CHAPTER 1 INTRODUCTION

MAIN POINTS

> The Henry Review, published in 2010, was the first major review of Australia’s tax and transfer system since 1975. Its framework, analysis and findings can contribute significantly to good tax reform.

> Tax reform should aim to support sustainable and inclusive economic prosperity through efficiency; promote fairness in an overall progressive tax-transfer system and build resilience in the tax system in the face of economic, social and technological challenges.

> As recommended by the Henry Review, Australia needs a broad-based tax system that raises adequate revenues from personal and business income, economic rents from resources and land, and private consumption. Tax reform should aim to strengthen the tax system across all of these bases in the long term.

> Economic modelling of tax efficiency and the incidence of the tax burden is difficult and relies on many assumptions. However, it is a useful input to tax policy decisions that aim to support economic prosperity by reducing distortions in individual and business decision making, especially where capital or labour is mobile or tax planning margins exist.

> Fairness is critical to the system to ensure appropriate contributions from those with capacity to pay, to enable redistribution to those in need through the transfer system and to support essential government goods and services for the wellbeing of all Australians. Fairness should be considered across the system as a whole. The principle of ability to pay remains important in delivering progressivity in the tax system.

> The concept of resilience of the tax and transfer system captures a range of important goals relating to the effectiveness and adaptability of the system as it operates in the real world. Goals for a more resilient tax-transfer system include simplicity, sustainability, certainty, cohesiveness, legitimacy, ease and low costs of administration and compliance, flexibility and resistance to tax avoidance and evasion.

1.1 Tax principles

This chapter discusses the history and context of the Henry Review and then explains key concepts and principles of tax policy that are essential to understanding and engaging in the tax reform debate.

The Henry Review discussed various principles of taxation in detail in its Architecture Report (Henry et al 2008a) and Consultation Report (Henry et al 2008b). In the final analysis, the Henry Review identified five tax and transfer design principles (Henry et al 2010a, Box 2.1):

> Equity
> Efficiency
> Simplicity
> Sustainability
> Policy consistency.

The first three principles are traditional tax policy and design principles. The latter two principles reflect a focus in the Henry Review on revenue and environmental sustainability and coherence of the tax-transfer system with overall government policy.

In this report, we follow the Henry Review in using the principles of efficiency (to contribute to economic prosperity) and fairness (equity). In place of simplicity, sustainability and policy consistency we use the single concept of resilience to indicate a tax system able to operate effectively in the face of social, technological and economic challenges. Each of these principles is discussed below.
It is important to view tax and transfer laws and reforms in the context of the system as a whole. Sometimes tax principles are mutually reinforcing. Often, the principles seem to be in conflict. In any real-world tax system, all tax policy and reform decisions will have trade-offs and consequences for the distribution of benefits and burdens. However, taking a broader view of the goals of economic prosperity, fairness or resilience for the system as a whole can assist in resolving conflicts in these tax principles.

1.2 The Henry Review

The Henry Review was the first ‘root and branch’ review of Australia’s tax and transfer system in more than 30 years. The Review was system-wide in scope and long-term in vision, presenting an ambitious blueprint that identifies a range of reform directions. It was intentionally framed in terms of a 40-year vision aimed at identifying reform pathways for emerging medium and long-term challenges facing Australia.

The last comprehensive reviews of Australia’s tax and transfer system were completed in 1975. The Asprey Review (Asprey et al 1975) examined the tax system and the Henderson Review (Henderson et al 1975) examined the social security system. The Asprey Review set a reform framework with the central objective of broadening the tax base and lowering tax rates; this was progressively achieved in successive reform packages over ensuing decades. These goals continue to be relevant in current debates about tax reform.

Changes to the tax system following the Asprey Review took place through a number of policy analysis and political reform processes. The Draft White Paper (Commonwealth of Australia 1985) led to the introduction of Fringe Benefits Tax (FBT), Capital Gains Tax (CGT) and the corporate-shareholder dividend imputation system while reducing personal and company tax rates. Numerous tax and retirement system reforms established our superannuation system and associated tax concessions during the 1980s and 1990s. A New Tax System (Commonwealth of Australia 1998) introduced the GST, eliminated many inefficient indirect taxes including the wholesale sales tax, and reduced income tax rates. The Review of Business Taxation (Commonwealth of Australia 1999) led to a reduction in the company tax rate, broadening of the company tax base and lower tax on savings, including the introduction of the CGT 50 percent discount.

The Henry Review had a breadth of expertise on its Panel drawn from the public sector, academia and business. It engaged both the community and tax experts through an extensive process of consultation which attracted more than a thousand public submissions and carried out significant research and economic modelling, releasing several preliminary papers and convening an international academic and policy conference. Some other countries conducted substantial tax reviews at the same time, including the Mirrlees Review (Institute for Fiscal Studies 2011) in the United Kingdom and the Tax Working Group (2010) in New Zealand.

The guiding principles and motivations for the Henry Review were set out in its Preface (2010a, v-vi). Its underlying premise was that economic, social, technological and environmental changes would profoundly affect Australia’s tax and transfer system but that these changes would evolve slowly. The Review did not conclude that the tax and transfer system was broken or in crisis, but it recommended that early consideration of challenges and reforms is needed in order to position Australia’s tax and transfer system for the future.

In spite of its broad remit, there were limitations in the Henry Review’s terms of reference that hampered its ability to comprehensively examine tax policy settings. The two most significant limitations were exclusion from consideration of the GST rate and base and the treatment of tax-exempt superannuation benefits (although the Review addressed taxation of superannuation contributions and earnings). The Review did examine the role of a consumption tax base in Australia’s tax system, suggesting a business cash flow tax as a direction for reform. However, there is no doubt that exclusions from its terms of reference influenced the final form of the Henry Review’s recommendations.

The Review examined Commonwealth, State and local taxes in the federation and it identified the need for intergovernmental agreement in a federal context as necessary for reform of Australia’s tax system. However, the Review did not consider a reform of the federation including State and Commonwealth roles and responsibilities, tax allocation, grants and expenditures. If it is to contribute to sustainable tax and transfer reform, the analysis of taxes must be embedded in a fuller understanding of how we fund governments in our federation, while any federation reform necessarily requires analysis of taxes.

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The Review produced a list of 138 Recommendations (see the Appendix), some of which are specific and others general. Most of the reforms proposed by the Henry Review were intended to be considered in a holistic way with other recommendations rather than separately, and as guidance for future tax policy and law development rather than as a discrete package of tax reforms. Around a third of the Recommendations have been implemented by governments in the last 5 years. However, no coherent package of reform has been based on the Review and previous attempts to enact some of the more important recommendations have led to significant missteps in tax policy and law design and implementation, especially in relation to the Minerals Rent Resource Tax (MRRT). Proposed reforms to State taxes have scarcely been addressed, except in the ACT.

The Henry Review made the following fundamental recommendation about tax bases, which remains centrally important today:

**Recommendation 1 (Henry et al 2010a)**

Revenue raising should be concentrated on four robust and efficient broad-based taxes:

- personal income, assessed on a more comprehensive base;
- business income, designed to support economic growth;
- economic rents from natural resources and land; and
- private consumption.

This recommendation acknowledges that to be effective, a tax system must likely use all substantial bases, rather than relying on any one ‘ideal’ base. Reform proposals to change the tax mix usually aim to shift the balance between these tax bases, especially between income, consumption and land. However, it is useful to consider tax policy in light of two well-established ‘ideal’ approaches to defining tax bases as this can provide a benchmark for analysing the current system.

An ‘ideal’ income tax base is the comprehensive income tax. The comprehensive income tax applies to net economic gain, adjusted for inflation, derived by an individual taxpayer in a period of time. Income defined comprehensively includes all real, accrued gains from work or investment, net of losses or expenses. Comprehensive income is equivalent to consumption plus the change in net wealth of an individual in the period.\(^2\) In the real world, income taxes do not succeed in taxing all net economic gain of an individual for various reasons. In particular, they usually only apply to realized gain, gain derived when an asset is sold or income is earned, and rarely adjust fully for inflation or capture all forms of return.

An ‘ideal’ consumption tax, sometimes known as an ‘expenditure tax’, would tax all expenditures of an individual in a period of time and would exempt savings and investment. Savings are assumed to be deferred consumption and so would not be taxed until actually consumed. Thus, the expenditure tax base excludes the change in net wealth and under certain restrictive conditions it is equivalent to a tax on labour income. The longstanding practice of exempting the home from the income tax, zero or lower taxation of capital gains and low taxed superannuation means that Australia’s personal income tax is a hybrid that has characteristics of a expenditure tax (see discussion in Chapter 4).

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\(^2\) It is sometimes called the Schanz-Haig-Simons income tax base in honour of the economists who invented it, most famously Simons (1938).
**Tax incidence**

Public perceptions of tax incidence may differ from economic or legal incidence, while alternative academic views about the relative merits of taxation reform proposals often reflect a different understanding of where the burden of taxation actually falls (Henry et al 2010a, 19). All taxes ultimately fall on the returns to individuals as owners of the three factors of production of labour, capital and land (Henry et al 2008a, Appendix B). That is, all taxes are borne by people, whether as workers, investors or consumers.

For instance, company tax is not borne by the company but is ultimately borne by individuals who may be investors through a reduction in the return to capital, or consumers or workers through a shifting of the burden in prices or wages. The extent of tax shifting through prices or wages may vary.

The question of who bears the incidence, or real financial burden, of taxation is a difficult and debated area of tax policy analysis that requires complex whole-of-economy modeling. Tax shifting is a consequence of the impact of taxes on prices and factor returns and of individuals’ decisions. The responsiveness of prices and factor returns, such as the economic return earned by working, is known as the *price elasticity* of the good, service or factor. This depends on a range of factors including:

> the extent of market competition and the existence of economic rents (returns above a ‘normal’ rate of return taking into account inflation and a risk premium);
> mobility of factors of production, principally capital but also labour;
> substitutability of products, and of labour for capital (and vice versa); and
> size of the domestic economy and its degree of openness (Rimmer et al 2014, 35).

To take another example, the GST levied on the producers and retailers of goods is borne by the ultimate consumer through being passed on in prices. However, in some circumstances, the GST may not be fully passed on to the consumer. For example, the burden of GST may fall instead on an individual business owner if the market for a product is not fully competitive.

In spite of the complexity and difficulty of tax incidence analysis, it is useful to try to model tax incidence to help understand the economic and distributional impact of a tax change. The estimated tax incidence may also help in assessing arguments for compensating particular groups who might be affected by tax reform.

**1.4 Efficiency to support economic prosperity**

Tax reform should aim to support sustainable and inclusive economic growth through improving efficiency, to ensure economic prosperity for all. While taxation clearly delivers benefits to society through government goods and services and redistribution, it also imposes economic costs.

To support economic growth, the tax system should be as efficient as possible. Economists define an *efficient* tax system as one that meets revenue needs while minimising the distorting effects of taxes on private decisions to work, save, consume and invest.

In some circumstances the distorting effects of taxes can be utilised by governments to improve societal outcomes using *selective taxes* or *tax expenditures*. Taxes may be used to correct market distortions or to regulate behaviour.

For example, the substantial tax concessions for voluntary superannuation saving are intended to encourage individuals who have sufficient income to save as much as possible in superannuation. The research and development tax offset available for companies is intended to address a market failure that leads to underinvestment in research and development, by improving the returns to companies which engage in research and development activities. Selective taxes or tax expenditures may also generate economic costs and may have unintended consequences and reduce revenue-raising overall.

**Optimal tax design**

One important theoretical approach to modeling economic efficiency of taxes is called ‘optimal tax design’ (see Abelson 2008, 416). It aims to inform policy-makers about how taxes and transfers can best be designed to minimise negative effects on economic growth, accepting that almost all taxes distort economic behaviour in one way or another.

In the case of businesses, taxation can alter decisions about how businesses are structured; how much they invest and where; how many people they employ and what they produce. For individuals, the tax system can alter the choice of investment, work and saving in ways that are less productive for the economy as a whole (see, e.g. Heferen (2012)). The greater the size of these taxation-induced behavioural changes or distortions, the more the tax system detracts from overall economic efficiency. This distortion can be at a point in time when a tax is paid, or it may affect future behaviour and actions over time.
The simplest economic model compares decisions made in the tax system to decisions made in a ‘no-tax world’. In this model, all taxes are inefficient apart from a head tax which is a lump sum on every individual. However, as all decisions by individuals are made in the real world with pre-existing taxes, regulations and public goods, this simple theoretical basis is of limited relevance in practice.

The extent to which an individual actually responds to a tax—the elasticity of his or her response to taxation—is an empirical question and will depend on the characteristics, choices and context for the individual. Studies in optimal taxation recognise that ‘real world’ choices must be taken into account in assessing efficiency of a tax system (Slemrod and Gillitzer 2014, Apps and Rees 2010).

Efficiency should be considered in the context of the tax and transfer system as a whole. It is often difficult to identify how taxpayers will respond to changes in taxes or transfers. Consequently, it may be difficult to target tax bases and set tax rates in ways that are least likely to distort behaviour (see, e.g. Mankiw et al 2009). However, in some contexts, the empirical evidence is clear. One important lesson from optimal tax theory combined with empirical measurement concerns the different responses of men and women to changes in the tax system (for example, see Apps and Rees 2010). Women are more responsive to tax rates, in respect of their work behaviour, than men. High effective marginal tax rates as incomes rise and transfers are withdrawn can reduce work, particularly among low and middle-income women. We return to this issue in Chapter 4.

Individuals and businesses may respond to tax systems in a variety of ways, not only through choosing to change their decisions about work, investing and saving. For instance, a taxpayer may plan their affairs by claiming a large expense deduction so as to reduce taxable income, or choose to leverage investment in an asset such as real estate, generating a tax deduction to shelter their wage income from tax. Some large businesses, including some multinational enterprises, have almost unlimited ability to minimise taxes while maintaining investment in productive sectors around the globe. Small or privately owned businesses have less access to global strategies but can take advantage of family relationships that may facilitate minimizing tax.

On the other hand, many economic decisions of taxpayers are driven by factors other than taxes, and most taxpayers are compliant with the tax system. It is critical to build and maintain a tax system that is easy to comply with and is perceived as legitimate to support Australia’s high level of voluntary compliance, so that it will raise adequate revenues.

A feature of tax policy design has been reliance upon a broad-based personal income tax for much of the revenue raising task, featuring a progressive rate scale with the average tax rate rising as incomes rise. This can achieve a reasonable degree of progressivity and distributional equity without excessively harming efficiency (Auerbach 2010, 63).

**Excess burden of taxes**

Economists attempt to estimate the efficiency effects of tax reform proposals for taxation by estimating the excess burden of a tax. Mathematically, economists seek to estimate the dollar value of the size of the tax-induced change in economic behaviour (substituting an activity that is taxed for another activity) over and above the cost of the tax.

The marginal excess burden reflects the economic cost over and above the revenue impact from a small increase in a tax expressed in cents per dollar of additional revenue. The average excess burden represents the economic cost from introducing a new tax, expressed in cents per dollar of additional revenue raised by the new tax. The marginal excess burden may be useful for considering the impact of small changes in the tax, such as an incremental change in the tax rate or tax base, while the average excess burden may be useful for considering the impact of introducing, or abolishing, a tax (KPMG Econtech 2010, 4). Both measures provide some rough and ready guidance about what taxes are preferred from an economic efficiency perspective.

The lower the calculated marginal excess burden, the more efficient is the tax. The Henry Review presented indicative modelling undertaken by KPMG Econtech of the excess burden from a 5 per cent increase in selected major Australian taxes. This modelling indicated a wide variation in the relative efficiency of different taxes (Henry et al 2010a, 13).

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3 The Henry Review noted that its modelling results could only be indicative due to the difficulty of modelling the full range of potential efficiency costs and interaction effects when there are simultaneous changes to different taxes (Henry et al 2010a, 13).

4 Royalties and crude oil excise, insurance taxes, payroll tax, corporate income tax, labour income tax, motor vehicle taxes, stamp duties, GST, land taxes, municipal rates and petroleum resource rent tax.

The most efficient taxes (with lowest marginal excess burden) are found to be land and resource taxes, as they are considered to apply in general to an immobile source of return. The next most efficient taxes according to this model are broad-based taxes on consumption because they do not distort the decision to save or consume, and taxes on labour such as the personal income tax or a comprehensive payroll tax. The GST is an efficient tax; however, the GST base has many exemptions which make it less efficient, as explained in chapter 6.

The least efficient taxes are modelled to be company income tax and taxes on capital, assuming that capital investment is mobile and taxes that fall on market transactions, such as stamp duties and insurance levies, that impede people from productive market activity.

The Henry Review recommended reducing company income tax in the long term, while increasing taxation of non-renewable resources and land. This does not mean that Australia would stop levying taxes on capital. Rather, a shift in the tax mix towards consumption tax and taxes on land is argued to increase economic prosperity because these taxes are more efficient. OECD modelling (Johansson et al 2008) suggests that a revenue-neutral shift of one per cent of tax revenue from income tax to consumption tax could increase long-run GDP by up to three quarters of a per cent. However, Hines and Summers (2009) point out that greater use of consumption taxes in place of income taxes has potential implications for tax progressivity and distributional consequences that would require careful consideration from the perspective of fairness.

### 1.5 Fairness

Two principles are useful for determining fairness of the tax and transfer system. These are the benefit principle and the ability to pay principle.

Fairness may be considered at a point in time (a static distribution) or over the lifecourse of individuals. There are times when considering inequality between individuals at a particular time is appropriate. While it may be more difficult to assess, it is also important to examine the effect of the tax and transfer system for individuals as they move in and out of dependence and independence and are situated in different family and work structures through the lifecourse, or even across generations (intergenerational equity). The Henry Review placed a strong emphasis on lifecourse and intergenerational equity. We discuss this further in Chapter 4.

#### Benefit principle

The benefit principle states that it is fair that we pay taxes in exchange for the benefit derived from government as a whole including government services such as education and health and public goods such as roads, rail, public transport, sewage and water infrastructure, and our redistributive transfer or social security system. This can be expressed broadly as “taxes are what we pay for civilized society.”

The benefit principle is most useful as a broad justification for adequate taxation across the community as a whole, rather than the distribution of relative burdens of taxation. It carries considerable weight in the community, for example in terms of the relationship between taxes paid and transfer payments and tax concessions received over a person’s life, with an expectation that some tax paid over the course of a working life should be returned in retirement.

In applying the benefit principle, we should take a broad view of outcomes from government as a whole, including taxes and transfers, as well as expenditures on public goods. Examining the tax system in isolation, and at a single point in time, does not present the full picture of the distributional impact of taxes and transfers.

The benefit principle also underpins specific taxes or user charges on identifiable groups, such as agricultural levies or local government rates applied to a particular community. In an international context, the benefit principle is the main justification for taxing multinational enterprises that are not based in Australia on their profits derived from Australian operations or activities. This is because these multinationals gain a positive benefit from goods and services such as infrastructure that are funded from Australian tax revenues.

#### Ability to pay

The ability to pay principle helps to identify what is a fair amount or proportion of tax to be paid by individuals relative to each other. Ability, or capacity, to pay taxes is generally considered across two dimensions:

- > individuals with the same economic capacity should pay the same amount of tax (horizontal equity); and
- > individuals with greater economic capacity should pay more tax than those with lower economic capacity (vertical equity).

These principles of horizontal and vertical equity are widely accepted, yet equally open to wide interpretation. They depend on the particular characteristics of a taxpayer and their circumstances, and on a measure or metric of ability to pay.

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6 However, the extent to which even resources such as minerals are ‘immobile’ depends on how much technology or intellectual property is used in their extraction. See further chapter 5.

7 Compania General De Tabacos De Filipinas v. Collector of Internal Revenue, 275 US 87 (1922) (United States Supreme Court) per Oliver Wendell Holmes J, 100.
In an income tax, the measure of ability is provided by the concept of taxable income, which is the legal definition of income, less deductions, that is subject to tax. To ensure fairness, it is important to ensure that the legal definition of taxable income provides a proper reflection of ability to pay. In a consumption tax such as the GST, ability to pay can be assessed by examining taxed consumption against a benchmark of either total consumption or total income of the taxpayer.

We often consider ability to pay in respect of a single tax, such as the personal income tax. However, it is the overall outcome across the tax and transfer system, including interactions between policy at different levels of government and effects over the lifecycle, which ultimately determines the fairness of the system.

### Progressive, proportional and regressive taxes

In general, we measure the progressivity of a tax with respect to the income of the taxpayer. A head or lump sum tax would be fair in the sense that each individual would pay exactly the same amount. However, it is clear that such a tax would have a larger impact on a low income individual, relative to its impact on a higher income individual. That is, because incomes are unequal, individuals must pay different amounts of tax if the system is to be fair.

A **proportional** tax levied at a flat percentage rate would provide for an equal and proportionate sacrifice across all individual taxpayers. An example would be a 30 per cent tax on all income.

In Australia, as in most comparable countries, it is recognised that an individual’s ability to pay tax increases as his or her income or assets increase. This supports a **progressive** tax in which higher income earners are subject to higher marginal tax rates and average tax rates than lower income earners. This has been a long-standing design feature of the Australian tax system. Progressivity in our tax system is principally delivered through the personal income tax, by increasing the marginal tax rate as incomes rise. Some other taxes, such as local government rates, are also progressive to a limited extent.

Chart 1.1 indicates the marginal tax rates and average tax rates in Australia’s personal income tax (for more detail, see section 4.2 below). The **average** tax rate is calculated as the total tax an individual pays as a percentage of his or her taxable income. The average tax rate is always lower than the marginal tax rate except at very high income levels when it converges to the marginal tax rate.

Chart 1.1 shows that even for income earners in the top one per cent earning more than $250,000 per year, the average tax rate (the tax take as a percentage of taxable income) is less than 35 per cent although they face a marginal tax rate of 45 per cent (excluding the Medicare levy and deficit reduction levy). The GST is a proportional tax as it is levied at a flat 10 per cent rate on all consumption in the base. However, relative to the income of taxpayers, the GST falls more heavily on low income taxpayers who spend more of their disposable income and have less capacity to save. This is because the GST does not tax income that is saved but only income that is ‘consumed’. High income individuals can afford to, and do, save some of their income. Consequently, the GST is considered to be regressive with respect to income. Australia’s GST exempts many basic consumption items including fresh food and vegetables, education, health, childcare and water, which are widely thought to reduce its regressivity. However, the extent to which these exemptions achieve this outcome is less clear.

Chart 1.2 represents how the average tax rate increases as income increases under a progressive tax, compared to a proportional tax (average tax rate stays the same) or a regressive tax (average tax rate declines).

The tax and transfer system takes account of a broader range of factors that affect an individual’s ability to pay, including household size, the number and age of children and the nature of any caring responsibilities. In Australia, as in most comparable countries, the basic unit of taxation is the individual. The tax system contains some allowances for variations in living costs due to family structure and other factors through targeted tax relief. However, most provisions recognising family circumstances are in the transfer system. We discuss this in Chapter 4.
Chart 1.1: Marginal and average tax rates

Source: ATO (2014a). Tax rates are the individual resident income tax rates in 2013-14, excluding Medicare Levy and temporary levies.

Chart 1.2: Progressive, proportional and regressive taxes
1.6 A resilient tax and transfer system

The concept of resilience of the tax and transfer system aims to capture a range of important goals relating to the effectiveness and adaptability of the system as it operates in the real world. The dictionary definition of ‘resilience’ is the ability to rebound or recover quickly and to be adaptable or flexible in changing circumstances.

In this report, we use the concept of resilience to embrace a range of important principles for design and operation of taxes and transfers, including:

- simplicity
- sustainability
- certainty
- cohesiveness
- legitimacy
- ease and low costs of administration
- ease and low costs of compliance for taxpayers
- flexibility
- resistance to tax avoidance and evasion.

The tax system needs to be adaptable to changing economic circumstances locally and globally including changes in the way we do things, technologies and employment, investment and savings patterns. Resilience is a dynamic concept that aims to capture how the tax and transfer system responds and adapts to address changes in the behaviour of individuals in relation to their family, work, and other economic and social opportunities or misfortunes.

**Examples**

- Individuals and employers are changing how work is done from standard employment relationships to casual, self-employed and flexible working hours. The tax and transfer system must be designed to ensure that a fair share of tax is borne by all who earn income and that social security payments are available for this flexible workforce when needed most.

- In a digital economy, the value in multinational businesses is increasingly located in intangibles such as brands and trademarks. The tax law must be able to define and locate profits based on the value of intangibles, so tax administrators can identify the taxing rights of Australia and apply this law so that the right level of company tax can be collected.

**Sustainability**

Resilience includes the ability for tax revenues to be sustainable and to recover in the face of external shocks. Australia’s tax revenues as a proportion of GDP have not fully recovered since the Henry Review reported, in part because of the GFC and in part because of slowing economic growth. A decline and lag in recovery of tax revenues is not surprising and shows flexibility of the system, as business and investment losses are absorbed over time. Tax revenues should grow with the economy, but Commonwealth tax receipts are lower now as a proportion of GDP than they were in the last decade. State tax receipts have also declined as a percentage of GDP.

**Simplicity, certainty and consistency**

Resilience requires certain and reasonably simple tax laws. It also requires a stable and predictable tax system. Dramatic swings of policy direction generate significant uncertainty for individuals and businesses and this may undermine economic prosperity. Nonetheless, the system should also be sufficiently responsive and flexible to changes in the technological, social and economic environment.

Tax laws should be internally coherent and consistent with transfer policy and laws, to the extent possible. There are numerous tradeoffs in this context. For example, the individual unit is used in the tax system as it best reflects ability to pay and supports work incentives. However, the transfer system generally tests eligibility for income support payments based on couple or household income. Tax and transfer laws should also be consistent with other government policy, especially regulatory policies aimed at changing behaviour.

A relatively uniform treatment of different kinds of income, consumption, or assets, and of different individuals and legal entities will contribute to resilience of the tax system. The more uniform the system, the fewer planning margins exist to create opportunities and incentives for individual taxpayers to modify their behaviour or to avoid or evade tax. However, a balance must be struck. Tax law cannot be completely uniform because of inevitable differences in the characteristics and circumstances of taxpayers and goals of fairness.

Excessive complexity can make the tax and transfer system less fair. Some taxpayers will be better able to deal with complexity and adapt to change in the tax system (including by adopting structures for minimising or avoiding tax) than others. It is for these reasons that many tax systems offer simplified taxation arrangements to small businesses, for example in relation to depreciation of assets, while targeting complex integrity measures at larger businesses and multinational corporations.
Poorly managed interactions between different parts of the tax system offer avenues for taxpayers to exploit boundaries, for example, by shifting income to a lower taxed individual or entity or converting it into a more lightly taxed form, such as capital gains. The tax system should be designed to cope with these challenges without increasing the wasteful burden of complexity for the system and economy as a whole.

Minimise administration and compliance costs

All taxes involve administration and compliance costs that detract from overall efficiency.

Administration costs include the costs to government of designing, operating and changing the tax system. The Australian Tax Office (ATO) is widely regarded as an effective tax administrator. It has an overall cost of collection of less than $1 for every $100 of net tax collected (ATO 2014b). The ATO’s cost of collection ratio, which measures the administrative cost per $100 of net revenue is comparable to the ratio for similar countries. This is indicated in Chart 1.3 below. However, overall, New Zealand and the United Kingdom have lower ratios than Australia.8

Tax administration costs vary depending on the tax and as a result of specific contextual factors. In Australia, the GST has a relatively high administration cost of approximately $1.29 per $100 of GST revenue, close to $700 million in 2014-15 (Treasury 2014a, Paper 3, Table 3.9). We discuss some reasons for this in chapter 6. The ATO’s cost of collection for the personal income tax is lower than the cost of collection ratio indicated in Chart 1.3.

A range of other indicators may also indicate challenges for tax administration. For example, the ATO has a significant amount of ‘collectable debt’ from Business Activity Statements, income tax and superannuation guarantee obligations, totalling $19.5 billion in 2013-14 (ATO 2014b, Table 2.13).

![Chart 1.3: Tax administration costs as a percentage of revenue collected](image)

Source: OECD (2013b) Table 5-3.

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8 Caution is needed in comparing the cost of collection ratio as this ratio is an average across taxes and also does not cover all taxes in each country; nor does it usually cover sub-national tax agencies.
A more resilient tax system would enable the ATO to reduce administration costs further, to provide clearer up-front legal guidance, settle outcomes to disputes for timely collection and build cooperative approaches to audit backed by strong enforcement where needed, while enabling it to adapt to new tax planning structures and approaches.

Compliance costs are borne by taxpayers and include the financial cost and time individuals and entities spend complying with their tax obligations. This encompasses the costs of engaging tax agents and accountants to assist with managing and planning tax affairs. Compliance costs in Australia are substantial and the empirical evidence suggests that compliance costs tend to be regressive.

Recent analysis by Tran-Nam et al (2014) reports survey data suggesting that personal tax compliance costs totalled around $9.6 billion in 2011-12, or around 7 per cent of Commonwealth tax revenue. They also provide evidence suggesting that personal tax compliance costs fall disproportionately on lower-income earners who are least able to deal with them. For businesses, compliance costs fall more heavily on small firms relative to larger firms.

More than 75 per cent of all individual taxpayers lodging a tax return utilised a tax agent in 2011-12 (ATO 2014c), among the highest rates of tax agent use in comparable countries. For individual taxpayers, a resilient tax system would be one which compliance costs are reasonable, engagement with the system simple and minimal, and tax payments could be easily made on time so that tax debt is manageable.

Digital advances in data, payment and financial systems have potential to streamline and improve tax administration and compliance in future. Technological upgrades are costly but may generate benefits. For example, individual taxpayers may be able to view their tax obligations and transfer entitlements in a single uniform online account in future. Governments may be able to collect multiple taxes, perhaps even for different levels of government, from businesses in a simpler way using online business accounting systems, such as the Pay-As-You-Go (PAYG) wage withholding system.

1.7 Institutions and the pathway to tax reform

It is crucial for a resilient tax system that taxpayers accept that the tax law is legitimate and that processes of tax reform, law making and administration are fair, transparent and accountable. The Henry Review focused significant attention on tax institutions, governance and administration. Recommendations 111 to 138 address processes of tax policy and law making, tax and transfer administration and monitoring of the tax system.

This report does not address the institutions and processes of the tax system in detail. However, one Recommendation that we wish to highlight concerns the need for good empirical research to build a resilient tax system. As far as possible, we should aim to design and administer the tax and transfer system based on empirical evidence of how the system really works and how people really behave. The Henry Review recommended that the Commonwealth, State and Territory governments should systematically collect data on taxes and transfers and make this information available for empirical research (Recommendation 133) while also updating the privacy framework for taxpayers (Recommendation 129). The TTPI aims to support governments in making tax and transfer data available for good research to support a resilient tax system.

The Henry Review also put forward a number of necessary elements in the pathway towards tax reform. Its main points concerning the pathway to tax reform, which we support, are briefly summarized here (Henry et al 2010a, xxiv-xxv):

> Tax and transfers are instruments of government policy and must be reviewed and reformed in light of overall tax, regulatory and expenditure policy of government.
> The field of taxes and transfers is very broad and tax reforms will need to be made over time.
> Businesses, individuals and markets need time to adjust to new settings in the tax and transfer system; it must also be recognised that adjustment has costs.
> Implementation of effective tax reform will require agreement of the Commonwealth and all State and Territory governments and the implications for revenue sustainability must be assessed in detail.
> Tax reform should not be pursued independently of the overall fiscal and macro-economic circumstances facing Australia.
> All tax reforms affect the distribution of benefits and burdens across taxpayers. Transition is critical and compensation or other assistance may be required for affected taxpayers.