

## **Australia's Future Tax System Review – Issues Paper**

This issues paper summarises the main points in the Treasury paper titled 'Architecture of Australia's tax and transfer system' which was released in August 2008 in the context of the abovementioned review.

### *Emerging challenges*

This Treasury paper identifies the following emerging challenges that Australia's tax-transfer system will need to cope with in the years ahead as :

- climate change and its associated costs as the world moves towards a low-emissions economy
- increasing pressure for Australia's tax-transfer system to remain internationally competitive in an increasingly globalised world
- demographic challenges of an ageing population (but participation and productivity increases may ameliorate some of this impact), and
- increasing need for coordinated action across federal and state governments to overcome problems associated with the disparity in Commonwealth and State taxing powers ('vertical fiscal imbalance').

The review provides an opportunity for shaping the tax-transfer system in ways that position Australia to address these and other challenges so as to modernise the economy and secure Australia's future prosperity.

### *Overview of current system*

There are at least 125 taxes levied in Australia. Of these, 99 are levied by the Australian government (including 67 agricultural levies), 25 by the states/territories and 1 by local government. In 2006/07, 90% of total tax revenues were derived from 10 taxes. For individuals/businesses operating in more than one jurisdiction, there could be as many as 160 different state taxes and 259 taxes nationally! A list of the main taxes is contained in the Treasury 'Architecture' paper (pages 12-13).

These revenues were raised by the various tiers of government as follows:

- \$262.5 billion by the Australian government via income tax, GST, taxes on fuel, alcohol and tobacco, customs tariffs and a range of other indirect taxes
- \$48.9 billion by the states/territories via taxes such as those on property, payroll, motor vehicles, insurance contracts and gambling, and
- \$9.4 billion from local government taxes (property rates).

There are around 40 cash transfers paid by the Australian government costing over \$70 billion in 2006/07 and accounting for more than a quarter of Australian Government spending.

The main transfers are income support payments and payments to families including all Age and other pensions, Newstart Allowance and other allowance payments, FTB and supplementary payments.

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

Further details on the current tax/transfer system are available from the Treasury 'Architecture' paper.

### *International comparison*

By OECD standards Australia is a low tax country – eighth lowest, and also a low expenditure country – third lowest in the OECD. 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 vis-à-vis less developed countries.

Australia's mix of direct/indirect taxes is broadly comparable to other OECD countries but the composition differs. For example, Australia and New Zealand are the only OECD countries that do not levy a social security tax (the SGC is not regarded as a tax as the proceeds are paid to individuals' superannuation accounts and not to the government) and have a dividend imputation system.

Other points to note:

- general consumption taxes (mainly the GST) contribute 13% of total tax revenue compared with an OECD average of 19%
- property taxes contribute just under 9% of total tax revenue compared to an OECD average of just under 6%
- Australia does not levy specific wealth taxes like most other countries but such taxes in other countries are not significant (around 0.5% of GDP) in any event
- Australia's retirement savings are taxed concessionally compared to other savings but on an income-based model as opposed to variants of an expenditure tax model in other countries
- Australia's top personal tax rate threshold is broadly comparable to the OECD average
- Australia has one of the higher top personal tax rates on capital gains (notwithstanding the general 50% discount rule)
- Australia also has a relatively high rate of tax on interest income (this generally arises because social security contributions apply to wage/salary income but not to capital income and/or due to some countries taxing interest under a schedular system), and
- Australia's corporate tax rate is above the OECD average.

Australia's uncompetitive company tax rate (30%) reflects the 6% reduction in average OECD rates since 2001. Australia's corporate tax revenue as a proportion of GDP is the 4<sup>th</sup> highest in the OECD and significantly higher than the OECD average of 3.7%. Treasury argues that this largely reflects structural differences in the composition of the incorporated sector in Australia compared with other OECD countries, the imputation system and the strong performance of the Australian corporate sector in recent years due to favourable movements in Australia's terms of trade.

### *Tax mix*

Most countries have a tax system based on a mix of taxes on labour income, capital income and consumption. Australia's tax mix is as follows:

- taxes on labour income (40% of revenue)
- capital income taxes (33%)
- consumption taxes (27%).

Compared with other OECD countries, Australia has a low share of tax revenue from labour income (reflecting the absence of social security contributions which are a significant source of revenue for many OECD countries) and the greatest reliance on tax revenue from capital. In part, this reflects the relatively greater contribution of corporate income taxes to total income tax revenue.

Australia's reliance on consumption taxes such as the GST and excise is around the middle of the OECD-10 countries but at the lower end of the OECD as a whole. Australia's tax mix is slightly skewed towards direct taxes

Treasury notes that it is a surprising result in a globalising world with increasingly mobile capital flows for a small open economy such as Australia to depend so heavily on taxing capital income.

### *Personal tax/transfer systems*

The Australian tax/transfer systems are separate systems with different bases of assessment including in respect to 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 (such as via means testing) but the result is that the system as a whole is complex.

The combination of these systems is progressive and redistributive (particularly by OECD standards) Nonetheless, there are many families and individuals who receive transfers and pay tax in the same year and from one year to the next. While this 'churn' imposes costs on individuals as well the administration of the system, Australia has a low level of churn by international standards.

### *Taxing saving and investment*

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

International factors are now more important when considering how Australia taxes saving and investment, particularly since company tax rates overseas continue to fall. There are ongoing challenges in Australia's ability to tax residents on their foreign source income and non-residents on their income from investing in Australia.

Major elements of the transfer system such as income support arrangements and means testing can impact on individual incentives to save.

The principal tax-preferred savings vehicles are owner-occupied housing and superannuation. The former is completely exempt from income tax and also exempt from asset-testing under the transfer system.

Superannuation is generally taxed on a concessional basis particularly for older Australians as benefits from a taxed super fund are paid tax free from age 60 in certain circumstances. However, in the light of personal tax changes since 2000, many low and middle income earners receive little or no benefit in respect to the tax rate applied to their concessional super contributions.

Different holding entities (such as companies trust and partnerships) are also commonly used for business and/or investment purposes. These entities are taxed differently and small businesses can also utilise a wide range of special tax concessions.

Companies are the most common entity used and also the most significant both in terms of net income and for cross-border investments. As a result of the dividend imputation system, company tax effectively operates as a withholding tax on income earned by Australian residents and as a

final tax on Australian source income of non-residents, albeit that the latter receive only a limited benefit from imputation credits.

Since non-residents now own around 32% of the shares in Australian companies (including more than 50% in resource companies), the role of company tax is particularly important in respect to such cross-border investments. Special tax arrangements such as royalties and PRRT also apply to non-resident investments in Australia's natural resources.

An important feature of dividend imputation is that it provides neutral treatment of debt and equity but there now appear to be other mechanisms for achieving this outcome that might also be more favourable to non-residents.

### *Taxing goods and services*

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

Taxes on specific goods/services (such as alcohol, tobacco and petrol) still exist reflecting (at least at the Commonwealth level) a range of industry and social policy objectives, but Australia's taxes on fuel are low in comparison to other OECD countries. Improving technology is also making it easier to replace some taxes with direct user charges.

### *State, etc taxes*

In 2006/07, state taxes accounted for 15% (or \$48.9 billion) of total tax revenue in Australia. They include some inefficient transaction and other taxes with thresholds, rates and exemptions differing between the states.

In 2006/07, local government rates and other minor taxes on immovable property raised \$9.4 billion.

The fiscal relationship between the Australian government and the States is characterised by 'vertical fiscal imbalance' as the States own revenue sources are insufficient to fund their expenditure responsibilities and thus they are heavily reliant on transfers from the Commonwealth to cover the shortfall.

### *Complexity and operating costs*

Current costs associated with the tax/transfer systems are generally considered to be excessive largely due to the following reasons:

- incremental development of 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.

### *CPRS*

The Australian Government is committed to providing assistance to households (particularly low-income ones) for the introduction of the proposed Carbon Pollution Reduction Scheme (CPRS). The mechanism for the delivery of such assistance will be considered by the Henry tax review.

### *Economic structure of the tax/transfer system*

The many taxes levied in Australia (see above) are ultimately paid from earnings from only three factors of production being labour, capital and land (including natural resources).

Individuals (rather than businesses) own these factors of production and thus ultimately bear the burden of taxation. Who bears a tax (or benefits from a transfer payment) can differ to who pays the tax or receives the payment. For example, payroll tax is paid by a business owner(s) but its actual incidence could fall on the owner(s), employees (if any) or consumers. It could be argued though that small businesses have less control over labour and product markets than larger firms and are thus less able to shift the tax burden on to other parties.

Negative interactions between inflation and the tax/transfer systems have been ameliorated in recent years by the following:

- role of the Reserve Bank in restricting inflation to a 2-3% range
- frequent adjustments to personal income tax thresholds over the last decade
- CGT relief either via CPI indexation or more recently by the 50% discount factor for assets held by individuals or trusts, and
- indexation of most pensions and allowances to at least compensate for inflation.

However, some forms of income such as interest do not appear to have received as much protection as other investments.

The tax and transfer systems differ in terms of the unit of assessment to which they are applied, eg:

- the individual is generally the unit of assessment for the tax system (other than in respect to the MLS and SATO)
- the couple/family is the unit of assessment in the transfer system based on the principle that providing targeted support should take into account other sources of financial support including from close family members
- the major problems with family unit taxation appear to be its greater complexity and tendency to reduce work incentives for secondary earners since the family's tax rate reflects the income of the primary earner, and
- it should also be noted that many OECD countries have moved away from family based taxation in recent years.

Australia's tax-transfer system is highly redistributive for those with least means as compared with other OECD countries, while our spending is below the OECD average. This reflects the highly targeted nature of the Australian tax/transfer system particularly via the widespread use of means-testing of benefits. However, this has resulted in Australia generally having higher effective marginal tax rates (EMTRs) for welfare beneficiaries than in other OECD countries with consequential adverse implications for workforce participation.