

# 2: Australia's tax system

## Overview

This chapter surveys Australia's current tax system at both the federal and state levels and how it compares internationally. It considers: how costs imposed by the tax system affect economic growth and living standards; the challenges of complexity; and the importance of fairness in maintaining an effective and sustainable tax system.

### Key points

- A good tax system raises the revenue needed to finance government activities without imposing unnecessary costs on the economy. Tax reform is about how revenue is raised, not just about how much.
- Australia's overall tax burden is relatively low compared to other developed countries. The Australian Government raises around 81 per cent of total tax revenue in Australia. State and territory governments receive 45 per cent of their revenue through transfers from the Australian Government, including all GST revenue.
- Australia relies heavily on income taxes, particularly company income tax, compared to other developed countries as well as our Asian competitors. Australia's reliance on income taxes remains much the same as it was in the 1950s, despite changes in the economy, and is projected to increase further, largely as a result of wages growth leading to individuals paying higher average rates of tax (bracket creep).
- Economic modelling suggests that the taxes with particularly high costs to economic growth are company tax and stamp duties. The benefits of reducing the economic costs of taxation are spread throughout the economy, including to workers through higher wages.
- Complexity and compliance costs have many drivers and are a growing problem in the tax system. Tax compliance costs are in the order of \$40 billion per year. Approaches to tax design and governance practices will need to change if complexity in the tax system is to be reduced.
- Australia's tax and transfer systems are highly progressive, which supports fairness. High effective tax rates, including as a result of targeting in the transfer system, can reduce participation incentives for some groups. Bracket creep exacerbates this problem.
- Tax settings for savings should give people the incentive to save for their future, but differences in the taxation of alternative savings vehicles affects savings choices.

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## 2.1: Opportunities for a better tax system to deliver taxes that are lower, simpler, fairer

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Like any tax system, Australia's tax system is fundamental to raising the revenue that finances the activities of government at the Australian Government and state and territory government levels. These activities include important public services like health, education, infrastructure and national defence, as well as the social safety net that supports our society's most vulnerable.

A good tax system achieves this purpose without imposing unnecessary costs on the economy. For this reason, tax reform is not just about how much revenue is raised but how it is raised. This includes appropriately balancing the principles of fairness, efficiency and simplicity (Box 2.1).

While Australia's tax system has served the nation well over the decades, it is increasingly outdated. The changing global environment, costs associated with complexity and the need to raise revenue to fund the activities of government in a more efficient and fair way mean the tax system is under increasing strain.

There are opportunities to make a better tax system to deliver taxes that are lower, simpler, fairer. This will help to raise, rather than hold back, Australian living standards.

### Box 2.1: Principles for tax systems

It is accepted that a well-designed tax system will meet its revenue raising objective, while balancing the core principles of equity, efficiency and simplicity:

- *equity* — fairness in the distribution of the tax burden;
- *efficiency* — economy in tax collection so as to have the lowest possible cost over and above the revenue that is raised; and
- *simplicity* — the tax system should be easy to understand and simple to comply with.<sup>2</sup>

Other principles could usefully be added to this list. For example, the UK House of Commons Treasury Committee's *Principles of tax policy* added procedural principles to this list.<sup>3</sup> These include certainty, stability and proper consultation and review. The Henry tax review emphasised the importance of sustainability, where this is the ability to meet the changing revenue needs of governments, and consistency across tax laws and treatments.<sup>4</sup>

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2 Asprey, K (Chairman), Lloyd, J, Parsons, R and Wood, K 1975, *Taxation Review Committee — Full Report (The Asprey Review)*, AGPS, Canberra, pages 12-15.

3 House of Commons Treasury Committee 2011, *Principles of tax policy*, The Stationery Office by Order of the House, London.

4 Australian Government 2010, *Australia's Future Taxation System Review (Henry Tax review)*, Australian Government, Canberra, page 17.

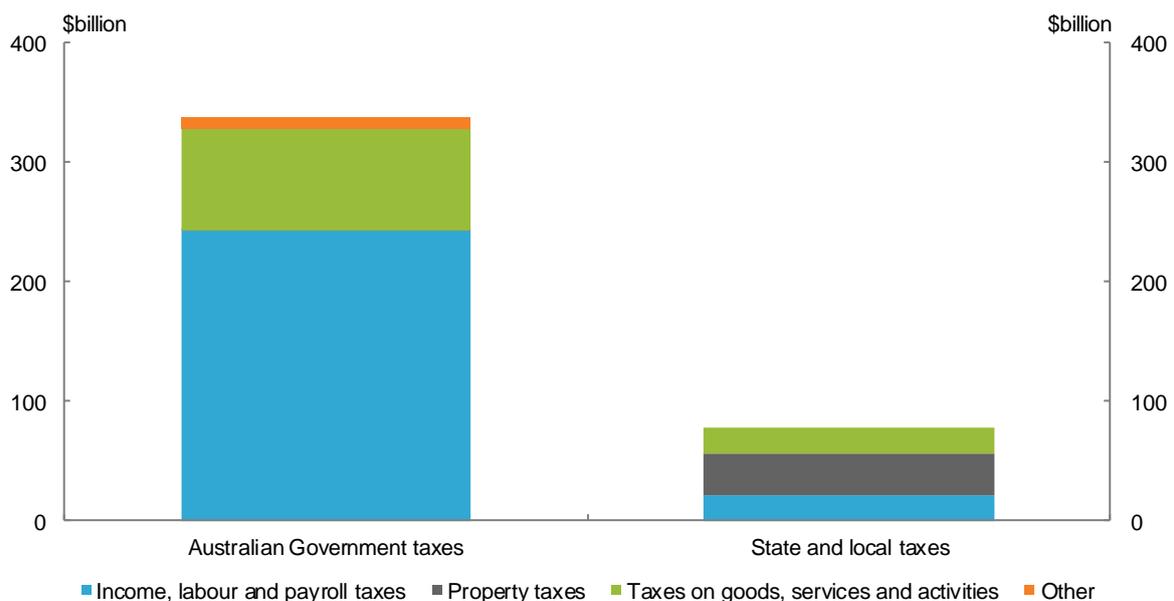
## 2.2: Australia's current tax system

### Like many other countries with a federal system, the Australian Government raises the majority of revenue

Both the Australian Government and state and territory governments (including local governments) have responsibility for raising revenue in Australia, by means of their control of particular tax bases.

While Australian tax revenue is drawn from more than 100 different taxes, most revenue is collected from just a few taxes.<sup>5</sup> In 2012-13, the federal Government collected around 81 per cent of tax revenue in Australia, mainly from income taxes levied on individuals and corporates (Chart 2.1). State and territory governments collected around 15 per cent of tax revenue, largely through payroll taxes and property taxes (especially stamp duties). Local governments collected around 3 per cent of tax revenue through municipal rates. The tax rates, thresholds and exemptions for state and local government taxes vary across jurisdictions.

Chart 2.1 Composition of Australian and state and local taxes, 2012-13



Note: Under the *Australian System of Government Financial Statistics*,<sup>6</sup> royalty income is not a form of taxation and is included in the property income category along with interest income and dividends. Federal 'Taxes on goods, services and activities' includes the goods and services tax revenue.  
Source: Australian Bureau of Statistics (ABS) 2014, *Taxation Revenue, Australia, 2012-13*, cat. no. 5506.0, ABS, Canberra.

5 Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra.

6 ABS 2006, *Australian System of Government Finance Statistics: Concepts, Sources and Methods, 2005*, cat. no. 5514.0.55.001, ABS, Canberra.

In 2013-14, state and territory governments (excluding local governments) generated around 31 per cent of their total revenue from the taxes they administer. The states and territories received around a further 45 per cent of their revenue from the federal Government by way of specific purpose payments and general revenue assistance, including all GST revenue.<sup>7</sup> The remainder of state and territory revenue comes from other sources, including the sale of goods and services and royalties.<sup>8</sup>

The situation where the states and territories rely on funding transfers from the federal Government to meet their expenditure responsibilities is referred to as vertical fiscal imbalance (VFI).

## Australia has a relatively low tax burden compared to other developed countries

Australia's aggregate tax burden is relatively low compared with other developed countries, but higher than some of our major regional trading partners, at around 27.3 per cent of GDP in 2012 (Chart 2.2).<sup>9</sup> This is a product of Australia's smaller overall size of government compared to many of its developed counterparts and that it is only one of two developed countries that do not levy specific social security taxes (the other being New Zealand).

Australia's compulsory superannuation system — the superannuation guarantee — is sometimes equated to a social security tax. However, as it is paid directly into private superannuation accounts (currently set at 9.5 per cent of an employee's ordinary time earnings) rather than to the government, it does not meet the definition of a tax.<sup>10</sup>

The Government's budget projections incorporate a cap on Commonwealth taxation at 23.9 per cent of GDP (which, the 2014-15 MYEFO 2014-15 projected to be reached in 2020-21).

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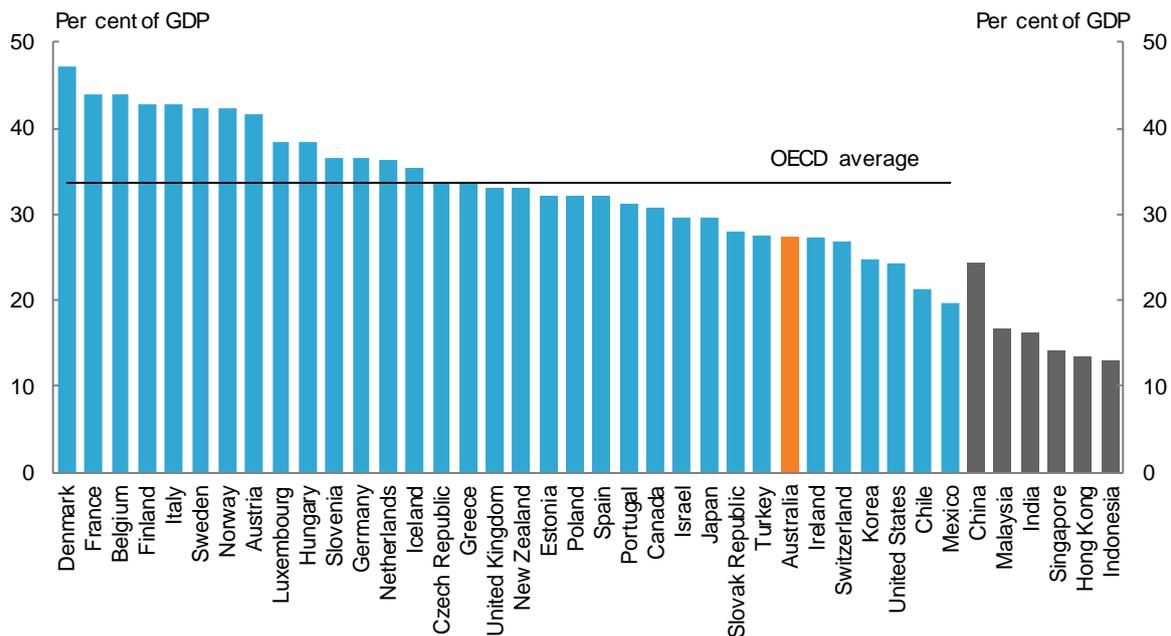
7 Treasury calculations using State and Territory Final Budget Outcomes (or equivalents). See Chapter 8 for full bibliographic details.

8 Unlike taxes, which are unrequited transfers, royalties are a charge for the right to extract a mineral resource and, as such, are not classified as taxes.

9 In this discussion paper, comparisons with other developed countries generally utilise data from the Organisation for Economic Cooperation and Development (OECD).

10 The OECD defines a tax as a compulsory and unrequited transfer to government. See the OECD's glossary of tax terms: [www.oecd.org/ctp/glossaryoftaxterms.htm](http://www.oecd.org/ctp/glossaryoftaxterms.htm).

**Chart 2.2 Total tax revenue as a percentage of GDP, for OECD and selected Asian economies, 2012**



Note: Tax-to-GDP statistics for China, Hong Kong, Singapore and India have been prepared using the IMF's Government Finance Statistics and are not directly comparable to OECD statistics. Unlike the OECD, the IMF does not classify social security contributions as a tax. To improve comparability with OECD statistics, tax-to-GDP ratios for China, Hong Kong, Singapore and India are calculated using IMF data but inclusive of social security contributions. Statistics for China are for 2011 and for India are for 2011-12.

Source: OECD 2014, *Revenue Statistics 2014*, OECD Publications, Paris; OECD 2014, *Revenue Statistics in Asian Countries: Trends in Indonesia and Malaysia*, OECD Publications, Paris; International Monetary Fund (IMF) 2014, *Government Finance Statistics Yearbook*, viewed 21 January 2015:

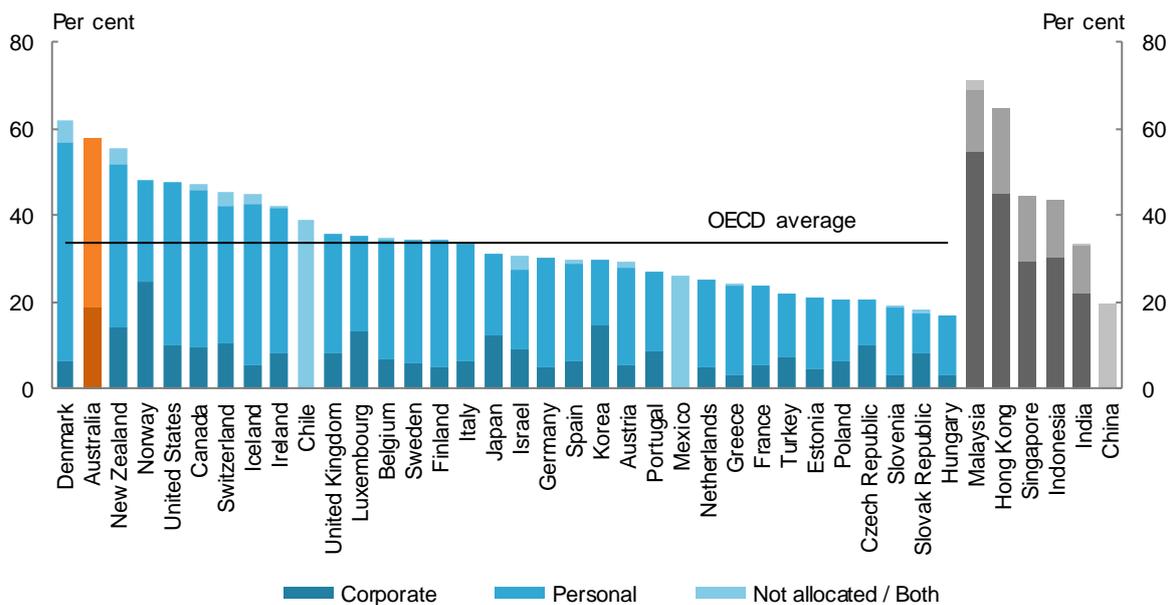
<http://elibrary-data.imf.org>; IMF 2014, *India Country Report No. 14/57*, viewed 22 January 2015: [www.imf.org/external/pubs/ft/scr/2014/cr1457.pdf](http://www.imf.org/external/pubs/ft/scr/2014/cr1457.pdf).

## Australia relies more on corporate and individuals income taxes than other developed countries

Australia has a comprehensive framework of broad-based taxes. Taxes levied on income from inputs to production (that is labour, capital and land) include individuals income tax, company income tax, tax on superannuation funds, land tax, and resource rent taxes.

Australia relies more heavily on income taxes on company and individual income (often termed 'personal income tax', including by the OECD) than other developed countries (Chart 2.3). Income tax levied on individuals comprised 39.2 per cent of total tax revenue in 2012, while corporate taxes comprised 18.9 per cent of total tax revenue in 2012, among the highest in the developed world and significantly higher than some key regional competitors.

**Chart 2.3 Taxes on corporate and personal income as a percentage of total taxation, for OECD and selected Asian economies, 2012**



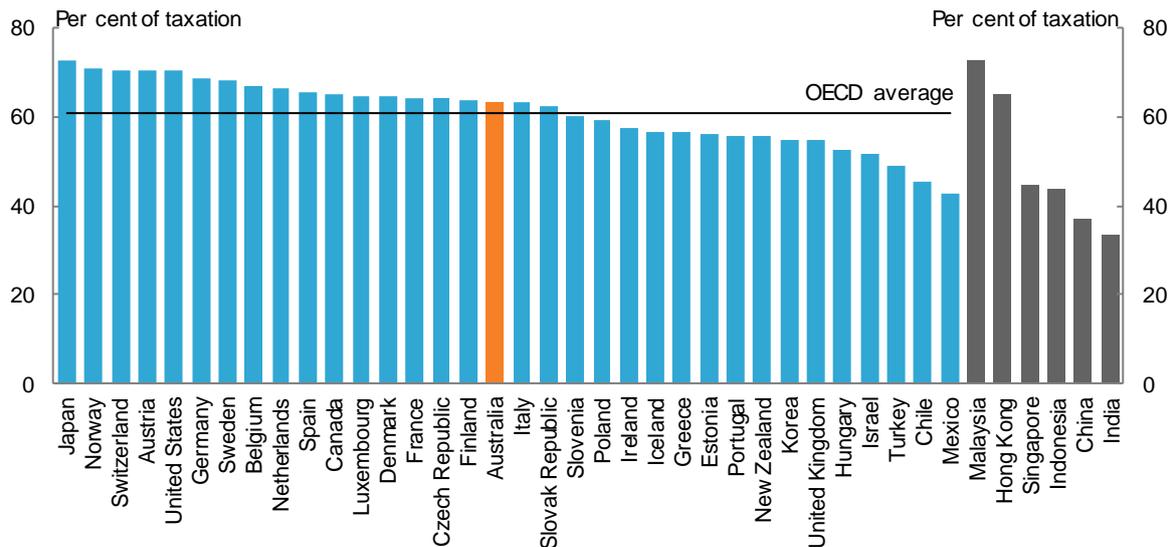
Note: Taxes on income are based on the OECD (series 1000) and IMF classifications (series 11). Estimates for China, Hong Kong and Singapore have been prepared using the IMF's Government Finance Statistics, while estimates for India have been prepared using the CMIE database. These estimates are not directly comparable to OECD statistics. Unlike the OECD, the IMF does not classify social security contributions as a tax. To improve comparability with OECD statistics, total taxation estimates are prepared using IMF data but inclusive of social security contributions. Statistics for China are for 2011 and for India are for 2011-12. Source: OECD 2014, *Revenue Statistics 2014*, OECD Publications, Paris; OECD 2014, *Revenue Statistics in Asian Countries: Trends in Indonesia and Malaysia*, OECD Publications, Paris; IMF 2014, *Government Finance Statistics Yearbook*, viewed 21 January 2014: <http://elibrary-data.imf.org>; IMF 2014, *Government Finance Statistics*, Mimas, University of Manchester, viewed 21 January 2015: <http://ukdataservice.ac.uk/help/get-in-touch.aspx>; Treasury calculations using CMIE 2014, viewed 23 January 2015: <http://economicoutlook.cmie.com>.

Unlike most other developed countries, Australia does not levy social security contributions. Compulsory social security contributions tend to be levied at a flat rate on earnings, unlike the progressive tax rate scale applied to income earned by individuals. In OECD countries, social security contributions on average comprise one quarter of total taxation, but make up over 40 per cent of total taxation in some countries (such as Japan and the Netherlands).

Although Australia does not have any compulsory social security contributions, the states and territories do levy payroll tax on employee remuneration above a threshold. This is another form of direct taxation. Although Australia relies more on payroll tax than other OECD countries, this only comprised five per cent of taxation in Australia in 2012.

Direct forms of taxation — individuals and corporate income taxes, compulsory social security contributions plus payroll taxes — comprise around 63 per cent of taxation in Australia. This compares to the OECD average for direct taxes of 61 per cent (Chart 2.4).

**Chart 2.4 Direct taxes as a percentage of total taxation, for OECD and selected Asian economies, 2012**



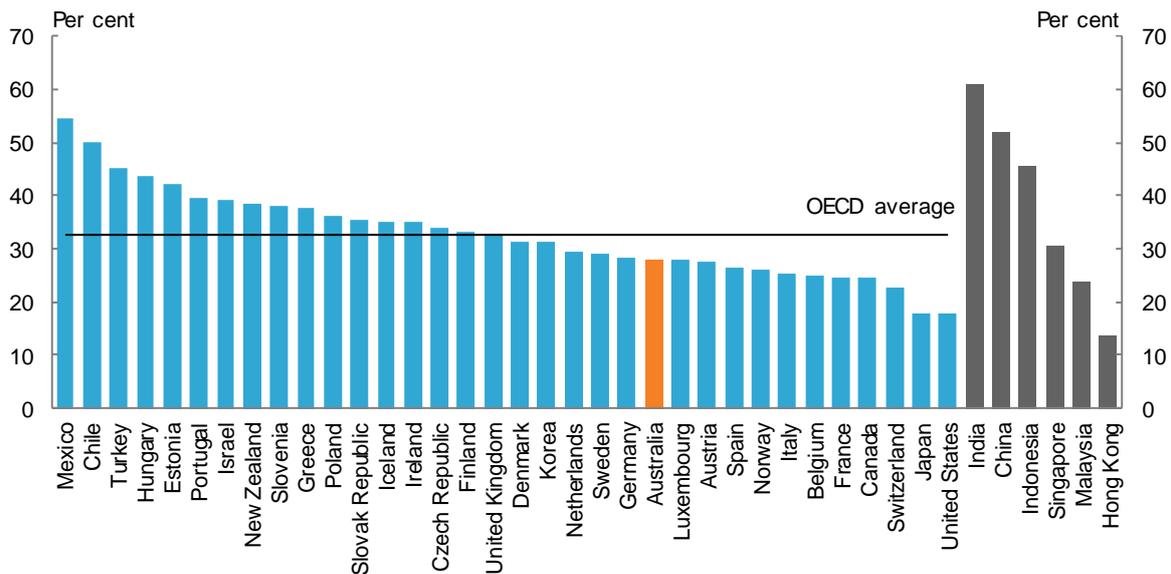
Note: Direct taxes include personal and corporate income taxes (OECD series 1000), social security contributions (OECD series 2000) and payroll and workforce taxes (OECD series 3000), but does not include other compulsory non-tax payments (such as the Superannuation Guarantee). Estimates for China, Hong Kong and Singapore have been prepared using the IMF's Government Finance Statistics, while estimates for India have been prepared using the CMIE database. These estimates are not directly comparable to OECD statistics. Unlike the OECD, the IMF does not classify social security contributions as a tax. To improve comparability with OECD statistics, direct and total taxation estimates are prepared using IMF data but inclusive of social security contributions. Statistics for China are for 2011 and for India are for 2011-12.

Source: OECD 2014, *Revenue Statistics 2014*, OECD Publications, Paris; OECD 2014, *Revenue Statistics in Asian Countries: Trends in Indonesia and Malaysia*, OECD Publications, Paris; IMF 2014, *Government Finance Statistics Yearbook*, viewed 21 January 2014: <http://elibrary-data.imf.org>; IMF 2014, *Government Finance Statistics*, Mimas, University of Manchester, viewed 12 March 2015: <http://ukdataservice.ac.uk/help/get-in-touch.aspx>; Treasury calculations using CMIE 2014, viewed 23 January 2015: <http://economicoutlook.cmie.com>.

Taxes on consumption include the goods and services tax (GST), tariffs and customs duties levied on imported goods and excise levied on the domestic consumption of particular products (such as fuel, alcohol and tobacco). Australia has a lower reliance on consumption taxes than most developed countries (Chart 2.5).

State and territories also levy a range of property taxes, including stamp duties and land tax. Taxes on property comprise around 9 per cent of taxation in Australia in 2012, compared to the OECD average of around 5 per cent.

**Chart 2.5 Consumption taxes as a percentage of total taxation, for OECD and selected Asian economies, 2012**



Note: Taxes on goods and services are based on the OECD (series 5000) and IMF classifications (series 14). Estimates for China, Hong Kong and Singapore have been prepared using the IMF's Government Finance Statistics, while estimates for India have been prepared using the CMIE database. These estimates are not directly comparable to OECD statistics. Unlike the OECD, the IMF does not classify social security contributions as a tax. To improve comparability with OECD statistics, total taxation estimates are prepared using IMF data but inclusive of social security contributions. Statistics for China are for 2011 and for India are for 2011-12.

Source: OECD 2014, *Revenue Statistics 2014*, OECD Publications, Paris; OECD 2014, *Revenue Statistics in Asian Countries: Trends in Indonesia and Malaysia*, OECD Publications, Paris; IMF 2014, *Government Finance Statistics Yearbook*, viewed 21 January 2014: <http://elibrary-data.imf.org>; IMF 2014, *Government Finance Statistics*, Mimas, University of Manchester, viewed 21 January 2014: <http://ukdataservice.ac.uk/help/get-in-touch.aspx>; Treasury calculations using CMIE 2014, viewed 23 January 2015: <http://economicoutlook.cmie.com>

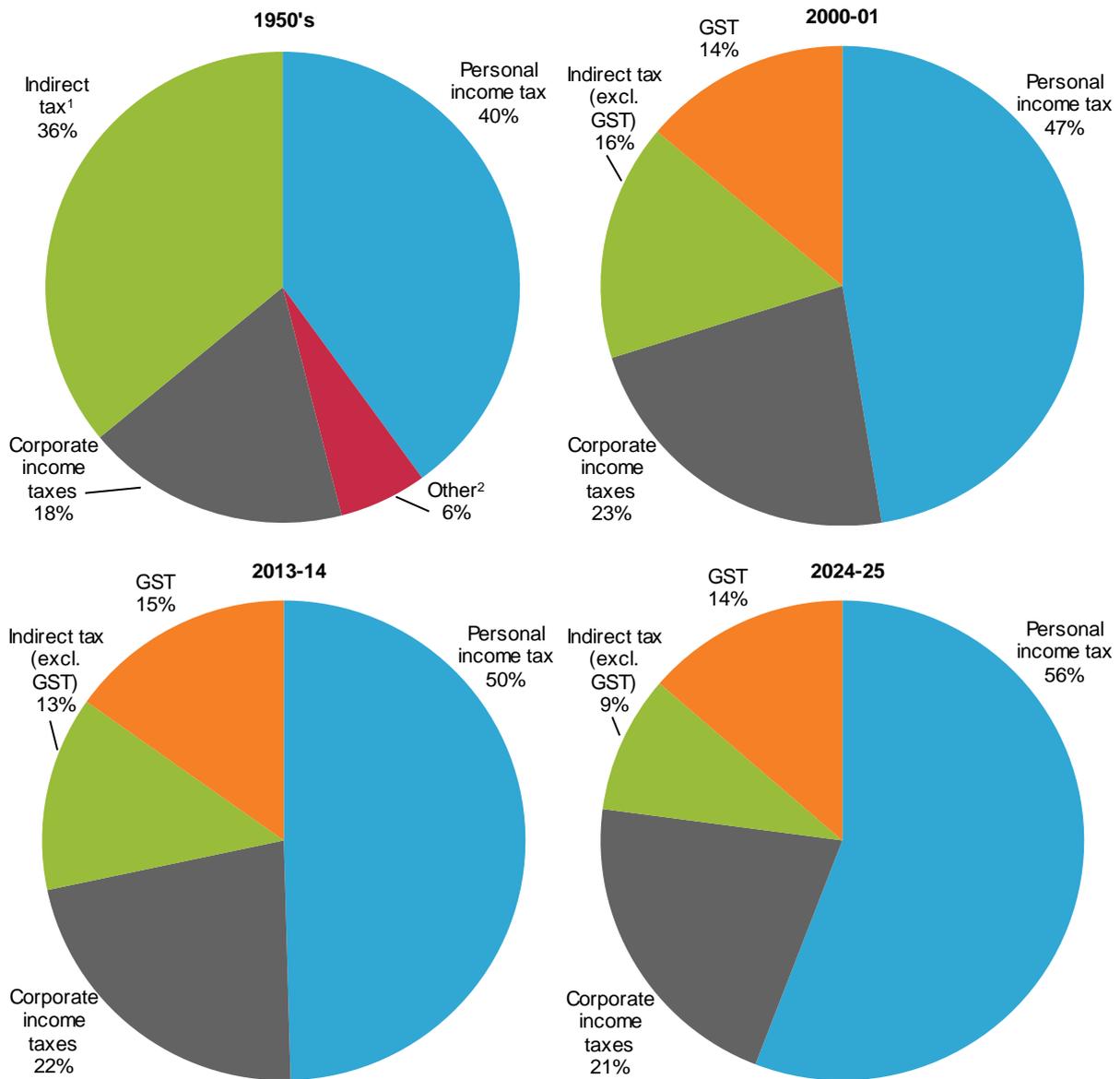
## The overall tax mix has not changed much over the last few decades while economic circumstances have changed significantly

At the federal level, Australia's overall tax mix has consistently favoured individuals and corporate income taxes (Chart 2.6). The average tax mix through the decade of the 1950s was weighted towards income taxes (60 per cent of tax receipts). Income taxes now contribute around 70 per cent of tax receipts, noting that some of the increase is because of economic factors, such as corporate profitability, rather than policy changes. Income tax reform in recent decades has focussed on broadening the income tax bases and lowering income tax rates, while indirect tax reform has reduced reliance on sales taxes and customs duties in favour of the GST. Policy changes have not, however, materially changed the overall mix of income tax compared to indirect tax.

Based on existing policy settings, Australia's reliance on individuals income tax is projected to increase further over the next decade, largely as a result of wages growth leading to individuals paying higher average rates of tax, known as 'bracket creep' (Box 2.2).

As noted in Chapter 1, changes in the global economy mean that the flow of financial capital and labour is becoming increasingly sensitive to Australia's tax settings.

Chart 2.6 Composition of Australian Government taxes over time



Note 1: On average in the 1950s, customs duties made up around 25 per cent of indirect tax compared with 10 per cent in 2013-14.

Note 2: For the 1950s, 'Other' includes payroll tax, land tax, estate duty, entertainments tax, gift duty and gold tax.

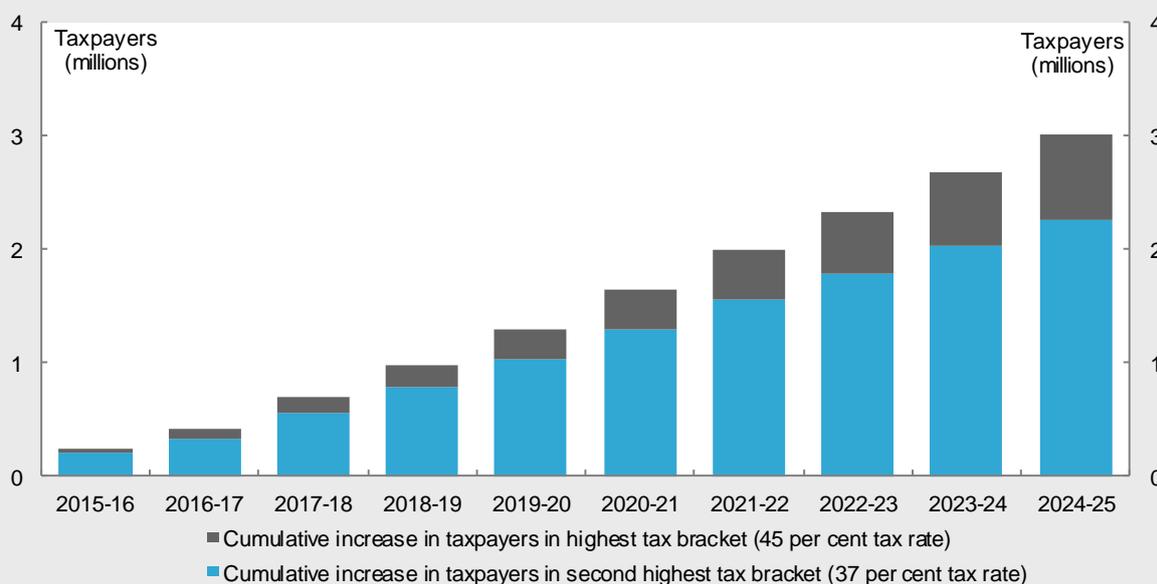
Source: Reserve Bank of Australia 1997, *Australian Economic Statistics 1949-50 to 1994-95*, Occasional Paper Number 8, viewed 10 December 2014: [www.rba.gov.au/statistics/frequency/occ-paper-8.html](http://www.rba.gov.au/statistics/frequency/occ-paper-8.html); Australian Government 2014, *Budget 2014-15 — online supplementary tables*, Australian Government, Canberra, viewed 10 December 2014: [http://budget.gov.au/2014-15/content/bp1/html/bp1\\_bst5-06.htm](http://budget.gov.au/2014-15/content/bp1/html/bp1_bst5-06.htm); and Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra; and Treasury estimates.

## Box 2.2: Bracket creep

Progressivity in the individuals income tax system is delivered by applying higher marginal rates of tax at different income thresholds. These thresholds do not automatically keep pace with inflation or wages growth. Bracket creep (also called fiscal drag) refers to the fact that taxpayers will face higher average, and sometimes marginal, tax rates over time even if their income has only increased by inflation.

Between 2014-15 and 2024-25, the percentage of taxpayers in the top two tax brackets (that is, with taxable income in excess of \$80,000) is estimated to increase from around 27 per cent to 43 per cent under current policy settings. It is estimated that over 2 million more taxpayers will be in the third income tax bracket (taxable income from \$80,000 to \$180,000) in 2024-25, compared to 2014-15. There is also estimated to be around 750,000 more taxpayers in the fourth tax bracket (taxable income above \$180,000) in 2024-25 compared to 2014-15 (Chart 2.7).

**Chart 2.7 Estimated cumulative increase in taxpayers in third and fourth tax brackets, relative to 2014-15**



Note: Tax rates exclude Medicare Levy and Temporary Budget Repair Levy.  
Source: Treasury estimates.

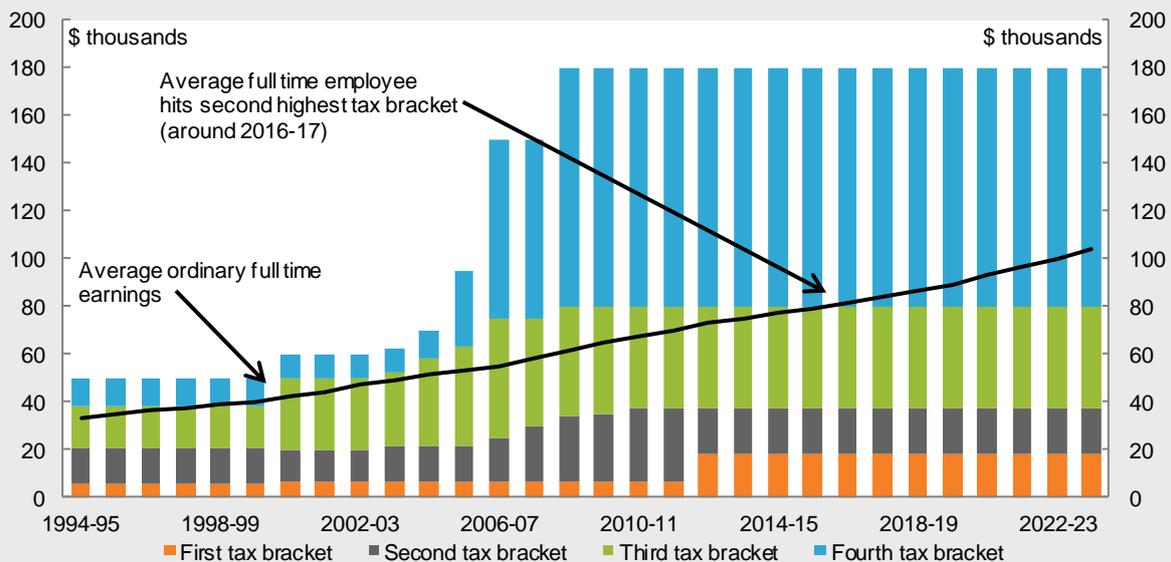
While bracket creep exists because of the progressivity of the individuals income tax system, unchecked bracket creep affects lower and middle income earners proportionally more than higher income earners.

For example, average ordinary full-time earnings were around \$75,000 in 2013-14, and are expected to be around \$104,000 in 2023-24 (see Chart 2.8). Someone on average full-time earnings therefore had an average tax rate of 22.7 per cent in 2013-14, increasing to 27.4 per cent by 2023-24. By contrast, someone with only half that income earned \$37,500 in 2013-14, increasing to \$52,000 in 2023-24. However, their average tax rate will increase from 10.3 per cent to 17.8 per cent. Someone earning twice the average full-time wage is on \$150,000, increasing to \$208,000 in 2023-24, but their average tax rate will only increase from 30.5 per cent to 34.3 per cent.

## Box 2.2 con't

For some people, particularly those on relatively low incomes, bracket creep can reduce incentives to work. At higher incomes, bracket creep increases the incentives for tax planning and structuring, and even overseas relocation. Bracket creep is therefore not just an issue because of its effect on progressivity, but because over time it exacerbates the other problems in the individuals income tax system.

**Chart 2.8 Personal income tax rates and the effects of bracket creep**



Source: Australian Bureau of Statistics (ABS) 2014, *Average Weekly Earnings, Australia, May 2014*, cat. no. 6302.0, ABS, Canberra and Treasury calculations.

## 2.3: Costs imposed by the tax system affect economic growth and the living standards of Australians

Recent research supports the importance of tax settings for economic growth.<sup>11</sup> Greater global economic integration means that investment and highly skilled workers have become more mobile. If tax settings are too high, Australia will be a less attractive place to invest and work and this will affect growth in Australians' living standards.

Other countries in a similar position to Australia, with a limited capacity to influence global capital markets, have generally sought to reduce the economic costs of taxation by having lower taxes on mobile factors of production (especially capital investment).

11 OECD 2010, *Tax Policy Reform and Economic Growth*, tax policy studies no. 20, OECD, Paris.

## The tax system imposes economic costs by distorting the decisions of individuals and entities

All tax systems impose economic costs by altering the decisions of individuals and entities and compliance costs associated with meeting tax obligations and administering the system.

Tax systems impose economic costs by changing relative prices, which influence decisions individuals and entities make to work, save, invest and employ. Different types of activities are taxed at different rates in the tax system, which means that taxes discourage some activities while encouraging others. These tax-induced changes have costs to both the economy and households.

In general, taxes have a greater impact on behaviour and, hence, a greater cost to economic growth and household living standards, where the tax is levied at a high rate and/or when it is easier for a person or entity to reduce tax by changing behaviour.

Taxes applied to narrower economic bases due to exemptions and concessions have to be set at higher rates to raise the same amount of revenue compared to taxes applied across broad bases. Generally, a tax applied at a higher rate on a narrower base will have higher economic costs than if applied more broadly at a lower rate.

## Modelling suggests that some taxes with high costs to economic growth and living standards are company tax and stamp duties

Recent Treasury modelling of the major taxes in Australia suggests the taxes with high long-term costs for living standards (measured as the 'marginal excess burden'<sup>12</sup>) are company income tax and stamp duties (Chart 2.9).<sup>13</sup> Company income tax has a high marginal excess burden because of the relatively high company tax rate of 30 per cent in Australia, combined with the high level of mobility of the underlying tax base. Conveyancing stamp duties also have a high excess burden because they discourage the exchange of residential and business properties. Other modelling also suggests that insurance duties have fairly high costs because they discourage some households from taking out appropriate levels of insurance.<sup>14</sup>

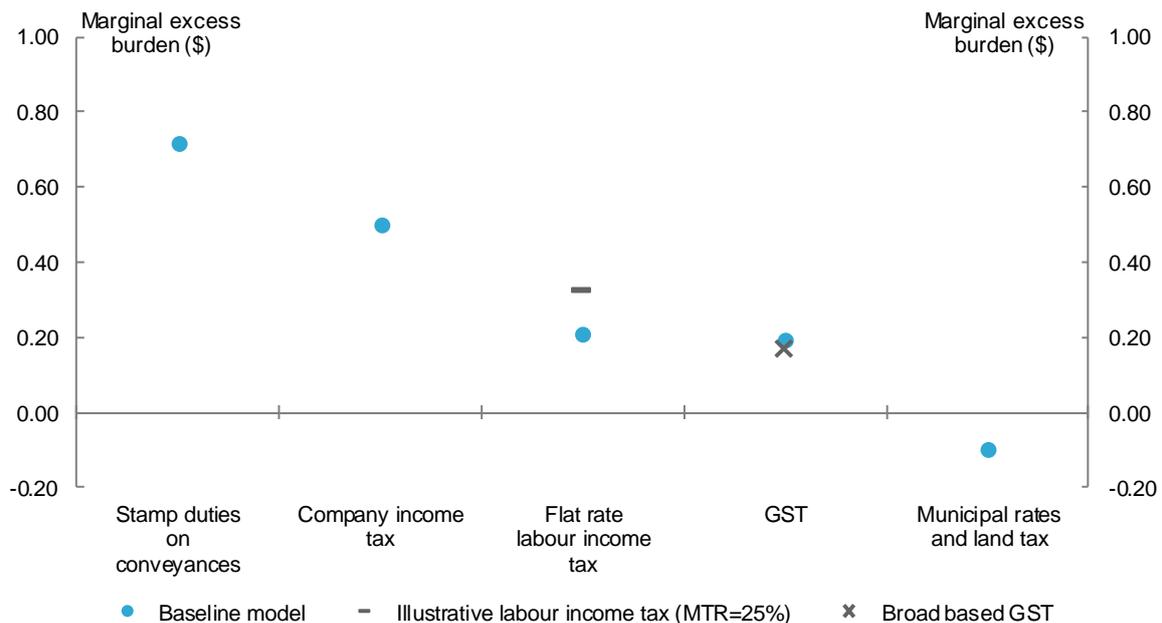
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12 The 'marginal excess burden' is a measure of some of the economic costs associated with a tax on the aggregate welfare of Australian households. In particular, the measure examines the impact of raising an additional \$1 of revenue on the level of consumption of goods and services by households, as well as time for leisure.

13 Cao, L, Hosking, A, Kouparitsas, M, Mullaly, D, Rimmer, X, Shi, Q, Stark, W, and Wende, S, forthcoming, *Understanding the economy-wide efficiency and incidence of major Australian taxes*, Australian Treasury working paper, Treasury, Canberra.

14 KPMG Econtech 2010, *CGE analysis of the current Australian tax system — Report for the Australia's Future Tax System review*, KPMG Econtech, Canberra; KPMG Econtech 2011, *Economic analysis of the impacts of using GST to reform taxes — Report for the CPA Australia*, KPMG Econtech, Canberra; and NSW Treasury 2012, *NSW Financial Audit 2011 (Lambert review)*, Volume 2, Chapter 13, NSW Treasury, Sydney.

**Chart 2.9 Long-run modelling estimates of the marginal excess burden of some of Australia's taxes**



Note: Marginal excess burdens were estimated using a long-run CGE model of the Australian economy and tax system. Australian households are captured as a single economic unit in this model. The labour income tax is modelled as a stylised flat tax on labour income only. An out-of-model calculation for a marginal tax rate (MTR) of 25 per cent is presented as an illustration of an average taxpayer in 2011-12. Transfer payments are not captured in this model. For more information on this modelling, as well as analysis of a stylised capital component of individuals taxation, see the Australian Treasury working paper forthcoming, *Understanding the economy-wide efficiency and incidence of major Australian taxes*.

Source: Treasury estimates.

The GST and taxes on labour, particularly through the individuals income tax system, have a medium marginal excess burden. These taxes affect the decisions people make about how much time they spend in paid employment (and, in turn, the amount of goods and services they can consume with this income, or save) versus leisure or unpaid work at home.

Individuals income tax on labour is sometimes assessed as having higher economic costs than the GST because of the progressive rates scale. A key feature of a progressive individuals income tax system is that marginal tax rates are higher than average tax rates. When combined with means-tested assistance in the transfer system, this can lead to high effective tax rates, which can reduce the immediate rewards for work. Effective tax rates can affect workforce participation decisions. The current individuals income tax scales will lower living standards over time as more taxpayers fall into higher income tax brackets.

Modelling also suggests that broad-based land taxes, such as municipal rates, have a low economic cost (Chart 2.9). This is because land is immobile (unlike other capital) and cannot be moved or varied to avoid tax. The model applies this assumption to both domestic and foreign ownership of land. Land taxes paid by foreign and domestic landowners are only redistributed to the domestic households, providing a benefit to Australian households and

generating a negative marginal excess burden for a broad-based land tax shown in the chart.<sup>15</sup>

## The benefits of reducing the economic costs of taxation are spread throughout the economy, including workers

A tax system that relies too heavily on inefficient taxes, uncompetitive tax rates and poorly targeted or ineffective concessions will impose significant economic costs on the economy. These costs fall disproportionately on less mobile factors of production, including domestic labour.

An important consideration for designing the tax system is who actually bears the economic costs of taxation — commonly referred to as the ‘incidence’ of a tax. The legal incidence and economic incidence of a tax are often not the same, and the distribution of the economic incidence can have a significant impact on the economy.

Many taxes are legally required to be paid by companies and other entities, such as superannuation funds. However, the final economic incidence of these taxes often falls elsewhere. This occurs when the entity legally responsible for paying a tax can pass the cost of that tax to individuals as workers, consumers and investors, for example, by charging higher prices for goods or services or offering lower wages to employees.

Recent research by the Treasury<sup>16</sup> indicates that, in the long run, much of the burden or incidence of company tax falls on Australian workers. This is because, over time, the amount of capital investment in Australia (for example, the construction of buildings and purchase of equipment for production) is affected by the company tax rate. Lower amounts of capital investment in the Australian economy will reduce the output or productivity of labour and, in turn, reduce the real wages of workers.

Transference of the cost of a tax through the economy forms the basis of the ‘marginal excess burden’ measure of the economic cost of taxes on the welfare of Australian households (Chart 2.9).

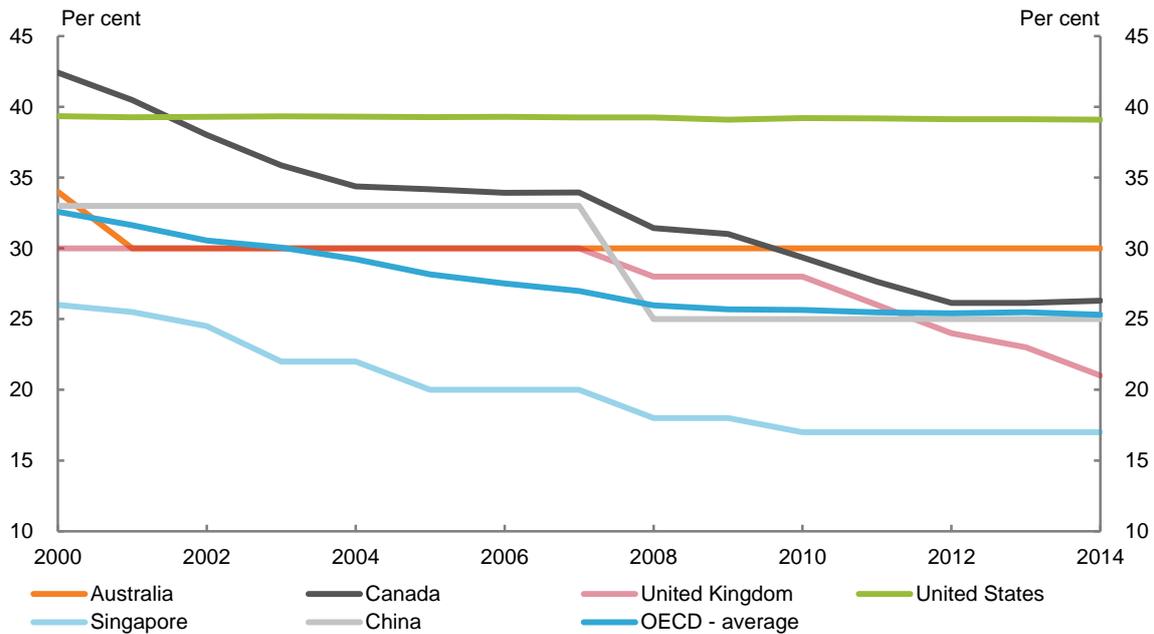
The high economic cost of some taxes, combined with the distribution of those costs through the economy, has prompted a policy response internationally. Many countries, including the United Kingdom and Canada, have reduced their company tax rate in recent years and strengthened their integrity rules to counter multinational tax planning (Chart 2.10). Consequently, while Australia’s integrity rules are strong, our company tax rate of 30 per cent is now significantly above the average rate of other countries, particularly our Asian neighbours, with whom we compete for foreign investment.

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15 Independent Economics also recently estimated a similar marginal excess burden for a broad-based land tax. See Independent Economics 2014, *Economic impacts of negative gearing of residential property — report for the Housing Industry Association*, Independent Economics, Canberra.

16 Cao, L, Hosking, A, Kouparitsas, M, Mullaly, D, Rimmer, X, Shi, Q, Stark, W, and Wende, S, forthcoming, *Understanding the economy-wide efficiency and incidence of major Australian taxes*, Australian Treasury working paper, Australian Treasury, Canberra; and Rimmer, X, Smith, J, and Wende, S 2014, ‘The incidence of company tax in Australia’, *Economic Roundup*, issue 1, 2014, Australian Treasury, Canberra, pages 33-47.

Chart 2.10 Trends in corporate tax rates in selected economies



Source: OECD 2014, *Tax Database — Taxation of Corporate and Capital Income*, OECD, Paris, viewed 5 December 2014: [www.oecd.org/ctp/tax-policy/Table%20II.1-May-2014.xlsx](http://www.oecd.org/ctp/tax-policy/Table%20II.1-May-2014.xlsx); KPMG 2014, *Corporate tax rates table*, viewed 5 December 2014: [www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx](http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx); and KPMG 2007, *Hong Kong Tax Competitiveness Series: Corporate Tax Rates*, viewed 5 December 2014: [www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/corp-tax-rate-0707.pdf](http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/corp-tax-rate-0707.pdf); KPMG 2006, *KPMG's Corporate Tax Rate Survey, An international analysis of corporate tax rates from 1993 to 2006*, viewed on 21 January 2015: [www.lib.uwo.ca/files/business/KPMGCorporateTaxRateSurvey.pdf](http://www.lib.uwo.ca/files/business/KPMGCorporateTaxRateSurvey.pdf).

## 2.4: There are opportunities to reduce the high costs of taxation due to complexity

A certain level of complexity is an inevitable part of any nation's tax system, reflecting the inherent complexity of the modern economy and society. The complexity of Australia's tax system continues to increase and is becoming a problem in its own right.

Complexity in the design of the tax system is a major driver of costs to individuals and entities, particularly compliance costs as taxpayers interact with the system and administration costs. Complexity also increases uncertainty and risk for taxpayers and can undermine trust in the system.

While it is broadly agreed that Australia's tax system is complex, there is no single measure of complexity. As such, administration and compliance cost estimates are often used as a proxy. The costs of administering the tax system at the Commonwealth level (including the GST) were around \$3.6 billion in 2013-14.<sup>17</sup> The Australian Taxation Office (ATO) estimates

<sup>17</sup> Australian Taxation Office (ATO) 2014, *ATO Annual Report 2013-14*, ATO, Canberra, viewed 5 December 2014: <http://annualreport.ato.gov.au/01-overview/commissioners-review>.

that total tax compliance costs are in the order of \$40 billion per year.<sup>18</sup> Around 72 per cent of Australian tax filers engaged a tax agent to assist them in meeting their tax obligations for the 2011-12 income year.<sup>19</sup> These costs represent resources diverted from other more productive or enjoyable activities.

## Tax compliance costs have multiple drivers

Changes in global business models and multinational tax planning are major drivers of complexity in tax policy design, in part because they threaten the revenue-raising capacity of tax systems. Complexity has also increased as new treatments and concessions are added in a piecemeal fashion, usually to assist a particular group or otherwise correct for an unintended outcome. Although these measures are meant to provide benefits, efforts to carefully target concessions often impose substantial compliance costs on taxpayers.

Complexity acts as an additional drag on the Australian economy when the costs of taxation arrangements outweigh their intended benefits. Reducing unnecessary complexity would clearly provide benefits to the economy. The Government's deregulation agenda seeks to address compliance costs directly by reducing the amount of regulation individuals and entities must comply with, including by simplifying particularly complicated areas of law, such as taxation law.

Of course, the impacts of complexity are broader than just compliance and administration costs. Individuals may alter investment decisions based on the tax treatment of particular activities. In the business context, this can manifest as a business choosing a particular business structure (or combination of structures) to achieve a particular tax outcome.

Individuals and entities willing to engage with complexity in the tax system can structure their affairs so as to minimise their tax liability. This can involve using different legal forms or structures to take advantage of opportunities presented by concessions or gaps in the structure of the law. Economically similar activities may end up being taxed differently, depending on professional advice or choice of legal structure. Tax planning of this nature is usually more accessible to higher-income taxpayers, which can contribute to perceptions that the tax system is inequitable.

## Approaches and practices will need to change to reduce complexity in the tax system

There are limited opportunities for a holistic, 'first principles' consideration of the tax system, including whether its fundamentals are still relevant. Historically, successive tax reviews have focused on the need to reduce the complexity of the tax system. This focus tended to diminish once the review process was complete. Substantial and enduring progress towards reducing complexity has remained elusive for a range of reasons, including the trade-offs involved.

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18 ATO analysis of commissioned Newspoll survey data relating to the 2011-12 tax year, to be presented at a forthcoming conference in 2015.

19 ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

Minimising tax complexity requires a broad change in attitudes and practices, including community acceptance that, while a reduction in complexity is likely to deliver substantial benefits for taxpayers as a whole, solutions are also likely to entail costs for some.

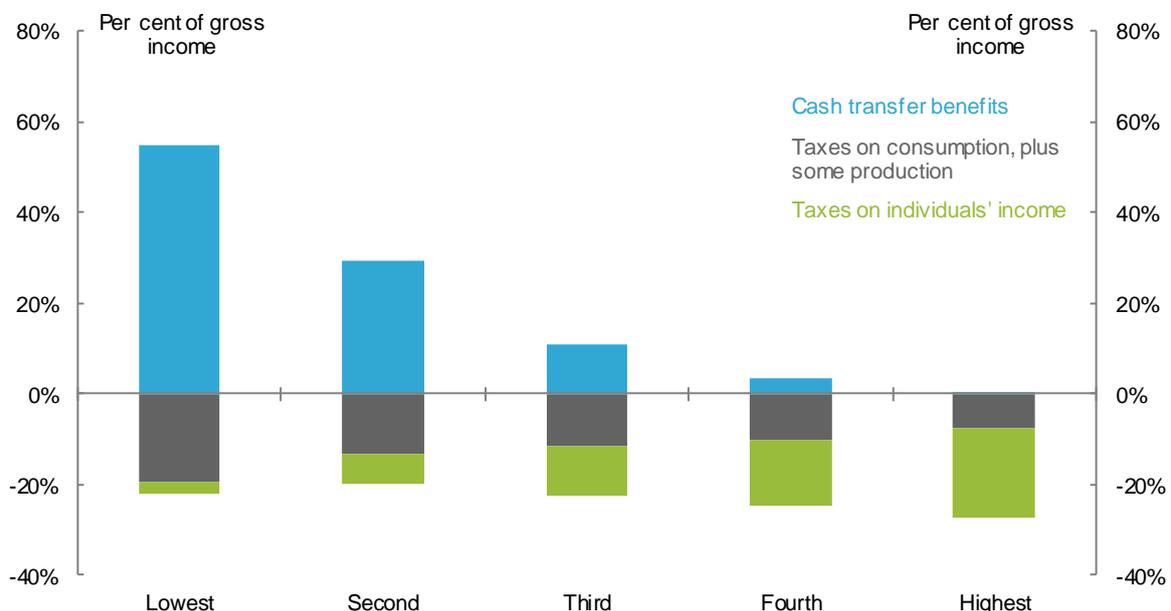
## 2.5: Tax systems need to be accepted as fair to be effective, sustainable and credible

To be sustainable, a tax system must be accepted by the community as fair. There is general acceptance (not just in Australia but around the world) that taxpayers with a greater ability to pay tax should pay more tax (vertical equity) and that taxpayers in economically similar situations should pay similar amounts of tax (horizontal equity). The progressivity of a tax system refers to the extent to which those with a greater ability to pay are expected to pay more. Progressivity in the tax system operates alongside the transfer system to deliver on income redistribution goals.

### Australia's tax and transfer systems are highly progressive

Australia's tax and transfer systems are highly progressive. Progressive individuals tax rates and thresholds underpin the overall progressivity of the tax system (Chart 2.11).

**Chart 2.11 Transfer payments and taxes as a percentage of gross income by household income quintile, Australia, 2009-10**



Note: Taxes on income include individuals income tax plus the Medicare levy and Medicare levy surcharge. Taxes on production include taxes payable on goods and services; taxes and duties on imports; and taxes on the ownership or use of land, buildings or other assets used in production or on labour (but not taxes on corporate profits or other business income). Transfer payments and taxes are expressed as a percentage of household gross income, which is before income tax and includes social assistance benefits received in cash. Household quintiles are defined according to equivalised disposable household income.

Source: Treasury calculations using ABS 2012, *Government benefits, taxes and household income, Australia, 2009-10*, cat. no. 6537.0, ABS, Canberra.

Progressivity is also illustrated by the 'tax wedge' for different households, where the tax wedge is the difference between the labour costs to an employer (effectively the 'pre-tax' wage) and the household's net take-home pay (after subtracting tax and adding transfer payments). In Australia, the tax wedge is low at low levels of income, reflecting low tax rates and any transfer payments received. As household incomes increase, the tax wedge becomes larger, reflecting the imposition of higher rates of tax and the withdrawal of transfer payments.

Chart 2.12 shows that the increase in the tax wedge between a low-income household and a high-income household (the 'tax wedge progression') is much higher in Australia than the OECD average. The tax wedge progression for a single person with no dependants is high in Australia, which demonstrates the progressivity of the individuals income tax system (Chart 2.12, top chart). Countries with lower tax wedge progression have flatter tax schedules. Unlike some European countries that have universal payments for families with children, assistance in Australia is targeted, leading to an even higher tax wedge progression for families with children (Chart 2.12, bottom chart).

The progressivity of Australia's tax system is a consequence of increasing individuals tax rates as incomes rise and the absence of flat-rate social security contributions (which are levied in many other countries).

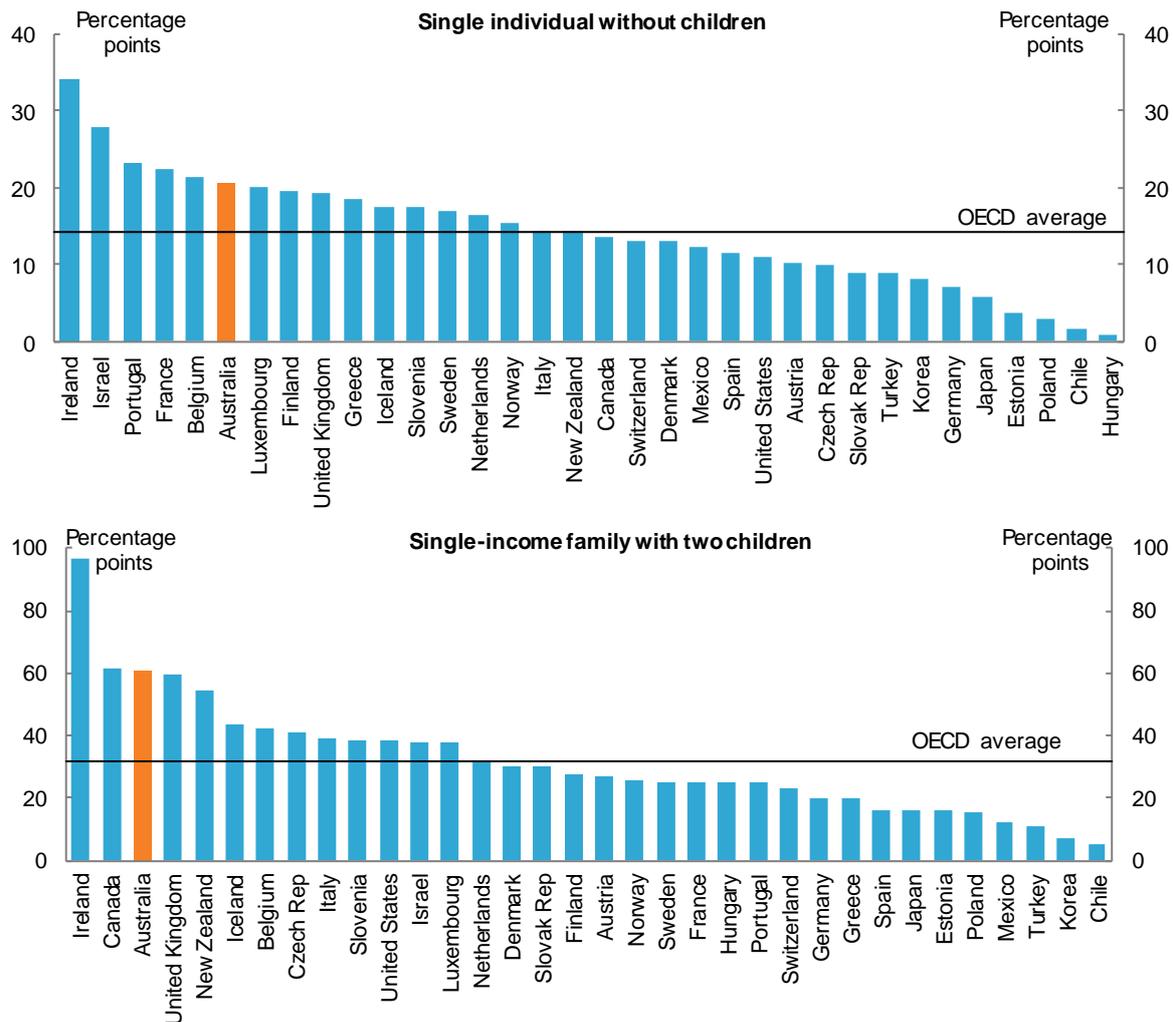
The tax system also provides that individuals earning below \$20,542 do not pay any tax (taking into account the tax-free threshold and low-income tax offset). Single seniors who receive the seniors and pensioners tax offset have an effective tax-free threshold of \$32,279. This system means that the average tax burden in Australia is lower than other similar countries. A single average wage earner in Australia faces an average tax burden of 27 per cent. In comparison, the average tax burden in Canada, the UK and the US is around 31 per cent.<sup>20</sup>

Many jurisdictions apply a flat-rate social security contribution, levied on an employee's wages, that is notionally allocated to pay for unemployment and aged care allowances over a person's lifetime. Social security contributions, as a flat rate tax, have a greater impact on the discretionary spending options of low income earners. Australia does not apply a separate social security contribution. Instead, pension costs are funded from Australia's main revenue stream and supplemented by the private superannuation system.

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20 OECD 2014, *Taxing Wages*, OECD, Paris, viewed 21 November 2014: [www.oecd.org/tax/tax-policy/taxing-wages.htm](http://www.oecd.org/tax/tax-policy/taxing-wages.htm).

Chart 2.12 Average tax wedge progression, OECD countries, 2013



Note: The average tax wedge progression is the percentage point difference between the average tax wedge of an individual (or family) earning 250 per cent of average wages and the average tax wedge of an individual (or family) earning 50 per cent of average wages. The average tax wedge progression includes the effect of employee and employer social security contributions, payroll taxes and cash benefits.

Source: Treasury calculations using OECD 2014, *Taxing Wages*, OECD, Paris, viewed 3 December 2014: <http://stats.oecd.org/>.

A trade-off for Australia's low average individuals' tax burden is that the statutory and effective tax rates produced by the interaction between the tax system and tightly targeted transfer system are comparatively high by international standards. For example, a single person in New Zealand earning NZ\$40,000 a year would pay 18.95 cents in tax on their next dollar of income and pay NZ\$6,600 in tax for the year.<sup>21</sup> In Australia, someone earning A\$40,000 would pay 36 cents in tax on their next dollar of income, yet pay annual tax of only A\$4,947.<sup>22</sup>

21 Includes Accident Compensation Corporation earner's levy.

22 Includes Medicare levy and low-income tax offset.

## High effective tax rates can reduce participation incentives for some groups

The combined effect on a person's earnings of income tax and the withdrawal of means-tested tax offsets and cash transfers in the welfare system is reflected in their effective tax rates. High effective tax rates can alter individuals' decisions about whether, and how much, they work.

The impact of high effective tax rates on individuals' decisions is most pronounced at lower levels of income and for particular groups like secondary earners, sole parents and those transitioning from income support into work. High effective tax rates can have economic consequences, and can also be seen as unfair where they excessively reduce returns from working.

## Perceptions of fairness also underpin wider confidence in the tax system

Confidence in the tax system can be eroded when people think others are not paying their fair share of tax. This can be due to concerns over concessions, aggressive tax avoidance or tax evasion activities. Maintaining confidence is particularly important given our reliance on self-assessment, which in the first instance asks individuals and entities to calculate their own tax liability. Effective tax design and administration are important in maintaining high levels of compliance and confidence in the system.

### Box 2.3: Perspectives on fairness in the tax system

Fairness is an important consideration for widespread acceptance and sustainability of the tax system. While fairness, or equity, is widely accepted as a fundamental design principle for the tax system, views about what this means in practice are very diverse. Similarly, there is no universally accepted benchmark for assessing the extent to which the tax system delivers equitable outcomes.

Most people consider that high-income earners should pay more tax than lower-income earners, both in dollar and percentage terms. Much of the controversy around tax fairness stems from disagreement about the extent to which the *percentage of income paid in taxes* should rise with higher levels of income.

Perspectives on equity are reflected in the different ways taxes can be structured: proportionally, progressively or regressively.

A *proportional tax* is one where the average tax rate is *constant* for all levels of the tax base. In these cases, the marginal tax rate equals the average tax rate. The GST, which has the same tax rate for all goods and services falling within its base, is an example of a proportional tax.

A *progressive tax* is one where the average tax rate *rises* as the tax base rises (because of increasing marginal tax rates). Australia's individuals income tax system is an example of a progressive tax.

A *regressive tax* is one where the average tax rate *falls* as the tax base rises (and the marginal tax rate is below the average tax rate).

### Box 2.3 con't

Just as the economic growth effect of tax reform is considered from the lens of the whole tax system (including individuals tax, fringe benefits tax, superannuation and so on) and the transfer system, the fairness of the tax system should also be assessed on a system-wide basis. For example, reforms that result in taxpayers in similar economic circumstances having similar tax liabilities (also called horizontal equity) are likely to make the system as a whole fairer, even when they have no impact on progressivity in the system.

Fairness in the tax system (and also the transfer system) is often assessed according to how much an individual pays in tax (and receives in benefits) relative to their current income. However, as people's incomes tend to change over their lives, an alternative perspective on fairness is taxes paid (and benefits received) relative to a person's lifetime income. Currently, there is limited data on tax and transfer outcomes for individuals and households over the lifecycle.

Questions of fairness or equity also arise when tax laws change with negative impacts for individuals or entities that have made decisions based on the previous policy.

To address these issues, special arrangements are often put in place temporarily to assist with a smooth transition. In some cases, 'grandfathering' allows past arrangements to be applied indefinitely in existing situations, with the new arrangements applying to all future cases. While grandfathering arrangements can assist those who are negatively affected by a tax change, they can also be a source of enduring complexity in the tax system.

### Tax on individual savings should give people the incentive to consider their future, but different types of savings are taxed differently, which affects savings choices

Most forms of private savings are taxed at lower rates than labour income. Taxing savings at lower rates than labour income can reduce or remove the negative effects of inflation on incentives for individuals to save for their future.

Australia's tax system treats alternative forms of saving differently. At one end of the spectrum, savings held in the family home are taxed at average effective tax rates approaching zero.<sup>23</sup> At the other end of the spectrum, savings held as financial deposits are taxed at full marginal rates, without any recognition for the costs of inflation.

The policy rationale for these differences is not always clear and can distort taxpayers' savings decisions. This has implications both for efficiently allocating savings in the economy and distributing risk across households.

23 This is because any capital gain from the family home and the benefit the household receives compared to a corresponding household living in a rental dwelling (commonly referred to as 'imputed rent') are not taxed.

### Discussion questions: Australia's tax system

2. How well does Australia's utilisation of its available taxes align with the evolving structure of Australia's economy and changes in the international economy?
3. How important is it to reform taxes to boost economic growth? What trade-offs need to be considered?
4. To what extent should reducing complexity be a priority for tax reform?
5. What parts of the tax system are most important for maintaining fairness in the tax system? Are there areas where fairness in the tax system could be improved?