4 History of Australia’s tax-transfer system

Outline

This section provides an overview of the development of Australia’s tax-transfer system since federation and of the shifting balance between Australian government and state revenue powers.

Key points

- The development of the Australian tax system can be categorised into two distinct periods. In the first period, from federation to the mid-1970s, the focus was largely on revenue adequacy to fund increasing levels of social provision of goods and services. In the second period, since the mid-1970s, there has been a greater focus on improving the equity, efficiency and simplicity of the tax system.
- Transfers have evolved from basic payments linked to war service and old age (with Age Pension age well above average life expectancy) to a more extensive system of social support. The principles of early pension payments 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.

4.1 Historical trends in tax

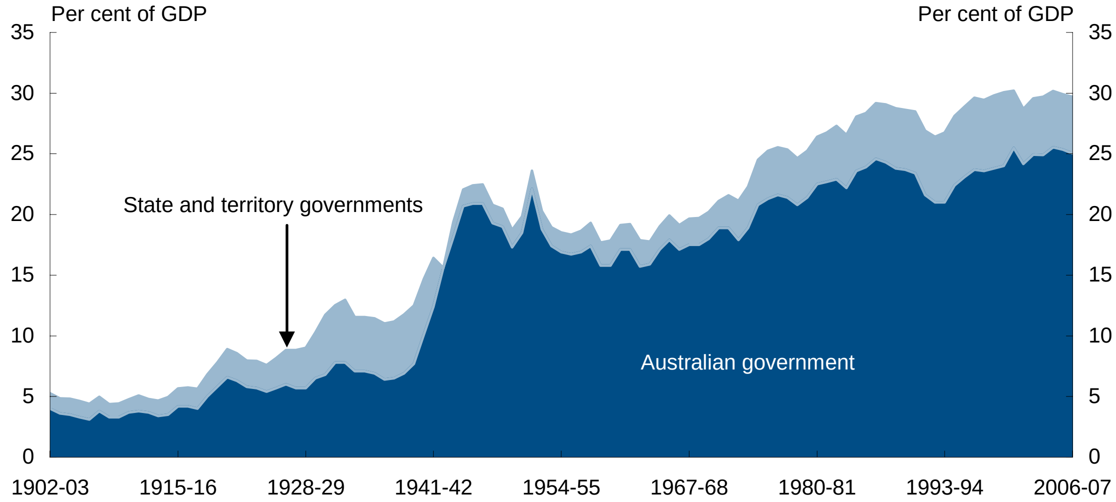
The Australian tax-transfer system has changed significantly since the end of the 19th century. The six colonies raised the bulk of their tax revenue from selective customs and excise duties. The original design of the tax systems of the six colonies was driven largely by the feasibility of administration, rather than principles of equity or efficiency. Customs duties were easy to collect from the limited number of wharves where goods entered the colonies. Although highly regressive, customs and excise duties levied on necessities ensured a relatively secure source of revenue. They also acted as trade barriers between the colonies. One of the significant results of federation in 1901 was the removal of all duties on goods traded between Australian States.

Since federation, developments in tax policy can be broadly classified into two periods. Up until the mid-1970s, the primary driver of significant changes to the tax system was expanding the revenue base to fund expenditure programs. Since then, the revenue requirement has been relatively stable. Increased attention has been paid to reforming the tax system to improve equity and efficiency and, more recently, attempting to reduce tax system complexity.

A revenue adequacy focus (1901 to mid-1970s)

At the time of federation Australia's tax to GDP ratio was around 5 per cent. This ratio remained reasonably constant until the introduction of the Australian government income tax in 1915, which was used to fund Australia's war effort. Between the two World Wars, government expenditure and tax revenues grew significantly and by the beginning of the Second World War, Australia's tax to GDP ratio was over 11 per cent (Chart 4.1).

Chart 4.1: Australian government and state taxation (1902-03 to 2006-07)



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

When income tax was first introduced in 1915, companies were taxed on their profits after deduction of dividends — that is, only on retained profits. Subsequently, this deduction was changed to a rebate for shareholders. In 1940, with additional revenue needed to fund Australia's involvement in the Second World War, the rebate of tax on dividends received by individual shareholders and non-resident companies was removed. The company tax rate was increased and an undistributed profits tax was imposed on public companies.

By the end of the Second World War, tax revenue had grown to over 22 per cent of GDP. The further increase in tax largely reflected Australia's involvement in the war and the introduction of government support programs, such as the Widows' Pension in 1942 and Unemployment Benefit in 1945. This marked the beginning of the modern social security system which is discussed in more detail in Section 4.2.

Tax revenues declined during the 1950s and by 1963-64 the tax to GDP ratio was around 18 per cent. In the early 1970s, tax revenue increased significantly, partly driven by funding requirements for social programs such as the introduction of free higher education.

Since the late 1980s Australia's overall tax to GDP ratio has been relatively stable and is currently around 30 per cent of GDP. The majority of tax revenue, equivalent to 25 per cent of GDP, is raised by the Australian government with around 5 per cent raised by the state governments.

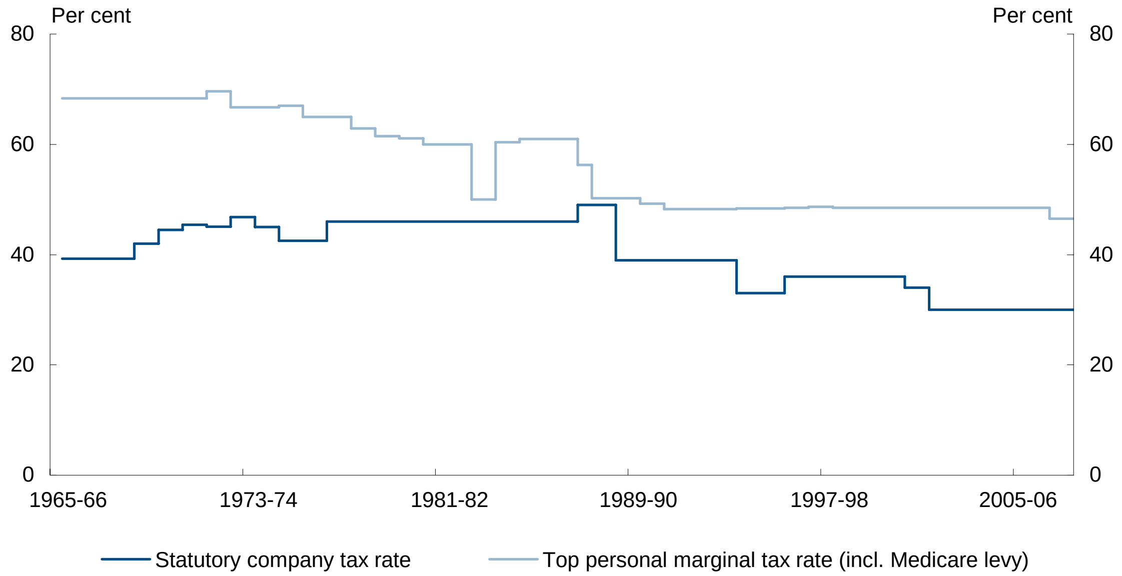
Improving efficiency, equity and simplicity (mid-1970s onwards)

From the early 1970s, a growing concern about the equity of the tax system led to the establishment of the Taxation Review Committee (Asprey et al 1975). A key theme of the Asprey Report was the need to broaden the tax base. In 1985, the Australian government released a draft White Paper which recommended a broadening of the tax base through the adoption of a broad-based consumption tax, the introduction of a capital gains tax and comprehensive taxation of fringe benefits, and a broader foreign income tax base (Australian Government 1985). The capital gains tax and fringe benefits tax were introduced in the second half of the 1980s and the GST was introduced in 2000.

The broadening of the foreign income tax base, in part driven by the opening of the Australian economy, was achieved initially by making most foreign income taxable with a credit for foreign tax paid. However, to reduce compliance costs and reflecting competitiveness concerns, in 1990 dividends from non-portfolio interests in foreign companies and active business profits of branches in comparable tax jurisdictions were made exempt from company tax. Further, to ensure residents could not defer tax by accumulating passive income offshore, attribution regimes (in particular, controlled foreign company and foreign investment fund regimes) were introduced in the early 1990s.

The focus of reforms since the mid-1970s has been to improve the efficiency, equity and simplicity of the tax system. As such, a key element of the reform agenda has been to broaden the personal and business tax base and lower the rate of tax (Chart 4.2).

Chart 4.2: Top personal income tax rate and company tax rate (1965-66 to 2007-08)



Source: Australian Treasury estimates.

Until 1987, Australia maintained a classical company taxation system, under which profits were taxed at the company rate and at personal rates when distributed. In 1987 an imputation system was introduced. Under this system, resident shareholders receive a credit for tax paid at the company level, thereby eliminating double taxation of dividends. Where the resident shareholder's marginal tax rate is below the company tax rate, the excess credit can be used to offset tax payable on other income (for example, wages and salary). Full refundability of excess tax credits for most resident shareholders was introduced to the Australian imputation system in 2000.

Under the imputation system, Australia's company income tax system operates as a withholding tax on the income that Australian residents earn through Australian resident companies, and as a final tax on (primarily Australian source) income earned by non-residents through an Australian resident company or permanent establishment in Australia.

A review of business taxation was conducted in 1999. Key elements of the review included: lowering the company tax rate; more concessional capital gains tax arrangements; replacing accelerated depreciation with effective life depreciation arrangements; revised 'thin capitalisation' rules to prevent profits being shifted offshore; and simplifying the tax system for small business. *The New Tax System* package was introduced from 2000. The GST was introduced as a replacement for the multi-rate wholesale sales tax and a range of inefficient state taxes. The GST revenue was provided to the States as a replacement for their state taxes and Australian government financial assistance grants. The package also included reductions in personal income and business taxes; reforms to the family payments system (outlined in more detail below); and reforms to the tax instalment arrangements for business income.

In response to the 2002-03 *Review of International Taxation Arrangements*, a package of reforms was implemented to improve the competitiveness of Australian managed funds and companies with offshore operations, and reform other aspects of the international tax rules. The reforms included reducing the commercial constraints and compliance costs arising from the controlled foreign company and foreign investment fund rules, as well as extending the exemption for non-portfolio dividends and branch profits to all foreign countries.

Retirement income taxation

Prior to the 1980s, no tax was paid on contributions to superannuation funds, earnings of superannuation funds were tax exempt and tax was only imposed on 5 per cent of lump sum benefits. In contrast, benefits paid as pensions or annuities were generally taxed at the recipient's marginal rates.

Changes made in 1983 reduced the scope for tax minimisation that resulted from the concessional treatment of lump sum superannuation and termination payments, by introducing a tax regime for eligible termination payments (ETPs). Under these arrangements, the full value of ETPs was included as income, with the post-1983 component of the benefit taxed at a maximum rate of 30 per cent. For those aged 55 and over, this rate was reduced to 15 per cent on the amount up to a threshold.

The superannuation taxation arrangements were restructured in 1988 to bring forward the receipt of tax revenue. This involved reducing tax on the post-1983 component of ETPs and imposing a 15 per cent tax on contributions and earnings of superannuation funds. A 15 per cent rebate was also introduced for the specified component of annuities and pensions paid to persons aged 55 and over.

In 1992, the superannuation guarantee was introduced which, enforceable through the Australian government's taxation powers, required employers to make minimum contributions to a superannuation fund on behalf of their employees. A superannuation contributions surcharge was introduced in 1996 to reduce the concessionality of superannuation contributions for higher income earners, but was subsequently reduced in a number of stages until its removal in 2005.

Reforms to superannuation in 2007 aimed to make superannuation easier to understand, and improve incentives to work and save. Under the reforms, superannuation benefits paid from a taxed fund to people aged 60 and over became tax free. The treatment of ETPs was also changed to differentiate between payments received from employers and those received from superannuation funds.

4.2 Historical trends in transfers

Before 1907, social security in Australia consisted of charitable relief provided by benevolent societies, sometimes with financial help from authorities. In 1907, the Harvester Judgment established the concept of an arbitrated 'living wage' — a non-market wage paid to a 'breadwinner' wage earner for the support of themselves and dependants. This effectively introduced a model where welfare outcomes were pursued via wage-related benefits rather than tax assistance or transfers, either in cash or kind.

From 1 July 1909, an Australian government old-age Pension replaced similar schemes operating in various states. An Australian government 'invalid' pension followed in 1910. The first form of family assistance, a non-means tested maternity allowance, began in 1912. Other than the maternity allowance, these payment programs focused assistance on those with no income and no capacity to work. The principles of these schemes set the Australian social security scene going forward, being: funded from general government revenue; based on circumstance 'categories', not past earnings; and means tested to direct assistance to those regarded as most in 'need'.

The establishment of the modern social security system (1940 to 1970s)

The impact of the Second World War saw the expansion in scope of the social security system at the national level (Chart 4.3). The Australian government also progressively took over and expanded state transfers. This period saw the introduction of:

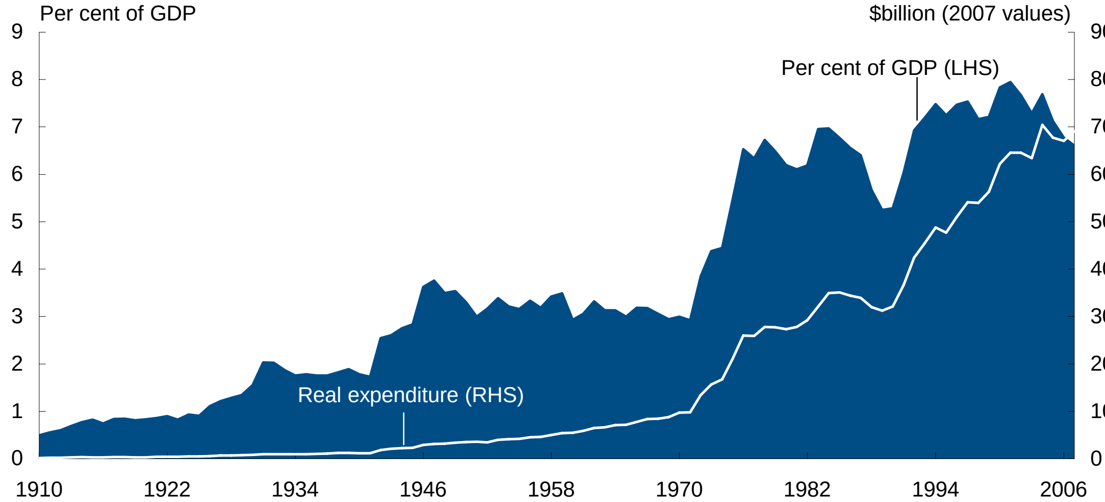
- Child Endowment (1941) — a family allowance paid at a fixed rate with no means test;
- Widow's Pension (1942) — designed to provide support to those who could not reasonably be expected to work, due to either the care of a child or their own age;
- allowances for the children of pensioners (1943) and allowees (1945);
- unemployment and sickness benefits (1945); and
- Special Benefit (1945) — to provide for people who had no other entitlement and were unable to provide for themselves. It was and is tightly means tested.

These changes formed a basic social security architecture, the essential elements of which are discernible in the current income support payment structures.

Over the next few decades the Australian social security system continued to expand. Additional assistance was introduced for those paying rent and for single adults with children. Income support underwent changes to liberalise the means test, to raise single rates in recognition of the higher relative cost of living alone, to provide a common rate structure for pensions and allowances, and to index rates.

In 1972 the Australian government provided its first funding for child care services. A 'universal' Family Allowance was introduced in 1976, replacing Child Endowment and tax rebates for children.

Chart 4.3: Australian government transfers as a proportion of GDP (1910 to 2007)



Source: FaHCSIA estimates.

Towards a more 'active' system of social protection (1980 to mid-1990s)

The *Social Security Review* was established in 1986, as recognition that economic, social and demographic change had created the need to establish a long term perspective on the priorities and directions of the system. The system was broadened from a predominant focus on poverty alleviation, to a system that also encouraged and rewarded self-provision (through work and saving) and that was better integrated with other social services and with economic, labour market and tax policies.

The main changes from the review aimed to improve payments for low income families with children and encourage and facilitate economic and social participation of payment recipients. This was particularly aimed at people with disabilities, single parents, widows, partners of income support recipients and the long term unemployed (through improved labour market assistance). Family payment 'benchmarks' were introduced and later increased. The benchmarks represented the level of assistance required by a couple without private income to raise a child and achieve a similar living standard as a couple without a child.

In the late 1980s and up to 1995, changes were made to social security payments to recognise the changing role of women in the labour force and the increased availability of part-time work. This included gradually increasing the Age Pension age for women; the phasing out of dependency based payments for women; and individual entitlement to income support for partners of income support recipients. The 1995 changes included the introduction of allowances without an obligation to seek work for partnered parents with a child aged under 16 and for older widows and partners of income support recipients with a labour market disadvantage. Other claimants were generally required to claim an activity tested allowance payment.

Also occurring in 1995 was the liberalisation of the allowance income test — the 100 per cent taper was reduced to 70 per cent to improve the reward for part-time work and couples became subject to an income test designed to improve work incentives for secondary earners.

Other changes during this period included: an increase in the coverage and level of Rent Assistance; the introduction of an 'earnings credit' for pensioners and allowees to improve the rewards for part-time work; the implementation of the Child Support Scheme; and the introduction of child care fee relief.

Increased assistance for pensioners and families and further work-related obligations (mid-1990s onwards)

In 1997 the benchmarking of the single pension to 25 per cent of male total average weekly earnings was included in legislation. Since 1 July 2000, a pension supplement available to all Age Pension recipients increases the rate beyond 25 per cent of male total average weekly earnings.

The Australian government established a reference group to consider and report on *Welfare Reform* in the late 1990s. The Australian government's initial response to the report of the reference group was the *Australians Working Together* (AWT) package in 2001. This included: a 'working credit'; the closing of Mature Age and Partner Allowances to new entrants; and new or improved supports and services for parents, people with a disability, the mature-aged and the long-term unemployed.

Building on the AWT changes, the *Welfare-to-Work* changes were announced in 2005. These imposed obligations to work part-time or look for part-time work on parents with older children and on new claimants of the Disability Support Pension with a partial capacity for work. New claimants were paid Newstart Allowance rather than a pension. Existing single parents on a pension with older children also became subject to part-time activity requirements, whereas existing Disability Support Pensioners with a moderate capacity did not. The income test for allowances was also liberalised, with the 70 per cent taper being lowered to 60 per cent to improve part-time work incentives.

This period was also characterised by further increases in support for families. In 2000, as part of *The New Tax System* package, the Family Tax Benefit (FTB) was introduced, replacing a range of pre-existing payments and increasing the assistance provided to families with children. Additional assistance for the direct costs of children was provided through an ad hoc increase to both the maximum and base rates of FTB Part A. FTB Part B further increased the level of assistance for single income families including single parents.

In subsequent years, FTB supplements, more generous means testing, and the Maternity Payment resulted in significant increases in family assistance outlays. After a period of tightening, assistance for child care costs was also increased.

In 2005 the Australian government accepted the main recommendations of the Ministerial Taskforce on Child Support. The recommendations were aimed at better aligning child support with community attitudes and have been progressively implemented, with a new child support formula introduced from 1 July 2008.

Retirement incomes policy was a strong focus in the mid to late 1990s, including the 'extended deeming' of financial investments and changes to the treatment of retirement income stream products. Assistance to carers has increased and lump sum payments to both older Australians and carers have been used since 2000.

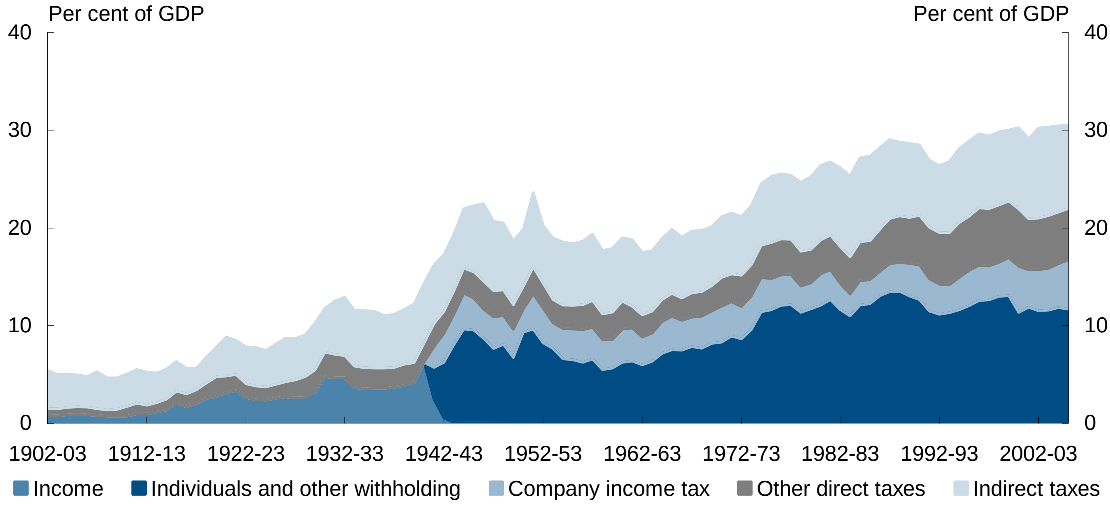
4.3 Australian government and state revenue powers

One of the challenges accompanying federation was the creation of a two-tier system of government that centralised control of some functions, while allowing each State sufficient autonomy to meet the social preferences of its constituency. The Australian Constitution specifically enumerates areas of legislative power to the Australian government, leaving the majority of expenditure responsibilities to the States as residual powers. Australian government powers were viewed as involving functions that the States were not able to conduct efficiently themselves, such as defence and foreign affairs.

In 1901 uniform Australian government tariff and excise duties replaced state customs and excise duties, in part, to secure free interstate trade and ensure adequate protection for Australian industry (Groenewegen 1985). They largely applied to the goods that had been taxed by the former colonies — tobacco products, beer and spirits and some basic food and clothing.

Although the States retained control of land and income taxes, at the time of federation customs and excise duties were by far the greatest source of tax revenue (Chart 4.4). The States were left with a shortfall of funding for their areas of expenditure responsibilities, whereas Australian government revenues exceeded the requirements of its limited role. To resolve this fiscal imbalance, the Constitution provided for a revenue sharing arrangement for the first 10 years following federation. The Australian government kept one quarter of customs and excise duty revenue with the remainder distributed to the States, along with any revenue that was surplus to Australian government needs.

Chart 4.4: Composition of Australian tax revenue (1902-03 to 2006-07)



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

It was not long after federation that fiscal inequality between the States led to federal funding in support of fiscal equalisation. In 1910-11 Western Australia requested fiscal assistance to compensate for the loss of tariffs, which had been its primary revenue source. In 1911-12 Tasmania also received Australian government grants, and South Australia became a recipient in the 1920s. Over time, horizontal fiscal equalisation was formalised with an independent body recommending the distribution of Australian government grants based on fiscal need.

The Australian government introduced its own income tax in 1915 to raise funds for Australia's involvement in the First World War. The Second World War also saw fundamental changes to Australia's tax system. In 1942, the Australian government assumed control of income tax, as a war-time measure, in exchange for government grants to the States. As a result the States' tax base was reduced until 1971 when the Australian government ceded control of payroll taxes to the States to supplement their tax base with a 'growth' tax. With the introduction of the GST in 2000, the States gained access to a further 'growth' tax, as a replacement for Australian Government Financial Assistance Grants and a range of inefficient indirect state taxes. Horizontal fiscal equalisation is applied through the distribution of the GST revenue to the States.

The role of the High Court and its interpretation of the Australian Constitution has been a significant contributor to determining the current distribution of taxing powers across levels of government. Both during and after the Second World War, the States unsuccessfully challenged, in the High Court, the means by which the Australian government, as a practical matter, excluded the States from the field of income tax. In a series of cases the High Court has considered the ability of the States to impose various kinds of indirect taxes (such as business franchise fees), in the context of the Australian government's exclusive power to impose duties of excise. The 'wide view' of excise duties adopted by the High Court in the late 1990s has meant that the power of the States to impose such taxes is severely limited.