

# CHAPTER 2 CHALLENGES FOR TAX REFORM

## MAIN POINTS

- > The Henry Review was undertaken over an 18 month period in 2008 and 2009, at a time of uncertainty regarding the economic outlook in Australia and globally. This uncertainty arose principally because of the impact of the global financial crisis (GFC) and the expected future trajectory of the mining boom.
- > The Henry Review identified six challenges and opportunities for designing a future tax and transfer system for Australia. These were: demographic change; the social context and expectations; the environment; increased factor mobility; addressing system weaknesses; and growth in Asia. These challenges remain for tax reform today however some aspects have become more pointed in the last five years.
- > The mining boom has transitioned to a third phase of production and lower investment accompanied by lower prices. Combined with the decline in the rate of economic growth and accelerating changes in the Australian economy towards services, this presents a number of tax challenges. These include lower corporate revenues than predicted and the need to build a tax system to support investment in Australia.
- > The digital global economy including new multinational business models poses a major challenge to the tax system. It is likely that coordinated global solutions will be needed to fully address these challenges. New technologies also present opportunities for improvements in tax systems that will make compliance and administration easier and more effective in future.
- > Australia's lagging productivity performance means that tax policy should focus on reducing distorting effects of taxation on decisions of individuals and businesses with the aim of improving skills and efficient allocation of labour and capital.
- > Since the Henry Review, Australia's population profile has reached a turning point, with the proportion of the population at working age in long term decline. There is a need to broaden workforce participation especially by young people, women currently working part-time or not at all, and older workers transitioning to retirement, in order to maintain the tax base while also addressing needs for family and care through the tax-transfer system. New work practices also pose challenges for resilience of the tax system.
- > The tax-transfer system is a key element of Australia's policy response to ensure a fair distribution of economic rewards. Fairness, actual and perceived, is critical to legitimacy and sustainability of the tax system. In the face of increasing public and policy concern about inequality, investigation of policies to address uneven benefits at the top end of the income and wealth distribution, and ensuring an adequate basic minimum for all, should be prioritised.
- > Environmental challenges and climate change impacts continue to grow, Tax policy should aim to support environmental sustainability coherently with other government policy, while not generating perverse incentives that run counter to environmental policy goals.

## 2.1 The mining boom and structural economic change

The greatest single influence on Australia's economic fortunes over the last decade has been the 'millennium' mining boom supported by East Asian industrialisation and burgeoning Chinese demand for coal, iron ore and natural gas (Garnaut 2013; Grafton 2014). The mining boom and the associated terms of trade effect has been the major factor driving the expansion in Australians' material living standards. This is reflected in increases in wages and profit levels and in the level of government goods and services funded through taxation, including family transfers and age pensions.

The mining boom has proceeded in three distinct, yet overlapping phases:

- > **Phase 1:** from 2003 and peaking in 2011, a rapid and sustained rise in global prices for Australian minerals exports which, in turn, drove the Australian dollar and terms of trade—the ratio of export prices received to import prices paid—to record levels;
- > **Phase 2:** from 2006 and peaking in 2013, a large and rapid increase in new mining investment; and
- > **Phase 3:** a production-driven phase, still continuing and characterised by rising export volumes, but accompanied by lower global minerals prices, with a lower level of new mining investment and a reduction in employment in the (mining) construction sector.

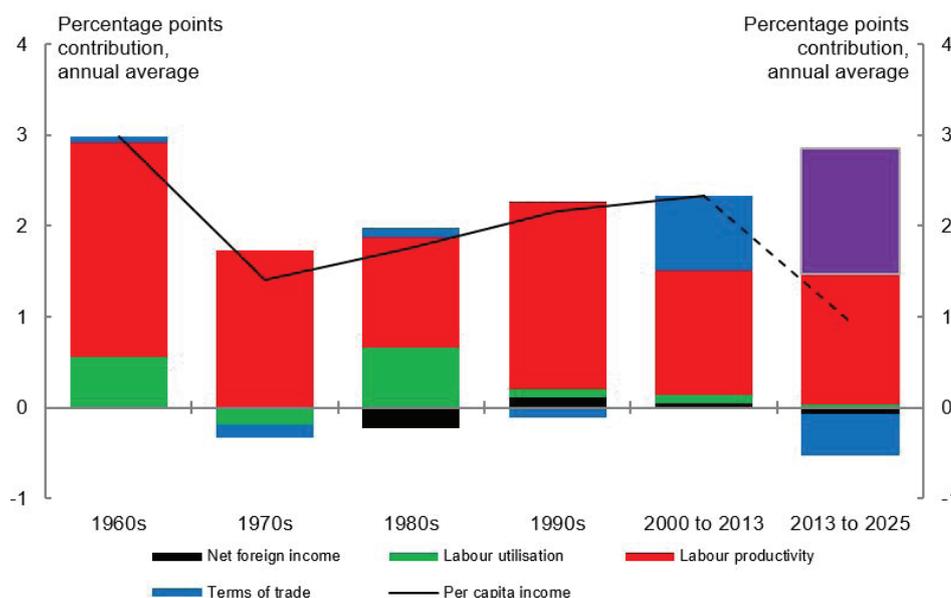
The resulting rise in living standards continues a record of strong Australian national income growth that started in the 1990s with a productivity boom. Per capita income grew steadily in the period from the 1970s to the mid-2000s. Per capita income is projected to level off in future years.

The effect of the mining boom on the broader economy is contested (see, e.g. Edwards 2014; Pincus 2014). It has been suggested that the mining boom and the high Australian dollar have contributed to accelerating structural change in the Australian economy. This involves a more rapid shift away from the trade-exposed agriculture and manufacturing sectors that previously lost international competitiveness under a high Australian dollar, towards mining and services (Connolly and Lewis 2010).

The recent pace of change has fuelled community concerns about the implications of a 'two-speed' economy and how returns from investment in previously expanding sectors such as mining and financial services should be captured and distributed as part of the structural adjustment process.

These changing drivers of income growth, as estimated in the 2014-15 Federal Budget, are shown Chart 2.1.

**Chart 2.1: Changing drivers of per capita income growth**



Source: Treasury (2014a), Paper One, Statement 4.

Note: The purple area in the 2013-2025 column represents the additional labour productivity growth required to achieve long-run average growth in real gross national income per capita. The dotted line is a forecast of the growth in national income per capita if labour productivity grows according to the 2014-15 Budget forecast.

The Henry Review coincided with the early part of the investment stage of the mining boom and linked it to the long run rise of Asian economies (Henry et al 2010a, 7). The latest projections in the Commonwealth Government's Mid-Year Financial and Economic Outlook Statement (MYEFO) (Treasury 2014b) indicate that annual growth in real per capita incomes will be 2.5 per cent in 2014-15, increasing to 3 per cent in 2015-16.

However, as the mining boom enters its third phase and Australia's terms of trade decline, *nominal* GDP growth will be only 1.5 per cent, 'the weakest nominal GDP growth in a financial year in over 50 years' (Treasury 2014b, 3). At the recent G20 summit, an overall challenge of increasing economic growth was highlighted by all participating governments including Australia.

The decline in the rate of economic growth is one cause of the recent and projected fall in tax revenues. As observed by the Parliamentary Budget Office (PBO), nominal economic growth is the main driver of government revenue (PBO 2014, vii). The mining boom underpinned strong growth in company tax collections during the early phases of the boom (2003-2008) but weaker growth since 2008. This is also partly a result of an increase in deductions generated by new mining investment.

A fall of more than 30 per cent in iron ore prices since the 2014-15 May Budget has led to downward revision of company tax receipts of \$2.3 billion in 2014-15 and \$14.4 billion over the next four years. Lower wage and employment growth will also reduce personal income tax receipts by an estimated \$2.3 billion in 2014-15 and \$8.6 billion over the next four years (Treasury 2014b, 3).<sup>9</sup>

The mining boom's transition raises other issues for tax policy, including how the taxation system supports capital investment and the efficient taxation of resource profits. The MRRT implemented by the previous government in 2012 was intended to harness gains from the mining boom. It failed to do so and in 2014 the MRRT was repealed by the current Government.

## 2.2 Demography

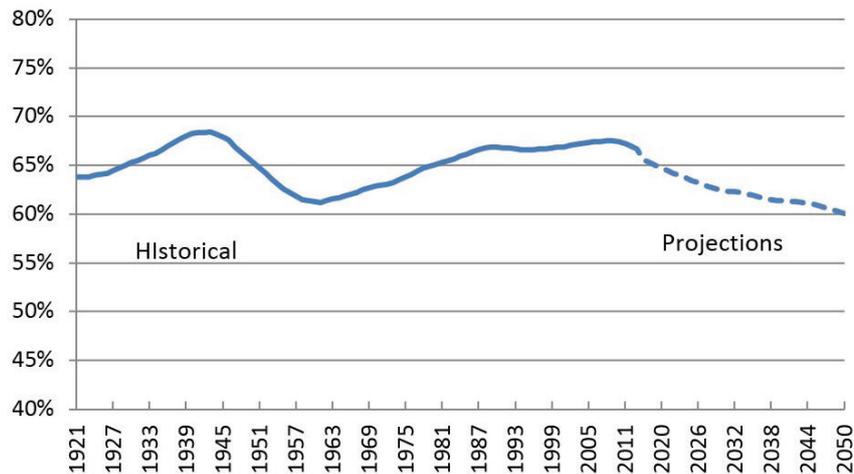
The changing structure of Australia's population has been a key driver of the rise in Australian living standards and tax revenues. The impact of population on economic wellbeing is driven by the size of the potential labour force and by the proportion of that potential labour force that is in work or is searching for a job. The forthcoming 2015 Intergenerational Report, not yet released, is expected to confirm these trends.

The working age population is often defined as that proportion of the total population that is between the ages of 16 and 65. The proportion of the labour force in work (or looking for work) is also called the *participation* rate. Between 1970 and 2010, the working age population as a proportion of the total population increased from 62.8 per cent to 67.4 per cent, largely a result of the baby boomers and net migration (Treasury 2010, 10). The participation rate rose from 60.7 per cent in 1978-79 to peak at around 66 per cent in 2010 (Connolly et al 2011, 1).

The Henry Review identified the ageing of the Australian population as a key feature of the next 40 years which would reduce some tax bases and raising the costs of health, aged care and dependency (Henry 2010a, xv). Since the Review, Australia's population profile has reached a turning point, as the proportion of the population that is working age is now in long-term decline. This trend is indicated in Chart 2.2.

<sup>9</sup> The sensitivity of budget parameters to changes in the economy are also discussed by the PBO (2014b).

**Chart 2.2: Working age share of the population (aged 16-65)**

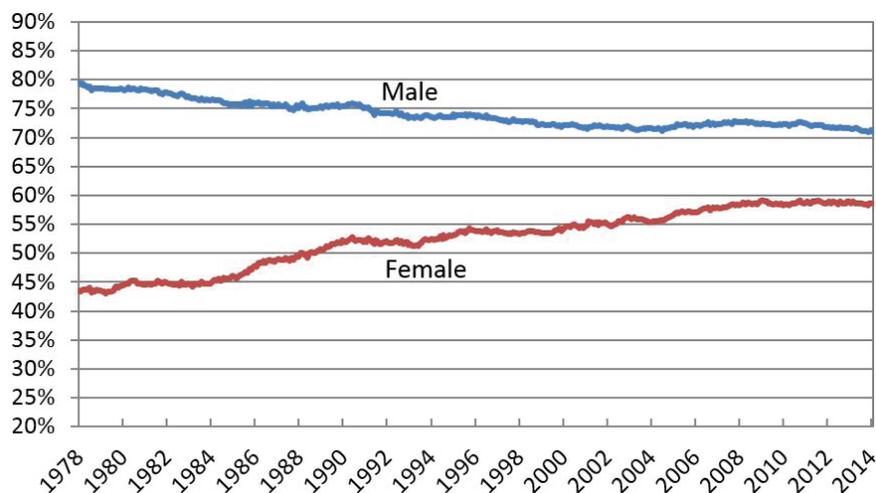


Source: ABS (2008), ABS (2014a) and Productivity Commission (2013b).

The increase in workforce participation from 1957 up to 2010 was primarily because of increasing participation by female workers, older workers (aged over 55) staying longer in the workforce, and a greater focus on attracting skilled migrants of working age. This participation was of various kinds including full and part-time work.

In particular, women’s workforce participation increased from below 45 per cent in the 1970s to almost 60 per cent by 2014. The *Harvester* family<sup>10</sup> comprising a man who works full time in paid work and a woman who cares for children at home without pay is now a small minority (Garnaut 2013, 162). Trends in male and female workforce participation since the 1970s are shown in Chart 2.3.

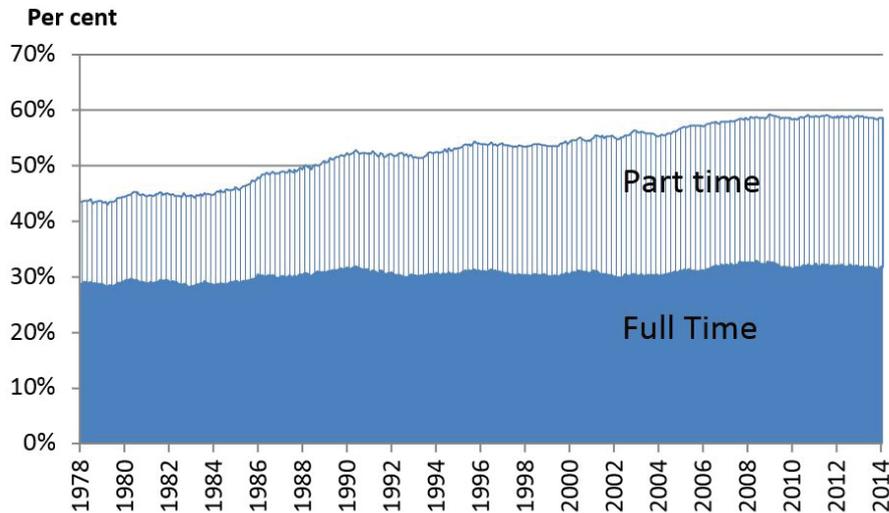
**Chart 2.3: Trends in male and female workforce participation**



Source: ABS (2014b).

<sup>10</sup> The famous *Harvester* ‘family wage’ judgment (1907) 2 Conciliation and Arbitration Reports 1.

**Chart 2.4: Trends in full-time and part-time female workforce participation**



Source: ABS (2014b).

Chart 2.4 shows that almost half of female workers are in part-time employment. It is growth in part-time work that has driven the dramatic increase in female workforce participation. Australia's female workforce participation rate is higher than the OECD average but lower than that of Canada and Scandinavian countries, while more Australian women work part-time than do Canadian women (OECD 2012).

The expansion of employment opportunities in service industries, flexible working arrangements, changing social norms, improved technology and access to paid parental leave and formal child care have provided families with more options for blending work and family. Among employed mothers with children aged between three and five years, utilisation of formal childcare increased from 48.8 per cent in 1984 to 71.2 percent in 2011 (Baxter 2011, 9). Provisions in the tax and transfer system support increased use of child care services, and hence female participation. These include the ability to salary sacrifice employer-provided child care and both universal and family means-tested child care benefits. However, around 65 per cent of households with children aged under 5 years experienced difficulties with the availability of childcare and around 55 per cent with affordability in 2011 (Wilkins 2014, 14).

Today, families face a complex array of choices about who works, how much and when; how to value and prioritise work, education and business decisions of individuals;

care arrangements; and how household saving should be managed including decisions about buying a home and saving for retirement. Many of these choices are directly affected by the tax and transfer system, as all individuals and families, to a greater or lesser extent, move in and out of engagement with paying taxes, and receiving transfers across the lifecycle.

### Effect of workforce participation on taxes and transfers

The 2010 *Intergenerational Report* (IGR) estimated that by 2049-50, there will be only 2.7 people of working age to support each Australian aged 65 years and older, compared with 5 people of working age per aged person in 2010 (Treasury 2010, viii). The workforce participation rate is projected to fall to less than 61 per cent by 2049-50 (Treasury 2010, ix).

The greater tendency for women and older workers to work part time, and for younger people to delay entering full time work to pursue further education, mean that even as the participation rate has increased, a greater proportion of the labour force are part-time workers (Connolly et al 2011, 1). This trend is expected to continue as baby boomers transition from full-time work into part-time work and retirement.

As noted by the Henry Review, an ageing population has implications for sustainability of government budgets. Until recently, increasing workforce participation by women and older workers more than offset the ageing of the population, contributing to higher national incomes and taxation revenues. However, population ageing will increasingly detract from economic growth and tax revenues in future decades. Demographic ageing also puts upward pressure on spending on age-related health, pensions and aged care (Treasury 2010, 45).

The IGR does not examine ageing-related fiscal impacts for the States and Territories. To address this gap, the Business Council of Australia commissioned ‘An Intergenerational Report for the States’, mirroring the approach taken in the 2010 IGR with a primary focus on long-term projections of health and ageing expenditure (Deloitte Access Economics, 2011). Based on the report’s projections, expenditure by the States and Territories on health and ageing sectors is projected to rise from 26 per cent of total State and Territory government expenditure in 2009-10 to 41 per cent in 2049-50.

Tax and transfer reform can help address these challenges through encouraging more workforce participation by women, older workers and the unemployed. Tax reform can also aim to improve productivity of the workforce, supporting higher wages and consumption which will also bolster tax revenues. To achieve growth and better tax revenue, governments at the G20 committed to a significant increase in women’s workforce participation (G20 2014).

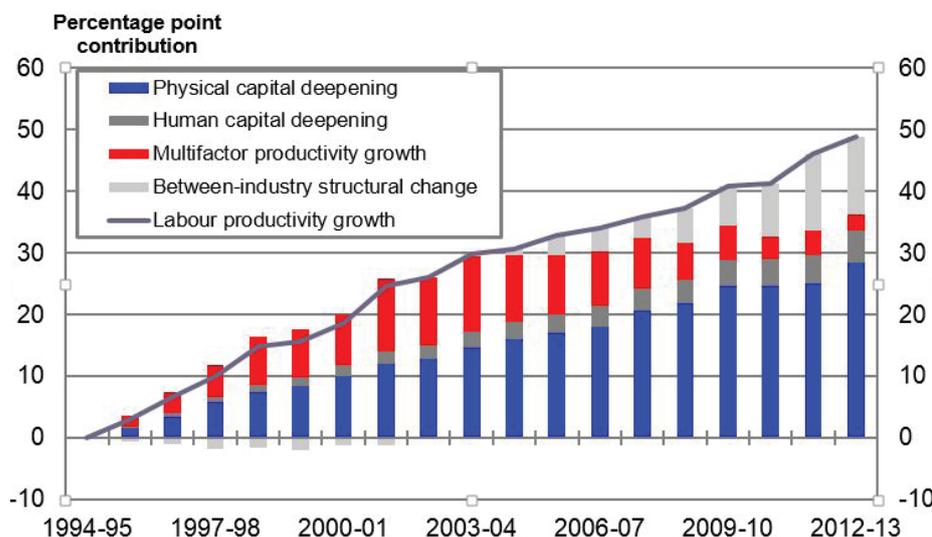
## 2.3 Productivity

As we face the end of the mining boom and population ageing, there is a need for other drivers of growth. Improved productivity can fill the gap so Australians can continue to enjoy improvements in living standards (e.g. Minifie et al 2013).

*Productivity* is defined as the amount of goods and services produced by an individual, a business or the whole economy, relative to the amount of resources or inputs used in production. Measures of productivity attempt to measure how efficiently and effectively those production inputs, such as labour and capital, are used to produce goods and services (Department of Industry 2013, 2).

In the last four decades of the 20th century, productivity accounted for around 90 per cent of national income growth (Gruen 2012, 3). Workforce productivity growth averaged around 1.5 per cent annually over this period and contributed strongly to overall productivity. However, workforce productivity growth has dropped significantly, with only a slight improvement in recent years (Treasury 2014a, 4-6). Multifactor productivity, a residual indicator that captures the efficiency with which labour and capital inputs are combined in production, has also declined in the last decade (Banks 2010; Treasury 2014a, 4-8, 4-13, 4-14).

**Chart 2.5: Contribution of various factors to labour productivity growth**



Source: Unpublished ABS data and Treasury.

There are multiple pathways to improving national productivity including adopting new production processes that allow existing resources to be used more efficiently, greater utilisation of technology and capital infrastructure, improving individual capabilities and skills. Another pathway is to reform regulatory and tax policy to support a more efficient allocation of factors of production (land, labour and capital).

Reforms that reduce the distorting effects of taxation on decisions taken by individuals and businesses can contribute to improving individual skills and participation in more productive work.

## 2.4 Inequality

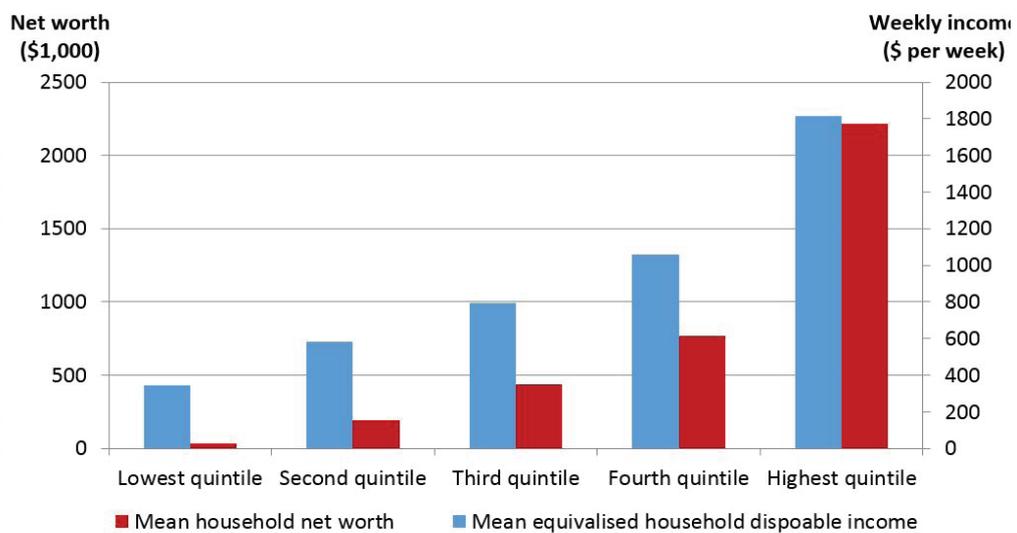
A fair distribution of economic rewards is important in maintaining national wellbeing, social cohesion and acceptance of our political and social institutions. There is widespread public concern about rising inequality and wealth in Australia and comparable countries. In Australia, concern has been expressed in community and policy studies (e.g., Oxfam 2014, Douglas et al 2014). The evidence of rising inequality in income and wealth and the effect of government policy has been discussed in government reports and scholarly research (e.g. ABS 2013a, 2013b; Wilkins 2013; Leigh 2013; Whiteford 2013).

Internationally, attention has focused on the long-term trends, causes and consequences of rising income inequality across wealthy and poor countries (OECD 2011; Piketty 2014; IMF 2014; Stiglitz 2014; Atkinson and Morelli 2014).

Australia’s tax and transfer system plays a central role in sharing the benefits of economic growth across society in an inclusive and fair manner. We can measure income inequality after taxes and transfers have applied, by measuring *equivalised household income* standardized for household size and composition. This is basically the *disposable income* of households after all sources of income (including income from work and business, capital gains, dividends, interest and so on), taxes and cash transfers from government are taken into account.

Using this measure, inequality in income and wealth may be measured by household income surveys (e.g. ABS 2013a, 2013b; Wilkins 2013) or expenditure surveys (Greenville et al 2013).<sup>11</sup> Chart 2.6, based on the ABS household income survey shows that the top 20 per cent (highest quintile) had nearly five times the disposable income of the bottom 20 per cent. The distribution of net assets is much more unequal.

**Chart 2.6: Distribution of Australian household disposable income and net worth**



Source: ABS (2013a).

11 Measures of income distribution and of inequality are sensitive to data sources and changes in data collection methodologies. There is some divergence of opinion about levels of inequality and the magnitude of change in Australia over time, depending on the timeframe and data source. However, the trends summarized here are consistently identified across studies.

## CHALLENGES FOR TAX REFORM continued

The mining boom generated economic benefits for most Australian households, and Australia has had stronger growth in real household disposable income than the OECD average leading to improvements in per capita living standards across the income distribution. The Productivity Commission estimates that equivalised household income grew by 4.5 per cent for the top 10 per cent and 3 per cent for the bottom 10 per cent per year since the 1990s in Australia (Greenville et al 2013, 99). This compares to 1.9 per cent growth for the top 10 per cent and 1.3 per cent for the bottom 10 per cent per year since the 1980s across the OECD (Greenville et al 2013, 103).

Nonetheless, the benefits of growth have not been spread equally. The groups enjoying the largest real increases were at or above the middle of the income distribution and those in the top 10 per cent.

### Measures of income inequality

The most commonly used index for tracking changes in inequality over time is the *Gini coefficient*. This index measures the degree to which the income distribution of a country is different from a perfectly equal distribution of income across a population. A lower Gini coefficient indicates a more equal distribution of income (a value of 0 represents perfect equality in which every person has

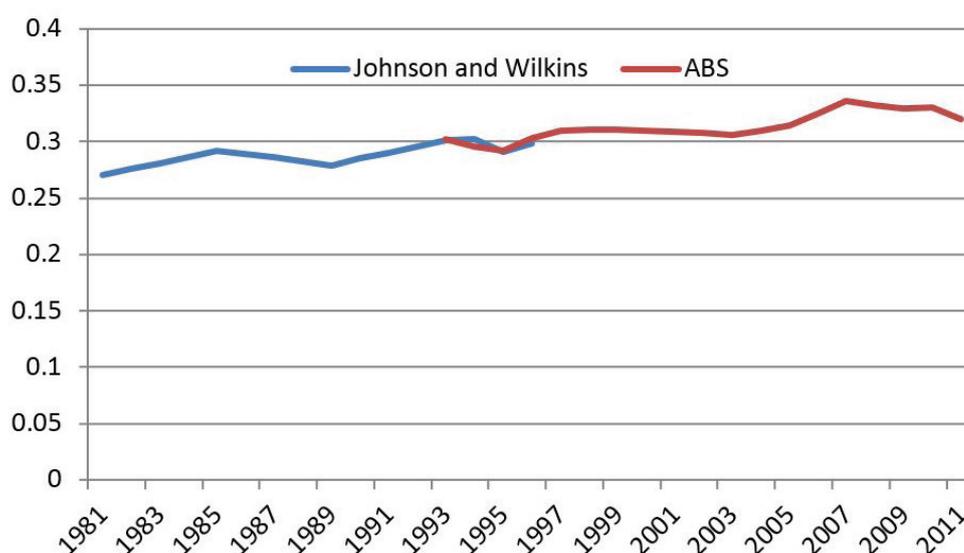
exactly the same income). A higher Gini coefficient indicates a more unequal distribution (a value of 1 represents perfect inequality, in which one person has 100 per cent of the income and all others have zero income).<sup>12</sup>

In Australia, inequality in disposable household income measured by the Gini coefficient has increased over the last few decades, as indicated in Chart 2.7. OECD estimates suggest that in Australia, inequality in income has grown faster than in most other OECD countries, although this is in part due to changes in ABS survey methods (Greenville et al 2013, 100-101).

The trend in growing inequality is not uniform. Whiteford (2013) shows that income inequality:

- > declined between 1994-95 and 1996-97 during a period of expanding employment following the recession in the early 1990s;
- > increased gradually between 1996-97 and 2003-04 during a period when the microeconomic reforms of the 1980s and early 1990s took hold;
- > declined in 2002-03 and 2003-04, coinciding with the expansion of government payments to families; and
- > rose rapidly from 2003-04 to 2007-08 during the early phases of the mining boom before falling back in 2009-10 following the GFC.

**Chart 2.7: Trends in income inequality in Australia, Gini coefficient, 1981 to 2011**



Source: Johnson and Wilkins (2006), ABS (2013a).

<sup>12</sup> See Jenkins and Van Kerm (2008) and Greenville et al (2013, Appendix A) for methods of measuring inequality, including the Gini Coefficient.

Increases in inequality are not just a function of increasing incomes at the top of the income distribution, but are spread across the income distribution. Household incomes at the top of the distribution have increased relative to the middle of the distribution, and incomes in the middle have increased relative to the bottom of the distribution over the last decade (Wilkins 2013).

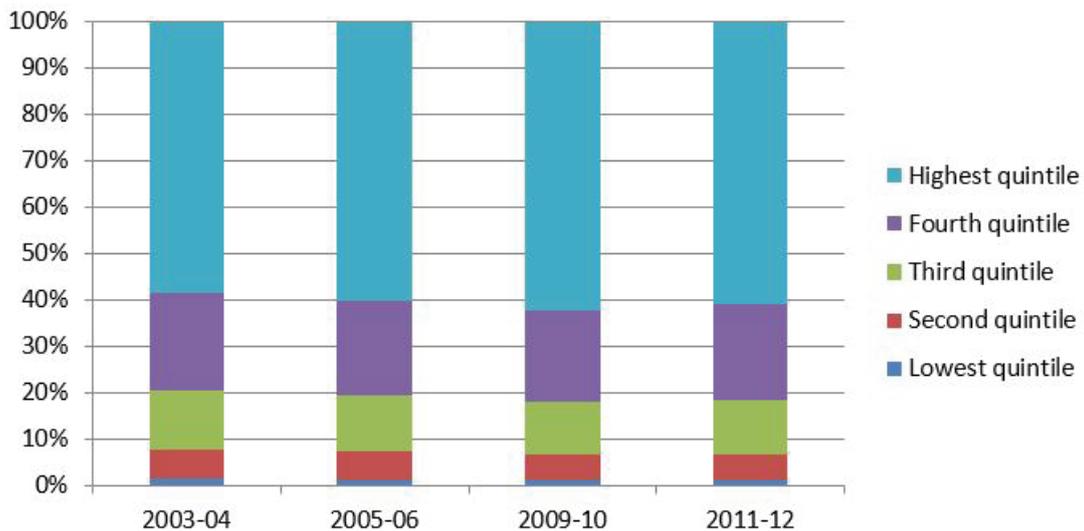
### Inequality in labour and capital income

A key factor driving change in household incomes especially in the upper half of the income distribution is growth in labour income. Between 1988-89 and 2009-10, individual labour earnings increased by 38 per cent across the Australian economy (Greenville et al 2013, 5). Low income households benefited from increased employment, while high income households benefited from higher wages (Greenville et al 2013, 106). Increases in some transfers, such as the age pension, have also supported rising incomes for households in the bottom 20 per cent, although the unemployment benefit has not kept pace with income.

We know less about the distribution, composition and trends in wealth and assets among Australian households than we do about income; this is an important issue that warrants significant further research. However, capital gains and income from assets have contributed to increased incomes for the top 20 per cent (Greenville et al 2013, 106). Recent analysis also indicates substantial and growing gender inequality in the distribution of assets (Austen et al, 2014).

Chart 2.8 shows that the top 20 per cent of households (highest quintile) own 61 per cent of total assets while the bottom 20 per cent of households (lowest quintile) own just 1 per cent of total assets. This distribution is fairly stable over the last decade.

**Chart 2.8: The distribution of household assets over time**



Source: ABS (2013b).

## 2.5 The digital global economy

The digital economy revolution, increasing capital mobility and the rising economic value of intangible assets may be the most significant factors influencing economic prospects in the next few decades. Digital developments also may offer opportunities for streamlined and more efficient tax administration in the future.

Rapid innovation in communications and digital technology and the emergence of new multinational business models have recently gained greater attention. Governments are increasingly concerned about so-called base erosion and profit shifting (BEPS) by multinationals. The OECD is currently carrying out a major project on BEPS, building consensus on an Action Plan focused on multilateral coordination on information exchange and design of tax integrity arrangements that has been endorsed by the G20 (OECD 2013a; G20 2014). We return to these challenges in Chapter 6.

In dealings with consumers, digital companies are increasingly selling goods and services including books, films and games online (famously represented by Google, Apple and Amazon). This poses challenges for sales taxes like the GST. The sale of goods and services via digital download has made the origin of supply increasingly uncertain, with suppliers often having no single location and consumers not being subject to taxes when they purchase online. The recent growth in the use of cloud technology and new ways of transmitting value, such as cryptocurrencies, also present challenges. These new systems potentially eliminate the intermediary from the transaction, allowing anonymity, while also allowing the location of supply to be determined arbitrarily by the supplier.

In the global economy, multinational enterprises can use legal and commercial structures to invest and operate across national borders and can shift mobile intangible assets within these structures. They can also take advantage of innovative financial structures that operate across many countries. All of these strategies can be used to reduce tax on multinational enterprises. For example, the use of a Luxembourg based company for financial arrangements can take advantage of differences in the taxation treatment of debt and equity in different countries.<sup>13</sup>

### Intangible assets

Increasingly, the economic value of businesses is held in *intangible* assets such as patents, trademarks, brand names, copyright, corporate and insurance services and marketing information about products, customers and systems. These intangible assets are central to the commercial success of many service and technology-based multinational companies.

Intangible assets have several features that make them difficult to tax. They are often intrinsic or unique to a particular firm and rarely traded, making it difficult to identify, value and measure income from the asset. They are also *mobile*, which means that they can be owned by legal entities anywhere in the world.

Not only digital companies, but ‘real’ or traditional businesses, are becoming digital in this way. Businesses that deal in assets, such as coffee (e.g. Starbucks) or furniture (e.g. IKEA) and even mining companies that must extract minerals where they find them, hold an increasing share of value in mobile intangibles including technology, services, brands and patents.

See further OECD (2013a).

A multinational enterprise can use offshore companies as a repository for marketing, corporate services, intellectual property and insurance functions, typically located in low tax or no tax jurisdictions. Multinational enterprises organise their supply chains on a global, rather than a national basis. Geographic dispersion of the different elements of a multinational’s operations offers considerable flexibility around how intra-firm revenues and expenses—and hence, corporate profits—are located.

The Henry Review identified these trends but they have become increasingly pointed. For example, in 2011, the Treasury’s review of transfer pricing rules pointed to significant growth in intra-firm trade in the areas of interest and insurance and services (Treasury 2011, 2).

<sup>13</sup> Some such structures were revealed in the ‘Luxembourg Leaks’ published by the International Consortium of Investigative Journalists: <http://www.icij.org/project/luxembourg-leaks>.

Australia's historical advantages that typically encourage inbound investment, such as high levels of political stability and institutional transparency, effective market regulation, quality infrastructure and an educated and skilled workforce may offer a less distinct advantage in the future as other nations in our region develop. This makes the burden of taxation on mobile factors of production a more important consideration. It is not clear whether these challenges are significant enough to warrant change to Australia's company tax system, for example by lowering the rate, or whether the current system can support economic prosperity and adequate revenues for the foreseeable future.

## 2.6 The environment

The Australian environment faces multiple challenges which are likely to have serious economic consequences. These include the economic costs of climate change and climate variability, the expanding footprint of our cities and suburbs as the Australian population grows and the impact of economic growth and structural change on resource utilisation, investment and consumption patterns of individuals and businesses. The goal of economic growth must be sustainable in the long-term.

Our growing population is leading to new and increasing demands on housing, transport, water, energy and communications and waste management infrastructure and supply. Over the coming decades, Australian governments will need to find ways to fund new investment in public infrastructure to meet these demands.

For example, land clearing associated with expanding agricultural production, resource extraction and expansion of Australia's urban centres averaged around 1 million hectares each year in the decade to 2010 (State of the Environment Committee 2011, 25). This leads to soil erosion and loss of habitat and biodiversity. Expanding development along Australia's coastline has impacts on the coastal environment. Other challenges include transport congestion and high levels of household energy use in our cities and towns.

The Intergovernmental Panel on Climate Change (IPCC) indicates that Australia is continuing to experience long-term trends towards higher surface temperatures, more heat extremes and fewer cold extremes and lower rainfall levels, particularly in south-eastern Australia (IPCC 2014).

Australia has many policy tools to address these challenges, although the appropriate policy response to some challenges is the subject of intense political and social debate.

The Henry Review emphasised sustainability of the tax and transfer system, referring to both revenue and environmental sustainability. In relation to climate change, the Henry Review did not directly address the issue of a carbon tax or emissions trading scheme, as this was the subject of a separate policy process. The contentious political debate about the use of a carbon tax or carbon pricing scheme is evidenced by the recent enactment and then repeal of the Carbon Pollution Reduction Scheme (CPRS), an emissions trading scheme that operated like a carbon tax in its initial period.

There are different tax and regulatory approaches that can be taken to climate change. We note that a carbon emissions pricing approach is being increasingly adopted in various other countries and regions in the world, including the European Union and China. The G20 has highlighted climate change as a key issue that requires policy reform (G20 2014).

It is also important to ensure that our tax and transfer settings do not work against environmental goals or generate perverse incentives that would undermine other environmental policy or regulation. For example, current Australian land tax arrangements tend to support land degradation at the expense of regeneration of native forests and other ecosystems (Wentworth Group 2014). The Henry Review recommended monitoring of tax concessions that affect environmental outcomes, to ensure their effectiveness (Henry et al 2010a, Recommendation 60).