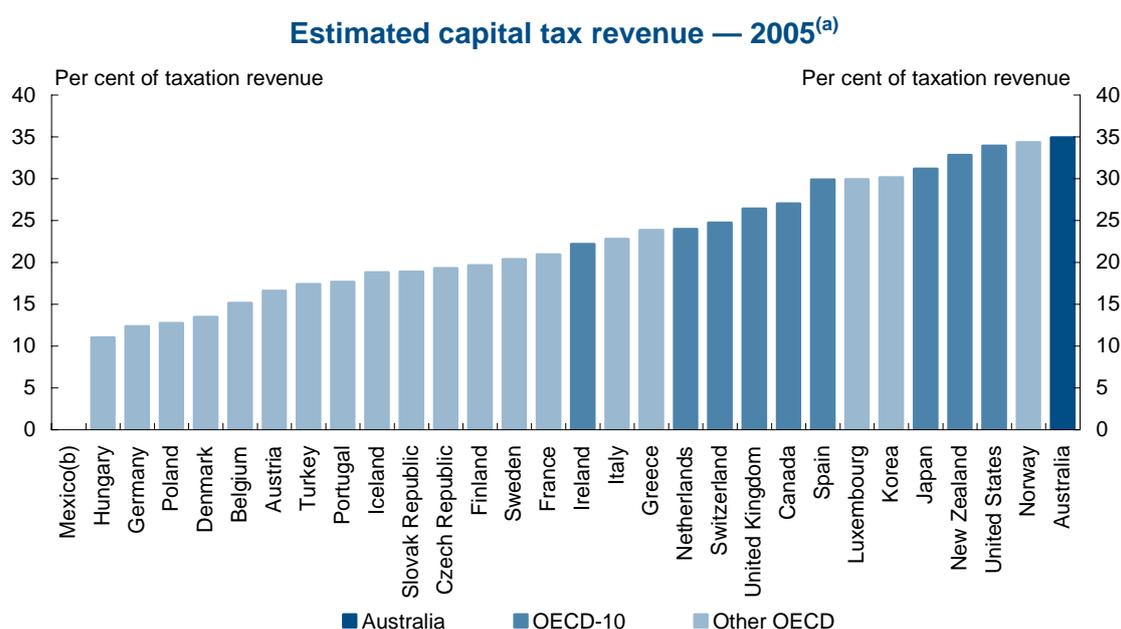
- company tax rate is now above the average;
- reliance on broad-based consumption taxes (such as the GST) is lower than average;
- reliance on revenue from taxes on property is greater;
- top personal income tax rate is average, but the absence of social security tax means we have a higher tax burden on capital income;
- taxes on fuel are low; and
- tax-transfer system is highly redistributive.

## The mix of taxes on work, investment and consumption

Most countries have a tax system based on a mix of taxes on labour income, capital income and consumption.

Australia's tax mix is slightly skewed towards direct taxes on labour income. This accounts for around 40 per cent of revenue. Taxes on capital income account for about 33 per cent, while taxes on consumption account for 27 per cent.

Compared with other OECD countries, Australia has a low share of tax revenue from labour income and the greatest reliance on tax revenue from capital. In part, this reflects the relatively greater contribution of corporate income taxes to total tax revenue.



(a) For Korea, Iceland, Switzerland and Turkey the share of personal income tax revenue derived from capital has been estimated using the average share of other OECD countries.

(b) Data for Mexico not available.

Source: OECD (2007a); Eurostat (2008), Treasury estimates.

As a share of GDP, the total tax burden in Australia on capital is around 11 per cent (fourth highest in the OECD). The total burden on labour is 12 per cent (fourth lowest in the OECD), and the total burden on consumption is 9 per cent (also fourth lowest in the OECD).

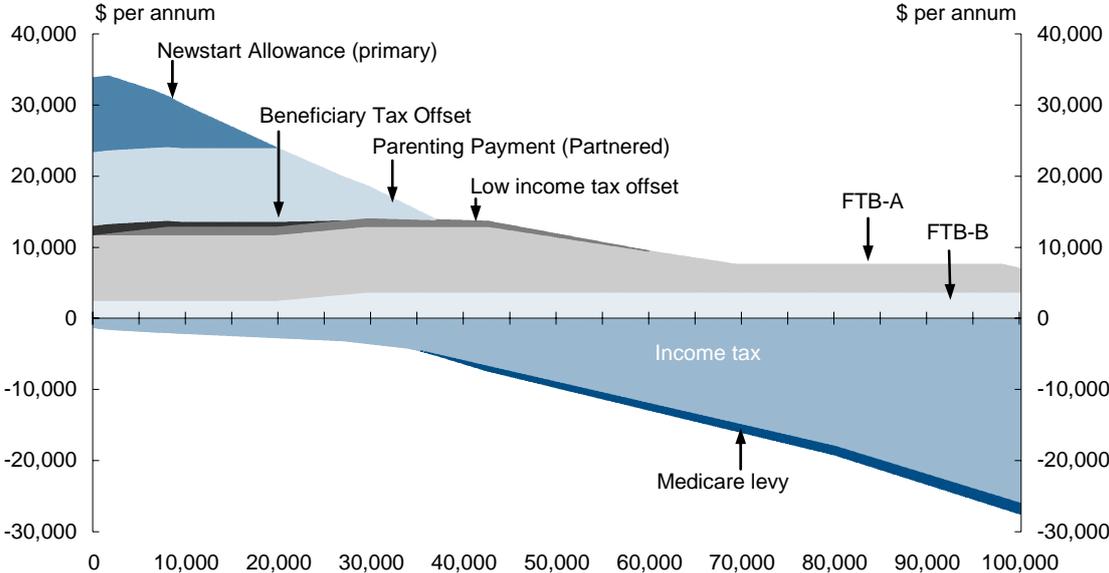
## The personal tax-transfer system

The Australian tax and transfer systems are separate systems that combine to affect the disposable income of individuals and families, and their incentives to work, save and invest (including in skills). There are different bases of assessment between and within the two systems, including the definition of income, the unit of assessment, the period of assessment and the basis of eligibility. These differences largely exist to achieve a targeted system, but the result is that the system as a whole is complex.

The combination of the personal tax and transfer systems is progressive and redistributive. There are many families and individuals who receive transfers and pay tax in the same year

and from one year to the next. This 'churn' imposes costs on individuals as well as the administration of the system.

**Transfers and taxes by level of income**  
**Single income family, two children aged 3 and 8 (2008-09)**



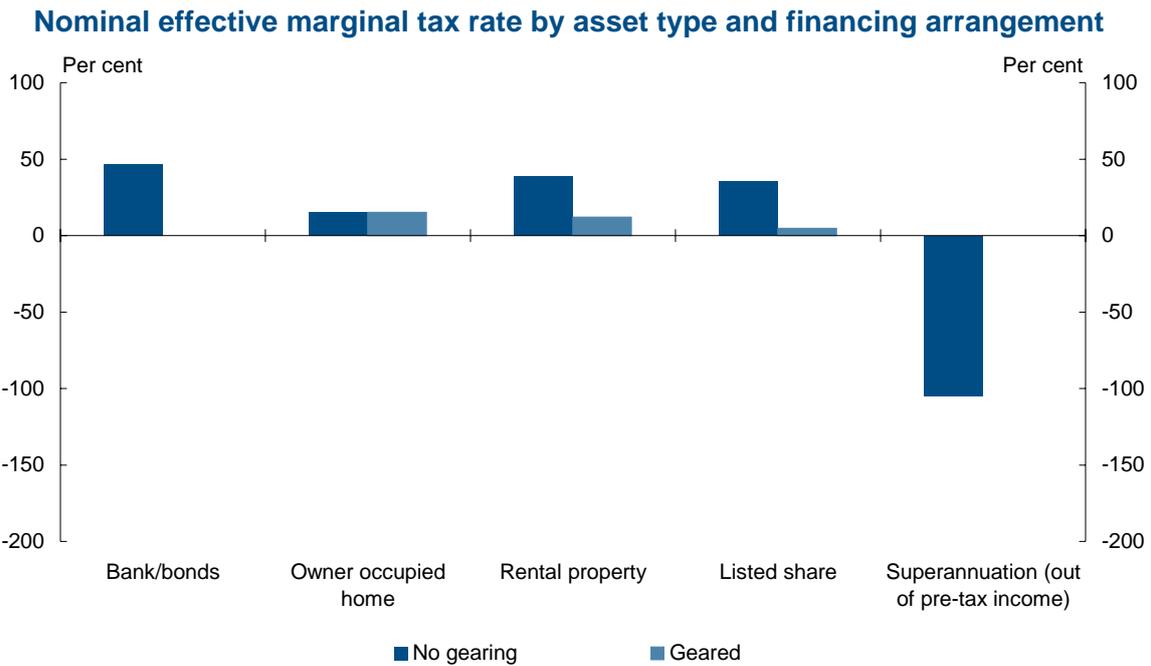
Source: Australian Treasury estimates.

Significant demographic change, including ageing of the population, will influence the affordability of the transfer system in the future. Participation and productivity increases may offset some of the impact of demographic change.

**Taxing saving and investment**

The level and form of tax affects incentives to save and the level of savings, decisions on the types of investments and how they are financed, and whether investments are made in Australia or overseas.

In Australia the tax system interacts differently across different assets, forms of financing, types of entities and international flows. These different tax treatments can affect savings and investment decisions across the economy, including for housing.



Source: Australian Treasury estimates.

The rapid growth in cross-border investments has highlighted the importance of international factors when considering how Australia taxes savings and investments. For example, company tax rates overseas continue to fall. There are ongoing challenges to our ability to tax residents on their foreign source income and non-residents on their income from investing in Australia.

## Taxing goods and services

Historically, taxes on goods and services have raised revenue in a relatively simple way from narrow bases that are easy to tax. Over time, there has been a shift toward more efficient broad-based taxes such as the GST.

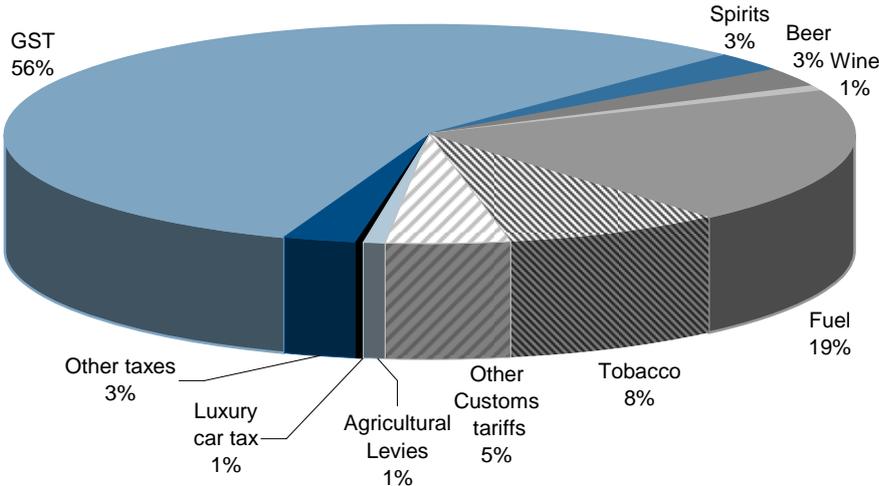
The GST is the principal tax on consumption, contributing over half of Australian government revenue from indirect taxes.

Taxes on specific goods and services still exist, some of which reflect a range of non-tax policy objectives. Some of these taxes are designed to reinforce social policy objectives, or provide assistance to domestic industry.

Specific taxes can also be levied to help correct market failures. For example, an effectively targeted tax creates incentives for individuals to respond to environmental concerns.

Improving technology is making it administratively feasible to replace some taxes with direct user charges.

**Australian government taxes on goods and services in 2006-07**

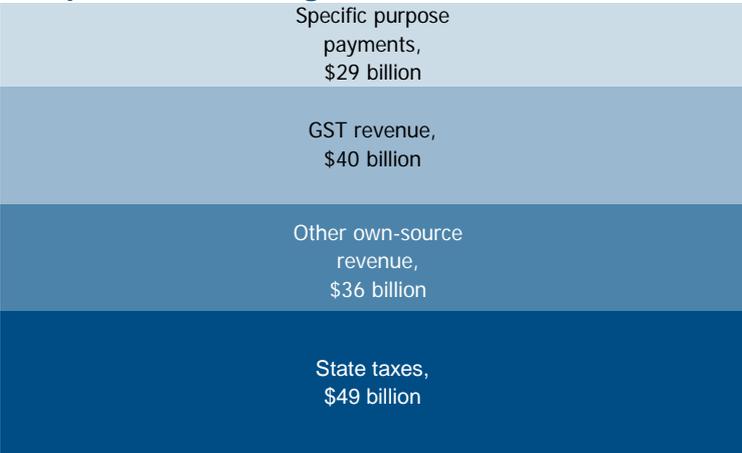


Source: Budget Statement 5, Budget Paper No. 1, 2008-09, Australian Customs Service Portfolio Budget Statement; Australian Treasury estimates.

**State taxes**

In 2006-07, taxes levied by the States accounted for 15 per cent of total tax revenue in Australia. Together with the States' other own-source revenue, this represented around 55 per cent of their total revenue. The remainder consisted of transfers from the Australian government.

**Composition of state government revenue in 2006-07**



Source: ABS (2008a); Australian Government (2007c).

State taxes have changed over time in response to the High Court's interpretation of the Constitution, and interstate competition.

The current array of state taxes includes transaction taxes and taxes levied on narrow tax bases. Thresholds, rates and the range of exemptions from these taxes differ between the States.

There are limited opportunities for the States to introduce new taxes, so often they have looked to narrowly-based taxes to realise some gain from a rapidly growing area of their economy.

The fiscal relationship between the Australian government and the States is characterised by 'vertical fiscal imbalance'. The States' own revenue sources are insufficient to fund their expenditure responsibilities, but the Australian government's revenue sources are greater than is necessary for its responsibilities.

There are both costs and benefits of this imbalance.

Some of the costs can include accountability problems in decision making, shifting responsibility for providing services, and the provision of a service being influenced by the relevant government providing the funding.

On the other hand, some of the benefits can include lower administration and compliance costs from a national tax system and increased opportunities for people to receive the same standard in national services.

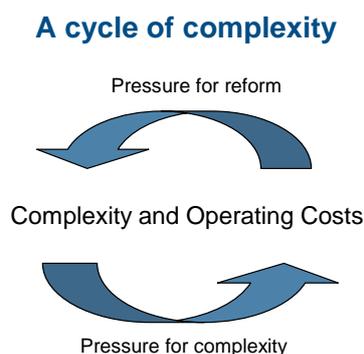
## Complexity and operating costs of the tax-transfer system

There are no reliable estimates of the complexity or operating costs of the tax-transfer system but there is a strong sense in the community that they are too high.

An excessive level of complexity impedes the ability of taxpayers and transfer recipients to make optimal decisions, diverts resources from more valuable uses, and gives rise to planning opportunities that undermine the fairness of the system. The impacts of this complexity tend to be greatest on those with the least capacity to deal with them.

A certain level of complexity and operating costs is required to implement the tax-transfer system in a manner that is efficient and equitable. However, at some point, equity or efficiency is likely to be compromised by increasing complexity.

Current levels of complexity and operating costs are likely to be above the level that is optimal for society as a whole. Two important reasons for this are incremental development of tax-transfer policy, based on partial assessments of the associated benefits and costs, and income maximising behaviours of taxpayers and transfer recipients. Broad reforms provide an opportunity to take a systemic view of the trade-offs between simplicity and other policy objectives.



## **Household assistance measures for the Carbon Pollution Reduction Scheme**

The Australian Government is committed to providing assistance to households for the introduction of the Carbon Pollution Reduction Scheme. The assistance is designed to help meet the overall cost of living from the scheme, especially for low-income households.

The mechanism for the delivery of assistance and the existing tax and transfer system will be considered by the Australia's Future Tax System review.