1 Context of the review

1.1 Introduction

The tax-transfer system is a fundamental part of the social and economic infrastructure of Australia. Its evolution reflects the demands and expectations of Australians, especially in relation to the balance between private and public provision of goods and services, and the level of income redistribution that should occur. These roles must be financed by government revenue.

At the Australian government level, the majority of this financing is done through the tax system. At the state level, the situation is not as clear. To help fund the services their citizens expect, States rely on payments from the Australian government (largely the GST and specific purpose payments) and a wide range of non-tax revenues (such as fees and charges) to supplement their own taxes.

Key determinants of how much tax needs to be raised are the level of income redistribution that society wants and its desired level of government provided goods and services — such as health and education services, defence and security, infrastructure and roads, appropriate forms of regulation, and support for social institutions.

The method for achieving income redistribution also has an impact on how much tax needs to be raised. For example, tax settings or tax collection mechanisms that more accurately reflect individuals' net tax-transfer positions require less tax to be raised and distributed.

At a macroeconomic level, the tax-transfer system also affects outcomes in the aggregate economy through its role as an 'automatic stabiliser' of fluctuations in economic growth. When the economy is growing more strongly, tax revenue will grow and transfers will tend to fall as a proportion of national income. This improves the government budget position, moderating the rate of expansion in the economy, unless a decision is taken to offset the increase in the budget through increased spending or reduced taxes. In periods of slower economic growth, the automatic stabilisers operate in the opposite direction, moderating the extent of the slowdown and the implications for unemployment and incomes.

All taxes and all transfers affect behaviour in some way. They change how much money people have and the incentives they face. For example, high levels of taxes on salary and wages reduce the disposable income of salary and wage earners, but can also make leisure (or at least doing unpaid work) more attractive. Put another way, it can dampen the incentive to work more to earn more money. In a similar way, the tax-transfer system can dampen incentives to save and invest.

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 expenditure, the level and targeting of transfers and the design of both these systems, influence the distribution of income across the Australian community.

1.2 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. To deal with these challenges cooperation across levels of government is needed. At its meeting on 3 July 2008, the Council of Australian Governments (COAG) noted the need to continue to progress reforms to boost productivity, increase workforce participation and mobility, and deliver better services for the community. COAG is progressing work on a wide range of fronts, including business deregulation and competition, health and ageing, education and training, housing, indigenous policy reform, infrastructure, climate change and water. These reforms will be underpinned by a new financial relations framework. Much of this work recognises that the States deliver, or at least facilitate, many of the services required by Australians, yet the Australian government raises the largest share of tax. The COAG reforms do not contemplate fundamentally redressing this imbalance.

A key driver of the urgency of COAG's reform agenda is the likely slowing of economic growth, due to our ageing population. This demographic challenge is profound. The second Intergenerational Report (IGR), released on 2 April 2007, makes clear that 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. Over the next 40 years economic growth is projected to slow, with growth in real per capita gross domestic product (GDP) to average 1.6 per cent per year compared with 2.1 per cent over the past 40 years. A quarter of the population is projected to be aged 65 or over by 2047 (almost double that today). Consequently, spending pressures in areas such as health, age pensions and aged care are projected to rise considerably.

Climate change is likely to generate significant costs, affecting the lives of all Australians. These costs will only increase with delay in mitigation activity. Recognising this, the Australian Government has committed to introducing a Carbon Pollution Reduction Scheme to curb greenhouse gas output in Australia. The Australian Government's Green Paper (Australian Government 2008c) sets out how the scheme will operate, including the preferred approach regarding the allocation of pollution permits and the nature of assistance for households and industry.

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. This is particularly important for the taxation of investment income because of the ease with which investment can be switched between alternative activities and locations, and the capacity to shift profit between jurisdictions. Of course, tax is not the only determinant of international investment decisions (a skilled workforce and high quality infrastructure are also significant), but it is nonetheless important.

Intrinsic to the policy responses to these issues is the nature of our federation. Coordinated action across governments is important. For example, COAG has acknowledged that Australia's overlapping and inconsistent regulations on business impede productivity growth. COAG noted that without change, Australia's future living standards would be compromised, the competitiveness of the economy reduced and our ability to meet the challenges posed by an ageing population diminished. Benefits of coordinated action should be balanced, where appropriate, with the need for States to tailor arrangements to be relevant to local issues.

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.

1.3 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.

It makes economic sense to design the tax-transfer system in a way that has minimal impact on incentives to work, save and invest and that achieves the intended outcomes with minimal complexity. This will allow Australia's productive resources to be better utilised. For example, every extra hour spent by households and business grappling with the myriad of tax rules and obligations (including the different regimes across the States) is an hour not used to produce goods and services (including utilising leisure time), that are of higher value to Australians. Likewise, every dollar needed to fund the administration of the tax-transfer system is a dollar that needs to be raised through taxation. Given the regressive nature of complexity, a complex and inefficient system is also likely to fall short of expectations for a fair distribution of opportunities and risk throughout the community.

The current tax-transfer system is a product of historical changes reflecting a range of policy objectives. Since federation, the primary focus of reforms has shifted from expanding the revenue base to fund growing expenditure programs, to improving the performance of the system in terms of its efficiency and equity, and reducing complexity, recognising that all three impact on the wellbeing of Australians.

It has been around 30 years since the last fundamental review of the tax system and around 20 years since the last major review of the transfer system. The Taxation Review Committee (the Asprey Review) which reported on 31 January 1975 provided a comprehensive set of proposals for reform of the Australian government tax system. Much of this agenda has been enacted over the ensuing 30 years. The income tax base has been broadened through capital gains tax and fringe benefits tax, the taxation of companies has been reformed through the imputation system, and a broad-based goods and services tax has been adopted. Similarly, on the transfer side, the reform agenda set by the Social Security Review (1986-88) introduced significant changes across all major social security programs.

Australia is now facing a different set of challenges. 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. It is an opportunity to consider how the system 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.