Tax reform is in the news daily. Calls for fundamental reform have become louder, but there are diverse views on the direction and scope of the reform that is needed. The Liberal/National Coalition Government has committed to a White Paper process on Tax Reform, which the Government has indicated will commence with the release of a discussion paper designed to prompt a national conversation about tax reform. The Government has also commenced a White Paper process for reform of the federation (DPMC 2014; 2015), which is examining the distribution of responsibilities between State and Commonwealth governments, with implications for federal financial relations, including taxation.

But what is tax reform? What needs fixing in Australia’s tax system, why, and what can and should be done? Hotly debated issues range from whether to broaden the base or increase the rate of the Goods and Services Tax (GST), to how we can properly tax multinational corporations. There is debate about whether superannuation tax concessions are fair; the impact of tax on housing; and many other issues ranging from the complexity of tax rules for small business to the volatility of stamp duty revenues.

Five years ago, the Henry Review (Report on Australia’s Future Tax System, Henry 2010a) made a detailed examination of Australia’s tax and transfer system. To place the myriad of tax issues, proposals and debates in context, this TTPI report provides a stocktake of the tax system five years after the Henry Review. Tax reform is fundamentally political. Rather than recommending specific reforms, we aim to identify key principles and directions for tax reform and to show what we know, and where the gaps are in our knowledge of tax policy.

This TTPI report:
> reviews the economic and social challenges which the Henry Review identified and identifies new ones which have come to the fore in the last five years;
> provides an overview of the tax and transfer system and changes since the Henry Review, including comparisons with selected countries;
> identifies principles for analysis and discusses some of the broad choices and trade-offs that will need to be considered in any reform;
> assesses the extent to which the Henry Review continues to provide a basis for considering the direction of tax and transfer system reform; and
> identifies areas that warrant further consideration and research.

**Principles of tax reform**

Taxation is our primary mechanism for funding government. The transfer (or social security) system is our primary tool for redistribution to those who are in need. The tax system must deliver sufficient revenue for governments to achieve service delivery and policy development, including adequate levels of transfers or social security, in line with expectations of the Australian people. Since federation, the Australian community has made broad choices about the desired level of government expenditures, redistribution and taxes based on the history of our government and economy, community values and the political contest of ideas.

Tax reform should aim to support sustainable and inclusive economic prosperity through improving efficiency, promoting fairness in an overall progressive tax-transfer system and building 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.

Taxes and transfers affect the behaviour of individuals and businesses. Economic theory and modelling of tax efficiency and the incidence of the tax burden is difficult and relies on many assumptions. However, it is an important 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 tax and transfer system, and government 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 aims to capture 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 and transfer system include simplicity, sustainability, certainty, cohesiveness, legitimacy, ease and low costs of administration and compliance, flexibility and resistance to tax avoidance and evasion.
Much of the recent commentary and analysis about reform of the Australian tax system has focused selectively on ‘priority’ areas for reform. The Henry Review addressed the overall Australian tax system including Commonwealth, State and local taxes and sought to take into account interactions between different taxes and in the tax and transfer system. It then identified a broad set of taxation arrangements to position Australia for dealing with the social, economic and environmental challenges for the next forty years.

There is much we do not know about the effects of the tax-transfer system. In particular, new empirical research into responses to the tax system and the effects of administrative and compliance mechanisms can give us new insights into how to design a resilient system. Significant research and policy analysis is needed on future options for tax reform.

Challenges for the tax system

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.

The following challenges have come to the fore in the last five years to form the context for tax reform today. These build on those identified by the Henry Review:
1. the effect of the mining investment boom as it declines, including the decline in the rate of economic growth, effects on revenue and structural changes in the Australian economy;
2. demographic changes especially population ageing and changing patterns of work, family and care;
3. Australia’s lagging productivity performance;
4. concerns about fairness and inequality;
5. the digital global economy including new multinational business models; and
6. environmental challenges and climate change impacts.

The current state of the tax-transfer system

The Commonwealth Government levies income tax and GST exclusively, as well as petroleum and gas resource rent taxation, customs and excise. State and Territory governments levy land tax, payroll tax, stamp duties, gambling taxes and some other levies exclusively and also receive royalties from mineral resources extracted from within their jurisdiction. Local governments levy property rates. Australia’s total tax burden across all levels of government in 2012 was 27.3 per cent of GDP. This was below the OECD average of 33.7 per cent and below Canada (44 per cent) and New Zealand (33 per cent). Australia’s tax level has declined in recent years.

The Commonwealth Government raises around 80 per cent of all tax revenues. There is a significant disparity between the broad governing responsibilities of States, and their limited tax revenues, termed vertical fiscal imbalance. This is a key issue for the government’s White Paper on reform of the federation, which must be taken into account in tax reform.

Australia relies less on consumption taxes than many other countries, especially in Europe. Australia collects proportionately less revenue than other countries including New Zealand and Canada, from a broad-based consumption tax such as the GST.

The Intergovernmental Agreement that allocates GST to the States and Territories requires any reform to the GST rate or base to be unanimously agreed between the Commonwealth and all State and Territory Governments. It has proved to be quite stable in its 15 years of operation. It is unlikely that the Commonwealth would proceed with any significant change without the agreement of all States and Territories.

The personal tax-transfer system is Australia’s main tool for redistribution of incomes. Tight targeting of transfers means Australia is the fifth lowest spender relative to other OECD countries and spends less than both Canada and New Zealand on the transfer system.

Government spending may be undertaken through targeted concessions or subsidies in the tax law, called tax expenditures. We cannot get a full picture of government taxing and spending without taking account of tax expenditures. The largest tax expenditures in the personal income tax relate to superannuation and other forms of savings and investment. In the GST, tax expenditures include the exemptions for food, education and health. Broadening the tax base often requires removing or reducing some tax expenditures.
Personal income tax, transfers and saving

Personal income tax comprises about 40 per cent of all tax revenues and close to half of Commonwealth taxation. It is Australia’s largest single source of tax revenue. Our reliance on personal income tax is similar to New Zealand and Canada. Australian personal income tax revenues have declined as a share of GDP because of cuts in average tax rates over the last 2 decades. Fiscal drag, or bracket creep, will cause average tax rates to rise again in the future, unless changes are made to rates or thresholds.

The highly targeted nature of Australia’s transfer system including income and asset testing produces high effective marginal tax rates for many who receive support. This reduces the incentive and economic return to paid work, lowering workforce participation especially for women caring for young children. The combined effect of personal income tax and transfers on work incentives and on fairness must be taken into account in any reform of either system. The economic return from increased women’s workforce participation supports a tax reform direction that would increase support for childcare and reduce effective marginal tax rates on low and moderate wage earners.

There are gaps and complexity in the personal income tax base. There is scope to broaden this base, especially in relation to savings and investment, and deductions related to work and saving. Broadening of the personal tax base would strengthen revenue collection and could enable a reduction in tax rates on work and business income if desired. Lower marginal tax rates on low and middle income earners could improve incentives to work and do productive investment. The Henry Review recommendations to tax saving more consistently under a 40 per cent savings discount and to restructure superannuation tax concessions can provide a significant direction for reform.

The personal income tax could also be made more resilient by simplifying the legal design. This could reduce planning boundaries in respect of expenses, legal entities and forms of investment as well as reducing administrative and compliance costs.

Company tax

Australia’s company tax is an important element in Australia’s tax mix. Australia raises substantially more revenue than many other countries in company tax (around 5 per cent of GDP, or 17 per cent of all tax revenues).

The Australian statutory company tax rate is 30 per cent and the effective tax rate for Australian companies is close to that rate, although it may vary across industries and sectors. The company tax has a fairly broad base with few exemptions and concessions. Australian nominal and effective company tax rates are higher than the OECD average and than Canada and New Zealand.

Economic modelling of the company tax in a global economy suggests that it deters foreign investment and is borne in the long run substantially by Australian workers or consumers. A reform implication of this modelling is that a lower company tax rate would lead to increased national wellbeing. However, the ideal level of taxation on companies, or capital more generally, is debatable.

The specific benefits of lowering the company tax rate are extremely difficult to test. Australia’s company tax collects revenues from economic rents, including from the resource industry, and is an important backstop to the personal income tax. The corporate-shareholder imputation system provides an incentive for Australian companies to pay company tax but also may deliver an excessive return to shareholders. A lower company tax rate would increase tax and planning margins for the personal income tax.

Company tax rules are complex for all sizes of business. Multinational enterprises carry out sophisticated global tax planning that may reduce their Australian and global tax rates to zero or close to it. The OECD Base Erosion and Profit Shifting (BEPS) project, and Australia domestically, are taking some steps to increase country cooperation to prevent base erosion. It is not clear how successful country efforts at coordination will be in protecting the company tax base. As indicated by the Henry Review, further research is needed into the best approach to company tax for Australia for large and small business in future.
GST and payroll tax

State and Territory governments have broad power to tax but raise only about 18 per cent of total tax revenue. Together, the GST and payroll tax are the most important taxes for the States. The GST raises about 13 per cent of total tax revenue.

GST is provided to the States and Territories under a horizontal fiscal equalisation formula. This means that GST is shared across States and Territories on a basis aiming to equalise their revenue and spending capabilities. There is dispute about whether the current formula achieves the correct balance.

The GST is Australia’s only broad-based tax on consumption. It applies at a flat 10 per cent rate on a wide range of goods and services but taxes less than half of consumption, as exemptions or input-taxed elements make up more than half of the GST base. The GST rate is lower in Australia than in many comparable countries. The Henry Review was not able to examine GST reform specifically. However, trends in other countries have been to raise the rate and to reduce exemptions in the base, to the extent possible.

The payroll tax is a tax on the wages paid by businesses. If comprehensive, a payroll tax is equivalent to a tax on wages. Australia’s State and Territory payroll taxes have various thresholds and exemptions that introduce distortions for business decisions and make it less efficient than otherwise. The Henry Review recommended broadening the payroll tax on wages, or that it be replaced by a cashflow business tax, perhaps also replacing the GST.

Property and insurance taxes

Australia raises about 3 per cent of GDP in taxes on property, a lower proportion than many comparable countries. Land taxes and council rates are the most efficient taxes, according to economic models. Land taxes are primarily levied by the States and Territories, but are designed less efficiently than they could be.

Most States and Territories rely significantly on stamp duties on property conveyancing and insurance. These are easy to collect but revenues are volatile. They are considered among the least efficient taxes as they deter individuals from moving as their personal circumstances change and encourage under-insurance. Reform is challenging politically and in terms of the potential impact on housing markets; a long term transition may be required.