

Australia's future tax system

Report to the Treasurer

December 2009

Part Two Detailed analysis

volume 1 of 2

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Part Two — Introduction

Part 1 of this Report outlined the emerging challenges faced by the tax and transfer system, and set out a broad overview of directions for reform. It identified the strengths of the current system and broad directions for improvement, expressed in the following overarching recommendation:

Recommendation 1:

- (a) Revenue raising should be concentrated on four robust and efficient broad-based taxes:
 - personal income, assessed on a more comprehensive base;
 - business income, designed to support economic growth;
 - economic rents from natural resources and land; and
 - private consumption.
- (b) Additional specific taxes should exist only where they improve social outcomes or market efficiency through better price signals. Such taxes would only be used where they are a better means to achieve the desired outcome than other policy instruments. The rate of tax would be set in accordance with the marginal spillover cost of the activity.
- (c) User charging should play a complementary role, as a mechanism for signalling the underlying resource cost of publicly provided goods and services.
- (d) With both specific taxes and user charges, revenue would be a by-product of the tax or charge, not the reason for it.
- (e) Other existing taxes should have no place in the future tax system and over time should be abolished.

The Review makes a further 137 recommendations — a consolidated list can be found in Part 1 of the report.

Part 2 of this Report is in two volumes (sections A to D and sections E to G) and sets out the detailed analysis that has led to these recommendations. For each tax base and component of the transfer system, it identifies design principles, presents findings on the operation of the current system, and recommends directions for reform.

Part 2 also applies the same analytical framework to the institutional arrangements that support the tax and transfer system, including arrangements for sharing tax revenue across the different levels of government.

Few, if any, of these topics can be satisfactorily dealt with in isolation. The directions for reform have been arrived at by looking at the system as a whole, and assessing how a change to one part of the system affects others. While the Report necessarily includes a set of tax- and issue-specific recommendations, they add up to an integrated blueprint for the future architecture of the Australian tax and transfer system, rather than a series of one-off tax policy measures.

Part Two: Detailed analysis
volume 1 of 2

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A1. Personal income tax

Personal income tax is Australia's single biggest source of taxation revenue, raising 37 per cent of total tax revenue. It should raise revenue simply and transparently from a relatively efficient tax base, while maintaining incentives to work and save. Personal income tax also plays a central role in achieving a progressive tax system by raising proportionally more revenue from those who have a greater capacity to pay.

Most adult Australians are affected by the personal income tax system every year, with around 12 million people filing tax returns annually.

As a proportion of GDP, revenue from personal income tax has fallen over the past two decades, with a series of tax cuts a major contributor in the last decade. In the future, demographic change will impact on growth in personal income tax revenue because a greater proportion of the population will be in retirement. If rising debt and reductions in government services are to be avoided, action will be needed to increase the amount of revenue raised from this or other tax bases.

The share of personal income tax in Australia, at 37 per cent of total tax revenue, is high compared to the OECD average of 25 per cent. Much of this difference is explained by the fact that Australia does not levy additional social security taxes in the way that most other OECD countries do (with benefits based on a person's previous earnings), at an average rate of 25 per cent of total tax revenue. Instead, Australia funds social security payments from general government revenues, and has a compulsory superannuation guarantee (that is, excluded from the calculation). Taking this into account, Australia's total taxation on personal income is among the lowest in the OECD, at 41 per cent compared to an OECD average of 51 per cent.¹

The tax system has a close relationship with the transfer payment system, given the large number of people who are in both systems at any given time. The two systems have different objectives, with the tax system focused on capacity to pay and the transfer system on need. The Review has considered in some depth the extent to which key structural elements of the two systems might be aligned, such as the definition of income and the unit and period of assessment. It has concluded that full integration of the two systems is neither achievable nor desirable because of the differences in their purposes, although policy in the two systems should always be developed jointly and service delivery should be coordinated.

Fairness should continue to be a key principle in the design of the personal income tax system. For the community to be willing to comply with the tax law, people need to be confident that their liability is assessed fairly and reflects their ability to pay. There is strong and widespread support for the proposition that proportionally more revenue should be raised from those with a greater ability to pay. While there are many ways to reach such outcomes, it is important they be achieved in as simple and transparent a way as possible. In

¹ Total taxation on personal income includes personal income tax, social security tax and payroll tax. It does not include Australia's compulsory superannuation guarantee, as this is not currently classified as a tax.

addition, a personal income tax system to suit an ageing population needs to be structured to reduce disincentives to work for the smaller proportion of the population who are of working age and to increase incentives for people to save and invest for their future.

Principles

The personal income tax system should raise revenue fairly — in terms of both the income on which tax is levied (the tax base) and the rates that apply — and contribute to achieving the government's redistribution goals.

Revenue-raising through the personal income tax system should operate as simply and transparently as possible.

Revenue-raising through the personal income tax system should avoid discouraging work and saving as far as possible.

A fair personal income tax system

The fairness of personal income tax is fundamental as an expression of societal values and is a prerequisite for people to be committed to the system and prepared to meet their obligations. There are two core elements to a fair system — a progressive tax rate structure and an appropriate definition of income.

The current personal income tax system seeks to aggregate income from both work and savings to form a single measure of taxable income. In practice the major part of household savings, including owner-occupied housing and superannuation, is exempt or effectively exempt. In designing the personal income tax system, labour income and the income from savings should be considered as separate though interconnected elements.

Income from work is currently taxed in different ways, depending on the nature of the worker's employment or their remuneration. While most people with work income have either salary and wage income or business income, which are taxed similarly, many people take some of their remuneration in the form of superannuation or fringe benefits, both of which have completely separate taxation arrangements. Some people's income from work is entirely exempt from tax. The costs associated with earning income are also treated inconsistently. A tax system for the future would tax wages and fringe benefits in a similar way, and also tax compulsory superannuation contributions with reference to a progressive personal income tax rates scale.

Income from savings, other than lifetime savings, is also taxed in a wide variety of ways. Varying arrangements apply to interest-bearing deposits, income from domestic shares, income from foreign shares, and rents from residential properties. A tax system for the future would tax these different forms of investment as consistently as possible, and also take account of the way inflation affects the effective tax rate on savings. It could do so by providing a common discount for a range of savings income or by applying a flat rate of tax to that income. Long-term, lifetime savings in the form of superannuation and owner-occupied housing should continue to be effectively exempt from income tax.

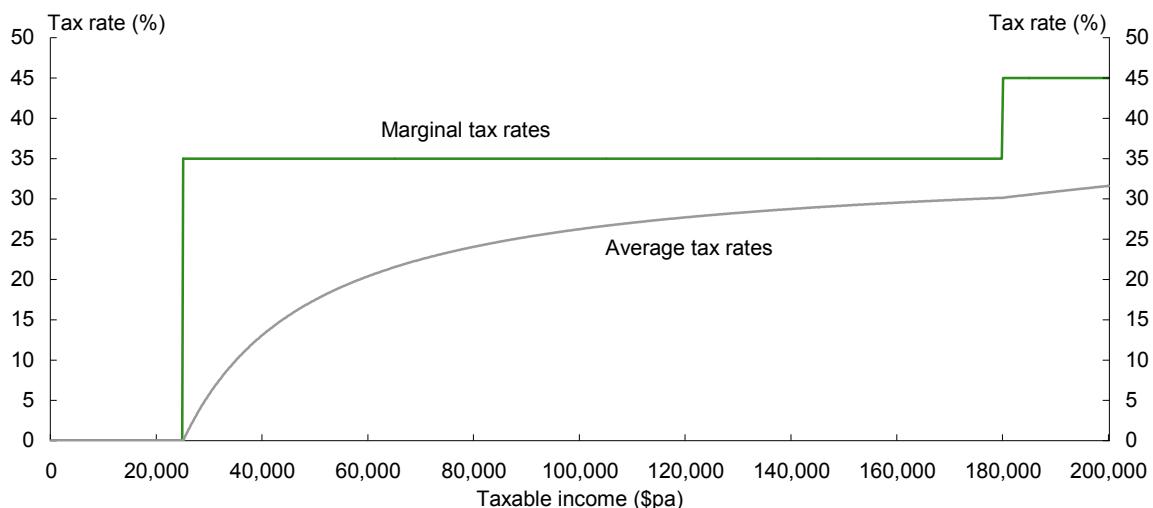
Personal income tax is calculated by applying a marginal rates scale to a person's combined income from work and savings. The progressive personal income tax rates scale is a strength

of the system that should be retained. At present, the great majority of tax revenue comes from higher income earners. In 2007–08, the 16 per cent of taxpayers on more than \$75,000 accounted for 55 per cent of personal income tax revenue, with almost half of that coming from the three per cent of taxpayers with taxable income over \$150,000.

A progressive system can be achieved in various ways. At present, Australia has a relatively low tax-free threshold and four marginal rates above it, along with a large number of tax offsets that alter the marginal rates for people in particular situations. The direction of change has been towards fewer marginal tax rates, from as many as six or seven during much of the 1980s and early 1990s. An alternative way of delivering a progressive personal income tax rates scale would be through a much higher tax-free threshold and a flat or rising rate scale. This would make the system easier to understand by removing the need for a number of tax offsets. By taking more income support recipients out of the tax system, it could also reduce the number of people who have to deal with both systems at the same time.

Chart A1-1 shows such a tax scale, with progressivity delivered through a large tax-free threshold and a constant marginal tax rate of 35 per cent for most taxpayers.

Chart A1-1: Indicative personal income tax rates scale
A simple scale with a high tax-free threshold



Source: Treasury estimates.

A simple and transparent system

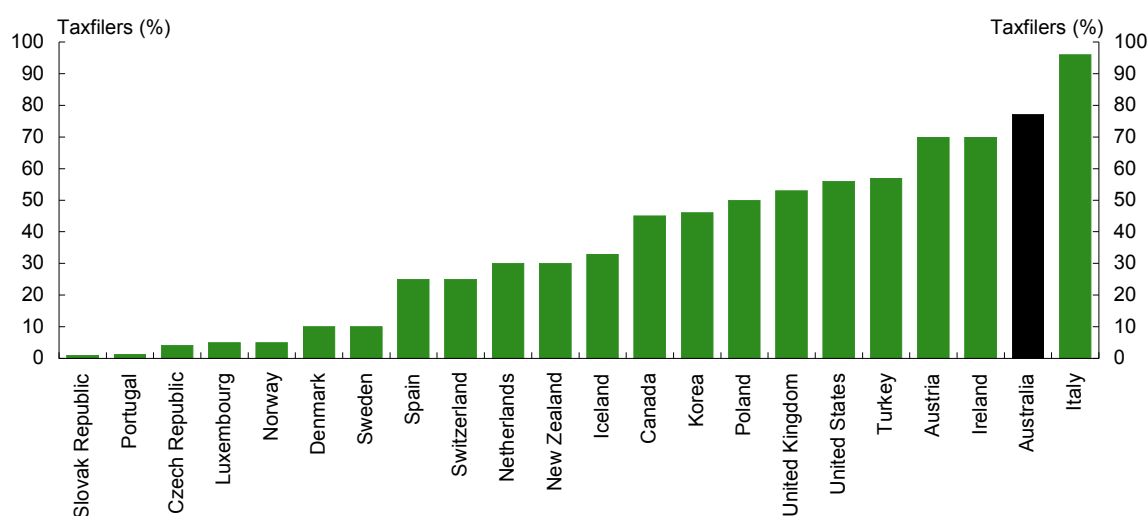
Many people find the personal income tax system complex, not only because of the rates scale and the lack of a coherent definition of taxable income, but also because they must deal with a large set of complex deduction rules, numerous tax offsets and different forms of exempt income.

A consequence of this is that the system is not transparent to taxpayers. It can be difficult for taxpayers to have a sense of their taxable income because of the complex rules associated with deductions, which are claimed by 80 per cent of personal income taxfilers. A common response to this and other forms of complexity in the tax system is to seek advice from a tax agent. Around three quarters of taxfilers seek such assistance. Nonetheless, in 2007–08, 86 per cent either claimed no deductions at all or only claimed work-related expenses, gifts

and the costs of managing tax affairs. This suggests that the system is too complex and the compliance burden too high.

Australia's use of tax agents is high by international standards; only Italy's is higher. By contrast, the Nordic countries, which have pre-filing arrangements for tax returns, have very low levels of tax agent use (see Chart A1-2). To simplify people's interactions with the tax system and facilitate much greater levels of pre-filing of tax returns, an automatic standard deduction should be introduced. However, to ensure that individuals with more complex affairs or high expenses are not disadvantaged, taxpayers would still have the option of substantiating a claim for all eligible expenses.

Chart A1-2: Percentage of taxfilers using a tax agent, 2005



Source: OECD (2005).

A more transparent system would improve people's ability to understand their tax rate and to predict the impact of changes in their work or savings arrangements. A key way of achieving this would be to incorporate some offsets into the personal income tax rates scale, and to limit non-structural offsets to situations where they meet an ongoing need that cannot be met in a more targeted way. The transparency of the system would also be improved by a more complete separation of the tax system from the transfer system. This could be achieved by setting the tax-free threshold at a much higher level for all taxpayers.

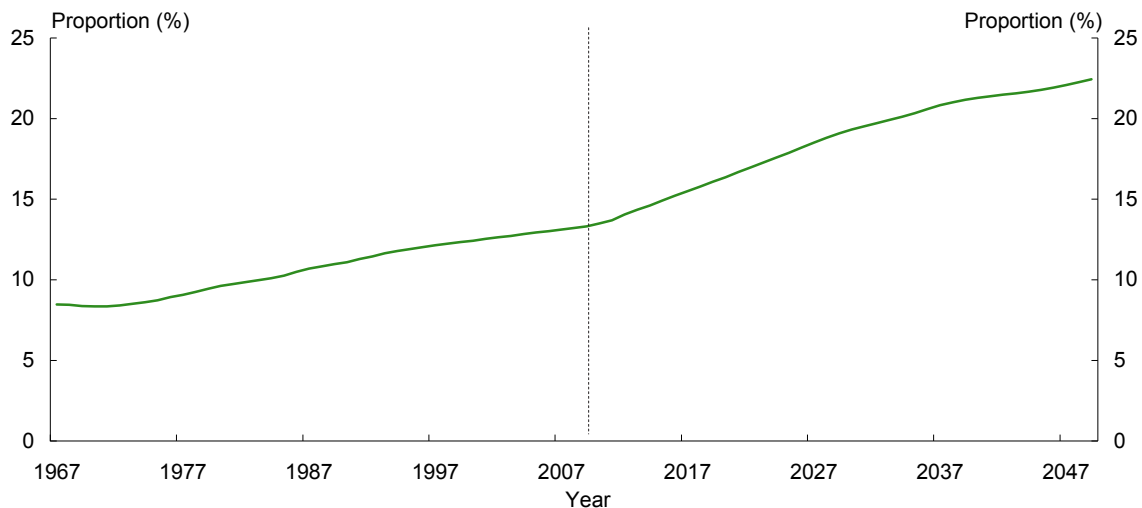
Longer term reforms should be made with a view to creating a simpler and more transparent system. Policy changes should support simplification by facilitating fully automated preparation of tax returns. Using information that is reported by a third party such as an employer or financial institution is an important part of this, rather than relying on information that has to be collected by the taxpayer over the course of the tax year. People of retirement age could be given the option of submitting their details on a single form with their partner, thus reducing the compliance burden where they own assets jointly. While it would be more complex, joint assessment could be considered for couples of late retirement age. Policy changes should also support transparency so that people can understand the incentives they face to work and save, and are better able to predict the impact of a change to their work or personal circumstances.

A system designed to reduce disincentives to work and save

The way that personal income tax is levied can make a significant difference to how much people work and save. Incentives to work and save are influenced by the effective tax rates that individuals face. Some people's effective rate is entirely determined by the personal income tax rates scale; although, for most adults, withdrawal rates on transfer payments and additional tax provisions also contribute to their effective tax rate.

A tax system for the future needs to take account of changes in the population, and particularly the relative size of the working age and retired populations. Over the next 40 years, the retirement age population is expected to grow faster than the working age population. By 2049, over one fifth of the population is projected to be aged 65 and over, compared to 13 per cent in 2009 (see Chart A1-3). While workforce participation rates are high now compared to rates in the past, maintaining high rates in future will require a tax and transfer system that supports and encourages work. Without high participation rates, the scope to fund payments and services for older Australians and to invest in younger generations will be compromised.

Chart A1-3: Proportion of the population aged 65 and over



Source: Treasury projections.

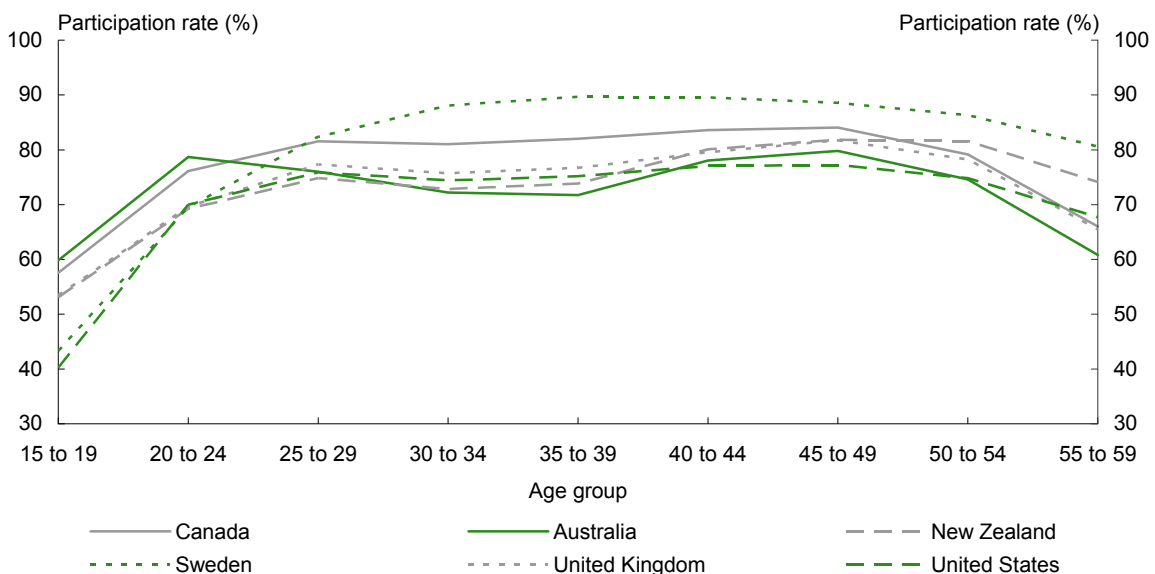
Incentives to work matter, not only because of the importance of personal income tax to total revenue collections, but also because people make important saving and investment contributions during the working phase of their lives. A tax system that supports work and saving must provide worthwhile returns to these activities, for those people already in work or looking for work, and potentially also for people who may not traditionally have sought employment, if they wish to work.

Returns from working influence people in different ways. A large body of theory and empirical studies has shed light on how tax policy can best respond to these differences. People who are relatively unresponsive to effective tax rates or financial incentives include men and women in their main working years without dependent children. These groups do not typically change their work effort in response to a higher marginal tax rate. Others, however, may withdraw from work altogether if faced with a high effective tax rate. These groups include women with an employed partner and those people who receive a non-activity-tested income support payment.

The capacity of the tax system to respond to these different behaviours is limited, but it does affect incentives for people who do not receive transfer payments and it interacts with transfer payments for people who may do some work now or in the future. At present, the tax system adapts to accommodate the transfer system, by removing maximum-rate full-year income support recipients from the requirement to pay tax. It does this by providing tax offsets for income support recipients with little or no private income. A more transparent system would reverse this arrangement, with the same tax rules applying to everyone and the transfer system adapting to the tax rules. This could be achieved by exempting income support and other transfer payments from tax entirely. In addition, withdrawal rates on payments could be reduced once an individual's income was high enough to produce a tax liability, to cap the overall effective marginal tax rate. The benefit of these changes would be more transparent effective tax rates.

While the proportion of Australians who participate in the workforce is high by international standards (76 per cent of the working age population compared to an OECD average of 71 per cent), this is partly due to Australia having the highest labour participation rate for students in the OECD. After making adjustments to account for measurement differences, the Productivity Commission found that the participation rate of Australian men aged 25 to 54 is below the OECD average. Australian women in the same age group have participation rates above the OECD average, but still curtail their engagement in the workforce during the typical child-bearing years more than is the case in New Zealand, the United Kingdom and the United States (Chart A1-4).

Chart A1-4: Female participation rates, by age, 2008



Source: OECD(2008b).

Lower participation rates for women of child-bearing age are also reflected in employment rates. The employment rate for women with a youngest child aged between three and five years is below the average for all OECD countries that collect this data, and is 25 percentage points below the Swedish rate (ABS 2007a).

This suggests that women of child bearing age constitute one of the key groups with greater potential for paid employment. Many of these women are caring for children, and prefer to take a period out of employment while they do so. Many seek employment, but do not

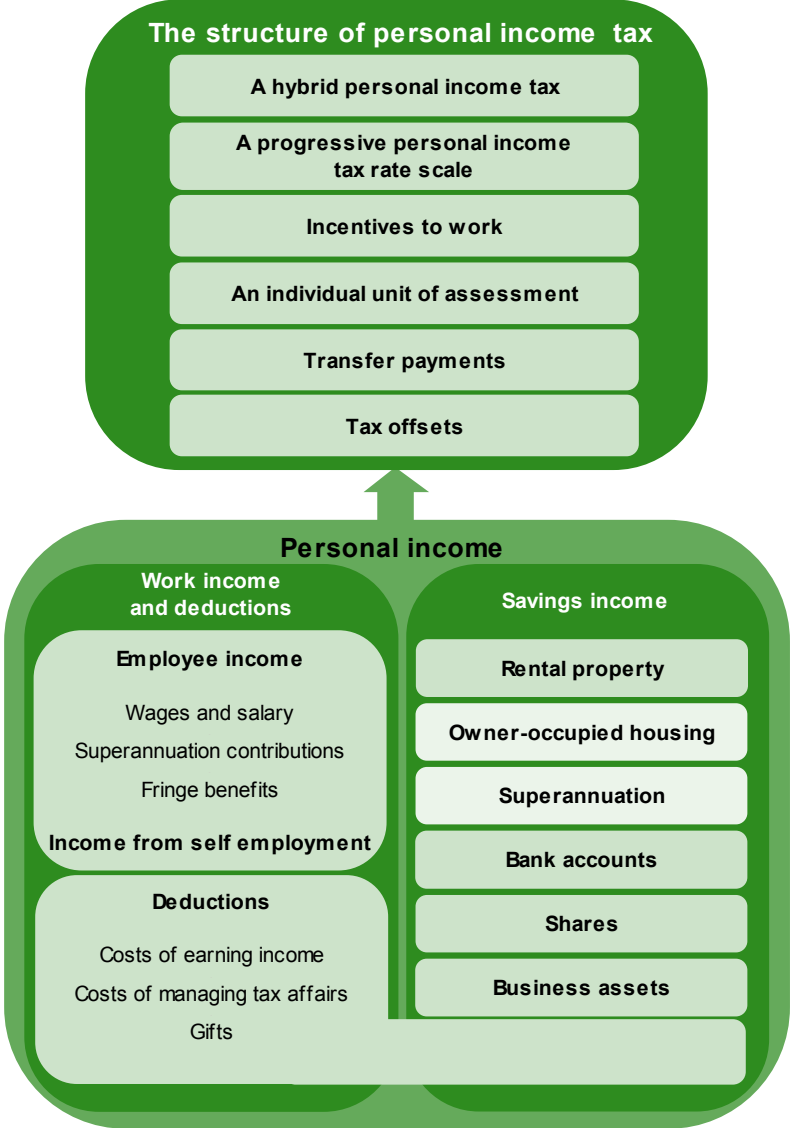
always have access to satisfactory child care. The longer the period out of the workforce, the greater the risk of skills atrophying and poorer employment opportunities later on. While there are many factors at play, financial incentives cannot be ignored. One of the most effective ways to improve financial incentives for people with dependent children is to set effective tax rates that support part-time work and recognise that carers in couple families are likely to have lower earnings than their partner. Taxing people as individuals is important in terms of financial incentives, because it applies a different tax rate to each partner in a couple rather than both people facing a pooled tax rate.

For non-lifetime savings, the current tax system's inconsistent treatment of different types of saving not only affects the level of savings but can also affect how households allocate their savings between different assets or savings vehicles. A future tax system would reduce these biases by taxing different types of saving more consistently.

The remainder of this section discusses core elements of the personal income tax system (see Chart A1-5) in more detail:

- A1-1 The structure of personal income tax — tax rates, particularly in terms of progressivity in the tax system and incentives to work and save.
- A1-2 Income from work and deductions.
- A1-3 Taxation of income from savings — other than superannuation (see Section A2 Retirement incomes).

Chart A1–5: The personal income tax system



A1–1 The structure of personal income tax

Key points

The personal income tax system should continue to be progressive, but it should operate in a simpler and more transparent way. The centrepiece of the system should be a high tax-free threshold with a constant marginal rate for most people.

The personal income tax system should support workforce participation by limiting high effective tax rates, especially for those people who are likely to be most responsive to financial incentives to work.

The primary unit in the personal tax system should continue to be the individual, and subsidies for dependants through the tax system should be restricted.

Income support and supplementary payments should be exempt to simplify tax and transfer interactions.

Where possible, tax offsets that are structural in nature should be incorporated into the personal income tax rates scale, along with the Medicare levy. Tax offsets that provide a concession for a particular group should be removed or delivered as a direct payment or service.

The taxation of personal income is the most important means of raising revenue in developed countries. However, personal income taxes discourage workforce participation and savings, both of which are important for economic growth.

The main purpose of the personal income tax system is to allow governments to raise revenue to pay for public goods (like education, health care and law enforcement), and to provide income support for those less able or available to support themselves. Underpinning the design of the income tax system is the desire to provide a balance between ensuring that those people with more capacity to pay contribute more (vertical equity) and that those with a similar capacity to pay bear the same burden (horizontal equity).

The practice of taxing those with greater capacity to pay reflects the view that an extra dollar of income is generally of more value for a person with a lower income than for a person with a higher income. That is, people on lower incomes benefit more from a lower average tax rate than people on higher incomes lose from paying a higher average tax rate.

An individual's capacity to pay is difficult to define. In the absence of existing wealth, there is an argument for redistributive tax policy to be based on an individual's potential earnings capacity. However, as information on potential earnings capacity is not readily available, observable proxies are required.

Actual labour income is often used as a proxy for potential earnings capacity. But wage and income differentials may reflect a number of other factors, including choices about how much to work or study. Taxing wages or income therefore biases decisions to undertake paid work and may also affect decisions about undertaking education and training. Savings income is also relevant to a person's capacity to pay, particularly for pre-existing savings or

taxes on economic rent. But taxing the normal return to saving is likely to bias savings, labour supply (for those that save part of their wages) and consumption decisions.

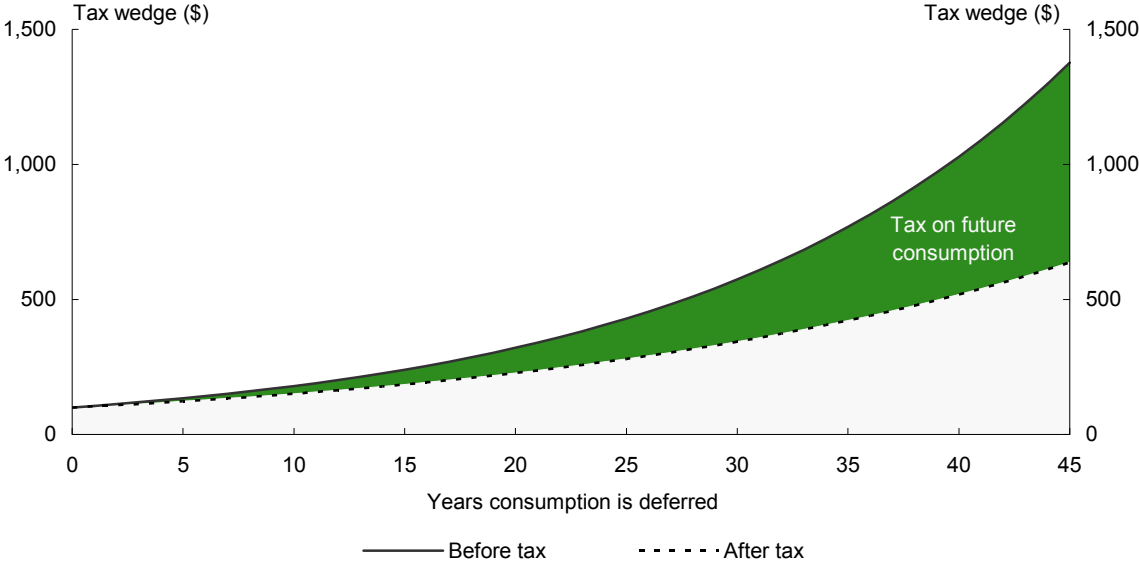
As income taxes can lead to a decline in overall economic output, there can be a trade-off between equity and efficiency when designing the personal income tax system.

A hybrid personal income tax base

Australia’s personal income tax system should continue to represent a hybrid personal income tax – with income from long-term, lifetime, savings taxed at a lower rate than other income or exempt from income tax. In particular, the main forms of lifetime savings for most Australians, superannuation and owner-occupied housing, should continue to be taxed at a lower rate or exempt from income tax – consistent with an expenditure tax benchmark that exempts the returns to saving (see Section A2-2). Comprehensive income taxation, under which all savings income is taxed in the same way as labour income, is not an appropriate policy goal or benchmark.

The essential reason for exempting lifetime savings or taxing them at a lower rate is that income taxation creates a bias against savings. The income taxation of savings therefore discriminates against taxpayers who save. They pay a higher lifetime tax bill than people with similar earnings who choose to save less. As savings can be thought of as deferred consumption, the longer the person saves and reinvests, the greater the implicit tax on future consumption (see Chart A1-6). For a person who works today and saves, taxing savings also reduces the benefit from working.

Chart A1-6: Tax wedge on future consumption



Source: Treasury estimates.
Assumptions: Pre-tax interest rate of 6 per cent per annum and a tax rate of 30 per cent.

The increasing implicit tax on future consumption provides an argument to tax longer-term lifetime savings at a lower rate. An individual can undertake lifetime saving through a variety of savings vehicles, but there are asset types that are more conducive or related to lifetime savings: namely superannuation and owner-occupied housing. It is possible to convert savings in these assets into present consumption by borrowing against them, directly or in effect. Further, the family home yields a stream of income (imputed rent) that is also a

form of current consumption. While these features could diminish their status as lifetime savings vehicles, in practice these assets will in net terms remain major forms of lifetime savings for most Australians, and provide for a major part of their retirement income.

An exemption from income tax or applying relatively low rates of tax to superannuation and owner-occupied housing is common practice around the world and has been a longstanding feature of the Australian tax system. The family home has not been subject to income tax in Australia since the earlier part of last century. Imputed rental income and capital gains from owner-occupied housing are generally exempt in the OECD countries, with a few exceptions.

While owner-occupied housing represents more than lifetime or retirement savings, other factors support its continued exemption. Given there is little community acceptance for applying income tax to the family home, any attempt to subject it to taxation is unlikely to be sustainable. Australia's current approach avoids the worst of the biases found in some other countries, where limited taxation of income or gains combined with full tax deductibility of mortgage expenses encourages people to over-invest in housing and take on too much household debt.

Retirement savings are also generally lightly taxed around the world. Many OECD countries tax retirement benefits at a person's marginal tax rate, and exempt contributions and earnings. In Australia, retirement savings are also taxed lightly but in a different manner — as both contributions and earnings are taxed at low rates while superannuation benefits are generally tax-exempt when paid after the age of 60.

Principles

Superannuation and owner-occupied housing should continue to be taxed at relatively low rates or be exempt from income tax, consistent with an expenditure tax benchmark.

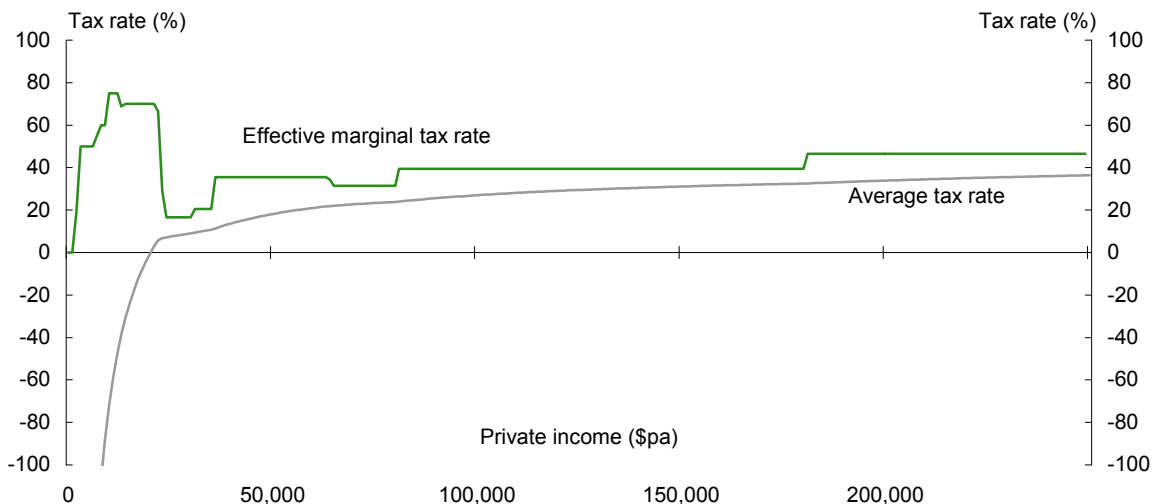
Other savings income should continue to be subject to income tax.

Personal income tax rates

Options for achieving a progressive personal income tax rates scale

A progressive income tax is characterised by average rates that rise with income, in line with the idea that reductions in income caused by taxation reduce the wellbeing of low-income earners more than high-income earners. This means that higher-income people bear a greater than proportional share of the tax burden.

Progressivity can be achieved either through a flat tax rate with a tax-free threshold, a rising personal income tax rates scale, or a combination of both. Progressivity does not necessarily require increasing effective marginal tax rates, as illustrated in Chart A1-7.

Chart A1–7: Increasing average tax rate for a single person without children, 2009–10

Source: Treasury estimates.

Imposing higher average tax rates on those with greater capacity to pay is typically better targeted if it is done through a progressive income tax system rather than through avenues that indirectly target income, such as carve-outs from the GST base or higher taxes on 'luxury' goods like cars and wine. Higher wage earners tend to vary their labour supply less than lower wage earners in the face of taxation (Breunig et al. 2008), so differential tax rates can also be less distortionary than flat rates. The overall progressivity of the tax system is reduced by other flat rate taxes, which makes progressivity in the personal income tax more important.

The redistributive goals of progressive taxation need to be weighed against the effects that progressive taxes have on incentives to invest in education, training and skills and to engage in entrepreneurial activity. Even with strong preferences for redistribution, steeply rising marginal rates at the top of the income distribution will be counter-productive – it only makes sense to tax people to the extent that they are still willing to work or engage in entrepreneurial activity.² A recent OECD report found that 'high top statutory income taxes reduce the post-tax income of a successful entrepreneur relative to an unsuccessful one and can reduce entrepreneurial activity and TFP (total factor productivity) growth' (Johansson et al. 2008). Increases in top marginal tax rates must therefore balance the desire for progressivity with the impact this may have on economic growth.

Progressive taxes can make income splitting more attractive, and give people incentives to manipulate the timing of large income amounts, as different patterns of income receipt will result in different tax liabilities. These effects can be mitigated by provisions that deal with alienation of income (see Sections A1–2 and A1–3), and by adopting approaches similar to accrual accounting that lessen the tax impact of timing differences in the receipt of income.

2 Theory suggests the optimal top marginal rate is the revenue maximising one, which would be zero if it began at the income level where the highest income taxpayer was no longer willing or able to earn more. See Brewer, M, Saez, E and Shephard, A (2008), Means-testing and tax rates on earnings, Institute for Fiscal Studies.

Principle

Personal income tax should be progressive, both through its own rates scale and also in combination with transfer payments.

Australia's progressive personal income tax system

The progressivity of a tax system can be assessed in various ways. A relatively straightforward approach is to compare the marginal and average tax rates inherent in the personal income tax rates scale at a particular point in the income distribution. The OECD commonly makes such an assessment at different points, illustrating how point measures of progressivity are sensitive to where they are evaluated.³ For example, for a single person in 2008, the Australian tax system was the 7th most progressive in the OECD if they were earning 67 per cent of the average wage, 20th most progressive at 100 per cent, and 11th most progressive at 167 per cent. Using this same measure, since 2000 the tax system has become slightly more progressive at 67 per cent of the average wage, and slightly less progressive at 100 per cent and 167 per cent.

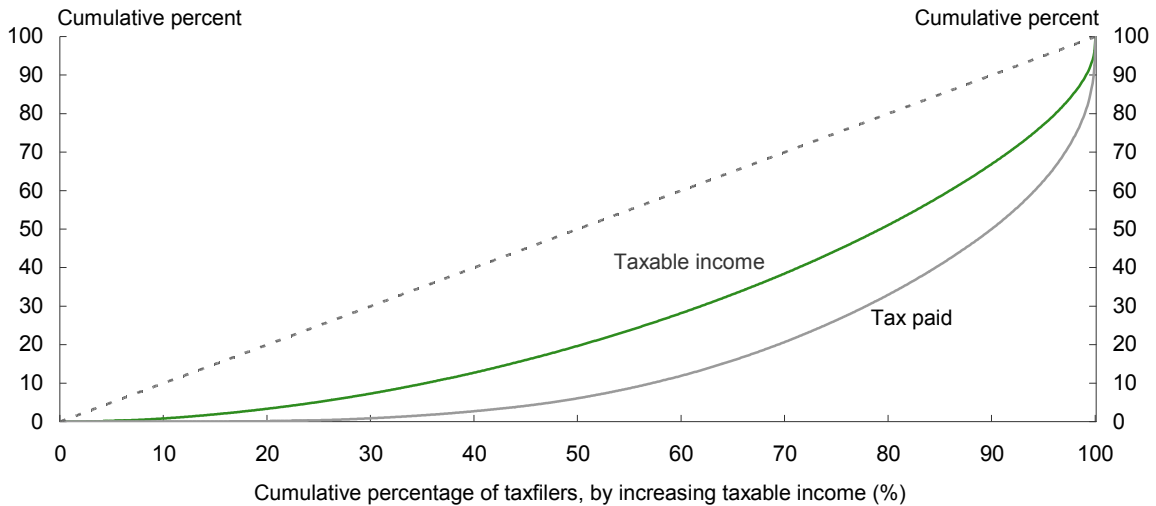
Complementary measures enable progressivity to be evaluated across the whole system, not only at specific income levels. As well as hypothetical calculations, actual outcomes can be assessed using empirical data.

Administrative data show that the tax-free threshold and rising marginal rates of the existing personal income tax system deliver progressive outcomes in Australia. Chart A1-8 compares how taxable income and tax paid are spread across the population, after ranking everyone according to their taxable income.⁴ Taxable income is unequally distributed across the population, with the top 20 per cent of taxfilers receiving 49 per cent of all taxable income. However, the income tax burden is even more concentrated, with the top 20 per cent of taxfilers paying 67 per cent of all personal income tax. Similarly, the bottom 20 per cent of taxfilers receive 3 per cent of all taxable income, but pay only 0.1 per cent of all personal income tax. This means that post-tax outcomes are more evenly distributed than pre-tax outcomes.

3 The measure is calculated as $(1 - \text{marginal tax rate}) / (1 - \text{average tax rate})$, and is reported in the annual OECD publication *Taxing Wages*. A variant of this was used in Arnold (2008).

4 People with negative or zero taxable income have been excluded.

Chart A1-8: Distribution of taxable income and tax paid, 2007-08

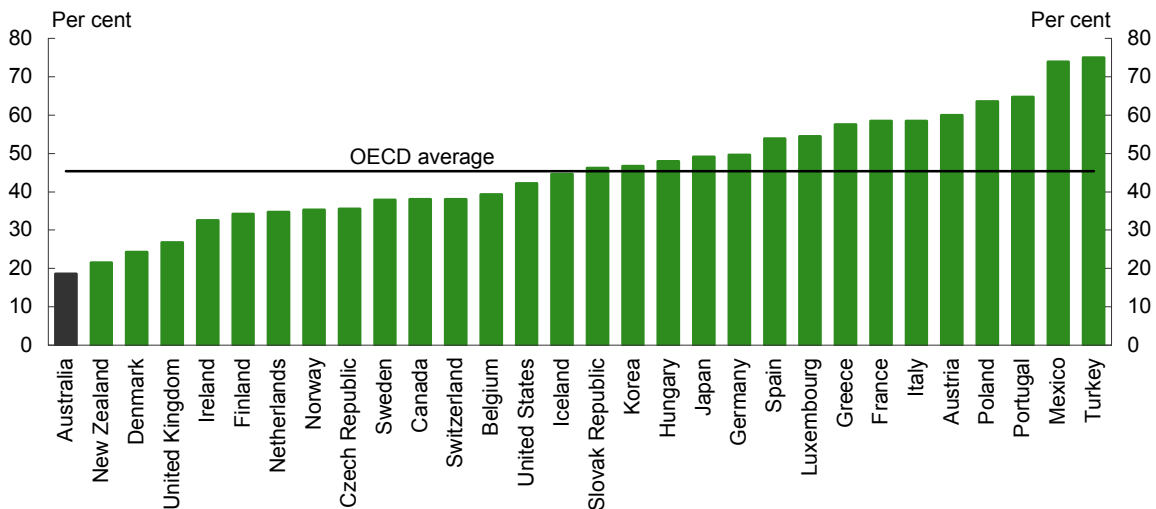


Excludes people with negative or zero taxable income.
Source: Australian government administrative data.

However, the progressivity of personal income tax also depends on how comprehensively income is assessed. The provision of tax offsets, concessions and exemptions affects the personal income tax rates scale that different individuals face, and hence changes the progressivity of the system. The more exemptions in the tax base, the weaker is taxable income as a guide to a person's actual income. Compromises to the tax base include income received in forms that are taxed more lightly; for example, from salary sacrificing into superannuation and from splitting income with others to avoid higher tax rates.

Alongside the tax system, transfer payments are another key mechanism for delivering progressivity. In contrast to many other countries, which have social insurance systems that pay benefits based on a person's previous earnings, Australia has a targeted transfer system focused on poverty alleviation. This delivers strongly progressive outcomes – Chart A1-9 compares the share of transfers paid to the richest half of the population in the OECD countries in 2005.

Chart A1-9: Share of transfers paid to the richest half of the population, 2005



Source: Whiteford 2009.

Finding

Overall, Australia has a progressive personal income tax system. The personal income tax and transfer system taken together is among the most progressive in the OECD.

Setting tax rates to support workforce participation

Rates of tax are one of the key factors in determining incentives to work and save. For many taxpayers, tax rates are a more visible part of the tax system than other key design elements, such as the way that income is defined for tax purposes.

As a matter of principle, taxes should interfere as little as possible with work incentives, as this leaves society as well off as possible. In practice, people can avoid taxes by earning less, and this is more costly to society than if the person was willing to work more and pay more tax. For example, a taxpayer can decide to work fewer hours than they otherwise might, or a person who receives income support can elect not to work at all to prevent withdrawal of their payment. People may respond to taxes in ways other than simply adjusting their hours of work. They may alter their education or entrepreneurial plans, or the form in which they receive income.

A large body of literature has explored how best to set tax rates to meet a government's needs for revenue while minimising the disincentive effects of taxes and taking account of societal preferences for redistribution; for example, Diamond (1998), Saez (2001), Moffitt (2008), Brewer, Saez and Shephard (2008). One of the key findings is that it can be more efficient to impose higher tax rates where fewer people are subject to them, such as at very low and very high incomes. Another insight from this literature is that it can be more efficient to impose higher rates on people whose behaviour is relatively unresponsive to tax rates, such as prime-aged men and women who are not caring for dependent children.

People respond to tax and to financial incentives delivered through both the tax and the transfer systems. For people who are able and expected to work full time, the progression from unemployment to self-support through work can involve a high effective tax rate. Relatively high effective tax rates on low earnings, such as earnings from part-time work, can encourage people to choose full time work to get a lower overall rate and a higher disposable income. By contrast, people who have limited capacity or limited availability for work may only ever seek part-time work. This could be due to caring responsibilities, disability or impairment, or age. People with such restrictions who work part-time may respond to a high effective tax rate by withdrawing from work altogether. A more efficient arrangement in those circumstances is to impose a lower effective tax rate on modest earnings. This could be delivered through the tax rate only, the income support withdrawal rate only, or a combination of the two. Greater certainty and transparency result from varying only the withdrawal rates rather than using the tax system as well.

If more people currently outside the workforce worked part or full time, this could help meet the challenges of an ageing population. This would be likely to require more employment services and other support, alongside financial incentives, for people who are sick or disabled, their carers, aged people and those who are engaged in home duties or the care of children (Abhayaratna et al. 2006).

Arrangements to support the employment of people who are sick or disabled are discussed in Section F The transfer system. The workforce participation of those who are engaged in home duties and the care of children is also discussed in that section. A key element of the personal income tax system that supports workforce participation is the unit of assessment.

Tax rates and withdrawal rates can have the same economic effect

In considering the incentive effects of the system, it is important to consider the combined impact of the personal tax system and the withdrawal rates applying to means tested benefits. This is because withdrawal rates can have the same economic impact as tax rates — the effect on a person's disposable income is the same whether part of a payment is withdrawn or an additional amount of tax is collected. For example, the pension assets test acts like a tax on savings, and can affect savings decisions in the same way.

While in general tax rates and withdrawal rates should have the same impact on decisions, the impact is not identical where they use different income bases. In addition, timing differences can also alter the effective tax rate at a point in time by comparison with the final effective tax rate after a tax assessment. The practice of taxing and making payments to people at the same time ('churn') can be criticised on the grounds of administrative cost, but has the advantage of allowing governments to target taxes and transfers with much greater precision than would be possible if it simply reduced tax liabilities. Taxing and making payments at the same time allows the tax and transfer systems to reflect work responsiveness, the presence of children, and other characteristics.

The impact of taxes and withdrawal rates may also differ because an individual may react differently to having their earned income taxed compared to having a transfer payment reduced, even though the effect on their net disposable income is the same.

These different characteristics of tax and withdrawal rates, and of the tax and transfer systems, suggest that decisions about imposing tax rates through the tax and transfer systems should consider the relative strengths of the two systems.

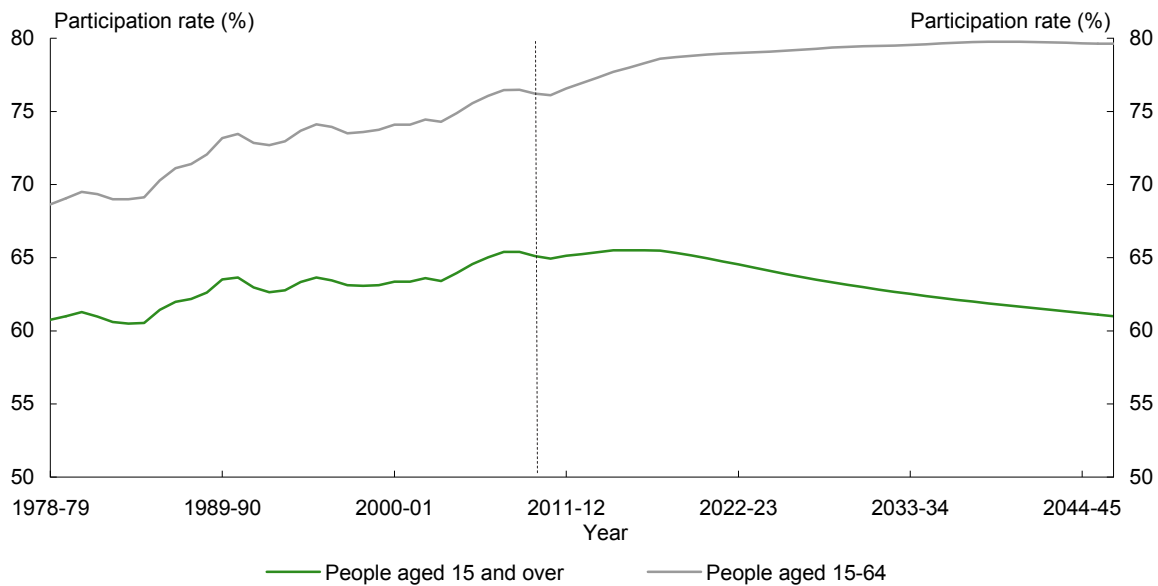
Principles

The tax system should limit the extent to which people face high effective tax rates, particularly for those who are most likely to reduce their work effort as a result.

Effective tax rates should be tailored to individual circumstances to support workforce participation for those who are able to work and choose to do so. Tailoring should be achieved through adjusting withdrawal rates on transfer payments rather than through tax mechanisms.

Supporting work in an ageing population

Levying taxes efficiently is likely to become increasingly important as the population ages and there are fewer working people as a proportion of the population. Over the next four decades, the retirement age population is expected to grow faster than the working age population. By 2049, over one fifth of the population is projected to be aged 65 or more, compared to around 13 per cent in 2009. As Chart A1-10 illustrates, a corresponding reduction is expected in the relative size of the working age population, and this suggests that economic growth will slow.

Chart A1–10: Historic and projected labour force participation rates

Source: Treasury projections.

Australia's current workforce participation rates are high compared to those in the past, at 65.4 per cent in 2008 compared to 60.8 per cent in 1979 (ABS 2009f). Maintaining high levels in the future will require a tax and transfer system that supports work. The Council of Australian Governments (COAG) made the following comment on this issue:

... with an ageing population, there will be relatively fewer Australians of working age. To avoid putting too great a burden on those already in work, more Australians need to realise their potential by entering or rejoining the workforce (COAG 2006).

Key groups where Australian participation rates are relatively low compared to other OECD countries include prime aged men, women of child-bearing age, and older men and women.⁵ This suggests that incentives for existing workers to remain in work are critical. In addition, increases in participation by those not currently working should be supported and encouraged, whether they are not currently working because of illness or disability, caring responsibilities, age, home duties or the care of children.

High effective tax rates reduce incentives to work and save

The personal income tax rates scale is often the most visible component of the effective tax rates that people face. However, other parts of the tax system can raise effective tax rates above the marginal rates in the tax scale. The Medicare levy collects 1.5 per cent of income, and is phased in at a 10 per cent rate over an income range that is not announced until the end of the tax year. Means tested offsets, such as the senior Australians tax offset and the low income tax offset, also increase effective tax rates when they are being withdrawn.

Average tax rates in Australia are in the bottom third of the OECD for single people at 67 per cent of the average wage and at 100 per cent, and are still below the OECD average at 167 per cent. The top marginal rate is in the bottom half of those in OECD countries, and the

⁵ In 2005, Australia was ranked 25th for prime aged men (aged 25 to 54 years), 23rd for women of child-bearing age (aged 25 to 44 years), and 13th and for older men and women (aged 55 to 64 years).

corresponding threshold is set slightly above the OECD average in terms of multiples of average earnings (OECD 2009d).⁶

Other elements of the tax system can result in very high effective tax rates at particular points (such as thresholds for HELP repayments and the Medicare levy surcharge). Crossing these thresholds results in a higher rate of tax being levied on every dollar of income, not only on income over the threshold. This means that people's disposable income can fall even though their private income has increased. Work by Chapman and Leigh identified a statistically significant degree of 'bunching' of incomes slightly below the HECS thresholds, suggesting that these very high effective tax rates do have an impact on behaviour (Chapman & Leigh 2006).

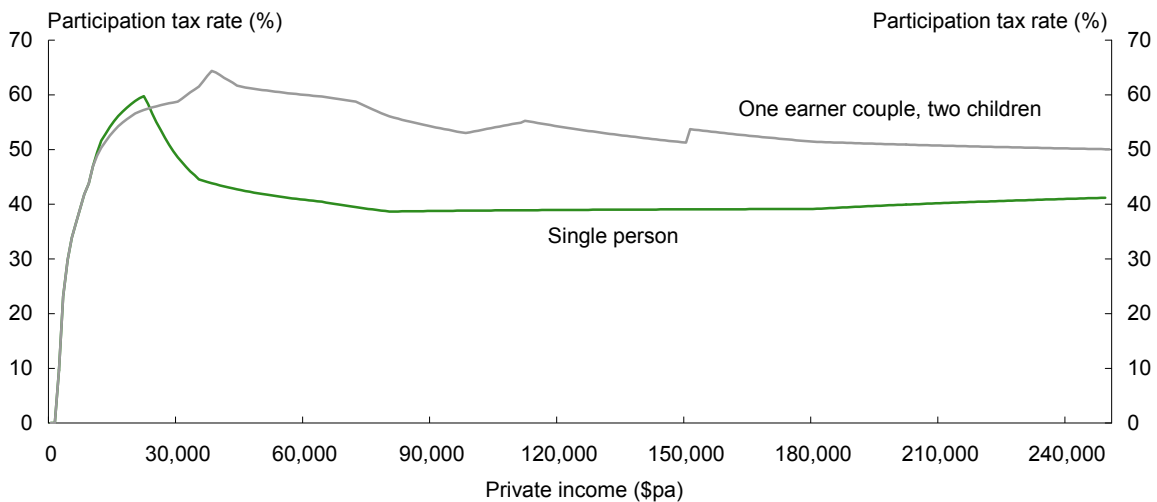
The transfer system overlays additional financial incentives on the tax system, because payment withdrawal rates interact with taxes. Recent studies of effective marginal tax rates (EMTRs) in Australia suggest that around 90 per cent of working age Australians face EMTRs below 40 per cent (Harding et al. 2006; Kalb 2007). (EMTRs measure the proportion of an extra dollar of income that is lost due to taxes and transfer withdrawals.) Due to the widening of eligibility for means tested family assistance, the proportion of working age Australians facing EMTRs over 50 per cent increased between 1996–97 and 2006–07, from 4.8 per cent to 7.1 per cent. However, the proportion facing EMTRs over 80 per cent declined over this period.

EMTRs do not give a complete picture of the incentive effects of the tax and transfer systems. It is difficult to fully capture these incentives, which may also be affected by factors such as child care costs, public housing rent-setting, and child support liabilities or receipts. More broadly, consumption and payroll taxes also affect the returns to work, and even corporate income taxes may be borne at least in part by workers (see Section B1 Company and other investment taxes).

In certain situations, EMTRs may not be an appropriate measure of the returns to work. For example, a person out of work may be less influenced by the effective tax rate on a small increase in earnings than by the effective tax rate when they move from not working to working — a much larger increase in private income. Effective tax rates on these larger increases in private income are often called participation tax rates (PTRs).

Research looking at the labour market transitions of Australian families over time found that PTRs have a moderate negative effect on the probability that women will enter employment, and a very large negative effect on the probability that an unemployed person will find work (Dockery et al. 2007). This may be a particular concern for jobless couple families with children, who can face high PTRs when one member takes up work. Among couple families with children under 15 where the woman is not working, around 19 per cent of the men are also out of work (ABS 2009g). This is in sharp contrast to males in couples generally, who have markedly higher rates of employment.

6 Average rates include employee social security contributions.

Chart A1–11: Participation tax rates

Source: Treasury estimates.

Chart A1–11 shows that, for an adult in a jobless couple family with two children, more than 58 per cent of their pay will be lost to tax and payment withdrawal if one member takes a job at the minimum wage. However, these high tax rates allow tax rates to be lower elsewhere in the system, which means that the overall effect on incentives is unclear.

To gain a clearer picture of the incentive effects of the tax and transfer systems, measures of effective tax rates need to be combined with empirical research on the responsiveness of the people who face them. The Australian Fair Pay Commission recently commissioned research into how much certain groups know about the impacts of the tax and transfer systems, and their motivation to work. This work established that people have limited theoretical understanding of how transfers are affected by changes in income, but also that once people are in receipt of a transfer payment, they may protect their entitlements by avoiding work that would move them off benefits.

Dandie and Mercante (2007) reviewed the literature on the responsiveness of various Australian groups, and found that partnered men, single men and single women without children are generally less responsive to changes in wages than partnered women. Lone parents tend to be more responsive than partnered women. Responsiveness varies according to factors such as level of education (higher responsiveness for those with lower education levels), whether the individual works part-time or full-time (higher responsiveness for part-time workers), and income level (generally higher responsiveness for those with lower incomes).

Finding

Effective tax rates can be high for some people, including for those likely to reduce their level of work as a result.

Reform directions — improve simplicity and incentives with a high tax-free threshold and a constant marginal rate for most people

Recommendation 2:

Progressivity in the tax and transfer systems should be delivered through the personal income tax rates scale and transfer payments. A high tax-free threshold with a constant marginal rate for most people should be introduced to provide greater transparency and simplicity.

The personal income tax rates scale is a key contributor to progressivity in the tax and transfer systems.

A new personal income tax rates scale would have a high tax-free threshold and a constant marginal rate for most people. This could take the form of a constant rate of tax for most taxpayers, with a higher rate for those on very high incomes. An indicative approach to implementing the personal income tax rates scale for Australian residents is shown in Table A1-1. The indicative scales shown in the table result in lower personal taxes for people with low incomes, and give rise to broadly comparable average tax rates for those with taxable incomes up to \$100,000.

Table A1-1: Indicative personal income tax rates scale

Taxable income (\$)	Rate (%)
0 – 25,000	0
25,001 – 180,000	35
180,001 +	45

This approach sets the tax-free threshold at \$25,000, where income support recipients would either have exhausted their payments or have substantial private income. This would mean that more than 1.2 million additional people would no longer pay tax – over 10 per cent of current taxpayers. Many of these would not have to file a tax return (although some would continue to do so to claim withheld amounts or imputation credits). Setting the tax-free threshold at this level would remove the need for the low income tax offset and limit the need for the senior Australians tax offset.

Above the tax-free threshold, a constant rate of 35 per cent would apply for most taxpayers. In the example provided in Table A1-1, over 97 per cent of people over the tax-free threshold would be subject to the 35 per cent rate of tax. A constant rate of tax of this kind has the advantage of transparency for most working people. Combined with a tax exemption for transfer payments, it would be much easier for people to understand their marginal rate of tax.

A higher rate of tax could be applied to those on around three times average wages – \$180,000 in this example. A top marginal rate that began at this multiple of average wages would be slightly above the OECD average, although internationally there is a high degree of variation in the level at which top marginal rates apply. For example, in the United States, the top marginal rate applies from nine times average wages, while in the United Kingdom it is 1.2 times average wages. Countries with top personal marginal tax rates that apply from around three times average wages include Canada, France, Italy and Korea.

This indicative personal income tax rates scale broadly reflects the aspirational tax cuts proposed by the Government for introduction in 2013–14. Introducing a rates scale of this kind would have a number of advantages. It would provide a higher level of transparency to individual taxpayers, as the great majority would have a single marginal rate. It would also improve the relationship between the tax and transfer systems: allied with a tax exemption for transfer payments, more people would be in only one system at any given time.

A tax scale of this kind could be implemented gradually, taking into account existing settings on marginal tax rates, offsets and the definition of income.

Incentives to work

A personal income tax system that provides more support to workforce participation should be delivered in a transparent way.

Currently, most taxpayers have more tax withheld throughout the year than is necessary, because part of the effective tax-free threshold is given through the low income tax offset (LITO) and is only available after the taxpayer files their tax return. By incorporating LITO into the explicit tax scale, people would receive better financial returns to work throughout the year, strengthening participation incentives.

As well as incorporating the existing LITO into the tax scale, a substantial increase in the tax-free threshold would increase the attractiveness of work to low-income earners (including secondary earners), who are typically more responsive to effective tax rates.

Reconfiguring the dependency offsets would better target support to those unable or not expected to work, which would improve participation incentives for those secondary earners not in these categories.

These changes build upon those proposed for the transfer system. Together, these reforms would better support employment and position Australia to meet the coming demographic challenges.

Taxing people as individuals

In designing a personal tax system based on anything other than a strictly flat rate of tax, a fundamental choice has to be made about the unit of assessment — that is, whether people are taxed as individuals or as part of a couple or family. This choice involves judgments about how people in couples operate in society compared to single people and about the needs of other family members, particularly children.

The key consideration in determining the unit of assessment is how it gives effect to contemporary social norms about individuals and couples. The judgment implied in the choice of unit is whether horizontal equity is concerned with treating individuals or couples in like circumstances alike. It has particular practical implications for workforce participation.

Specifically, the unit of assessment determines the marginal tax rate that each person in a couple faces. There are advantages in having each partner face different marginal tax rates, according to their earnings and other characteristics. For example, in a couple where one partner is the primary earner and the other earns less, perhaps working part-time and caring

for children, imposing the same marginal tax rate on both may cause the secondary earner to reduce their work effort. By contrast, a lower marginal rate for that person may encourage and support work.

This observation is supported by an extensive body of research on how responsive people are to financial incentives in determining how much to work and earn. Research shows that, in couples, women are typically more responsive to tax rates than men, and lone parents are often found to be more responsive still. Table A1–2 presents a summary of findings from Australian studies. A progressive individual tax system, with resulting lower tax rates for typically female secondary earners, is therefore more efficient than family taxation. In a similar vein, it is efficient for withdrawal rates on income support payments to take account of the fact that different groups have different levels of responsiveness to financial incentives.

Table A1–2: Uncompensated wage elasticities for Australia by population group^(a)

Population group	Range	Mean
Married men	–0.19 to 0.26	0.00
Married women	–0.19 to 1.3	0.30
Single men	0.28	0.28
Single women	0.34	0.34
Lone parents	–0.15 to 1.48	0.52

(a) Table summarises the range of wage elasticity estimates from Australian studies. Source: Dandie, S and Mercante, J (2007) p. 37.

Related to this, a progressive income tax levied on an individual basis corrects in part for the bias towards unpaid home production. For example, a couple where both partners are working has access to two tax-free thresholds, while a single-income family with more opportunity for home production only has access to one tax-free threshold.

There are other considerations in determining the appropriate unit of taxation. Stability over time is a factor: families change over time, as people partner and separate, and society's conception of what constitutes a couple or family also changes. The robustness of the unit of assessment is also a consideration. Given the changes over time in how couples and families are defined, there can be a level of uncertainty about whether a person is single or partnered. How much this matters depends partly on how much more favourable it is for a person to be assessed as partnered. The robustness of the unit is also relevant to administration and compliance costs. For example, it is more difficult to implement pre-filling of tax returns where tax liabilities depend upon partnering status.

For these reasons, the tax system should be based on an individual unit of assessment. However, a progressive income tax levied on an individual basis is not without difficulty. Income splitting becomes attractive: larger differences in marginal rates between partners create larger incentives to hold income-yielding assets in the name of the person who is taxed more lightly, or to split income. These effects can be mitigated by provisions that deal with the alienation of income (see Sections A1–2 and A1–3).

The effect of taking the individual as the unit of assessment is that there is no recognition of the differences in capacity to pay that arise from a taxpayer's responsibility to support adult dependants. The presence of adult dependants can arise in a range of circumstances — notably distinguished by whether or not the dependant is able to work and derive their own

income. These considerations are generally best addressed through the transfer system, while some horizontal equity benefits can be provided by dependant offsets.

Principle

The personal income tax system should generally tax people as individuals.

Retain the individual as the primary unit of assessment

The Australian tax system has always been based on individual assessment. This is one of the most important ways in which the personal tax system supports participation, by allowing different marginal tax rates to apply to each person in a couple. However, the system does include some elements that take account of the presence of a partner or children, and their circumstances.

Dependency offsets are examples of tax provisions that take account of partner or family circumstances. The senior Australians tax offset allows any unused value to be claimed by a person's partner, if they have one. The Medicare levy low income phase-in arrangements take account of family size and structure. The Medicare levy surcharge's thresholds are based on family size and structure. The spouse superannuation contributions tax offset is available for contributions on behalf of a spouse, while the medical expenses tax offset allows claims for family members as well as for the taxpayer themselves. These provisions are discussed in more detail in Annex A1.

These provisions depart from the principle that tax should be levied on each individual separately. They are a source of complexity in the system, often because the tax system does not routinely collect spouse information — a factor that can make compliance activity difficult. These provisions also tend not to provide responsive assistance in those cases where they are intended to support the costs of living. In many cases, more targeted support is available through the transfer system or other spending programs. They can also have a negative impact on participation incentives, where they affect dependants who could otherwise work.

There could be a case for optional couple assessment for people of retirement age or of late retirement age, on the grounds that these people are not expected to work and the great majority do not. Joint assessment would provide the same benefits to couples who have not shared their assets equally or where one member receives a superannuation pension from a defined benefit scheme, as for couples who have split their assets equally. Such a proposal would, however, introduce significant complexity into the tax system, by requiring the Australian Taxation Office (ATO) to assess relationships and changes in relationship status, as is currently required in the transfer system. While it is more complex, where participation incentives are not important, relaxation of the individual unit of assessment can assist other policy objectives.

Findings

The current tax system is generally based on taxing people as individuals. However, some provisions take account of couple or family circumstances.

Individual assessment supports workforce participation by secondary earners, by allowing different effective tax rates for each person in a couple.

Where participation incentives are not important, relaxation of the individual unit of assessment can assist other policy objectives.

Recommendation 3:

The primary unit in the personal tax system should continue to be the individual, and subsidies for dependants through the tax system should be restricted (see Recommendation 6a). However, there could be a case for optional couple assessment for people of late retirement age.

The taxation of transfer payments

Many Australians receive transfer payments, often at the same time as they pay tax. Income support and supplementary payments replace or supplement wages and salary for their recipients.

Commonwealth transfer payments are cash payments provided by the Australian government to individuals and families, including Age pensioners, veterans, people with a disability, carers, unemployed people, and people affected by natural disaster. Transfers play a vital role in the government's redistributive policies and take a variety of forms, from income support and supplementary payments to cash payments for families with children.

Reflecting their poverty alleviation objectives and redistributive goals, cash transfers are typically targeted at low-income individuals and are designed to help recipients pay for daily living expenses and otherwise support themselves. Income support payments in particular assist poor households or those likely to fall into poverty without the transfer.

The rate of income support includes the base payment and any supplementary payments, such as Rent Assistance, Telephone Allowance and Pharmaceutical Allowance. These components should be treated on a consistent basis for tax purposes. The same treatment should also apply to government scholarships.

Family assistance has some different characteristics. It is not wage-like in its nature, as it is paid in addition to wages or income support for costs associated with children. Its tax status need not be the same as the tax status of income support.

Transfer payments have a mix of tax treatments

The current system exempts some transfer payments from income tax but taxes others.

Most income support payments are taxable, including Newstart Allowance, the Age Pension and Parenting Payment. The pensioner and beneficiary tax offsets remove the tax liability of

recipients who receive the maximum rate of income support payment for the full year. A tax exemption applies to Disability Support Pension (if the recipient is under Age Pension age), Wife Pension (if both spouses are under Age Pension age), and Carer Payment (if the carer and person being cared for are under Age Pension age). The combined effect of the pensioner or beneficiary tax offset plus the low income tax offset and the Medicare levy low income phase-in is that there is only minimal difference in final outcomes. A mix of taxable and non-taxable payments with these additional provisions is a complex and non-transparent way of delivering effectively the same outcome.

A key difference between taxable and non-taxable income support payments in the current system is the outcome for people whose circumstances change significantly in the course of a tax year. If a person receives income support for part of a year and has a well-paid job for the other part of the year, a taxable income support payment is partially or fully clawed back through tax, while a non-taxable income support payment is not. This is because the taxable income support payment is added to the income from work. The impact of this is greater where the variation in income level is high, and was important when seasonal work was a larger component of the work available.

Supplementary payments are, in effect, part of the rate of income support. These payments include Rent Assistance, Telephone Allowance and Pharmaceutical Allowance. While most income support payments are taxable, supplementary payments are mostly non-taxable. Even parts of a payment can have a mixed treatment – the Pension Supplement (a single payment for pensioners) has both taxable and non-taxable elements.

Family assistance payments, including Family Tax Benefit Part A, Child Care Benefit, the Child Care Rebate and the Baby Bonus, are not taxable. These payments are unlike other payments in that Family Tax Benefit Part A, Child Care Benefit and the Child Care Rebate are assessed annually on a variant of taxable income, while the Baby Bonus takes the same assessment concept but applies it to the half year preceding the baby's birth. These payments address the direct costs of children and so should not be taxable.

Findings

Income support and supplementary payments have a variety of tax treatments. Some payments have taxable and non-taxable components.

Recipients of taxable and non-taxable income support payments have similar levels of disposable income, once the effects of offsets are taken into account.

Family assistance payments are tax-exempt and address the direct costs of children.

Reform directions — consistent tax treatment of income support and supplementary payments

Recommendation 4:

Income support and supplementary payments should be tax-exempt.

- (a) Family assistance should remain exempt from tax because it addresses direct costs associated with children.
- (b) Government payments that are similar in nature to income support, such as scholarships, should be exempt from tax to align their treatment with that of income support.

A key reform direction is to provide a consistent tax treatment for pensions, allowances and supplementary payments. All income support and supplementary payments should be exempt from tax. One of the main objectives of cash transfer payments is to increase poor households' real income, and taxing transfer payments can interfere with this objective. Taxing transfer payments also complicates individuals' interaction with the tax and transfer systems.

It should be noted that exempting payments from tax has a different impact from taxing most income support and providing an offset to the tax liability for maximum-rate full-year recipients. These two treatments have different effects because the assessment period for tax and for transfers is different; if they were the same, changes in the timing of income receipt or eligibility for transfer payments would not lead to varying tax outcomes. The income on which payments are assessed is also different, meaning that a person's income is counted in different ways in the two systems.

Making all income support and transfer payments non-taxable may result in some income support recipients, particularly pensioners, facing high EMTRs on income from certain sources where the means test withdrawal rates overlap with tax rates on income above the tax-free threshold. The resulting EMTRs would be higher when income support is non-taxable because withdrawal and tax rates would be additive, rather than offsetting each other as is the case when income support and transfer payments are taxable.

For tax-exempt income support payments, the effective tax rate is the sum of the withdrawal rate and the tax rate the recipient is paying on other income. This can result in very high effective tax rates: for example, a 65 per cent withdrawal rate and a 35 per cent tax rate combine to give an effective tax rate of 100 per cent. To reduce these very high effective tax rates, income support payments can be withdrawn at a slower rate at income levels where it is likely that the person is also paying tax, to maintain a desired overall effective tax rate. The fact that the tax and transfer systems have different periods of assessment would make this difficult to achieve precisely, but it would have participation benefits.

There may need to be some offsetting adjustments in the relevant means test to minimise the impact of this overlap for people with taxable income above the tax-free threshold.

Family assistance payments should remain exempt from tax. These payments are not wage-like in nature but are intended to address private and domestic costs associated with children.

The government will need to review the level of the tax-free threshold periodically to maintain a relationship between the tax and transfer systems that has the simple and transparent character of this proposal.

Tax offsets

Tax offsets provide a mechanism for delivering lower net taxes to taxpayers with particular characteristics or types of income. However, the design differences in the large number of tax offsets add significant complexity to the tax system. People's interactions with the tax system would be greatly simplified by rationalising the number of offsets. This would also provide a simpler and more transparent marginal tax rate structure.

Tax offsets reduce the transparency of the tax system

Tax offsets⁷ are used in the tax system for a number of purposes:

- to provide concessional tax treatment for some forms of income over others – for example, employment termination payment tax offsets;
- to provide concessional tax treatment of income received by particular groups of taxpayers relative to others – for example, the senior Australians tax offset (SATO); and
- to reduce interactions between taxable transfer payments and the tax system – through the beneficiary tax offset (BTO) and the pensioner tax offset (PTO).

At present there are more than 40 tax offsets, with different design features and impacts on people. Non-refundable tax offsets reduce the amount of tax that is payable on an individual's taxable income by the dollar value of the offset. The full amount of these offsets can only be utilised where there is sufficient tax liability – if the offset is larger than the person's tax liability no refund is available. Refundable tax offsets provide the full amount of the offset to the individual regardless of tax liability (that is, they can reduce tax to zero and create a refund).

The combination of all offsets, with their different interactions and eligibility criteria, contributes significantly to complexity in the tax system. Rationalising offsets could make the system simpler and reduce compliance costs. Many of the objectives of the current offsets could be (or have already been) achieved more effectively if delivered through transfer payments, other government spending, or through direct remuneration.

Some tax offsets are structural – that is, they alter the personal income tax rates scale for the majority or a large number of taxpayers. For example, in 2009–10 the low income tax offset (LITO) of \$1,350 increases the effective tax-free threshold to \$15,000 and changes the effective marginal tax rates for people with incomes between \$30,000 and \$63,750.

Most other offsets provide concessional treatment to a smaller group of people in specific circumstances. As concessional tax offsets are usually delivered on assessment, they generally do not deliver assistance to taxpayers at the time that the relevant expenses are

⁷ Known as tax rebates in the *Income Tax Assessment Act 1936*.

incurred, are not transparent because they are not directly related to the incurring of the expenses, and they are generally targeted only at those people who have a tax liability.

The objectives of the current set of offsets could be achieved more simply and effectively if they were rationalised in the following way:

- Structural offsets (such as the LITO, SATO, PTO and BTO) should largely be removed. A higher tax-free threshold and adjustments to the personal income tax rates scale would facilitate this.
- Concessional offsets, which have in many cases been replaced by direct transfer payments or other government spending, should in most cases, be removed from the tax system. Exceptions should apply where the dependant is unable to work due to disability or carer responsibilities, or either the taxpayer or dependant has reached Age Pension age.

Findings

Structural tax offsets alter the personal income tax rates scale for a large number of taxpayers and create complex interactions between the tax and transfer systems. The assistance provided by structural tax offsets would be more simply and transparently delivered through explicit marginal tax rates.

Concessional tax offsets provide a mechanism for delivering lower net tax rates to taxpayers with particular characteristics. However, assistance provided in this way is not transparent, timely or well targeted.

Medicare levy complicates personal income tax

While the Medicare levy is designed to help fund Medicare expenditure, it only partially funds Medicare, which in turn constitutes only a fraction of total government health spending. Of the \$71.2 billion spent on health by Australian, State and local governments in 2007–08, only \$7.4 billion was funded by the Medicare levy. In June 2009 the National Health and Hospitals Reform Commission (NHHRC) recommended that the levy be increased by 0.75 percentage points to finance its proposed Denticare scheme (NHHRC 2009).

The Medicare levy raises the marginal tax rate for most Australian residents by 1.5 percentage points. However, the levy does not apply to all taxpayers and it interacts with the marginal tax rates in complex ways, creating high effective tax rates at some income levels.

A complex set of low-income phase-in arrangements operates to provide an exemption from the Medicare levy for people without a tax liability (treating couples and singles differently). The complexity of these arrangements and the income levels at which they are phased in make it difficult to avoid stacking of tax rates and withdrawal rates.

In addition, many people are exempt from paying the levy based on their personal circumstances. For example, members of the Australian Defence Force and non-residents are exempt. As a result of the phase-in and exemption arrangements, in 2007–08 only 75 per cent of the 11.4 million taxpayers with a gross tax liability paid the levy.

The levy may send a misleading message to taxpayers about the cost of health spending. This may encourage inconsistent demands for more public funding of health care combined with an expectation that this can be absorbed without higher rates of tax.

The Medicare levy should be removed and incorporated into the personal income tax rates scale. This would simplify the tax system and remove potentially misleading messages to taxpayers about the cost of health spending.

However, to increase the transparency of the costs of health, a share of revenue raised from personal income tax could be allocated to health expenditure. This allocation could be made whether or not the funds were hypothecated formally to health. Total government health spending accounted for around 56 per cent of personal income tax revenue in 2007–08 (based on tax revenue of \$126.1 billion), increasing to 62 per cent in 2008–09 (based on estimated tax revenue of \$125.8 billion). This could be applied as a proportion of the net tax payable by an individual. This option would be simpler and raise revenue on the more efficient personal income tax base.

Medicare levy surcharge and private health insurance

To increase the take-up of private health insurance, the Medicare levy surcharge requires individuals with an income for surcharge purposes over \$73,000 and families with a combined income for surcharge purposes over \$146,000 (increased by \$1,500 for each dependent child after the first) in 2009–10 to pay an additional 1 per cent tax on their taxable income (including reportable fringe benefits) if they do not have complying health insurance for themselves and all their dependants. The singles threshold is indexed to AWOTE and increased in \$1,000 increments (rounded down). The threshold for families is double the singles threshold. While the surcharge is designed to be entirely avoidable (by purchasing the required insurance cover), it was levied on 725,000 individuals and raised revenue of around \$450 million in 2007–08.

As it currently operates, the Medicare levy surcharge is not ideal. Although levied on individuals, it is calculated on a family basis (by considering the presence of a spouse and the number, age and study status of any children). This means that the surcharge is levied on a high-income individual with insurance whose spouse does not have insurance. This complicates the system and makes compliance more difficult. It also creates spikes in EMTRs as it applies to every dollar of taxable income, including reportable fringe benefits, once the relevant income threshold is exceeded (rather than only the amount in excess of the threshold). The name of the surcharge is also misleading as it is not related to the Medicare levy and does not reflect its link with private health insurance. As a result, it should be relabelled to reflect this link.

The surcharge is closely linked with the private health insurance offset as part of a package of government policies aimed at increasing the take up of private health insurance. The offset is also problematic as it can be claimed using multiple mechanisms, including through the tax system, making the system unnecessarily complex and costly.

Finding

Tax arrangements relating to private health insurance, including the Medicare levy surcharge and the private health insurance tax offset, are unnecessarily complex.

Reform directions

Recommendation 5:

The Medicare levy and structural tax offsets — the low income, senior Australians, pensioner and beneficiary tax offsets — should be removed as separate components of the system and incorporated into the personal income tax rates scale. If a health levy is to be retained, it could be applied as a proportion of the net tax payable by an individual.

Recommendation 6:

To remove complexity and ensure government assistance is properly targeted, concessional offsets should be removed, rationalised, or replaced by outlays.

- (a) The existing dependency offsets should be replaced with a single dependant tax offset where one of the following circumstances apply:
 - the dependant is unable to work due to disability or carer responsibilities; or
 - either the taxpayer or dependant has reached Age Pension age.
- (b) The zone tax offset should be reviewed. If it is to be retained, it should be based on contemporary measures of remoteness.
- (c) The mature age worker, employment termination payment, overseas civilian, entrepreneurs' and notional tax offsets should be removed (see Annex A1). The education tax refund should be replaced as part of the single family payment, but as a back-to-school (lump-sum) amount.
- (d) The overseas forces tax offset should be replaced by adjusting remuneration to maintain net incomes.
- (e) Averaging tax offsets for primary producers, the offset for 'special professionals' and the lump sum payment in arrears tax offset should be retained to minimise the extent to which the timing of such income influences tax liability (see Annex A1).

Recommendation 7:

Consistent with the recommendations of the National Health and Hospitals Reform Commission:

- (a) The medical expenses tax offset should be removed following a review of the scope and structure of health safety net arrangements.
- (b) The Medicare levy surcharge and assistance for private health insurance should be reviewed as part of the package of tax and non-tax policies relating to private health insurance. The Medicare levy surcharge lump sum payment in arrears tax offset should be retained if the Medicare levy surcharge is retained (see Annex A1). Assistance, if retained, for private health insurance should be provided exclusively as a direct premium reduction.

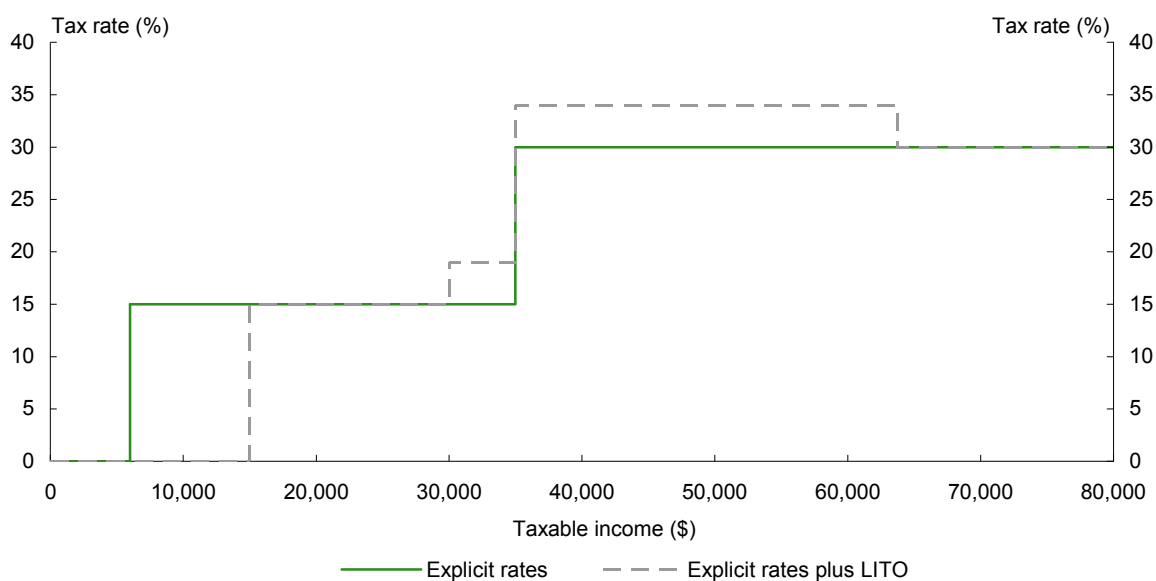
Structural offsets

The low income tax offset (LITO)

The LITO is the mechanism that changes the tax-free threshold for the largest number of people, 6.8 million in 2007–08. This number will increase as the LITO rises as a result of legislated tax cuts. The full amount of LITO is available to individuals with taxable income up to \$30,000, and the amount of LITO available is then reduced at the rate of four cents in the dollar. In 2009–10, the LITO has the same effect as increasing the tax-free threshold to \$15,000 for those with incomes up to \$30,000, increasing the 15 per cent marginal tax rate to 19 per cent (plus 1.5 per cent Medicare levy) for individuals with incomes between \$30,001 and \$35,000, and increasing the 30 per cent marginal tax rate to 34 per cent (plus 1.5 per cent Medicare levy) for those with income between \$35,001 and \$63,750 (the point at which the LITO is completely withdrawn).

The LITO not only increases the tax-free threshold, but also increases marginal tax rates at higher incomes (see Chart A1–12). As a result, many taxpayers with taxable income up to \$80,000 face an effective marginal tax rate different to that set out in the personal income tax rates scale. For example, the only taxpayers who face a 30 per cent effective marginal tax rate (excluding the Medicare levy) in 2009–10 were those who earn between \$63,751 and \$80,000.

Chart A1–12: Impact of the LITO on personal income tax rates 2009–10



Note: Does not include Medicare levy.
Source: Treasury estimates.

The LITO should be incorporated into the personal income tax rates scale, both for reasons of transparency and to retain the progressivity of the personal income tax rates scale. This change would also make the benefit of the LITO fully available through the pay as you go withholding rates scale, rather than half through withholding and half on assessment, as is currently the case.

Senior Australians tax offset (SATO)

The SATO increases the effective tax-free threshold for people of Age Pension or Veterans Service Pension age. In 2006–07, approximately 623,000 people claimed the offset at a cost of

\$1.1 billion. In 2010–11, the SATO, when combined with the LITO, will provide an effective tax-free threshold of \$30,685 for singles and \$26,680 for each partner in a couple. The SATO phases out (at the rate of 12.5 cents per dollar) for income above these thresholds and will be completely phased out once income reaches \$48,525 (singles) and \$39,496 (for each member of a couple not separated by illness). SATO amounts (\$2,230 for singles and \$1,602 for each member of a couple not separated by illness) are not indexed. Unused amounts of SATO can be transferred between partners up to the point where the maximum combined offset amount has been used.

The SATO should be removed, in conjunction with the Review's recommendations that the tax-free threshold be raised substantially and that pensions and benefits be made tax-exempt. As a transitional mechanism, it should be replaced with an offset that takes into account the new personal income tax rates and thresholds and delivers a similar effective tax-free threshold. In light of the increase in the number of Australians accessing tax-free superannuation benefits, and a higher tax-free threshold, the tax concession provided by the new offset should be reduced over time.

Pensioner tax offset (PTO)

The PTO was introduced to ensure that pensioners and some allowees on maximum rates of payment do not incur a tax liability. The PTO is available to recipients of specified payments made under the *Social Security Act 1991* and *Veterans' Entitlements Act 1986*. In 2008–09, the PTO was \$2,240 for singles, \$2,086 for partners in a couple who had to live apart due to illness or because one partner was in a nursing home, and \$1,699 for each partner in a couple not separated by illness. The PTO, when combined with the LITO, provides an effective tax-free threshold of \$25,298 for singles and \$21,691 for each partner in a couple not separated by illness. In 2006–07, approximately 294,000 people claimed the offset at a cost of \$459 million.

As the LITO has increased, there has been no offsetting downward adjustment to the PTO or SATO. This has pushed up the effective tax-free threshold delivered by the combination of PTO, SATO and LITO. As a result, most pensioners, whether full- or part-rate, no longer pay any tax on their combined pension and private incomes.

The PTO should be removed, in light of the recommendations to exempt all transfer payments from tax and increase the tax-free threshold. Pensioners of Age Pension age would have access to the transitional offset outlined in the SATO section above.

Beneficiary tax offset (BTO)

The BTO ensures that recipients of prescribed government payments such as allowances, drought assistance payments and wage supplements following disasters do not pay tax on the benefit or allowance component of their income. In 2006–07, approximately 279,000 people claimed the offset at a cost of \$130 million.

The BTO should be removed, in light of the recommendations to exempt all transfer payments from tax and increase the tax-free threshold.

Concessional tax offsets

Dependency tax offsets

Concessional tax arrangements for dependants have been a feature of the tax system for a long time and were generally introduced at a time when spouses (and other dependants) typically depended on a main breadwinner and full-time work was the norm. There are five dependency tax offsets, which provide different levels of tax concessions to taxpayers depending on whether they support:

- a spouse who has a very low income;
- an invalid relative who has a very low income;
- a child who is not employed, but is undertaking (unpaid) work as a housekeeper in the taxpayer's house;
- the engagement of a housekeeper to care for a child under 21 years, invalid relative or spouse receiving Disability Support Pension; or
- a dependent parent or parent-in-law who has a very low income.

The multiple dependency offsets complicate the tax system and are withdrawn from a low level of dependant's income. This can affect participation incentives and is generally only appropriate where there is less concern about the impact on participation of the dependant; for example, for dependants unable to participate due to invalidity, or for people over Age Pension age.

The dependency offsets should not be provided where the dependant is able to seek work, because in this situation the offset acts as a work disincentive. The offsets should be more narrowly focused on taxpayers supporting either a dependant who is unable to work due to disability or carer responsibilities or where the taxpayer or dependant has reached Age Pension age.

Other concessional offsets

Several other tax offsets are designed to influence behaviour. In some cases these would no longer be necessary as a result of recommended changes to the personal income tax rates scale or because assistance is already provided through the transfer system. For example, the mature age worker tax offset was intended to provide people over 55 years with an incentive for continued workforce participation. However, the recommended increase in the tax-free threshold provides a more transparent and effective participation incentive for these people.

As a general principle, offsets should be limited to circumstances where the assistance cannot be provided effectively through the transfer system or other government spending.

Further detail on existing concessional offsets and recommended reforms is presented in Annex A1.

Private health insurance tax offset

The Australian government currently subsidises private health insurance premiums based on a person's age through three mechanisms: a direct premium reduction, a reimbursement from Medicare Australia, or a tax offset. Most people claim the rebate as a direct premium reduction, with around 96 per cent of private health insurance subsidies claimed through

premium reductions and Medicare Australia and around 4 per cent claimed through the tax system. In 2008–09, total expenditure on the private health insurance rebate was around \$4 billion.

Providing multiple ways to claim assistance for private health insurance, including through the tax system, is unnecessarily complex and costly. If government wishes to subsidise private health insurance, assistance should only be provided as a direct premium reduction. This provides timely assistance, as it reduces the cost of insurance at the time it is paid, is simple to administer and is the most common way of claiming assistance.

Whether or not this subsidy is means tested requires a balancing of equity and complexity considerations. Means testing would help ensure this assistance is directed to those who need it most. On the other hand, it would require people to estimate their annual income when they receive assistance and then reconcile the assistance they receive against their actual income at the end of the income year. This would create a risk that inaccurate estimates of income would create debts. Means testing arrangements would also increase administrative complexity for policy holders, insurance providers and the ATO.

The National Health and Hospitals Reform Commission's (NHHRC) final report recommended that the Australian government 'commits to explore the design, benefits, risks and feasibility around the potential implementation of health and hospital plans to the governance of the Australian health system' (NHHRC 2009). This would include examining the potential role of private health insurance alongside health and hospital plans including examining any changes to the Australian government's 'regulatory, policy or financial support for private health insurance' (NHHRC 2009). As a result, tax arrangements for private health insurance, including the Medicare levy surcharge and the private health insurance tax offset, need to be assessed in light of an overall review of this sector. In keeping with this, the Review has only assessed the operation of these mechanisms in relation to the tax and transfer systems. It has not assessed the role, purpose and funding of private health insurance.

A1–2 Income from work and deductions

Key points

A broad definition of taxable income is both fair and efficient. Income from work should be taxed on a more consistent basis, whether it comes from wages and salaries, fringe benefits or superannuation contributions. Tax exemptions should not apply to income from work.

Fringe benefits that are readily valued and attributable to individual employees should be taxed in the hands of employees. To ease compliance costs for employers, valuation and apportionment methodologies should be simplified, and the scope of fringe benefits streamlined.

Arrangements to prevent the transfer or alienation of income arising from work are important to the integrity of the tax system, and should be improved.

Earned income that is subject to taxation should continue to be net of the costs required to earn that income, although those costs should be more tightly defined as those necessary to producing the income. A standard deduction should be introduced to cover work-related expenses and the costs of managing tax affairs for most taxpayers, although individuals with high expenses should continue to be able to claim all expenses with full substantiation.

The consistent taxation of income from work is fundamental to a fair and efficient tax system, ensuring that people with the same level of earned income are treated similarly, regardless of how they are paid, their occupation, or their employment status. Treating different forms of earned income in a similar way for tax purposes avoids creating incentives for people to structure their income purely for the sake of minimising their tax.

For employees, remuneration comprises three main elements:

- wages and salaries, which are generally taxed according to the personal income tax rates scale, although some forms of wages and salary are tax-exempt;
- employer superannuation contributions, which are included in the taxable income of the fund, and are subject to 15 per cent tax; and
- fringe benefits (non-cash benefits in the form of free or discounted goods and services provided by an employer to an employee), which are taxed in the employer's hands at the top marginal tax rate. In 2007–08, around 1.5 million employees received fringe benefits, such as cars and housing.

For self-employed people, some profits from their self-employment or business also represent labour income.

Some forms of income are neither from work nor from savings — most notably transfer payments. Income support and supplementary payments replace or supplement wage and salary income.

The costs associated with producing income are deductible for tax purposes. For employees, this takes the form of a deduction for work-related expenses; for self-employed people, a deduction for expenses necessarily incurred in operating a business. The costs of managing tax affairs are claimed by large numbers of people with earned income, as well as those with savings and investment income. Other allowable deductions include gifts to deductible gift recipients.

Various kinds of income are exempt from tax. Some of these are income from work, including certain forms of foreign and Defence force income. Some are not directly from work but have similar characteristics. These include superannuation benefits from a taxed source for people aged 60 or more, government transfer payments (of which some but not all are exempt), and government scholarships. Others are unlike work income, such as one-off bonuses from government and lump sum damages payments.

Principles

All income from work should be taxed consistently. This includes wages and salaries, fringe benefits (where they are a direct substitute for salary and wages), employer superannuation contributions, and the returns from self-employment.

Tax exemptions should not apply to income from work.

Employee income

Employee income most commonly takes the form of wages and salary, which are taxed through the personal income tax rates scale. A general principle of the income tax system is that amounts derived from employment or as a reward for services should be taxable. However, some forms of income from work are specifically exempted from tax, giving rise to inequities between taxpayers.

Wage and salary tax exemptions

Wages and salary are generally subject to the personal income tax rates scale. However, some income from work is exempt from tax, giving rise to horizontal inequities between employees.

Employment-related exempt payments

Genuine redundancy payments, foreign termination payments and certain payments from approved early retirement schemes are exempt from income tax.

The tax free arrangements for termination payments affect horizontal equity, as individuals with the same total income have different tax liabilities and different entitlements for means tested government assistance. The subjective definitions for redundancy payments and certain payments from approved early retirement schemes also complicate the income tax law. The exemption of these payments is inconsistent with the tax treatment of other forms of work income. The definitions used to determine whether a termination payment qualifies for an exemption are opaque and subjective.

Foreign income and income of foreign residents

The worldwide income of Australian residents and the Australian-source income of foreign residents is generally taxable, subject to the obligations set out in Australia's bilateral tax treaties and other international agreements.

As a general rule, payments in respect of employment or that are rewards for service are treated as taxable income. However, an exemption applies to some payments to foreign experts and officials for service or advice they provide in Australia, or work they undertake in relation to certain Australian government projects.

Exempting payments for work on some overseas projects or for expert foreign advice creates horizontal inequities between individuals and is contrary to basic income tax principles. Exempting some payments for foreign employment from tax also has a cost to revenue. The revenue forgone as a result of the exemption of income of individuals employed on certain overseas projects is estimated at \$520 million in 2008–09.

Defence and disciplined force payments

Members of disciplined forces such as the Australian Defence Force and the Australian Federal Police may receive taxation concessions on their income depending on the location of their duty and period of service. Defence force members serving on 'warlike' operations receive a full income tax exemption for pay and allowances earned while on deployment. Members serving on 'non-warlike' operations receive an exemption of pay and allowances earned while engaged in foreign service for a continuous period of not less than 91 days. Australian Federal Police deployed on International Deployment Group missions who are subject to Commander orders also receive this exemption. Further, supplementary remuneration for Defence force personnel such as deployment allowance and separation allowance are exempt from income tax.

The cost to revenue of exempting pay and allowances of Defence force personnel deployed on 'warlike' service is estimated at \$120 million in 2008–09. The cost of the exemption for part-time Defence reservist pay and allowances is estimated at \$40 million in 2008–09. Delivering these benefits as outlays would involve minimal net cost to the budget.

Finding

Wages and salary are generally taxed according to the personal income tax rates scale, but concessions apply to income in the form of superannuation and fringe benefits. A number of forms of remuneration from work are exempt from tax.

Reform directions — tax all forms of wages and salary consistently with minimal exemptions

Recommendation 8:

All forms of wages and salary for Australian resident taxpayers should be taxable on an equivalent basis and without exemptions.

- (a) Private education payments provided in respect of employment or as an incentive to undertake employment and employment-related payments should be assessed as income and taxed at marginal tax rates.
- (b) The broad exemptions for foreign employment income should be removed and such income should be taxed at marginal tax rates.
- (c) Defence and disciplined forces payments should be taxable and direct remuneration increased for affected personnel.

A simple and fair system would treat all forms of employee remuneration and related amounts in the same way, upholding the basic income tax rule that amounts derived from employment or as a reward for services are taxable. Pay and allowances for individuals working on government-approved overseas projects would be taxable in accordance with this principle. Pay and allowances of Defence and disciplined forces would also be taxed, with compensation provided through increases in direct remuneration.

All private education payments provided in respect of employment or as an incentive to undertake particular employment (such as bonded scholarships) should be taxable. However, government payments that are similar in nature to income support, such as scholarships or bursaries paid to a full-time student at a school, college or university, should be exempt from tax. This would align the tax treatment of these payments with that of income support. Taxing forms of remuneration that are currently exempt from tax may require employers and other bodies to make higher payments or individuals may receive lower disposable income.

Foreign-source employment income derived by an Australian resident and Australian-source employment income derived by a foreign resident should be taxable irrespective of whether the income is incurred on work for government or private entities, or for particular purposes. The tax status of payments for employment should not depend on whether the employer is government or non-government. If appropriate, compensation may be provided through direct remuneration.

Other exemptions from tax

A tax exemption is appropriate in some circumstances, although not for income from work. An exemption may be justified when payments are one-off in nature and not related to income-producing activities, such as compensation payments and personal injury awards, and government grants and one-off payments. An exemption may also be justified where double taxation would otherwise apply.

Superannuation contributions

Compulsory superannuation contributions are included in the taxable income of the fund, which is subject to 15 per cent tax. This concession means that there are distinct advantages

to taking income in the form of superannuation, and these advantages are greater the higher the income of the recipient. The taxation arrangements for superannuation are discussed in detail in Section A2.

Fringe benefits

Fringe benefits tax (FBT) was introduced in 1986 and applies where non-cash benefits are provided by an employer to an employee — such as through the provision of free or discounted goods and services. In most cases, fringe benefits are provided as a substitute for salary and wages; however, in some cases, they are incidental to an individual's employment.

Table A1-3 shows the major categories of fringe benefits, which were collectively valued at \$7.2 billion in 2007-08. The value of fringe benefits has risen sharply in recent years, particularly in relation to car parking benefits, housing benefits, and living away from home allowances.

Table A1-3: Taxable value of fringe benefits by type, 2007-08^(a)

Type of fringe benefit	Value (\$m)
Expense payment(b)	3,827.9
Car benefit	
– statutory formula	1,624.3
– operating cost	147.3
Car parking	213.3
Property	147.9
Meal entertainment	416.2
Housing benefit	303.0
Living away from home allowance	90.6
Entertainment	43.3
Loan fringe benefit	28.1
Debt waiver	19.6
Board	5.4
Airline transport	1.8
Residual	319.3
TOTAL BENEFITS(c)	7,188.1

(a) Total FBT payable was \$3,772 million in 2007-08.

(b) Expense payments arise where an employer reimburses an employee for expenses they incur, or pays a third party to meet expenses incurred by an employee. In either case, the expenses may be business expenses or private expenses, or a combination of the two.

(c) Totals may not add due to rounding.

Source: ATO (2009).

As Table A1-4 shows, Australia's fringe benefits tax system is complex, like those of many other countries. There are, however, some differences in the way in which Australia taxes fringe benefits. While the FBT system has the same broad tax base as other countries, it relies on a higher number of statutory valuation rules and a greater number of concessions and exemptions. The complexity of Australia's FBT system is exacerbated by the taxation of fringe benefits in the hands of employers, which has required the introduction of a large number of supplementary rules to ensure that fringe benefits are factored into means tests in the tax and transfer systems.

Table A1-4: International approaches to the taxation of fringe benefits

	Australia	Canada	Denmark	Ireland	Japan	Netherlands	New Zealand	Spain	Switzerland	UK	US
Incidence	Employer	Employee	Employee	Employee	Employee	Employee	Employer	Employee	Employee	Employee	Employee
Valuation principles	Statutory rules and some use of market valuation	Fair market value	Market value	Cash equivalent value for benefits convertible into cash	Cost to the employer	Economic value	Statutory rules are applied for four major classes of benefits	Market value	Either cost to employer or market value	Cash equivalent value (or cost value to the employer)	Fair market value
	Statutory rules apply to certain fringe benefits such as cars, loans and housing	Statutory rules apply to certain fringe benefits such as cars, loans and housing	Statutory rules apply to certain fringe benefits such as cars, loans and housing	Cost to the employer for benefits not convertible into cash	However, certain fringe benefits are valued using statutory rules	However, certain fringe benefits are valued using statutory rules	There is also a category of unclassified benefits where market value is applied to determine taxable value	Statutory rules apply to certain fringe benefits such as cars, loans and housing	However, specific valuation rules exist for particular benefits such as cars and loans	Statutory rules apply to certain fringe benefits such as cars, loans and housing	
Base	Broad	Broad	Broad	Broad	Broad	Broad	Broad	Broad	Broad	Broad	Broad
Concessions and exemptions	Exemptions and concessions narrow base considerably	Exemptions and concessions narrow base considerably	Few exemptions and concessions apply	Few exemptions and concessions apply	Few exemptions and concessions apply	Few exemptions and concessions apply	Few exemptions and concessions apply	Few exemptions and concessions apply	Few exemptions and concessions apply	Exemptions and concessions narrow base considerably	Exemptions and concessions narrow base considerably

In looking at the FBT system, the Review has considered narrowing the fringe benefits tax base and instead denying deductions for employers. While this approach would be simpler, it would also give rise to significant integrity and equity issues.

There is scope to reform the legal incidence of FBT, valuation methodologies and concessions and exemptions in a way that would reduce compliance costs for employers and employees and would deliver greater neutrality in the treatment of cash and non-cash remuneration.

Legal incidence

Most OECD countries either tax fringe benefits in the hands of employees, or align fringe benefits taxation with the employee's personal income tax rate.

In Australia, FBT is paid by employers (including government employers) at the top personal income tax rate plus the Medicare levy (currently 46.5 per cent), irrespective of the income of the employee receiving the fringe benefit. Submissions express concern that the application of the top marginal rate is inequitable, as employees ultimately bear the economic incidence of FBT. In 2007–08, less than 12 per cent of employees with reportable fringe benefits were in the top marginal tax bracket (even accounting for the value of their fringe benefits).

The value of reportable fringe benefits is included on an employee's payment summary on a 'grossed-up' basis — that is, the value of the fringe benefit is increased to reflect the value of income tax (at the top personal rate) that would be paid if the fringe benefit were purchased out of the employee's after-tax income.

Means tests in the tax system generally take account of the grossed-up value of fringe benefits; however, as Box A1–1 indicates, means tested transfers generally reflect the net or 'cash' value of fringe benefits (with the exception of the income test to assess child support liability).

Box A1–1: Fringe benefits and transfer payments

The 2006–07 Budget announced that the grossed-up value of fringe benefits would be included in the means test for family assistance payments from 1 July 2008. The Government reversed this measure on 19 June 2008, citing concerns over the implications for employees in the not-for-profit (NFP) sector.

As many NFP organisations are eligible for FBT concessions, employees in the NFP sector are more likely to receive their income as fringe benefits. Further, these employees often receive lower wages (and are hence taxed at lower rates) given the charitable nature of their work.

This issue was explicitly referred to the Review for consideration.

Finding

The current FBT arrangements are inequitable as they apply the top marginal tax rate regardless of the income of the recipient employee.

Valuation and reporting arrangements

The current approach to valuing fringe benefits is to use market value in some cases, complemented by a large number of statutory valuation methodologies. Submissions from business have expressed concern that these methodologies are highly complex, particularly in relation to meal entertainment. One submission claimed that a business meal can potentially be valued in 39 different ways for FBT purposes.

In some cases, any one of a number of methodologies may be used to value a single benefit. Generally, all the methodologies deliver broadly similar results. For example, property fringe benefits can be assessed in five different ways, all of which seek to proxy market value. Nonetheless, anecdotal evidence suggests that employers calculate the value of a fringe benefit using all available methodologies and then choose the lowest valuation. This results in unnecessary compliance costs. Table A1–5 shows that the compliance costs for FBT are significantly larger than those for other taxes (measured in terms of the costs of compliance relative to the amount of tax paid). These compliance costs are exacerbated by the need for employers to apportion the value of shared fringe benefits between employees (such as where several employees attend a business lunch).

Table A1–5: Compliance surtax^(a)

	Mean (%)	Median (%)
Income tax	1.6	0.9
Payroll tax	0.7	0.2
Fringe benefits tax	7.6	4.8
Overall	2.9	1.2

(a) The compliance surtax measures the costs of compliance for each tax relative to the amount of the tax paid. For example, an organisation that incurs \$2 in compliance costs for every \$100 it pays in GST would face a compliance surtax of 2 per cent for GST.

Source: PricewaterhouseCoopers (2009).

Concessions and exemptions

Market value is not applied as broadly as it could be, due to the volume of fringe benefits that receive concessional or exempt treatment. Many of these concessions and exemptions have a historical basis that is no longer relevant. For example, the concession applied to the living away from home allowance has evolved to encompass expenses that are essentially private in nature. This has led to inequities in employee remuneration.

The FBT concessions and exemptions have a significant impact on the FBT base. In 2008–09, FBT concessions and exemptions were estimated at \$3.3 billion (Treasury 2009), while FBT revenue collections amounted to \$3.6 billion.⁸

Not-for-profit organisations

Fringe benefits received by employees of certain NFP organisations attract concessional FBT treatment. For example, public benevolent institutions and health promotion charities receive a \$30,000 capped exemption from FBT per employee – that is, the first \$30,000 of fringe benefits received by each employee is exempt from FBT. Public and not-for-profit hospitals and public ambulance services receive a \$17,000 capped exemption. Meal entertainment expenses, entertainment facility leasing expenses, and car parking expenses

⁸ The ratio of concessionality to revenue collections is underestimated due to the omission of many fringe benefits from quantification in the TES (for example, in-house childcare).

do not count towards the caps. Anecdotal evidence suggests that the benefits of these concessions are shared between employers and employees (although the benefits are more likely to accrue to employees).

In addition, certain not-for-profit, non-government bodies are eligible for a 48 per cent rebate of FBT that would otherwise be payable. The rebate applies to the first \$30,000 worth of benefits per employee and reflects the fact that these employers do not benefit from tax deductibility for the cost of fringe benefits. In general, the rebate applies to religious institutions, not-for-profit scientific or educational institutions, charitable institutions, schools, trade unions, and associations of employers or employees. The rebate also applies to not-for-profit societies, organisations, and clubs that are exempt from income tax.

Submissions to the Review have expressed concern that the FBT concessions for NFP organisations result in horizontal inequity, as they are not equally accessible by all employees. For example, one submission notes that the FBT arrangements favour nurses in public and not-for-profit hospitals, even though they provide identical or similar services to their private hospital counterparts. Public and NFP hospitals argue that the concessions have a ‘profound’ impact on their ability to attract and retain staff and are a highly sensitive factor in their overall remuneration strategy.

Findings

Fringe benefit valuation and apportionment methodologies impose unnecessary compliance costs on employers and have embedded high levels of concessionality in the FBT system.

Most of the existing FBT concessions and exemptions have a historical basis that is no longer relevant. This has eroded the FBT tax base.

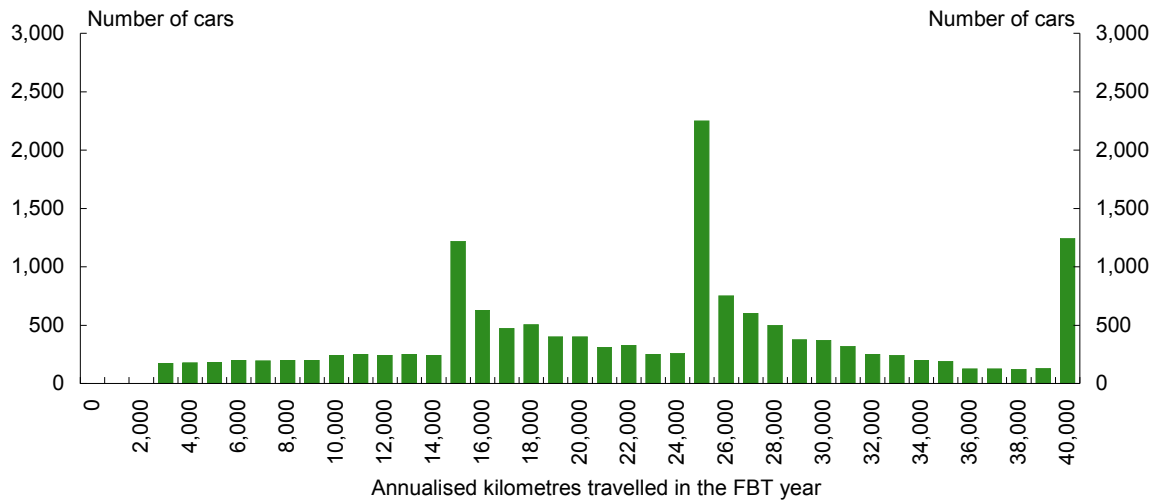
While the FBT concessions provided to certain NFP organisations help them deliver their services, they result in horizontal inequity and undermine the perceived integrity and fairness of the tax system.

Car fringe benefits

There are two approaches for determining the taxable value of car fringe benefits, the statutory formula and the operating cost method:

- The statutory formula applies so that the taxable value of a car fringe benefit falls as total kilometres rise. At the margin, this may create an incentive for individuals to travel additional kilometres to reduce the taxable value of their car (particularly at the points at which the statutory fraction falls – 15,000, 25,000 and 40,000 kilometres) (see Chart 1–13). This increases pollution and road congestion.
- Under the operating cost method, the actual operating costs of a car (for example, all car expenses, depreciation, registration, and insurance) are apportioned between business use and non-business use, as determined by a log book maintained over a 12-week period. The non-business portion of the operating costs is the value of the car fringe benefit. While the operating cost method provides a more accurate valuation than the statutory formula, it imposes a high compliance burden for users with low levels of business use.

Chart A1-13: Number of vehicles by kilometres travelled
(2007-08 fringe benefits tax (FBT) year)



Source: Based on SG fleet submission to the 2009 Review of Australia's Automotive Industry, as cited in the AFTS submission of the Federal Chamber of Automotive Industries.

Finding

The existing statutory formula for valuing car fringe benefits applies a reduced taxable value the further a vehicle is driven. At the margin, this may encourage individuals to travel unnecessary kilometres.

Reform directions — treat reportable fringe benefits like salary and wages

Recommendation 9:

Fringe benefits that are readily valued and attributable to individual employees should be taxed in the hands of employees through the PAYG system. Other fringe benefits, including those incidental to an individual's employment, should remain taxed to employers at the top marginal rate (and non-reportable for employees). The scope of fringe benefits that are subject to tax should be simplified.

- (a) Market value should generally be used to value fringe benefits (with an appropriate adjustment for employee contributions).
- (b) The current formula for valuing car fringe benefits should be replaced with a single statutory rate of 20 per cent, regardless of the kilometres travelled.
- (c) All fringe benefit tax (FBT) exemptions should be reviewed to determine their continuing appropriateness. To improve simplicity, consideration should also be given to excluding fringe benefits from tax where the costs of compliance outweigh equity and tax integrity considerations. The broad definition of fringe benefits in the FBT law could be reviewed to exclude essential workplace items such as chairs, stationery and toilets.
- (d) For fringe benefits that are taxed in the hands of employers, a small *de minimis* threshold, below which fringe benefits are exempt from tax, should apply. The threshold could vary depending on the number of employees within an organisation.
- (e) Not-for-profit entities' FBT concessions should be reconfigured (see Section B3). The FBT exemptions for members of the Defence force should be replaced with direct remuneration increases for affected personnel (see related Recommendation 8c).

Shift the legal incidence of reportable fringe benefits to employees

Fringe benefits that can readily be valued and assigned to a particular employee should be taxable in the employee's hands and reportable for transfer purposes. Other benefits that are incidental to an individual's employment or difficult to assign should be taxable to the employer at the top marginal tax rate (and be non-reportable for the employee for transfer purposes). The scope of fringe benefits that are subject to tax should be simplified.

This approach would provide a more neutral taxation of income, regardless of whether it is received as cash or fringe benefits. By removing the need for the current grossing-up process, it would also facilitate the consistent and equitable treatment of fringe benefits for means tested taxes and transfers (thereby addressing the issues raised in Box A1-1).

Under this approach, responsibility for valuing fringe benefits and including their taxable value on employee payment summaries would remain with employers. These tasks would be simplified through the proposed reforms to FBT valuation methodologies discussed below.

The transition to the new arrangements would require the renegotiation of remuneration packages for employees currently receiving fringe benefits. Collecting FBT fortnightly through the PAYG withholding schedules (rather than quarterly instalments) may require some level of smoothing to minimise fluctuations in tax payments. To facilitate these

processes, a lead-in period of at least two years should be provided before any changes take effect.

Adopt greater usage of market valuation

To simplify the valuation of fringe benefits, market valuation should be more widely used.

Market value represents the amount an employee would need to spend to purchase the same fringe benefit in the market (rather than the cost to the employer of providing the benefit). For example, the cost of discounted travel supplied by a public transport provider to its employees would be measured not in terms of the marginal cost to the provider (which is almost zero), but the cost of the travel for members of the public.

Market valuation would reduce compliance costs and provide a clear outcome for employers. It would also facilitate a significant reduction in the volume of FBT legislation (around 400 pages), much of which describes valuation and apportionment methodologies.

Table A1-6 summarises the different approaches to valuation in the current system, and the proposed valuation framework.

In most cases, market value is readily identifiable (such as where an employer reimburses an employee for a holiday). However, to assist employers and ease compliance costs, market valuation could be supported through ATO guidelines. Unlike the valuation methodologies in the FBT law, the guidelines could be quickly and easily adjusted to changing circumstances. The ATO could also provide a ruling about the market value of a fringe benefit in less common cases.

Market valuation would require an appropriate adjustment to account for any employee contributions; for example, rent paid by an employee receiving a housing fringe benefit would be deducted from the market value of the benefit to determine its taxable value.

Table A1–6: Approaches to FBT valuation

Type of fringe benefit	Current	Proposed valuation framework
Expense payment	Amount reimbursed or paid	Market value(a)(b)(c)
Property	Market value Lowest selling price Notional value 'Arms-length' purchase price Discounted price	
Housing benefit	Market value	
Loan fringe benefit	Statutory formula	
Airline transport	Stand-by value of the transport (37.5 per cent of the lowest publicly advertised economy airfare for a domestic route, and 37.5 of the lowest published fare for an international route).	
Residual	Lowest 'arms-length' price charged to the public Price that would reasonably be expected to be paid to receive the benefit Operating cost or c/km method (for car motor vehicles)	
Debt waiver	Actual amount of debt released	
(Meal) entertainment	Could apply the rules applying to other categories as appropriate (giving rise to the 39 different ways of valuing meal entertainment referred to in one submission) 50/50 split method 12 week register method	
Car parking	Market value Commercial parking station method Average cost 12 week register method Statutory value	
Board	Statutory formula (\$2 per meal per person, or \$1 if the person is aged under 12)	
Car benefit	Statutory formula Operating cost	

(a) Subject to an integrity rule encompassing non-arms-length payments for expense payment fringe benefits.

(b) To assist employers with apportionment, substantiation rules for meal entertainment could be provided.

(c) The market value of car parking could be linked to the methodologies used by State and municipal governments for determining car parking levies.

(d) For car benefits, the operating cost method would be retained for individuals with exceptional circumstances surrounding the usage and costs of their vehicle.

Source: Fringe benefits tax: A guide for employers, ATO (2006).

Improve the operation of the statutory formula for car fringe benefits

While market valuation would be appropriate for most fringe benefits, a statutory formula for car fringe benefits should be retained to reduce compliance costs in the medium-term.

The Review has carefully considered a range of options to enhance the operation of the statutory formula, from increasing the number of gradations in the formula to basing the taxable value of a vehicle on its emissions rating. It favours replacing the statutory formula with a single statutory rate that would apply to the original cost of the car regardless of the distance travelled. This approach would provide a more neutral taxation treatment for employee remuneration by reducing the concessions available to those who can take their income as a private car benefit. It would also remove any incentive for individuals to drive unnecessary kilometres to access a lower FBT rate. Under this approach, the operating cost method would be retained.

Review the existing FBT exemptions

The existing FBT exemptions should be reviewed. Consideration should be given to exempting fringe benefits from tax where the costs of compliance outweigh equity and tax integrity considerations. The broad definition of fringe benefits in the FBT law could also be reviewed to exclude essential workplace items such as chairs, stationery and toilets.

The exemptions relating to not-for-profit organisations and the Australian Defence Force should be reconfigured.

As discussed in Section B3, all NFP FBT concessions should be phased out over 10 years, to be replaced with annual direct government funding.

The important contribution of Australians serving overseas is best recognised through direct salary and wages, rather than complex fringe benefits tax concessions and exemptions. Consistent with this principle, the existing exemptions should be replaced with direct remuneration increases for affected personnel. This would simplify the tax system, while still recognising the hardships that members face while serving in particular localities.

Introduce a single threshold for non-reportable fringe benefits

The existing FBT thresholds, encompassing the \$300 exemption for minor benefits, the \$1,000 exemption for in-house benefits, and the \$2,000 exemption for reportable fringe benefits, should be removed.

Non-reportable fringe benefits should be subject to a small *de minimis* threshold, below which benefits would be exempt from tax. The threshold could vary depending on the number of employees within an organisation. It should be set at a level that encompasses minor benefits to reduce compliance costs for employers.

Income from self-employment

Income from self-employment is generally assessed on the same basis as income from employment. Aspects of the current income tax system may provide a favourable treatment to self-employment income. These include the retention of profits in a company to defer any additional personal income tax, the greater ability in practice to claim deductions for expenses (such as home office and travel expenses), and the greater ability to arrange income splitting.

Some self-employed people may also benefit from tax concessions applying to capital gains (the general 50 per cent capital gains discount), or small business capital gains (the small business capital gains tax concessions) and measures designed to reduce small business compliance costs (under the small business tax framework).

The capital gains discount and concessions can be particularly beneficial. For many business owners, their personal effort and investment of capital is rewarded through the appreciating value of their business and its assets. This is most common in businesses that can create valuable intangible assets such as business goodwill, customer lists and brand names, or other businesses with appreciating tangible assets such as land.

For these self-employed people, and their businesses, the capital gains tax arrangements provide two advantages. First, taxation is deferred until the gain is realised, and, secondly,

the amount of the gain taxed on realisation is significantly discounted. As a consequence, while 100 per cent of an employee's income is generally taxed as it is earned, income from self-employment may not be taxed until later and then only in small part. For example, on the sale of goodwill that benefits from the general and active assets discounts, only 25 per cent of the gain would be taxable.

Favourable treatment of self-employment income over income from salaried employment may give rise to efficiency or equity concerns, depending on the ultimate effects of that treatment. A tax that applies only to employees' wages creates incentives for people to shift from being employees to being self-employed and operating their own business.

To the extent that the burden of a tax on employment is spread to all workers, there is an efficiency cost because the allocation of labour in the economy is biased by the tax or because compliance costs are increased by efforts to artificially characterise wages as income from self-employment. To the extent that the burden of the tax is not spread, there may be equity concerns as a self-employed person on a given income pays less tax than an employed person on the same income.

Alienation of personal services income

Specific rules target the alienation of personal services income to a partnership, trust or company. The rules are effectively aimed at personal services income (income from working) earned by people in employee-like cases (such as dependent contractors). The rules are designed to prevent income splitting and the deferral of tax. They also act to ensure that deductions relating to such alienated income are limited to those available to employees.

While these specific rules have had some effect, their scope is generally limited to employee-like cases, compliance is poor, they are complex and a good deal of uncertainty remains around their operation (Board of Taxation 2009).

For personal services income arising in other cases (as well as cases covered by the specific rules above), general provisions and anti-avoidance rules are used to limit the alienation of income attributable to the efforts or exertion of a person. This includes alienation achieved both through the interposition of an entity like a partnership or trust, and through payments to associates (such as relatives who provide some services, or the use of service trusts by professional partnerships). Enforcement of these provisions and rules can be difficult and uncertain.

Findings

Some self-employed people can benefit from a relatively favourable tax outcome compared to an employee undertaking similar work.

Current rules limit, but do not eliminate, the scope for the alienation or assignment of an individual's earned income to other people or legal entities. These rules are not fully effective, and are complex and uncertain.

Reform directions — limit the alienation of personal services income

Recommendation 10:

Consideration should be given to a revised regime to prevent the alienation of personal services income that would extend to all entities earning a significant proportion of their business income from the personal services of their owner-managers, whether in employee-like or non-employee-like cases. This regime may also apply an arm's length rule to deductions arising from payments to associates to ensure deductions reflect the value of services provided.

Effective rules are required to deal with the alienation of income arising from a person's work and the possibility of income splitting or tax deferral. The ability to alienate such income undermines the individual basis of taxation and the overall progressivity of the personal income tax system. It also means that some taxpayers may be advantaged over others and poses a risk that labour and other resources will be misallocated as people move to occupations or forms of employment more suited to alienation.

A major failing with the current approach is that it attempts to distinguish between personal services income arising in employee-like cases and other personal services income, when in either case alienation or income splitting is inconsistent with the choice of the individual as the unit of taxation and with progressive income tax rates.

Consistent with an option raised in the Board of Taxation's recent post-implementation review of the alienation of personal services income rules, consideration could be given to a revised regime that would extend to all entities earning a significant part of their income from the personal services of their owner-managers, including personal services businesses (Board of Taxation 2009).

The focus would be on personal services income in general, and not on whether the income was derived by the taxpayer acting in, say, an employee-like capacity. Personal services income, as now, could be defined as income that is mainly a reward for personal exertion. Alternatively, the rules could be more explicitly aimed at closely-held entities where a set proportion of the business income of the entity arises from the efforts of owner-managers.

Such a revised regime, like the existing rules, would not apply to businesses with significant assets, as a significant proportion of the profits of such businesses include a return on investment and savings, rather than earned income.

Income splitting opportunities could also be further limited by applying an arm's length rule to deductions arising from payments to associates, to ensure deductions reflect the value of services provided.

Such approaches could provide a more effective constraint on the alienation of earned income, while simplifying the law and making administration easier (Board of Taxation 2009). It would also temper the additional incentives to alienate earned income to a company that may arise from any future reduction in the company income tax rate (see Section B1).

Deductions

Tax deductions are allowed for a range of expenses. Beyond those associated with earning income, deductions are available for the cost of managing tax affairs, and for gifts to deductible gift recipients. Deductions for deriving income from savings are discussed in the following section.

The costs of earning income

The personal income tax system allows deductions for the costs incurred in producing income. In the case of employee income, this entails the deductibility of work-related expenses, including expenses for self-education associated with earning income. For self-employed people, this entails the deductibility of expenses *incurred* in producing their assessable income, and expenses *necessarily incurred* in carrying on their business to produce income.

These deductions are consistent with the Schanz-Haig-Simons definition of income, under which income represents the increase in a person's stock of assets in a period, plus their consumption in the period (with consumption including expenditure other than that incurred in producing income). There are important equity reasons for maintaining this approach; that is, it is fair to recognise that people with the same level of income may incur different costs in earning that income.

Principle

Earned income subject to taxation should be net of the costs directly incurred in earning that income. Work-related expenses should be clearly defined as those that are necessary to produce income.

Australia's tax system is relatively generous to work expense claims

Deductions for work-related expenses (WREs) are the most common claims among employees. In 2006–07, three quarters of net taxpayers claimed WREs for items including tools of trade, equipment, technical and trade books, travel, self-education and home office costs. Under specific statutory concessions, employees are able to claim certain other WREs such as uniforms and motor vehicle costs.⁹

WRE claims account for around 42 per cent of the value of all deductions claimed by individuals, or around \$14 billion in 2006–07 (ATO 2009). Generally, the claimable amount is not capped, and the total claimed has grown substantially over time.

Most WREs are deductible for a taxpayer in a particular income year if the expense is incurred in the course of gaining or producing their assessable income and the expense is not 'private, domestic or capital' in nature. This provides taxpayers with a broad range of deductible expenses.

9 The statutory deduction for uniforms relates to non-compulsory uniforms – compulsory uniforms are deductible under the general provision. Motor vehicle expenses are deductible under the general provision but there are special statutory rules for valuing the expense incurred.

Compared to Australia, a number of countries that allow deductions for WREs do so only for a very limited and carefully prescribed set of expenses (see Box A1-2). In addition, the nexus between deductible expenses and income generation is much tighter than it is in Australia.

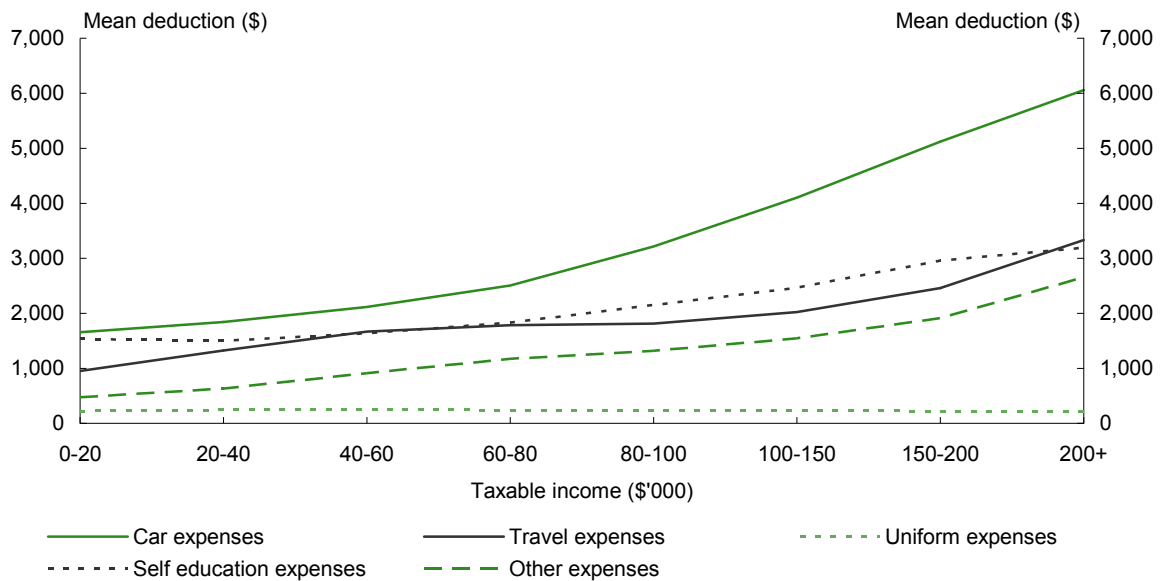
WRE deductions are intended to improve the equity of tax treatment between those who incur costs in producing their income and those who do not. By allowing deductions for these expenses, the existing framework seeks to treat income on net terms, because net inputs vary for different income producing activities. However, it is not clear that WRE deductions are necessary to maintain this type of equity. If they were no longer available it is likely that wages would rise or that expenses would be met by employers rather than employees (for example, Baldry 1998).

Box A1-2: International comparisons of deductions for WREs

Country	Deductions for work-related expenses	Scope of deductions and arrangements
Australia	Yes	Incurred in gaining or producing an employee's assessable income.
Canada	Limited	Only deductions specifically legislated are allowed, including accounting and legal fees.
Denmark	Yes	Wage or salary earners can fully deduct work-related expenses from income, after a standard deduction has been applied.
Ireland	Yes — narrow	Expenses incurred wholly, exclusively and necessarily in the performance of duties.
Japan	Limited	Specific deductions that exceed the standard deduction for employment income are allowed. Specific deductions include travelling expenses.
Netherlands	Yes — narrow	Most work-related expenses are not deductible; in limited circumstances exceptions apply for transport, education and home office expenses. There is an employed person's tax credit.
New Zealand	No	No deductions for work-related expenses for employees.
Spain	No	Expenses relating to employment are generally not deductible. Some exceptions include trade union / professional association fees and legal expenses on termination. Other allowances and a standard deduction are available.
Switzerland	Yes — narrow	Necessary work-related expenses are deductible — 3 per cent of net income with a minimum and maximum deduction.
United Kingdom	Yes — narrow	Most claimable expenses must be incurred wholly, exclusively and necessarily in the performance of an employee's duties, a condition that precludes the deduction of many employment-related expenses.
United States	Limited	Employees can deduct work-related expenses subject to limits (expenses generally only deductible to the extent they exceed 2 per cent of adjusted gross income). Taxpayers have the option of claiming a standard deduction in lieu of itemising deductions.

Source: Adapted and updated from *International comparison of Australia's taxes* released April 2006, OECD *Taxing Wages 2007-08* and International Fiscal Database Documentation.

Most WREs, including car and self-education expenses, increase with income. Generally, WRE claims follow income, although uniform expenses remain flat (see Chart A1-14).

Chart A1–14: Mean work-related expense deductions by type, 2006–07

Source: Treasury calculations based on ATO (2009).

The law for WREs is complex (supported by numerous ATO decisions, determinations and rulings). While the general principles are simple, many tax rulings, court rulings and legislative provisions underpin their application. WREs impose a compliance burden on individuals and practitioners and add to administration costs for the ATO.

Under the current framework, there are significant difficulties in correctly quantifying work-related costs, in apportioning expenses between income-earning purposes and private purposes, and in defining and claiming the deductions. These complex arrangements constitute one of the impediments to further pre-filing of tax returns and, ultimately, removing the need to complete a tax return for a large number of employees.

There is a high degree of variation in WRE claims among individuals with identical occupations and income levels. This variability could be explained by: some taxpayers over-claiming (including expenses that might be private, domestic or capital in nature), given the limited ability of the ATO to audit WREs; some taxpayers interpreting expenses that are incurred in performing their job differently from other taxpayers (raising issues of complexity and transparency in the system); and differences in employer behaviour, where some employers pay for a particular type of expense while other employers do not.

In Canada, a country with a similar tax system and administrative arrangements to Australia, it is estimated that 10 to 15 per cent of WRE claims each year are invalid. If over-claims in Australia are of a similar order, this would equate to an over-claim of between \$1.4 and \$2.1 billion in 2006–07. While no tax system can achieve perfect compliance, the potential magnitude of non-compliance suggests that administrative solutions alone cannot address this issue (Highfield 2009).

Findings

The scope of work-related expenses for which a tax deduction can be claimed is broad by international standards.

Deductibility for work-related expenses adds a great deal of complexity to the personal income tax system and imposes high compliance costs on taxpayers.

The scope and number of claims significantly limits opportunities for fully automating the preparation of tax returns using pre-filing.

Deductions for the cost of managing tax affairs

The costs of managing their tax affairs are deductible to all taxpayers, whether they are business taxpayers, salary or wage earners, or investors.

This deduction is important in recognising the compliance costs imposed by government on individuals, and can be seen as one of the direct costs of the tax system.

Principle

The costs of managing tax affairs should be deductible in recognition of the compliance burden the tax system imposes on individuals.

Claims for managing tax affairs reflect complexity

Individual taxpayers can deduct expenses incurred in managing their income tax affairs (including complying with legal obligations). These expenses include costs incurred in preparing an income tax return (including travel and other incidental costs), the purchase of tax reference material, and the costs of objecting or appealing against an assessment or determination made by the Commissioner of Taxation.

Of the 11.8 million individuals who lodged a tax return in 2006–07, around three quarters used a tax agent. Approximately two thirds of these, or 5.3 million individuals, claimed a deduction for the cost of managing their tax affairs, totalling over \$1.4 billion. The average deduction for these expenses was \$206 for employees and \$740 for investors.

Finding

The costs of managing tax affairs are widely claimed by individuals, reflecting the complexity of the system.

Reform directions — costs of earning income and managing tax affairs

Recommendation 11:

A standard deduction should be introduced to cover work-related expenses and the cost of managing tax affairs to simplify personal tax for most taxpayers. Taxpayers should be able to choose either to take a standard deduction or to claim actual expenses where they are above the claims threshold, with full substantiation.

Recommendation 12:

There should be a tighter nexus between the deductibility of the expense and its role in producing income.

A new test that better aligns income and work-related expenses

Under the current system an expense may be deductible as long as it is sufficiently related to earning income. The necessary link is considerably looser than in other countries. The current test adds to compliance costs, makes it hard to move to pre-filled (automated) tax returns, and expands the net of allowable expenses to such an extent that it is difficult to check that expenses conform with the law.

Requiring a tighter link between an expense and gaining income would improve clarity for taxpayers on what they can deduct and would ensure that WREs and other deductions are well-targeted.

A new test that more strictly defines deductible expenses incurred in producing income should be introduced. This test could be similar to the approach taken in the United Kingdom, where a tax deduction for WREs is only available if the employee is obliged to incur and pay the expense as holder of the employment, and if the expense is incurred wholly, exclusively and necessarily in the performance of the duties of the employment. A tighter nexus should be consistent with the fringe benefit tax arrangements, to eliminate opportunities for arbitrage.

This approach would exclude some expenses that are claimed under Australia's current arrangements: expenses that are only loosely linked to generating income, to the extent that they are so used.

Standard deduction to simplify tax arrangements

Many taxpayers face legitimate expenses that are directly related to generating their income, including business income for individuals. Recognising legitimate expenses is important to ensure that employment and business activities that involve relatively high expenses are appropriately taxed relative to those that have few expenses.

However, the current arrangements for deductions, particularly for WREs, place a considerable compliance burden on many taxpayers. To simplify individuals' interaction with the tax system and to facilitate much more pre-filling of tax returns, an automatic standard deduction should be introduced.

Taxpayers would be provided with a standard deduction as part of their pre-filled tax return, unless their claim for WREs (excluding tuition fees that should be separately deductible) and for the cost of managing their tax affairs exceeds a claims threshold and they

choose to claim their actual expenses with full substantiation. The standard deduction should be the default option. Taxpayers could opt out of the standard deduction and claim higher total expenses where these are above the claims threshold (see Chart A1-15).

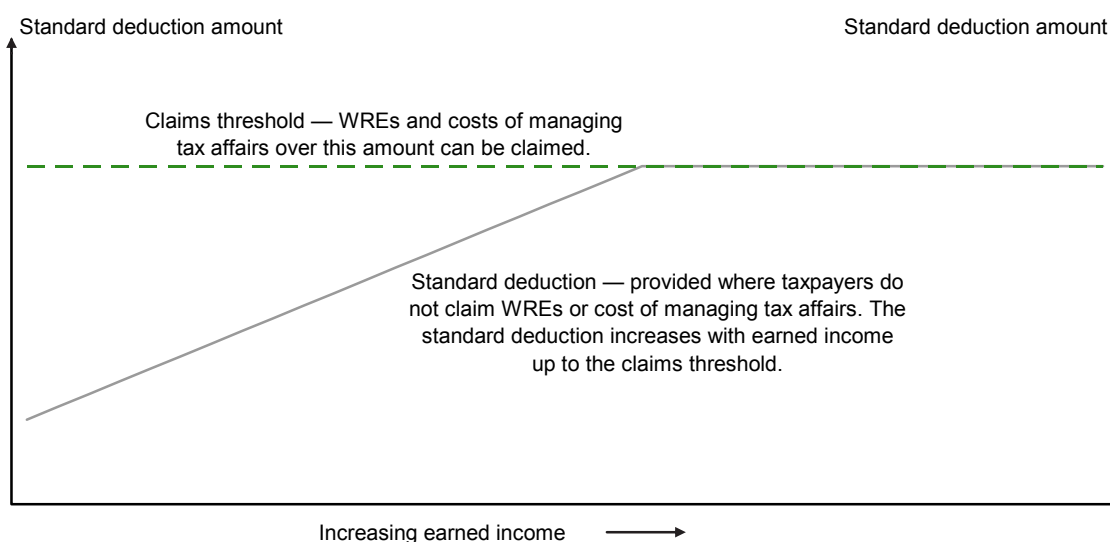
The standard deduction would consist of:

- a nominal base amount available to those with labour and/or capital (non-business) income who do not elect to claim itemised expenses (WREs, including some self-education expenses, and cost of managing tax affairs) above a minimum claim threshold; and
- a proportion of labour-related income up to a capped amount (the claims threshold).

While the increasing value of the standard deduction would reflect the fact that expense claims rise with income, the value of the tax concession should ultimately be set so as to bring most taxpayers into the standard deduction. The level of the standard deduction would need to be set with regard to changes in the requirements for expense deductions.

Taxpayers with high expenses above the claims threshold would be able to claim expenses above the claims threshold with full substantiation (and subject to the new requirements for expense deductions).

Chart A1-15: Standard deduction increases with labour-related income



An alternative approach would be to allow taxpayers to identify whether they wished to claim the standard deduction, or to claim all eligible expenses that meet the new substantiation requirements.

To bring as many taxpayers into the simplified system as possible, smaller capital-related deductions (excluding interest expenses) and the cost of managing tax affairs deduction should be incorporated into the standard deduction. However, consistent with current administrative arrangements, genuine and reasonable travel allowance expenses (including accommodation, food, and drink associated with working away from their ordinary residence) would not be include in a taxpayer's assessable income (or in the standard deduction). Consideration would need to be given to the interaction of the standard deduction and the proposed capital income discount.

Depending on the rate of the standard deduction and the claims threshold, a large number of individual taxpayers would no longer need to complete a detailed tax return. This would simplify the tax return lodgement process, and alleviate the compliance burden for many taxpayers.

Refine deductibility for self-education expenses associated with earning or producing income

Education and training is an essential part of human capital development and a significant contributor to economic outcomes for all Australians. It is essential that Australians have opportunities to train and study, both to enhance their skills for their current employment and to pursue new opportunities, particularly when structural change in the economy makes re-training essential for sustainable employment.

There is a role for the deductibility of self-education expenses to encourage further education and training. Tuition fees for education related to current employment should not be included in the standard deduction. Instead, these expenses should be deductible from the first dollar, with full substantiation.

To reduce complexity for taxpayers, other deductible self-education expenses (including travel expenses and educational materials) should be included in the standard deduction.

The Review has considered whether a taxpayer should be able to deduct education and training expenses that are not related to their current employment.

Extending deductibility in this way would be costly and difficult to administer. It would be challenging and inefficient for the administrators of the tax system to differentiate between (non-deductible) leisure activities, and (deductible) training that increases human capital. This risk would be reduced by ensuring that the tuition expense must be incurred in the generation of labour income with a sufficient link to employment. For this reason, financial support for people who want to build skills unrelated to their current employment should be delivered through direct transfers, not tax deductions.

Streamline the costs of managing tax affairs deduction to facilitate automated lodgement

The deduction for the cost of managing tax affairs can be attributed to the costs associated with generating both capital and labour income. As the deduction is claimed by a large number of taxpayers, rolling it into the standard deduction would simplify the taxpayers' experience of the tax system and facilitate tax return pre-filing. People whose income is solely derived from capital should have access to the base amount of the standard deduction.

The costs of managing tax affairs should continue to be separately deductible where the taxpayer's total expenses exceed their minimum claim threshold.

Deduction for gifts

Individuals and businesses support the activities of many not-for-profit (NFP) organisations, including through volunteering time and donating goods and services. Donations of money were valued at \$8.9 billion in 2004 (FaHCSIA 2005).

The decision to donate money to a NFP organisation may be motivated by a range of factors, including altruism, the possibility of material gain, family or business tradition, social

affiliation, values or beliefs, and humanitarianism. Submissions suggest that donations are also influenced by the tax concessions provided to certain NFP organisations. Donations over \$2 are tax deductible if they are made to a deductible gift recipient (DGR).

In 2006–07, 36.3 per cent of individuals claimed a gift or contribution to a DGR as a deduction in their income tax return. Of these individuals, 82.5 per cent donated less than 1 per cent of their total income (ATO 2009).

Assessment

Gifts are a longstanding and important source of funding for the NFP sector, and are supported through gift deductibility.

While it is unclear how gift deductibility influences the amount individuals donate, it provides several benefits. It supports pluralism by giving individuals the opportunity to direct government expenditures to their preferred causes, provides transparency in the provision of government assistance, and is an administratively simple mechanism for both donors and the ATO (although donors incur some compliance costs from the requirement to hold receipts for audit purposes).

Findings

Gifts are an important source of funding for the NFP sector.

Gift deductibility supports pluralism, and is a transparent and administratively simple mechanism.

Reform direction — retain gift deductibility for donations to deductible gift recipients

Recommendation 13:

Gift deductibility should be retained, with the deductibility threshold raised from \$2 to \$25.

The Review has investigated options to streamline the current arrangements, including replacing gift deductibility with a flat rebate that the donor could choose to assign to the NFP organisation. This approach has been successfully adopted in other jurisdictions, including New Zealand, the United Kingdom and the United States.

While a rebate would provide several benefits (including facilitating a more timely refund, lowering compliance costs through simplifying tax returns and addressing the vertical inequity of gift deductibility), it would also give rise to several integrity issues that require further detailed consideration (for example, ensuring individuals are not able to 'double dip' by claiming the rebate for themselves and assigning the rebate to the NFP organisation). Further, the impact of removing gift deductibility on philanthropy is unclear.

Given these concerns, the Review favours retaining gift deductibility, and raising the gift deductibility threshold to \$25 per recipient organisation per income year. A higher threshold would reduce the reporting burden for donors who have to retain receipts to be entitled to the tax deduction, and for DGRs that need to issue a large number of receipts for small donations.

In 2007–08, tax deductions for donations to NFP organisations were valued at \$1.8 billion. Of these, \$16 million were claimed by people with total donations of \$25 or less.

Other deductions

Over time, governments and the community have placed a high value on certain activities and projects – including standing for political elections, making additional superannuation contributions, investing in the Australian film industry, and investing in forestry – and have encouraged investment in them through tax deductions for individual taxpayers.

Deductions for these activities, can be claimed against labour or capital income. For example, election expenses incurred by candidates for any level of government are deductible although they may not be related to current income-earning activities and therefore would not be deductible under the general deduction provisions of the tax law.

Other deductions are available for investing in the Australian film industry and in forestry managed investment schemes. The cost of insurance premiums related to the loss of income, such as income protection, sickness and accident insurance premiums, is deductible under the general deduction provisions, because the premiums relate to the earning of assessable income.

A future review of the relevance and impact of these deductions could be undertaken.

A1–3 Taxation of income from savings

Key points

The income from the savings of Australian residents, other than savings invested in owner-occupied housing and superannuation, should continue to be a significant part of the personal income tax base.

The income tax treatment of these household savings would be improved by applying a 40 per cent discount to most interest income, net residential rental property income, capital gains and certain interest expenses. Doing so would provide a more consistent tax outcome for income from bank deposits and bonds, shares, and rental properties, and provide a means of adjusting for the effect of inflation.

A more consistent treatment of household savings would encourage households to seek the best pre-tax return on their savings and to invest their savings in assets that best suit their circumstances and risk-preferences. It would also largely remove the current bias towards negatively geared investment in rental properties and shares and so reduce a major distortion in the rental property market.

While a discount would provide a more consistent tax outcome for savings, its introduction would also substantially change incentives in some key markets, particularly for rental housing. Given the current problems in the rental housing market, the discount for net residential rental income should only be adopted following reforms to housing supply and housing assistance.

While a move to a broad 40 per cent discount would involve further boundaries in the income tax system, at least in the short- to medium-run, some areas of the current arrangements can be simplified. In particular, capital gains tax should be simplified by excluding some low-revenue generating assets, rationalising existing concessions, removing grandfathering rules, and considering a principles-based rewrite of the rules.

A consistent treatment of savings

Challenges in the taxation of savings

Productivity is reduced if tax-induced distortions lead to a misallocation of resources, with savings directed towards less productive investment opportunities. By favouring one form of savings income over another, the tax system alters the allocation, ownership and the management of the nation's capital. This can have adverse implications for the efficiency and stability of capital markets and the way risk is distributed between individuals.

Internationally, the tax treatment of gains and losses from saving typically varies depending on the asset type, the financing arrangement and the entity or entities involved. As well as reflecting discrete policy decisions to favour particular types of saving over others, these differences arise because of the inherent difficulties in measuring economic income.

In particular, there are difficulties with measuring changes in asset values over time, which have led to changes in value only being taken into account when an asset is sold and a gain realised, and in accounting for inflation.

Realisation-based taxes distort asset allocation

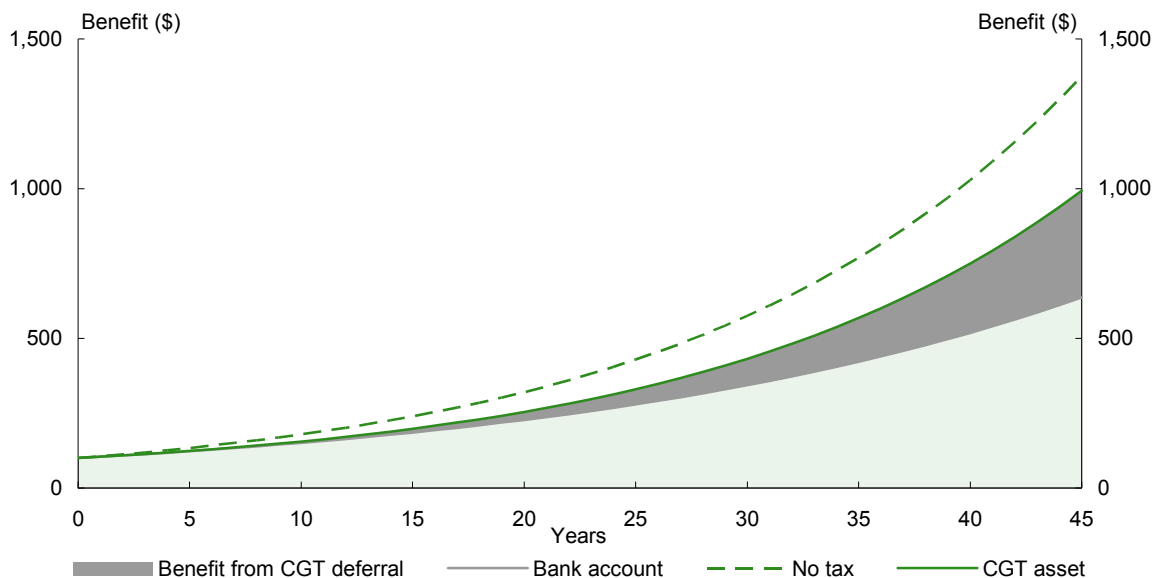
Income can be measured as current consumption plus changes in wealth. Despite this, income taxes in general, and particularly for individuals, are based on the realisation principle. That is, income is recognised as taxable when it is realised through a taxable event, such as the sale of an asset, rather than as the change in value of assets or wealth over time.

Lock-in allows tax to be deferred and can disrupt the operation of markets

Taxing capital gains on a realisation basis lowers the effective tax rate on accrued capital gains by providing a tax deferral advantage — that is, the payment of tax is deferred until the gain is realised. This encourages investors to hold on to assets with accrued capital gains.

This lock-in effect can impede the efficient functioning of the capital market and distort ownership patterns as investors are discouraged from switching assets when they would pay tax on a realised gain. The lock-in effect can also destabilise the stock market and real property market as shares and property are sold when prices decline (to realise losses) and are held onto when prices rise (to defer the realisation of the gains).

Chart A1-16: Benefit from taxation on a realisation basis



Source: Treasury estimates.

Assumptions: \$100 initial investment; nominal return of 6 per cent; 30 per cent tax rate on nominal income.

Chart A1-16 compares the consumption possibilities from investing \$100 today in an asset according to whether it is exempt from tax, generating a capital gain with tax deferred until sale, or generating a capital gain with income taxed as it accrues (similar to interest from a bank account). The benefit from being able to defer tax under the capital gains tax provisions increases over time and provides a tax advantage over other assets, such as bank accounts.

Realisation-based methods lead to arbitrage opportunities and other problems

The adverse impact of a realisation-based capital gains tax is broader than the lock-in effect. Taxation based on the realisation principle also introduces tax arbitrage opportunities. Under a realisation-based tax, there is an incentive for an investor to hold gains and realise losses, thereby using the realisation event for tax arbitrage. Such possibilities then require limits in the tax system, such as limitations on loss utilisation even where a taxpayer incurs a true economic loss.

The realisation principle for capital gains may also create additional complexity and compliance costs. Under a realisation-based tax, taxpayers are required to keep records for long periods, and are also likely to have less frequent exposure to the relevant tax rules. Separating capital gains from other forms of income also creates uncertainty, and arbitrage opportunities, over how particular forms of income should be classified for tax purposes.

But there are practical impediments to accrual income taxation

While there could be benefits from moving towards taxing on an accruals or accruals-equivalent basis, there would also be a number of practical problems in doing so for individuals across-the-board.

The first is the need to accurately measure changes in asset values. While there are practical difficulties associated with accounting on an accruals basis for business profits and other income, unrealised capital gains (other than for assets where a market price is readily observable) are even more difficult to measure. The act of measurement could also affect market pricing.

These practical difficulties are likely to give rise to their own compliance costs and differential tax treatments of assets, depending on how easily accruing income can be measured for different assets. Different tax treatments, with only some assets taxed on an accruals or accruals-equivalent basis, would also give rise to their own tax arbitrage and minimisation arrangements.

Further, where unrealised gains accrue a taxpayer may not have the cash at hand to pay the tax liability, and borrowing against or selling down assets to meet the tax liability would not be costless. Volatility in asset prices combined with lags in tax liabilities falling due may exacerbate these concerns.

While some of the problems of valuation and liquidity arising from accruals taxation could be addressed by using an accruals-equivalent approach (for example, deeming a rate of return based on the value of an asset), this would have other disadvantages. For example, taxing savings on a deemed return or presumptive tax basis would forgo tax on any above-normal returns or economic rent.

In the longer-run, improvements in technology and changes in the operation of capital markets may mean that some of these practical impediments become less significant.

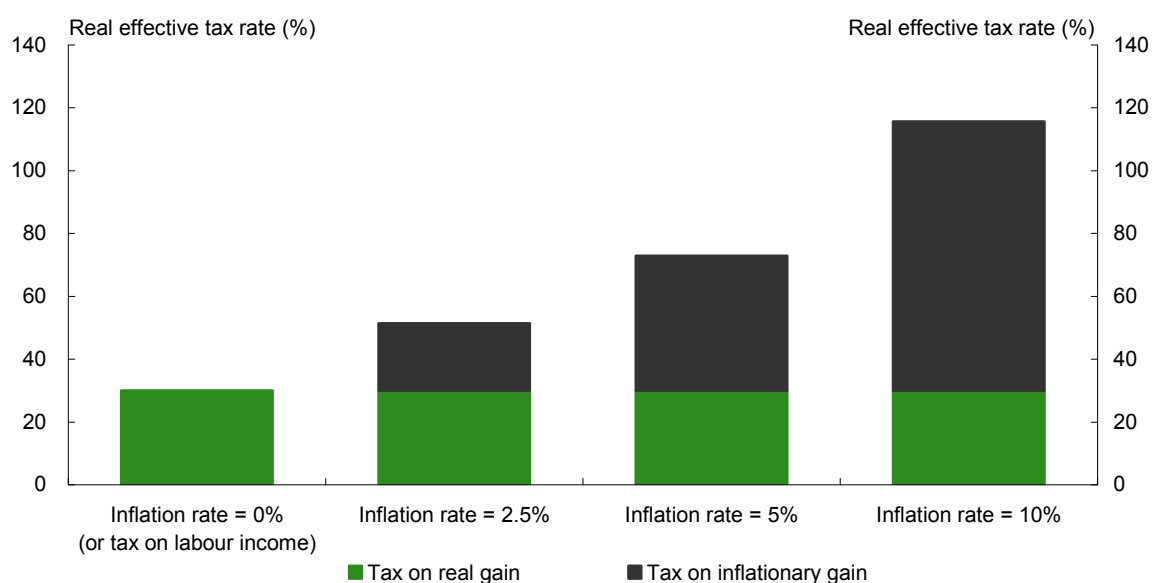
Principle

Savings should be taxed as consistently as possible to minimise tax arbitrage opportunities and to avoid biasing household and investor decisions about what assets best suit their needs and preferences.

Taxing inflationary gains erodes consumption power

The current tax system is based on nominal income. That is, the income tax base includes compensation for inflation as well as real gains. The inflationary component compensates investors for the reduction in their purchasing power arising from inflation, allowing them to purchase the same quantity of goods and services in future periods. By taxing the inflation component, an individual's consumption power is eroded.

Chart A1–17: Real effective tax rate on the return to savings under different inflation rates



Assumptions: Real return of 3.5 per cent; 30 per cent tax rate on nominal income.
Source: Treasury estimates.

For example, if an individual purchases an asset for \$100 and sells it a year later for \$106 — earning a 6 per cent return — the full return (\$6) is subject to tax. If inflation is also 6 per cent, the individual would have had no increase in consumption power — a real return of zero. That is, the same bundle of goods that cost \$100 last year would cost \$106 this year. By being taxed on the inflationary return the individual is no longer able to consume the same bundle of goods.

Taxing the inflation component increases the effective tax rate on savings above the statutory tax rate, which may reduce incentives to save. For a given real return, the effective tax rate increases as the inflation component increases (see Chart A1-17). The impact from taxing nominal gains may also be exacerbated under a progressive income tax where the average tax rate increases as taxable income increases.

The impact of inflation is less of an issue for capital gain assets where taxation is deferred until realisation. In this case, the real post-tax return increases the longer an asset is held. In contrast, for an interest generating asset the real after tax return does not vary with the holding period. Consequently, the argument for accounting for inflation for capital gain assets is not as strong as that for other assets (Brinner 1976).

While comprehensive adjustments can in theory be made to measure real rather than nominal income, in practice such adjustments can be very complex. A number of jurisdictions that typically face higher rates of inflation than Australia make or have made adjustments on a comprehensive basis for some items of capital income.

As price stability has been a key objective of effective Australian monetary policy settings that target a low rate of consumer price inflation, the biases caused by inflation expectations on the taxation of nominal income in Australia have been reduced.

Finding

Inflation exacerbates the biases in the current income tax treatment of savings, leading to an increase in the effective tax rate on the nominal return to savings.

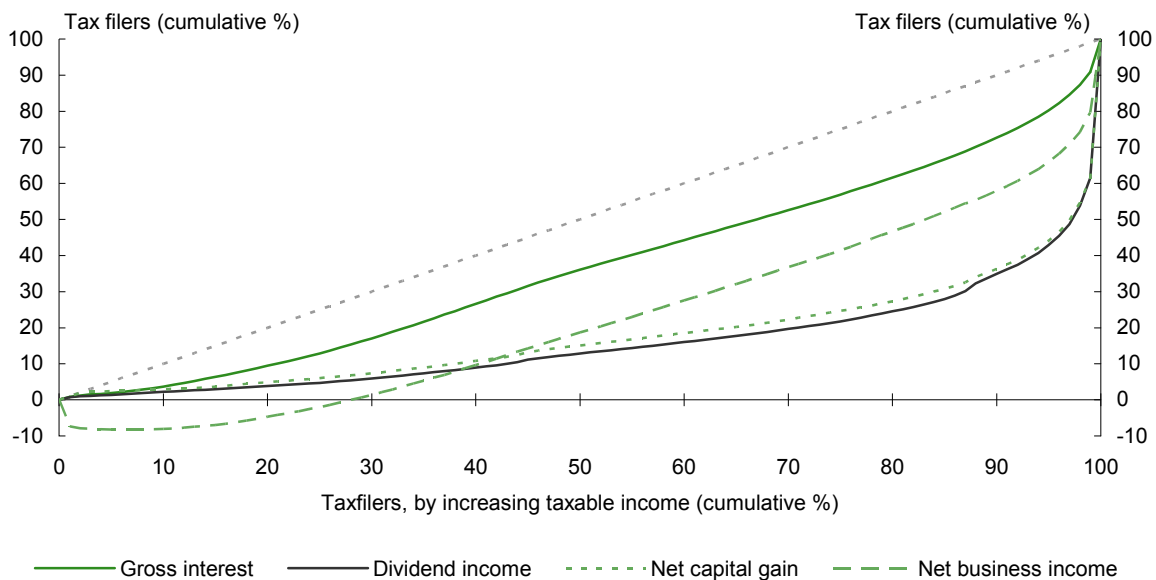
Income tax applies inconsistently to different types of savings

While Australians save in a variety of ways, most household savings is concentrated in property and superannuation – both of which are either exempt or lightly taxed. According to the Australian Bureau of Statistics, the principal assets of Australian households are their own home (44 per cent of household assets), other property including rental property (16 per cent), superannuation (13 per cent), shares and interests in trusts (12 per cent), personal use assets (11 per cent) and bank accounts and bonds (4 per cent) (ABS 2007).

There are considerable differences in the distribution of the income from these different saving forms between households (see Chart A1-18). Taxable income from savings is typically skewed towards high income taxpayers. Interest income, however, tends to be more evenly distributed over the taxable income scale. Dividends and capital gains are the least evenly distributed.

In 2007-08, the bottom 20 per cent of taxpayers earned around 9 per cent of gross interest income but only 4 per cent of dividend income and around 5 per cent of net capital gains. In contrast, the top 10 per cent of taxpayers received around 27 per cent of gross interest income but over 60 per cent of net capital gains and dividends.

Chart A1-18: Distribution of savings income items, 2007-08



Source: Australian Government administrative data, includes taxfilers without a tax liability.

Tax outcomes depend on the form of saving

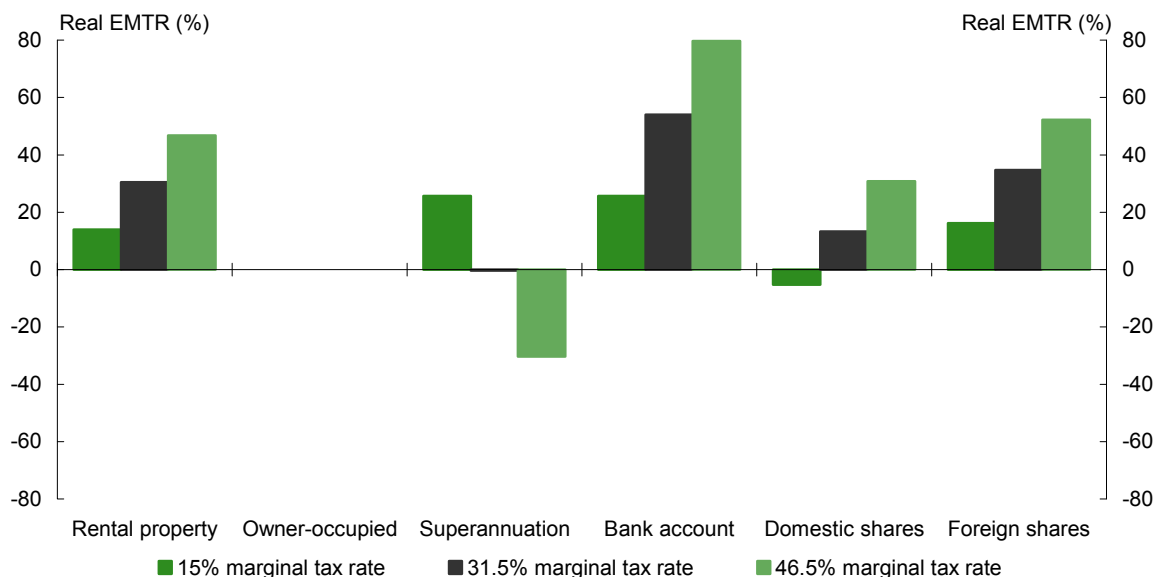
The tax treatment of the assets that Australian households typically invest in varies considerably. These differences arise from a long history of discrete and ad hoc government decisions as well as difficulties in properly measuring income from savings.

Before the Asprey Report in 1975, the tax laws recognised many items that fall within an economist’s definition of nominal capital income: profits from a business, interest, rent, dividends and other periodic receipts. These were generally included in the calculation of taxable income and taxed at the same progressive rates as labour income.

Items that were not recognised, or were only brought into the tax base to a limited extent, included capital gains, superannuation earnings, retirement lump sum benefits, imputed rent from owner-occupied housing and consumer durables, bequests and gifts received. Of these untaxed or lightly taxed items, capital gains have been generally brought into the tax base while superannuation is now taxed as earnings accumulate in the fund. The introduction of dividend imputation was a major change in the taxation of dividends.

The different tax treatments of these assets can be expressed as effective marginal tax rates (see Chart A1-19). The estimated tax rates quantify the effect of the tax system on an investment in a specified asset that earns a normal risk-free rate of return. A zero effective tax rate represents an expenditure or consumption tax treatment; a rate equal to the statutory tax rate represents a real income tax outcome.

Chart A1-19: Real effective marginal tax rates on savings depend on asset class



Notes: Real effective marginal tax rates show the tax levied on the normal real return to saving, and reflect the tax treatment of the income from which savings are made (where it deviates from tax payable if that income had been immediately consumed), earnings on those savings, and the final use of the accumulated savings. A zero effective tax rate corresponds to an expenditure tax benchmark, with the investment funded out of post-tax wages, and earnings and the subsequent realisation of the investment untaxed. The negative rate for superannuation reflects the reduction in tax otherwise payable on wages by making contributions out of pre-tax income. The estimates do not model interactions with the transfer system.

Assumptions: 6 per cent nominal return; 2.5 per cent inflation; for rental property, 50 per cent of the return is attributable to capital gain and 50 per cent to rental income and the rental property is held for 7 years then sold; shares are held for 7 years then sold; superannuation is held for 25 years and the individual is eligible for a tax-free payout at the end of the period.

Source: Treasury estimates.

For interest bearing deposits, the effective tax rate exceeds the taxpayer’s marginal statutory rate because the entire return, including that part representing compensation for inflation, is included in taxable income as it accrues annually. Income from listed shares in companies with domestic investments benefits from imputation credits for dividends and a discount for realised capital gains. Income from foreign shares does not benefit from imputation and so has a higher effective tax rate than income from domestic shares. Rental properties benefit from the capital gains tax discount, though net rents are taxed at the full marginal tax rate.

Savings placed in lifetime savings such as superannuation and owner-occupied housing are more preferentially taxed. Owner-occupied housing is outside of the income tax base and faces a zero effective tax rate. Superannuation is advantaged because contributions into a superannuation fund are generally made out of pre-tax income (unlike for a bank account, where deposits are made out of post-tax income), though they are subject to a 15 per cent contributions tax. Earnings in the fund are also taxed at a 15 per cent statutory rate and are eligible for a one-third capital gains tax discount and for refundable imputation credits.

For superannuation, the access to the effective partial deduction for saving (or co-contributions from the Australian government, or both), the very low rate of tax on earnings and the exemption from income tax of retirement benefits, means that for many individuals saving in a superannuation fund is treated more generously than it would be under an expenditure tax.

There is considerable evidence that tax differences have large effects on which assets a household's savings are invested in. Based on an examination of the literature and OECD data, the OECD concluded that while low-income individuals respond to tax incentives with more saving, for high-income individuals in particular savings are diverted from taxable to tax-preferred savings (OECD 2007a).

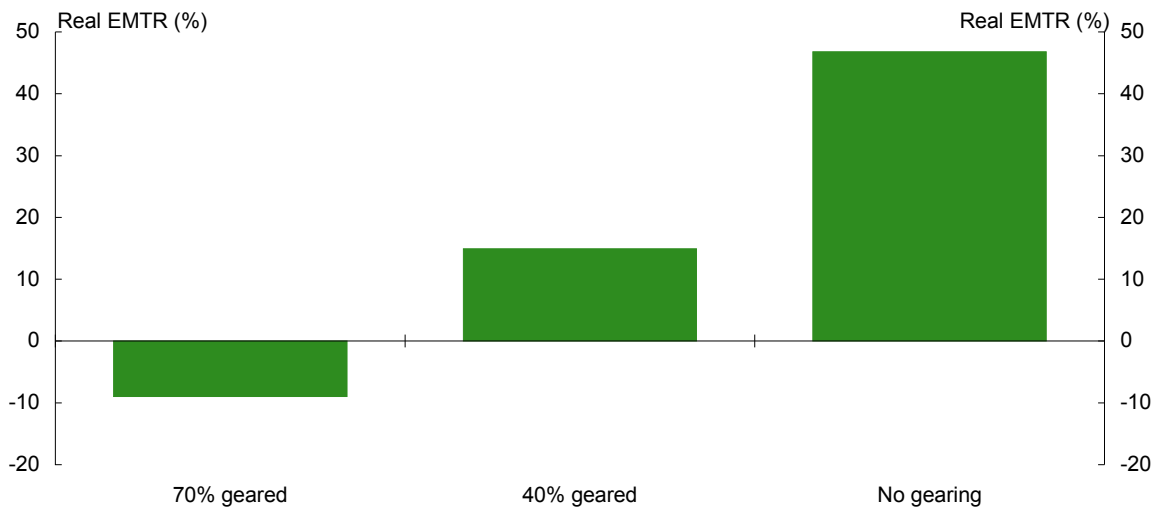
Finding

The tax outcomes for different types of savings vary considerably and have evolved in an ad hoc manner. How households allocate their savings between different assets or savings vehicles is likely to be significantly affected.

Different tax treatment of financing gives rise to arbitrage opportunities

Investments in assets by individuals face different effective tax rates depending on the financing choices of the saver. When equity financed, rental properties yield a positive effective tax rate. When negatively geared, asymmetries in the treatment of expenses and receipts give rise to a more favourable treatment (see Chart A1-20). This asymmetry ranks amongst the greatest tax induced biases to the savings choices of households.

Chart A1–20: Real effective marginal tax rates on rental properties, by gearing ratio (current approach)



Assumptions: 6 per cent nominal return; 2.5 per cent inflation; for rental property, 50 per cent of the return is attributable to capital gain and 50 per cent to rental income and the rental property is held for seven years then sold; tax on debt provider disregarded.

Source: Treasury estimates.

For example, assume that the full amount required to purchase an investment property for \$400,000 is borrowed. The return, part of which is a capital gain, is just enough to cover costs (including interest repayments). In the absence of tax the investment will break even. The same outcome would occur under an accrual-based tax without discounts, as all income and all expenditure would be pooled together and taxed at the same rate.

Under the current system, however, the same investment receives a tax advantage that allows it to do better than break even after tax. All expenses (less rents received) can be pooled and offset against other income – in full and at the individual’s marginal tax rate. But any capital gain would not be taxed until realised, and if the asset is held for at least 12 months, only half the gain would be subject to tax. The same results apply for other types of geared investment that yield capital gains; in particular shares, where margin lending arrangements are used to negatively gear share investments.

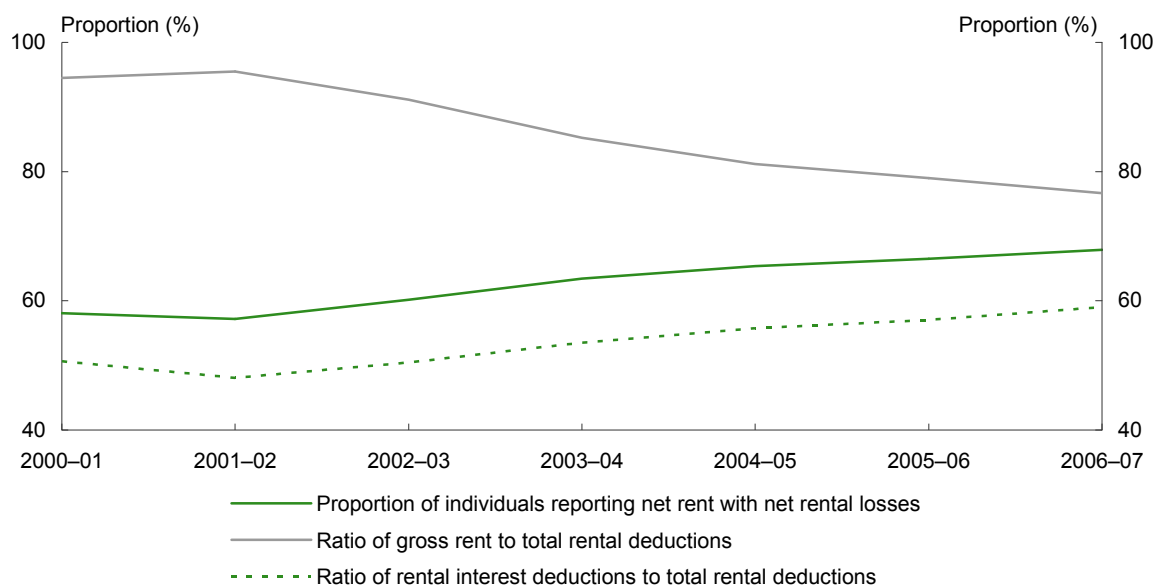
The realisation principle also leads to an adverse selection bias. That is, there is an incentive to realise capital losses immediately, while deferring the realisation of accrued capital gains, which would be taxed at a discount. For this reason, the tax law quarantines capital losses, which can only be offset against other capital gains, not against other income.

Negative gearing of rental properties has become more prevalent

Households held around \$700 billion of residential investment property assets in 2005–06 (ABS 2007). This represented around 14 per cent of total household assets, a proportion that has increased over the last decade.

Currently, around 70 per cent of individual investors in rental properties are in a net loss position. This figure has increased from 58 per cent in 2000–01 (see Chart A1–21). The increase largely reflects increases in interest deductions, reflecting rising levels of gearing rather than higher interest costs. Rental deduction claims have also increased relative to gross rent.

Chart A1–21: Selected taxation statistics —rental income and deductions



Source: ATO, *Taxation statistics* (various years).

The biases arising from the current income tax treatment of rental properties may amplify volatility in the housing market. (See Section E4.)

Finding

Current income tax arrangements for savings lead to significant arbitrage opportunities. The different treatment of capital gains as against other savings income and related expenses is an important driver of these opportunities. This creates significant distortions in how rental properties, in particular, are financed and for the rental property market.

Reform directions

Recommendation 14:

Provide a 40 per cent savings income discount to individuals for non-business related:

- (a) net interest income;
- (b) net residential rental income (including related interest expenses);
- (c) capital gains (and losses); and
- (d) interest expenses related to listed shares held by individuals as non-business investments.

In conjunction with introducing the discount further consideration should be given to how the boundaries between discounted and non-discounted amounts are best drawn to achieve certainty, reduce compliance costs, and prevent labour and other income being converted into discounted income. Further consideration should also be given to addressing existing tax law boundaries related to the treatment of individuals owning shares in order to address uncertainties about when the shares are held on capital account (and subject to capital gains tax) and on revenue account (and taxed as ordinary income).

Recommendation 15:

When the 40 per cent savings income discount is introduced a smooth transition should be provided to minimise any disruption that may arise. The transition to a savings income discount for net residential rental income should only be adopted following reforms to the supply of housing (Section E4 Housing affordability) and reforms to housing assistance (Section F5 Housing assistance).

Recommendation 16:

As part of the consideration of alternative company income tax arrangements and dividend imputation (see Recommendations 26 and 37), consideration should be given to extending the discount to other savings income.

Towards better taxation of savings

The reform direction for savings income taxation aims to provide a more consistent treatment of savings income, to reduce opportunities for tax arbitrage and to reduce incentives for investors to take on too much debt, while broadly compensating for the effects of inflation, particularly for interest income.

To give effect to this reform direction the Review has considered two primary methods of reducing the taxation of income from savings: discounting savings income (like the current arrangements for capital gains) or taxing savings income at a relatively low flat rate (like the current arrangements for superannuation). Both can be seen as representing a form of dual income tax, as indeed can current arrangements though in a more ad hoc way.

While both alternatives have the potential to represent a good fit for Australia's future tax system, a discount approach is the Review's overall preference as it assists in upholding the current progressivity of the income tax system. Deciding between the two reform paths depends on the trade-off between equity concerns of moving away from progressive marginal tax rates and the potential integrity and simplicity benefits of adopting a flat rate. Both options provide a pragmatic approach to dealing with inflation.

The proportional inclusion achieved under a discount would continue to tax other income from savings at progressive marginal tax rates, which may be desirable from an equity perspective. Proportional taxation of a notional real return to saving may also be efficient. To the extent that savings by high income earners are relatively unresponsive to post-tax returns it may be efficient to tax the returns from savings by higher income earners at higher rates and use the revenue to reduce taxes elsewhere.

However, while a proportional inclusion approach may assist in making the tax system more progressive, the degree to which it would do so is less clear. Progressive rates create opportunities for tax arbitrage, as individuals seek to exploit differences in marginal tax rates, or retain income in companies. For example, under the current tax system individuals can reduce the tax paid on the returns to saving by streaming the income to a family member facing a lower tax rate using a discretionary trust.

A flat tax rate on other forms of savings would also reduce incentives and opportunities for tax arbitrage; for example, from realising income in periods where a person's marginal tax rate is low. Furthermore, a flat tax rate would reduce incentives for investors in high income

tax brackets to allocate their savings towards tax favoured assets or to try to evade tax by investing offshore and not reporting income received.

A flat tax rate would also reduce the lock-in effects of a realisation-based capital gains tax relative to progressive taxation. Under progressive taxation taxpayers can be pushed into a higher tax bracket when gains accumulated over a long time are realised. In addition, unlike a proportional inclusion, gains and losses would be taxed at the same low flat rate, reducing disincentives towards risk taking and entrepreneurship. Even so, a proportional inclusion approach would still reduce these drawbacks of progressive taxation, because the differences in marginal tax rates between tax brackets would be smaller.

While a flat tax on the income from savings has many desirable features, the transition to a flat tax rate would raise a number of challenges. A flat tax rate, even at a low rate, is likely to result in an increase in the tax rate faced by some low-income earners. In the long-run, however, flat rate taxation of savings income may be more easily integrated with other potentially desirable directions for the future taxation of capital income, including deeming and accrual taxation of capital gains, and integration of personal income tax with a business level expenditure tax (see Sections B1 and B2) (Sørensen & Johnson 2010).

A savings income discount would tax savings more consistently

Individuals should be provided with a 40 per cent discount for the returns and expenses from certain forms of taxable savings. This would include interest income from certain interest-bearing assets, including deposit accounts, net rental income from residential properties, including discounting interest expenses, and (as now, but with a reduced discount) capital gains. The discount would also apply to such income earned through trusts and partnerships. The discount would not generally apply to dividends and business income.

It is not recommended that the discount be applied to dividend and certain other business and savings income (such as related party interest and commercial property rentals) while dividend imputation is retained and given the potential for returns to labour to be converted into discounted income. These issues are discussed further below.

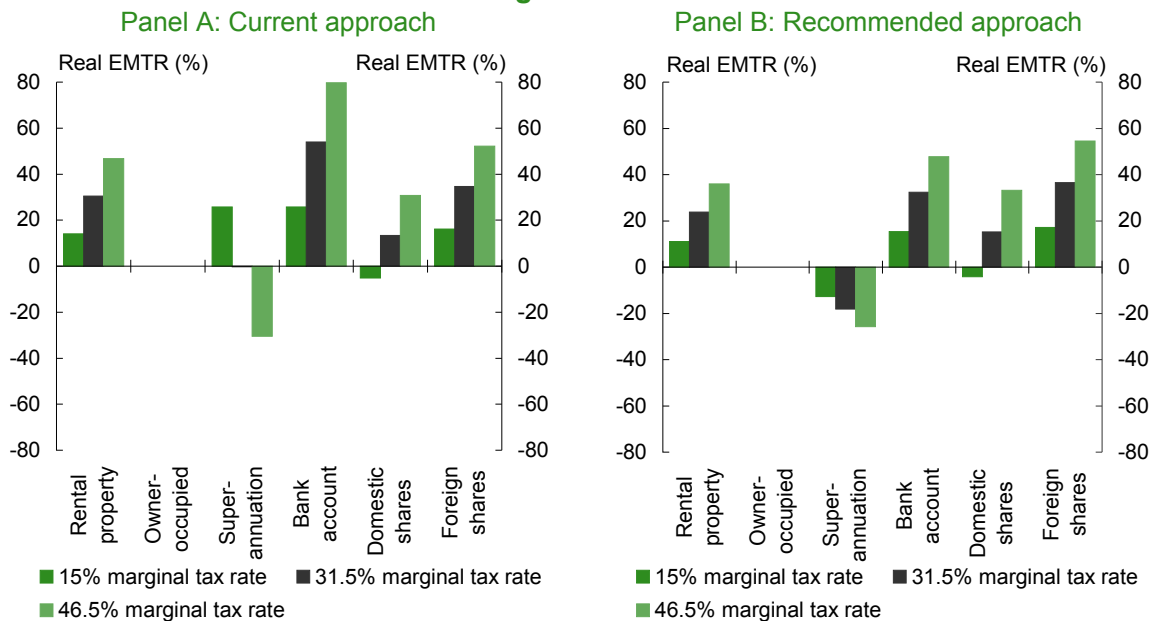
A 40 per cent discount represents a more realistic inflation adjustment than the 50 per cent discount currently provided for certain capital gains given the recent history of real risk-free returns and the Reserve Bank of Australia's objective of medium term price stability – with the goal of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. Moving to a 40 per cent discount on capital gains would also reduce the arbitrage opportunities currently available while limiting the transitional costs involved with the abolition of the existing capital gains discount.

Certain investment products (such as income bonds, funeral policies, fixed-term annuities and scholarship plans) are currently taxed like bank accounts in some, but not all, ways. Consideration should therefore be given to how these investments are to be treated in light of the general savings income discount.

The savings income discount would reduce the large differences in effective tax rates across different savings vehicles (Chart A1-22). For an individual on the top marginal tax rate, the real effective tax rate on interest income would fall from around 80 per cent to 50 per cent. The treatment of owner-occupied housing and superannuation would remain significantly

different, reflecting their lifetime savings characteristics, but the degree of difference would be reduced.

Chart A1–22: Real effective marginal tax rates for selected asset classes



Notes: The real effective marginal tax rate on saving is defined as the difference between pre-tax and post-tax return from a marginal investment as a proportion of the pre-tax return (net inflation). A zero effective tax rate reflects a prepaid expenditure tax benchmark, where saving is undertaken out of post-tax labour income and the return to saving is exempt from income tax. Negative rates for superannuation reflect the reduction in tax from either making contributions out of pre-tax income (current approach) or by assessing the recommended refundable tax offset for contributions.

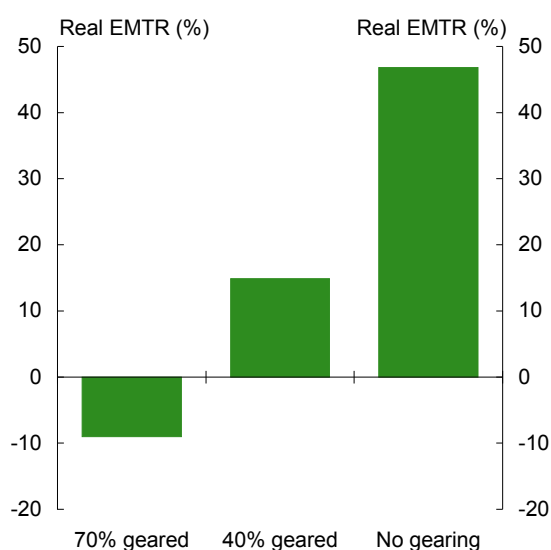
Assumptions: 6 per cent nominal return; 2.5 per cent inflation; for rental property, 50 per cent of the return is attributable to capital gain and 50 per cent to rental income and the rental property is held for 7 years then sold; shares are held for 7 years then sold; superannuation is held for 25 years and the individual is eligible for a tax-free payout at the end of the period. Does not account for interactions with the transfer system.

Source: Treasury estimates.

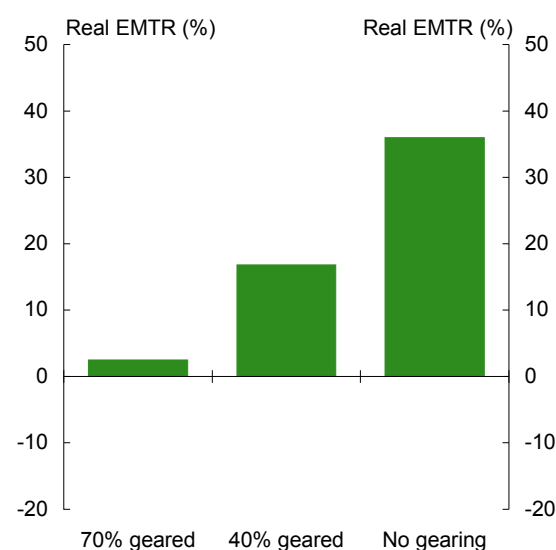
As previously discussed, the current system for taxing assets that yield capital gains, in particular shares and rental properties, allows for interest to be deductible at the full marginal tax rate, while only half the capital gain is subject to tax. This encourages households to take on too much debt and risk when undertaking these investments.

This bias can encourage surges of debt-funded investor activity in anticipation of concessionally taxed capital gains, potentially adding to the volatility of capital markets. The savings income discount would reduce, but not completely eliminate this bias (see Chart A1-23). Under the savings income discount, income from shares would take discounted (capital gains) and undiscounted forms (dividends). Interest expenses in relation to investments in listed companies should be discounted given the difficulties in assigning debt to particular investments and the significant tax benefits that would otherwise still remain for margin lending.

Chart A1–23: Real effective marginal tax rates on rental property, by gearing ratio
 Panel A: Current approach



Panel B: Recommended approach



Assumptions: Individual on 46.5 per cent marginal tax rate; 6 per cent nominal return; 2.5 per cent inflation; for rental property, 50 per cent of the return is attributable to capital gain and 50 per cent to rental income and the rental property is held for seven years then sold; tax on debt provider disregarded.

Source: Treasury estimates.

Under the savings income discount, there would also be a generally better outcome for rental property investors that finance out of equity (see Chart A1–23). The more neutral treatment would reduce the crowding out (by those undertaking negative gearing) of other potential investors in rental housing, and improve the long-term stability of the housing market. In the medium to long-run, there would be a shift in how rental property investments are financed. Applying the savings income discount to rental properties would also have the benefit of improving the overall operation and stability of the housing market.

The current system favours returns from capital gains compared to rental returns. Moving to a lower rate of tax on net rental income may also encourage more capital-intensive use of residential land, with increasing investment in higher density, higher rental income yielding developments and less reliance on capital gains from land.

However, there are currently constraints to the supply of housing that need to be taken into account. Amendments to the taxation of rental housing should only be adopted following reforms to the supply of housing, such as the approvals processes around the planning system and land supply (see Section E4). In addition, the tax benefit available to negatively geared properties may place downward pressure on rents though it is poorly targeted to this purpose. As such, steps to reduce the existing tax distortion should only be undertaken following reforms to housing assistance (see Section F5).

Boundary issues need to be considered

Despite achieving more consistent tax outcomes for savings, further consideration would need to be given to a number of boundary issues before implementation. Some existing distinctions in the tax system would become more important.

To prevent the labour income of owner-managers from benefiting from the discount, consideration would need to be given to how best to define eligible interest income. Interest income from deposits with deposit-taking institutions, government and widely marketed

bonds should be eligible for the discount. But interest income from transactions involving related parties or associates would need to be excluded or otherwise limited, otherwise returns to labour could be converted into interest payments.

In addition, the interaction of the boundary between eligible and ineligible interest and the boundary between business and non-business income would need some consideration, particularly where the eligibility of interest income or deductions for the discount may depend on the behaviour of the taxpayer. For example, consideration would need to be given to the treatment of interest expenses associated with borrowing to purchase units in a unit trust or company that may carry on a business or may invest in rental properties, debt or listed shares.

The distinction between residential and non-residential properties would become more important. The status of properties on the borderline between residential and commercial property, such as serviced apartments, would need to be clarified. However, although not straightforward, this is an existing challenge in relation to income tax and the GST.

In addition, it would be appropriate to give further consideration to addressing the existing boundaries relating to the tax treatment of income from shares. In particular, whether gains and losses are treated on the capital or revenue account is affected by whether the taxpayer is engaged in passive investment or active trading. Such a distinction can be difficult to apply in practice, because the differences between these are often a matter of degree. Under the savings income discount, there would be a greater incentive for taxpayers to classify their share ownership as a passive investment when they make gains and to classify their ownership as active trading when they make losses so that they can offset (undiscounted) losses against other revenue income.

Transitional issues

The recommended discount would reduce the rate of tax on the returns to existing assets that yield eligible interest and rental income. On the other hand, the reduction in the discount on capital gains would negatively affect individuals with significant unrealised capital gains. For geared investors in rental properties and shares, the application of the discount to net rental income and interest expenses would also have implications for their preferred level of gearing.

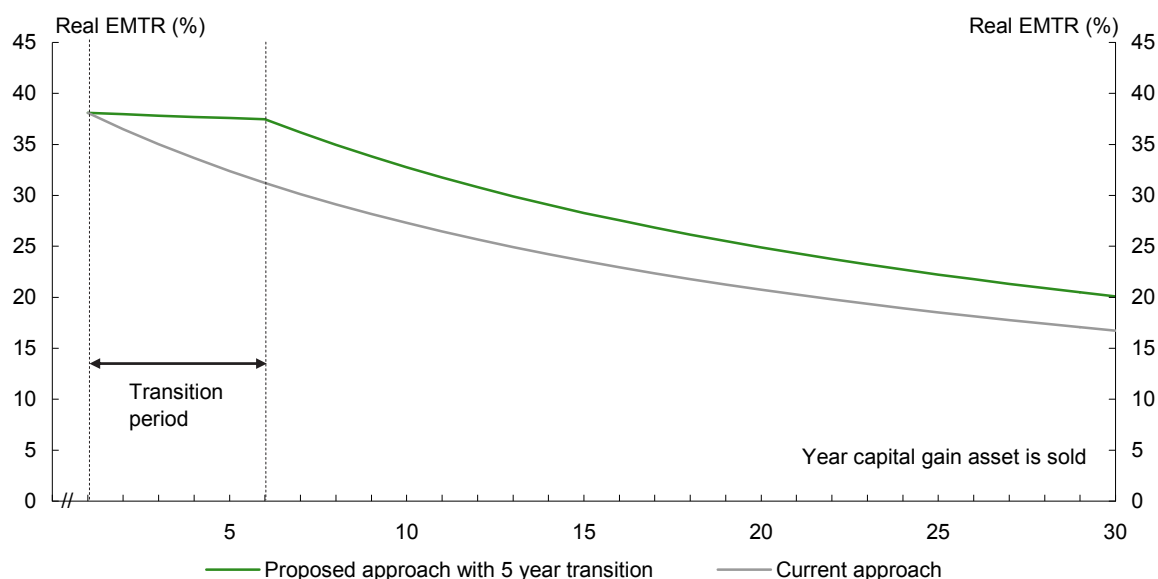
Transitional relief should be provided to minimise the disruption that may arise when the savings discount is introduced (see Recommendation 15). Options include a phasing in of the new rate of discount (the best approach) or introducing grandfathering provisions for existing assets. Grandfathering provisions, such as those in capital gains tax, tend to be long lived and are among the most complex provisions in the tax law, and should be avoided where possible.

For example, the discount for savings income and related expenses could be gradually increased from 0 per cent to 40 per cent over five years. A five-year transitional period could also apply for capital gains, with the current 50 per cent discount declining each year by 2 percentage points.

For ungeared capital gains assets, such a phase-in would reduce the likelihood of market disruption caused by the incentive to bring forward the realisation of capital gains between the time of announcement and the enactment of legislation. A phased reduction in the capital

gains tax discount over five years would offset the natural decline in the effective tax rate arising from the deferral benefits of a realisation-based capital gains tax (see Chart A1-24).

Chart A1-24: Real effective marginal tax rates on capital gains from a five year transition



Assumptions: Recommended approach introduced one year after capital gain asset is acquired; individual on 46.5 per cent marginal tax rate; 6 per cent nominal return; 2.5 per cent inflation.
Source: Treasury estimates.

For highly geared investors in rental properties, such transitional arrangements would achieve a smooth transition to an outcome that still provides some tax benefits relative to other investments, though significantly less than before. A smooth transition would limit any short-term disruptions in the supply of rental properties if some investors were to respond to the changed tax arrangements by selling out rather than adjusting their level of gearing.

As well as providing long-term benefits, reforms to address supply side constraints in residential housing markets would also assist with managing any transition and so would become more necessary. Reforms to State land taxes and stamp duties would be of some value in this regard, while there are also potential gains from improving the supply of housing and its responsiveness through other policy reforms, such as to planning and land release (see Section E4).

Treatment of dividends and other business and savings income

The Review has considered whether the savings discount should be extended to dividends, business income, other interest income and rental income from non-residential properties and other assets. Such an extension is not recommended for now, but could be reconsidered in the context of a long-term move away from dividend imputation. However, such consideration would need to account for the deferral benefits afforded by the difference between the company income tax rate and the personal income tax rates.

For larger, more internationally orientated companies, not providing the discount for dividends could partially offset the portfolio bias for domestic savers to hold domestic shares rather than debt and foreign shares. This bias arises to the extent that an imputation credit to resident shareholders is a refund for company income tax that they have not entirely borne given that Australia is an open economy (see Section B2).

Further, if the savings income discount was made available for dividends, there would be an incentive for owner managers to convert their labour income into profits. They could then effectively pay themselves a wage through a dividend of which only 60 per cent would be subject to tax, thereby undermining the tax base for income from work.

The labour to capital conversion problem also arises with non-commercial or non-arm's length loans and with rental income from non-arm's length commercial property. For example, if a discount applied to interest income there would be an incentive to convert business profits that represent the non-wage labour income of owner-managers into interest income from a loan provided by the owner at an artificially high rate of interest.

Nevertheless, excluding dividends and certain other types of income has some downsides. In particular, it would lead to a difference in the tax treatment between debt and equity for domestic savers. This would reduce the cost of debt finance, creating an incentive for domestic companies to finance new investment with debt to the extent that the financing choices of domestic companies reflect the availability of domestic capital. Excluding these items also gives rise to some of the boundary issues identified above.

For the longer term, however, a continuing trend of increased openness in the Australian economy suggests consideration may need to be given to moving away from dividend imputation as a means of integrating personal and company income tax (see Section B2 The treatment of business entities and their owners, Recommendation 37).

Longer-term options for dividends and business income

Under most alternatives to dividend imputation, a typical feature of the taxation of dividends is to provide double taxation relief, either through a discount or a low flat rate. As part of a move to such an alternative, a discount could directly apply to dividends from listed shares where the conversion of labour income into profits is less of an issue.

For unlisted businesses, however, providing relief to all business income would, as discussed above, be problematic. Such income often includes a mix of returns to the labour of the owner-managers as well as the capital employed in the business. On the other hand, if income from unlisted businesses is taxed in full, the savings income component could be over-taxed compared to income from listed companies, discouraging small business and entrepreneurial activity.

To address the difference between saving through widely-held listed shares and through a closely-held business, the savings income discount could be extended to business income through a business allowance. Internationally, business allowance systems are already used where there are dual income taxes, such as in the Scandinavian countries, to separate capital income from other income.

Business allowance systems split the net business income of sole traders, partnerships and trusts into labour and savings or capital components, with the discount applying to the capital component. A similar approach could apply to dividends received from unlisted companies, non-commercial loans and non-arm's length commercial property arrangements. Under the allowance system, owners of unlisted businesses (shareholders in unlisted companies, trust beneficiaries, partners or a sole proprietor) would receive an allowance for a deemed return on their equity (savings) in the business.

Extending the discount, or applying a flat tax rate, to all savings income would mean that many of the boundary issues previously discussed, and the differential treatment of debt and equity, would be of less concern. An allowance arrangement would however give rise to some complexity of its own, though allowance-like arrangements may be an appropriate way of dealing with non-arm's length interest payments.

As part of the longer-term consideration of alternative company tax arrangements and dividend imputation, consideration should therefore be given to extending the discount (or possibly a flat rate of tax on savings income) to all savings income.

Treatment of earnings from life insurance policies

Currently, life insurance providers are taxed at the company income tax rate on investment earnings from assets that support ordinary life insurance policies. Reversionary bonuses (or accumulated earnings) paid to policyholders when an insured event occurs, or when the policy is cancelled or matures after it has been held for more than 10 years, are tax free. Therefore, the policyholder is effectively taxed at the company tax rate on the earnings.

Where the policy is cancelled or matures after it has been held for eight years or less, the accumulated earnings paid to policyholders are taxed at marginal tax rates. A proportion of the accumulated earnings is taxed if the policy is cancelled or matures after it has been held for nine or 10 years. To the extent that the accumulated earnings are taxed, policyholders are entitled to a tax offset to prevent double taxation. Currently, the tax offset is 30 per cent of the taxable component of the earnings, a proxy for the company tax rate.

Accumulated earnings paid to policyholders should not benefit from the savings income discount. Life insurance policyholders would benefit from the recommended reduction in the company income tax rate to 25 per cent (see Recommendation 27), increasing the potential tax deferral advantages of life insurance. In addition, life insurance providers invest in assets that produce income, particularly dividends, that would not attract the discount.

Simplifying the taxation of capital gains

The regime for taxing business and savings income includes complex provisions that reflect the complexity of commercial activity, the increasing sophistication of financial instruments, and the wide variety of saving structures and intermediaries. There will be a continuing need to re-assess such provisions with a view to improving certainty, reducing administration and compliance costs, and dealing with design or integrity failings.

Particular emphasis should be placed on simplifying the rules directly affecting large numbers of individuals who are not equipped to deal with tax complexity. The capital gains tax regime is the primary example of such complexity, and should be simplified to reduce administration and compliance costs for individuals and small business in particular.

Capital gains tax is complex

A number of submissions to the Review have highlighted the complexity of the current capital gains tax regime. Principal drivers of the high administration and compliance costs include the complexity of the legislation, the frequency of changes to the legislation, the number of rules and exceptions, and record keeping requirements.

For individuals, shares and real estate give rise to the majority of taxable capital gains (see Table A1-7). Collectables and personal use assets generate little capital gains tax revenue.

Table A1-7: Total current year capital gains of taxable individuals by source (2006-07)^{(a)(b)}

Source of gain(c)	Number of individuals reporting gains	Value of capital gain (\$million)
Shares	436,395	20,415
Real estate	152,056	15,061
Other assets(d)	214,918	11,196
Collectables	1,120	67
Total number of individuals reporting gains	668,415(e)	46,739

(a) Refers to individual taxpayers with net tax payable greater than \$0 who completed a schedule.

(b) Includes data processed up to 31 October 2008.

(c) Sources include both active and non-active assets.

(d) Includes other capital gains tax assets and any other capital gains tax events.

(e) This is not the sum of figures in this column as individuals may report capital gains from more than one source, so that the total of individuals reporting gains from different sources will exceed the total number of individuals reporting gains.

Note: The figures in this table are derived from the capital gains tax schedule, which individuals who lodge a paper return are not required to complete. Therefore these figures cannot be directly compared to the statistics reported on net capital gains in *Taxation statistics*.

Source: ATO (2009).

The complexity of capital gains tax is compounded by the various exemptions and the grandfathering of previous provisions. For example, there are various concessions for small business, in addition to the general 50 per cent discount for individuals, while capital gains made on assets acquired before the introduction of the capital gains tax regime are generally exempt and the pre-1999 indexation arrangements remain available for assets acquired before indexation was abolished. A number of submissions also noted that the mechanical and prescriptive nature of the capital gains tax legislation adds significantly to administration and compliance costs.

Small business capital gains tax concessions

There are currently four separate small business capital gains tax concessions available to qualifying businesses or their owners: an exemption for capital gains made on active assets held for at least 15 years (generally available only to an individual aged 55 or over who retires); a retirement exemption for capital gains made on active assets up to a lifetime limit of \$500,000 per individual; a further 50 per cent discount for the sale of active business assets; and a small business roll-over, which allows deferral of a capital gain made on an active asset if within two years the proceeds are reinvested in another business asset.

There are currently two initial criteria a taxpayer must satisfy to be eligible for the small business CGT concessions: they must either be conducting a business with an aggregated turnover of less than \$2 million (the small business entity test) or they must have net assets of \$6 million or less (the maximum net asset value test).

The concessions are a significant area of complexity within the capital gains tax rules. In a survey of tax practitioners on the drivers of capital gains tax compliance costs, Evans (2004) found that the small business concessions ranked prominently (6 out of 18) in the list of factors. Despite attempts to simplify the concessions, taxpayers are required to navigate a legislative maze of gateway and threshold conditions and then additional conditions that relate to each of the specific concessions.

Evans also found that the concessions have become more complex over time. They have frequently been amended to extend their reach and to ensure that the concessions do not provide opportunities for tax avoidance. The outcome is provisions so complex that specialist professional advice is typically required to access them. Despite this complexity, but perhaps reflecting their value, the concessions are widely used (see Table A1-8).

Table A1-8: Number of claimants of the small business capital gains tax concessions, 2006-07

Concession	Companies	Individuals
15 year exemption	207	764
Retirement exemption	1,264	10,057
Active asset reduction	2,746	24,220
Rollover	519	4,676

Source: ATO (2009).

Finding

The current capital gains tax rules are particularly complex, with that complexity compounded by various exemptions and the grandfathering of previous provisions.

Simplifying capital gains tax

Recommendation 17:

The capital gains tax regime should be simplified by:

- (a) increasing the exemption threshold for collectables and exempting all personal use assets;
- (b) rationalising and streamlining the current small business capital gains tax concessions by:
 - removing the active asset 50 per cent reduction and 15-year exemption concessions;
 - increasing the lifetime limit of the retirement exemption by permanently aligning it with the capital gains tax cap for contributions to a superannuation fund; and
 - allowing taxpayers who sell a share in a company or an interest in a trust to access the concessions via the turnover test.
- (c) removing current grandfathering provisions relating to assets acquired before the commencement of capital gains tax, with a market value cost base provided for those assets when the exemption is removed, or before the end of previous indexation arrangements. A relatively long lead-time should be provided before these removals take effect; and
- (d) rewriting the capital gains tax legislation using a principles-based approach that better integrates it with the rest of the income tax system.

The capital gains tax system should be simplified by rationalising existing concessions, exempting certain assets, simplifying the legislative provisions, and removing some

grandfathering arrangements. While the Review has considered the potential benefits of an annual exemption, it is not clear that there would be net benefits from such an approach.

For any simplification of capital gains tax to substantially reduce overall complexity and compliance costs, trade-offs that favour simplicity over equity and efficiency would be required, as well as an acceptance that there would be losers as well as winners in respect of future tax liabilities. As a possible exception, in the medium to long term the greater use of real time reporting of taxpayer information from share registries could also significantly reduce the need for shareholders to retain records and calculate their own capital gains.

Rationalising and streamlining small business concessions

The small business capital gains tax concessions are a significant contributor to complexity and compliance costs. As discussed above in relation to income from work, taken together with the general 50 per cent capital gains tax discount the concessions also result in a highly favourable tax outcome for those small businesses benefiting from them. This outcome may skew the allocation of resources in the economy to less productive uses and detract from equity goals.

Rationalising the provisions – by removing the active asset 50 per cent reduction and the 15 year exemption – and streamlining the remaining concessions would reduce compliance costs as well as improve efficiency and equity around the treatment of earned income (see Recommendation 17b). The small business roll-over provision would be retained, as it has an efficiency benefit of reducing lock-in effects that prevent assets and businesses being reallocated and organised most productively.

Two of the existing concessions – the 15 year exemption and the retirement exemption – raise issues related to the self-employed and superannuation arrangements, and the principle that lifetime savings should face little or no income tax. Many self-employed people effectively use the accumulation of value in their business as a lifetime savings vehicle for their retirement. But the system should be simplified by providing the retirement exemption only.

Access to the retirement exemption should be increased and better aligned to concessions available within the superannuation system. The current lifetime contribution limit should be increased and permanently aligned to the cap for contributions to a superannuation fund derived from the disposal of small business assets. This would increase the current lifetime limit from \$500,000 to \$1.1 million (in 2009–10), and ensure the limit is indexed annually.

The small business capital gains tax concessions could also be rationalised and simplified by allowing taxpayers who sell a share in a company or an interest in a trust that is a small business entity to access the concessions using the turnover test. Under the current arrangements the concessions can only be accessed under the maximum net asset value test. Under the recommendation, owners of businesses who already access the other small business concessions will not need to determine eligibility under the maximum net asset value test, and instead rely on the same test used to access the other small business concessions.

Exempting certain assets can reduce compliance costs

The capital gains tax regime could also be simplified by exempting all personal use assets and increasing the exemption threshold for collectables. Currently collectables with a cost

base of \$500 or less and personal use assets that cost \$10,000 or less are disregarded for capital gains tax purposes.

All personal use assets should be exempt from capital gains tax, reducing compliance costs at minimal cost to revenue. Increasing the threshold for collectables would also reduce compliance costs, without establishing a tax bias to invest in high-value collectables (such as works of art).

Rewrite the capital gains tax rules

The complexity and uncertainty of the capital gains tax regime could also be reduced by adopting a principles-based approach to simplifying the legislative provisions. The current legislative provisions are prescriptive and mechanical. For example, under the current rules there are 53 separate capital gains tax events, five elements that make up an asset's cost base and five elements of an asset's reduced cost base, and an anti-overlap rule preventing double taxation through capital gains tax.

A principles-based approach could be used to reduce complexity while also increasing comprehension and awareness of the regime. Subject to consideration of the feasibility and net benefits of alternative approaches, a principles-based approach could build on the existing core capital gains tax concepts (such as events, cost base and capital proceeds) to minimise any impacts or disruption to other parts of the tax law that also use these concepts. Any redrafting should focus on the relationship of the capital gains tax regime to the rest of the income tax system.

In 2000, the Board of Taxation commissioned draft legislation on a more principled expression of the capital gains tax law (as part of a wider project known as the 'tax value method'). That redraft reduced 126 pages of capital gains tax law to only 28, without significant policy change. Though the government of the time decided against proceeding with the more ambitious project of which it was a part (and which the Review is not proposing be relaunched), the redraft highlighted the potential for significant legislative simplification.

More substantial simplification of the legislation would inevitably involve some policy change, with some taxpayers made worse off and others better off. Furthermore, while a principles-based approach has the potential to simplify the law, much of the complexity in the capital gains tax regime is due to concessions and the need to address integrity concerns. Whether such concessions or integrity provisions are worth retaining would need to be re-assessed.

Remove grandfathering provisions

The abolition of grandfathering for pre-capital gains tax assets and for pre-1999 indexation arrangements would reduce the complexity of the capital gains tax regime. Evans (1998) suggested that up to 20 per cent of the capital gains tax legislation is attributable to the decision to grandfather old provisions. Removing the grandfathering provisions would also improve the efficiency and equity of the system. For example, grandfathering increases the lock-in effect of a realisation-based capital gains tax, which can lead to inefficient resource allocation.

'Grandfathering' (that is, preserving the treatment of pre-existing arrangements when rules are changed) often occurs in response to concerns about the equity and efficiency

implications of a change in policy settings. However, it can add to the complexity of the tax system, particularly where its effects are long lived.

Capital gains tax only applies to gains made on assets acquired after 19 September 1985. While grandfathering reduced the impact of change for existing investors, more complex legislation is needed to maintain the exemption and prevent avoidance. For those holding grandfathered assets there would be compliance costs associated with ending grandfathering, but as the number of such assets declines over time the case for ending grandfathering becomes more compelling.

The indexation rules also contribute to the regime's complexity, although to a lesser extent than grandfathering. Indexation was phased out from September 1999 but remains available for assets acquired before then. It is likely that only a small number of taxpayers are currently better off under indexation relative to the outcome they would receive under the discount method with respect to capital gains unless they can offset such gains with relatively large capital losses.

Concerns over removing the pre-capital gains tax exemption could be offset to some extent by providing a market value cost base for remaining pre-capital gains tax assets at the time the exemption is removed. This would ensure that only capital gains that accrue going forward are taxable. Providing a relatively long lead time for such a change would also provide an opportunity for taxpayers holding pre-capital gains tax assets to dispose of those assets without capital gains tax consequences.

Taxing savings on an individual basis

One practical difficulty with taking the individual as the unit of assessment for tax purposes is the alienation of income from saving, where an individual can attribute their income to another person or legal entity. A particular issue is the difficulty in drawing a distinction between gifts to others and the assignment of income from assets to others.

A person can transfer ownership of an asset to another person. This can be done formally, or can happen naturally such as when a couple has a joint bank account or owns assets jointly. Income tax systems typically permit these gifts, with the future income from the gifted asset included in the taxable income of the other person. Such gifts, however, raise a question of whether gifts or other wealth transfers should be taxed (see Section A3).

Alternatively, a person can retain ownership of an asset but assign (pre-tax) income from the asset to another person or entity, for example, by legally assigning the right to any interest or dividend to another person, or settling the asset on a trust that then distributes the income to the other person. Income tax systems may not recognise these assignments, particularly where it is only the current income that is applied for the benefit of another.

However, there is no clear line between the gift of an asset and an assignment of the income from an asset. The value of an asset can be seen as the net present value of the expected, risk adjusted, future income stream from that asset. The assignment of part of the future income of an asset is simply the giving of another type of asset, that of the right to income for a defined period.

The relative ease with which savings income can be split between individuals, particularly within a household, may have implications for attempts to improve workforce participation by keeping the marginal personal income tax rates facing secondary earners low (see Section A1-1). Including the household's savings income in the secondary earner's income may increase their marginal tax rates, reducing incentives to work or to work more.

Attempts to limit assignments of savings or business income, from either a person's labour or savings can be constrained by practical considerations such as the difficulty of properly targeting any measures. For example, in the case of a family trust used in connection with a family business, the underlying ownership claims to the assets of the business and the contributions of unpaid labour by the different family members may be diffuse and complex.

Current rules only partly limit the alienation of savings income

For savings income, specific rules apply to limit the transfer of income from property, but transfers of property itself are generally effective in assigning future income to the recipient of the property (though on transfer capital gains tax may apply to any gains in the value of the asset that have arisen up to that point in time). Entities such as companies and trusts can also be used to split income from assets, while the underlying ownership or control of the assets remains unchanged.

A number of submissions to the Review raised concerns about the use of discretionary trusts, in particular, to split income. Trusts have the advantages of preserving tax preferences such as capital gains tax discounts and foreign tax credits. Companies allow deferral of any taxation above the company income tax rate, and the potential to smooth an individual's taxable income over time. Trusts and companies are often used together to obtain the particular tax benefits of each.

There are also instances where a (low-tax) beneficiary of a trust is taxed on trust income (for example, as they are considered to be presently entitled to the income) but the actual income is effectively provided to another. The different components of income associated with the same asset may also be allocated for tax purposes to the beneficiary best suited from a tax perspective to receive them. Those beneficiaries to whom the different types of income are allocated may change over time.

Finding

Current rules limit, but do not eliminate, the scope for the alienation or assignment of an individual's income to other persons or legal entities.

Options to further limit the alienation of savings income

The Review has considered options to further limit the potential to alienate savings income, particularly through the use of trusts. However, given the potential downsides of these options for the overall progressivity of the system or for other taxpayers, their adoption has not been recommended. The case for change is also weakened by the difficulty in drawing a line between allowing gifts and common ownership of assets within households and preventing income splitting.

Applying a flat rate of tax to savings income, from the first dollar, would remove all income tax advantages from income splitting. However, a discount for net interest, rental income

and capital gains would also flatten the income tax rates to some extent as they apply to nominal savings income. This would reduce the benefits from income splitting or deferring tax through sheltering income in a company.

For trusts, attributing income to the settlor of assets on the trust when they retain control would directly target the alienation of income. Foreign trusts are already subject to such rules for income tax purposes (the transferor trust provisions), and the transfer system adopts a similar approach to private trusts and companies. However, the administration and compliance costs associated with the general adoption of this approach in the income tax system is likely to be significant and enforcement would be difficult.

Another option considered would be to tax trusts, or discretionary trusts, as companies. Taxing trusts as companies does not directly address the problem of the alienation of income. Use of a trust would potentially confer tax deferral advantages (where the company income tax rate is less than the marginal tax rate of shareholders), while income could still be split between the various beneficiaries of the trust who could in turn benefit from refunds of any excess imputation credits.

Taxing trusts as companies could, however, indirectly limit income splitting by imposing tax penalties on the use of trusts, such as the non-flow through of capital gains discounts. But taxing trusts as companies would be poorly targeted, disadvantaging trusts not used for income splitting. Previous consideration of this option following the Review of Business Taxation also pointed to the practical difficulties involved (Board of Taxation 2002).

While the current income tax structure is broadly retained, the use of trusts for tax avoidance or evasion is, however, likely to remain an area of concern that may require targeted responses. The Australian Government has recently announced the introduction of tax file number reporting and associated withholding requirements for closely-held and family trusts. An updating and rewriting of the current trust income tax rules (Division 6) also has the potential to consider any abuses of current trust tax arrangements (Section B2 The treatment of business entities and their owners, Recommendation 36).

Annex A1: Concessional offsets in detail

This attachment outlines the concessional offsets that are available in the existing system and the proposed approach to reforming, removing or retaining them.

Dependency tax offsets – Dependent spouse tax offset

Taxpayers are eligible to claim a dependent spouse tax offset if they maintain a spouse on either a married or a de facto basis, and neither the taxpayer claiming the offset nor the spouse is entitled to Family Tax Benefit Part B. The offset subsidises the costs of maintaining a spouse who is not in the full-time workforce, and cuts out when the income of the spouse reaches \$8,917 (2008–09) or when income of the taxpayer reaches \$150,000. In 2006–07, around 354,000 taxpayers claimed the offset at a cost to the Government of approximately \$465 million.

The dependent spouse tax offset should be removed where it impacts on participation incentives and should be limited to circumstances where there is less concern about the impact on workforce participation of the secondary earner – for example, for dependants unable to work due to invalidity or for those over Age Pension age.

The dependency offsets should be combined into a single offset to provide a tax concession where the taxpayer is supporting either a dependant who is unable to work due to disability or carer responsibility or where the taxpayer or dependant has reached Age Pension age.

Dependency tax offsets – Invalid relative tax offset

The invalid relative tax offset is available to taxpayers who maintain an invalid brother, sister or child who has been certified by a medical practitioner as unable to work. In 2006–07, around 29,000 taxpayers claimed the invalid relative and parent/parent-in-law tax offset at a cost of \$43 million.

The means test applied to the invalid relative (which has an income cut-out point of \$3,448 in 2008–09) makes taxpayers ineligible where the invalid relative receives Disability Support Pension or an alternative income support payment.

Support to families maintaining invalid relatives is essential. It is best delivered through the transfer system via the non-means tested Carer Allowance supplementary payment and the means tested Carer Payment. The transfer system is well equipped to deal with these circumstances and is a timely and effective way of delivering assistance to those in need.

The tax system can play an additional role in providing an offset for invalid dependent relatives, although this requires a parallel system for assessing invalidity. The tax system should provide a tax offset for taxpayers who maintain and provide daily care and attention for a disabled relative where the dependant does not receive an income support payment. This should form a component of the new dependency offset.

Dependency tax offsets – Housekeeper tax offset

The housekeeper tax offset is a subsidy to taxpayers who engage a full-time housekeeper for their house. The housekeeper must care for a child under 21 years of age, invalid relative or spouse of the taxpayer who is receiving a Disability Support Pension. In 2006–07, almost 11,000 taxpayers claimed the housekeeper tax offset at a cost of approximately \$16 million.

The housekeeper tax offset should be replaced with the single dependency offset for those situations where the dependant or taxpayer is unable to work or is of Age Pension age.

Dependency tax offsets – Child-housekeeper tax offset

The child-housekeeper tax offset subsidises taxpayers where their child, adopted child or stepchild keeps house for the taxpayer full-time and has some responsibility for the general running of the household. The child-housekeeper does not have to care for a dependant. Around 2,500 taxpayers claim the child-housekeeper tax offset each year at a cost of around \$10 million.

The child-housekeeper tax offset should be removed, to encourage active engagement in study, training and work on the part of older dependent children. There are transfer programs that assist with the costs of undertaking work search, or full-time study or training.

Dependency tax offsets – Parent/parent-in-law tax offset

Taxpayers who maintain their parent or their spouse's parent may be eligible for the parent/parent-in-law tax offset. The means test applied to the parent or parent-in-law (which has a separate net income cut-out point of \$6,614 in 2008–09) makes taxpayers ineligible for the offset where the parent receives the Age Pension or some other form of income support. Assistance for taxpayers with dependent parents or parents-in-law is better provided through the transfer system. The tax system can play an additional role in providing an offset for dependent parents and parents-in-law aged over 65 who are ineligible for the Age Pension.

Mature age worker tax offset

The mature age worker tax offset (MAWTO) is a non-refundable offset with a complicated design. While it is intended to increase work incentives for older Australians, it is unclear whether it has achieved this goal. It is delivered at the end of the year (not through withholding tax arrangements). While it reduces effective rates of tax on earned income over one range of income, it increases them over another.

The MAWTO was introduced in the 2004–05 tax year for eligible Australian residents aged 55 or over who remain in the workforce. It offers a rebate of up to \$500 based on the amount of net income generated from working during the year. The amount of the rebate is not indexed. It is phased in at five cents per dollar of assessable labour income less related deductions, reaches the maximum amount when net income from working reaches \$10,000, and phases out completely when this type of income reaches \$63,000. As with other offsets, the benefit is received when tax is assessed.

The MAWTO should be removed. Removal of this and other offsets would facilitate lower tax rates and a higher tax-free threshold, which is a more effective way of encouraging workforce participation than offsets like the MAWTO.

Private health insurance tax offset

To encourage the take up of private health insurance the Australian government currently subsidises premiums based on a person's age (see Table A1–9). It does this through direct premium reductions or by providing individuals with assistance through the tax or transfer system.

Table A1–9: Amount of private health insurance subsidy, by age

Age of the oldest person covered by the policy(a)	Amount of the subsidy
Less than 65 years	30% of the amount of premium paid
65 years to under 70 years	35% of the amount of premium paid
70 years or over	40% of the amount of premium paid

(a) If the oldest person moves into the next age group during the year, the rebate is based on the number of days that person was in each group.

Source: ATO.

As a general principle, it is administratively costly to provide the same benefit through multiple mechanisms. This also makes it more complicated for people to decide how to claim the subsidy. Providing assistance as a direct premium reduction is more efficient than through a tax offset because a premium reduction provides timely assistance, particularly for those who are least able to afford the cost of insurance at the time it is purchased. It is also the most common method of claiming assistance.

Means testing subsidy entitlements risks inaccurate assessments of annual income and consequent debts. If government wishes to increase the fairness and sustainability of private health insurance subsidies, it could consider other ways of limiting the cost of the subsidy, such as limiting the type of eligible policies or capping the value of subsidies paid. If used as an alternative to means testing, these approaches could also facilitate the use of direct premium reductions as the sole method of subsidising private health insurance. This would simplify the system, increase transparency and make it easier for people to make decisions about their insurance cover.

Medical expenses tax offset

The Australian government assists people with very high unreimbursed medical expenses through the medical expenses tax offset. This provides a 20 per cent tax offset to taxpayers who have unreimbursed family medical expenses above \$1,500 in an income year.

Unreimbursed medical expenses include medical expenses which have been paid in full minus any refunds – for example, from Medicare or a private health insurer – that have been received, or that could have been received. Medical expenses that qualify for the offset include payments to doctors, dentists and optometrists. Other expenses, such as ambulance charges, do not qualify, while some expenses that are not covered by Medicare are covered by the offset. This can make it difficult for people to understand their entitlements. In 2008-09 this offset provided individuals with approximately \$440 million in assistance.

The offset does not provide assistance when the expense is incurred, as it can only be claimed at the end of the income year. A family that incurs significant medical expenses early in the financial year will have to wait some time to recoup part of the cost through the offset.

The offset must be claimed by an individual but is assessed on a family basis. This can make it difficult for people to decide which family member should make a claim for assistance. The design of the offset is also inequitable for single people as the amount of unreimbursed medical expenses they must incur before they can receive assistance is the same as for families. In addition, some low-income individuals and families with high medical expenses cannot claim the full value of the offset because they have an insufficient tax liability and the offset is not refundable.

For these reasons, the medical expenses tax offset should be removed and an alternative method for delivering safety net arrangements for individuals with very high medical expenses should be developed using (for example, Medicare safety net arrangements). In light of this, the Review supports the NHHRC's recommendation that the scope and structure of safety net arrangements be reviewed. The purpose of the review would be 'to create a simpler, more family-centred approach that protects people from unaffordably high' health care costs (National Health and Hospitals Reform Commission 2009).

Education tax refund

The education tax refund (ETR) was introduced for the 2008–09 tax year as a refundable offset to assist parents and independent students with certain prescribed education expenses (including computers) related to primary and secondary schooling. To be eligible, parents must meet the means test for Family Tax Benefit Part A (FTB A), and independent students must be in receipt of Youth Allowance, ABSTUDY or a like payment. An offset of 50 per cent of expenses up to an indexed maximum refund of \$375 for primary students and \$750 for secondary students is available.

As the refund is paid through the tax system, there is a time lag between when the expense is incurred and when the refund is received. More generally, payments such as the ETR, which are linked to receipt of other payments (in this case FTB A), effectively create 'sudden death' cut outs and result in very high (over 100 per cent) effective rates of tax at the point at which the main payment (FTB A) is extinguished.

The ETR should be removed from the personal tax system and replaced with automatic advance payments through the family payment system at the beginning of each school semester to those that meet the existing eligibility criteria. The *Back to School Bonus* would be an appropriate model.¹⁰ While eligibility for the rebate would no longer be contingent on the purchase of particular items, the proposed reform would reduce the compliance burden (substantiation requirements) for family payment recipients, provide more timely compensation and reduce complexity and administration costs in the tax system.

Entrepreneurs' tax offset

The entrepreneurs' tax offset (ETO) was introduced in 2005 to provide encouragement to entrepreneurs in the very early stages of business development. The ETO provides a 25 per cent tax offset on the annual income tax liability attributable to business income of very small businesses. Around 73 per cent of recipients of the ETO receive less than \$600 (though the maximum rebate is \$2,500). The ETO begins to phase out for businesses whose turnover exceeds \$50,000, and businesses with a turnover of \$75,000 cease to be eligible. Eligibility for the offset is also restricted through a means test on the claimant's other (non-small business) income.

Removing the ETO would reduce compliance and administration costs and provide a more equitable and neutral treatment between self-employment and employment income. The ETO is very complex to administer and provides problematic incentives related to business structure.

¹⁰ The *Back to School Bonus* is part of the Nation Building and Jobs Plan announced on 3 February 2009. It was a one-off, upfront bonus of \$950 paid to families eligible for FTB A for each eligible child of school age.

Overseas defence forces and civilian tax offsets

The overseas defence forces tax offset is available to members of the Australian Defence Force (ADF) serving in places where the nature of service is declared to be uncongenial and isolated. The overseas civilian offset is available to prescribed civilian personnel, such as Australian Federal Police (AFP) personnel, contributed by Australia to an armed force of the United Nations overseas.

For both offsets the annual amount is \$338 plus 50 per cent of any dependency tax offsets for which the taxpayer is eligible.

The important contribution of Australians serving overseas is best recognised through direct salary and wages, rather than delayed payments delivered through the taxation system. The overseas defence forces tax offset and the overseas civilian tax offset should be replaced with additional remuneration. This would simplify the tax system, while still recognising the specific hardships that members face while serving in particular places.

Zone tax offset

The zone tax offset (ZTO) is available to residents of particular areas in Australia, designated Zone A, Zone B and special areas within each zone. While the special areas are defined by reference to remoteness, and can shift as concentrations of population shift, Zones A and B have not been changed for some time. Special areas include places that are more than 250 kilometres by the shortest practicable surface route from the nearest town with more than 2,500 people, as of 1981.

For special areas the offset is equal to \$1,173 plus 50 per cent of the relevant rebate amount per year. For ordinary Zone A the offset is equal to \$338 plus 50 per cent of the relevant rebate amount per year. For ordinary Zone B the offset is equal to \$57 plus 20 per cent of the relevant rebate amount per year. The relevant rebate amount is the total of dependency offsets the taxpayer is eligible for, including notional offsets.

Data on the number of taxpayers claiming the ZTO is combined with the overseas forces offsets. In 2006–07 around 550,000 taxpayers claimed the ZTO or overseas forces offsets at a cost of \$234 million.

While the Review has not examined the ZTO in detail, it is notable that the zones do not appear to be determined by any modern concept of remoteness. The zones were established in 1945 and the boundaries have remained broadly unchanged since 1956. Given changes in population and the distribution of industry and transport infrastructure since 1956, many areas in the zones are not disadvantaged or isolated. On the other hand some remote areas fall outside the zones. For example while Darwin is in Zone A and Townsville and Cairns are in Zone B, Ivanhoe, in western New South Wales, with a population of around 250 and more than 200 kilometres from the nearest town with over 2,500 people, lies outside the zones.

The zone tax offset should be reviewed, with a view to providing assistance based on contemporary measures of remoteness.

Notional tax offsets

In general there are three categories of notional dependant tax offsets: the sole parent offset, the dependent spouse with child offset, and the dependant child offset (where the amount of the offset depends on the number of children and whether the child is a student). Although

these offsets have been abolished in their own right, they are still used to determine a taxpayer's eligibility for the zone, overseas forces and medical expenses tax offsets and for determining the amount of the Medicare levy family income threshold offsets.

For example, taxpayers who are living in a zone or are on eligible overseas service and who are sole parents or have a dependent spouse or child are eligible for an increased amount of ZTO or overseas forces offset as a result of the notional tax offsets. The notional dependent spouse with child tax offset of \$2,508 allows a taxpayer who qualifies for the ZTO an additional offset of \$1,254 if they are a resident of a special area or ordinary Zone A, or \$502 if they are a resident of ordinary Zone B.

The notional tax offsets should be removed.

Averaging tax offsets – Employment termination payment tax offset

Historically, payments made in respect of termination of employment have been taxed at a concessional rate. The employment termination payment tax offset limits the maximum rate of tax applied to taxed elements of employment termination payments.

The taxable component of an employment termination payment up to \$145,000 (in 2008–09) is taxed at 15 per cent if the recipient is at or above preservation age, and at 30 per cent if they are under preservation age. Amounts received in excess of this threshold are taxed at the top marginal tax rate. The offset was introduced in 2007 as part of the *Better Super* changes to replace previous arrangements under which the concessional taxation treatment of employment termination payments was aligned with the taxation arrangements applying to superannuation benefits. A limit to the concessional treatment of these payments was introduced, because they could less clearly be characterised as retirement-related.

The existing arrangements are complex and the income threshold for the concession differs significantly from the marginal tax rate thresholds. In addition, the concession is provided for generous 'golden handshakes' as well as for unpaid salary.

Elements of employment termination payments, such as 'golden handshakes', should be treated as income and taxed at marginal rates. Over time, the remaining concessions in relation to these payments should be removed and the payments taxed as income.

Averaging tax offsets – Lump sum in arrears tax offset

The lump sum in arrears tax offset limits the tax payable on the arrears component of eligible lump sum income that accrued in earlier years, such as salary or wages that accrued during a period ending more than 12 months before the date on which they were paid. It reduces the tax liability to what it would have been if the income had been received in the year(s) in which it accrued. The offset enables smoothing of tax liabilities where taxpayers receive lump sum income. The offset ensures that a taxpayer who receives a lump sum is not penalised through a higher tax liability purely because of the timing of the payment which may be out of their control.

The lump sum in arrears tax offset should be retained.

Averaging tax offsets – Medicare levy surcharge lump sum payment in arrears tax offset

The Medicare levy surcharge lump sum payment in arrears tax offset provides an offset to taxpayers who have incurred a Medicare levy surcharge liability or an increased liability in

the current year due to the receipt of an eligible lump sum payment in arrears. It ensures that any Medicare levy surcharge liability arising from receipt of an eligible lump sum payment in arrears, such as a workers compensation payment, is offset.

The Medicare levy surcharge lump sum payment in arrears tax offset should be retained if the Medicare levy surcharge is retained.

Other averaging offsets

A taxpayer with income from primary production may have their income from previous years averaged out over a period of up to five years. This is designed to ensure that a primary producer with a fluctuating income is taxed comparably to a person with a steady income stream. Where tax on the current year's income would exceed the tax on the average income amount, the taxpayer is eligible for an offset equal to the difference. Where tax on the current year's income would be less than the tax on the averaged income amount they incur an additional tax liability.

A taxpayer who is a 'special professional' – an author, inventor, performing artist, production associate or sports person – is also able to use an income averaging scheme under which the tax payable is calculated by applying to the total amount of 'above-average' special professional income the average rate of tax that one-fifth of that amount would have borne if it had been the top slice of the taxpayer's taxable income in the relevant income year. Averaging plays an important role in ensuring reasonable treatment for primary producers and special professionals.

The averaging arrangements for primary producers and special professionals should be retained.

Superannuation tax offsets – Spouse superannuation contributions offset

The spouse superannuation contributions tax offset should be removed. Under the proposed superannuation contribution rules, all contributions would be eligible for an offset. The spouse superannuation contribution tax offset would no longer be necessary.

Other offsets for individuals

There are a number of other smaller offsets that would need to be considered on a case-by-case basis if the number of offsets were to be reduced further. In general, tax offsets should not be used to provide assistance to groups or individuals. This should instead be done through direct government spending, including through the transfer system.

Unused annual leave tax offset

This offset applies to unused annual leave accrued before 18 August 1993 or made in connection with a payment that includes or consists of a genuine redundancy payment, payment from an approved early retirement scheme or a payment that consists of an invalidity segment. The offset limits the rate of tax on the unused annual leave payment to 30 per cent.

Unused long service leave offset

This offset applies to unused long service leave accrued before 18 August 1993 and to genuine redundancy payments, early retirement scheme payments and an invalidity segment of an employment termination payment or superannuation benefit

post-18 August 1993. The offset limits the rate of tax on the unused long service leave payment to 30 per cent.

Payments for unused annual leave and long service leave should be treated as income and taxed at marginal tax rates.

A2. Retirement incomes

Key points

The retirement income system will face challenges as the 21st century unfolds. These include the ageing of the population, longer life expectancies and more people interacting with the system. A key finding of the Review's strategic report on the retirement income system, released in May 2009, was that the current three-pillar retirement income system is well placed to deal with these challenges.

Many OECD countries tax retirement savings using an expenditure tax benchmark linked to personal income tax. Such a treatment is consistent with encouraging retirement saving, which is important in the context of population ageing. The Review recommends a number of tax changes to retirement saving that would combine to achieve a similar outcome as in these OECD countries.

The Review recommends that employer superannuation contributions be treated as employee income, with employees receiving a flat-rate tax offset. This would result in a more equitable distribution of tax concessions between low- and high-income earners. Access to concessions should be broadened by making voluntary contributions eligible for the offset. Retirement incomes should be improved by removing the tax on superannuation contributions currently payable by the fund, and halving the tax on superannuation fund earnings to 7.5 per cent.

These changes would address equity concerns with present arrangements, simplify the taxation of superannuation and improve retirement incomes, but they may not be sufficient to enable people to effectively manage their retirement incomes for longer as life expectancies increase. The current retirement income system does not provide the products that would allow a person to manage longevity risk. This is a structural weakness. The government should support the development of these products and better facilitate their provision by the private sector. This could be achieved through issuing long-dated bonds and removing rules that restrict the development of income stream products. The Review Panel is not convinced, however, that the purchase of such products should be made compulsory.

The government has a role in improving people's awareness of the retirement income system. Arrangements could be improved by requiring superannuation guarantee contributions to be paid at the same time as wages, linking superannuation records and developing a single portal through which people could interact with government agencies.

A2-1 The strategic report into the retirement income system

The retirement income system is facing challenges that will test it as the 21st century unfolds. These challenges include the ageing of the population, longer life expectancies and more people interacting with the system.

The Review made some key findings and recommendations on the retirement income system in its strategic report released in May 2009 (AFTS 2009). The report assessed the retirement income system against the following five objectives:

- It should be *broad and adequate*, in that it protects those unable to save against poverty in their old age and provides the means by which individuals must, or can, save for their retirement.
- It should be *acceptable* to individuals, in that it considers the income needs of individuals both before and after retirement, is equitable and does not bias inappropriately other savings decisions.
- It should be *robust*, in that it deals appropriately with investment, inflation and longevity risk.
- It should be *simple and approachable*, in that it allows individuals to make decisions that are in their best interests.
- It should be *sustainable*, in that it is financially sound and detracts as little as possible from economic growth.

The key finding of the retirement income report is that the three-pillar architecture of the current system is well-suited for a balanced and flexible response to the challenges it faces and should be retained. The three-pillar architecture consists of the means tested Age Pension, compulsory saving through the superannuation guarantee and voluntary saving for retirement.

The retirement income report recommends maintaining the superannuation guarantee at 9 per cent and gradually increasing both the Age Pension age and the superannuation preservation age to 67. The retirement income report deferred some issues until this Report:

- the taxation of superannuation;
- arrangements for dealing with longevity risk;
- public awareness of the retirement income system;
- a single means test for income support payments; and
- the interactions between the tax and transfer systems and aged care.

The first three issues are considered in this section of the Report, while means testing and aged care are considered in sections F2 and F7 respectively.

A2–2 Taxing retirement incomes

Superannuation is the main form of lifetime saving outside the family home. There is a bias in the current taxation system against long-term saving, particularly lifetime saving such as superannuation. There are at least two reasons for taxing superannuation more favourably than other saving (with the exception of housing) to reduce this bias.

The first reason is that taxing superannuation earnings, like the earnings on most forms of savings, means that the effective rate of tax on the real value of saving increases the longer an asset is held (see Section A1 Personal income tax). This effect is more pronounced in superannuation than other savings as superannuation saving is generally held for a longer time. This justifies a more favourable tax treatment.

The second reason is that superannuation is a form of deferred income. People should be taxed on superannuation at the rate that would apply if their income had been spread over their entire life rather than merely over their working life. This is an income-smoothing argument. As a person's retirement income is generally lower than their income while they were working it should be taxed at a lower rate.

Many OECD countries deal with the effects of inflation and income-smoothing by taxing retirement benefits at a person's marginal tax rate, and exempting contributions and earnings from income tax. This is an example of an expenditure tax treatment of savings (see Box A2-1). The Australian approach is, instead, to achieve an approximation to the expenditure tax treatment by embedding superannuation concessions in an income tax framework.

Box A2-1: Tax benchmarks for retirement savings

The return to savings is made up of a number of components including compensation for deferring consumption (the 'risk-free' or normal return), a return to risk-taking and economic rent (see for example, US President's Tax Reform Panel 2005).

Most countries' retirement income systems use an expenditure tax benchmark. There are two types of expenditure tax benchmarks: pre-paid and post-paid.

A pre-paid expenditure tax is based on direct taxation of labour income with an exemption for income from saving. That is, all components of the return to savings are exempt from tax. Under the pre-paid expenditure tax benchmark, superannuation contributions are taxed at an individual's personal tax rate with both earnings and benefits tax-exempt.

A post-paid expenditure tax is based on the taxation of a direct measure of expenditure or of goods and services. This differs from a comprehensive income tax in that it exempts the normal return to saving. The return to risk-taking and any additional returns are treated similarly under both an income tax and a post-paid expenditure tax. Under the post-paid expenditure tax, both contributions and earnings would be tax-exempt but benefits would be fully taxable when paid.

In Australia, both contributions and earnings are included as income in the superannuation fund and taxed, generally at 15 per cent, while superannuation benefits are tax-exempt when paid after the age of 60. The terms of reference of this Review preclude it from considering the tax-free status of superannuation payments for the over-60s.

It is possible, however, to achieve a system that provides a similar tax outcome as other OECD countries. This system would tax contributions at a rate lower than the marginal tax rate on employment income and have earnings and benefits largely tax-free. As savings are taxed only once — on contributions — this is another type of expenditure tax of retirement savings. The Review's recommendations in this section — to tax contributions at marginal

tax rates with a capped offset, and with a very low tax rate on earnings — combine to achieve this outcome.

In considering the equity of the superannuation tax concessions, the Review has had regard to whether people on different incomes are treated consistently and whether people can readily take advantage of the tax preferences. Rules that restrict access to concessions based on a person's employment arrangements, such as whether their employer allows salary sacrifice contributions, mean that people in similar circumstances can receive different outcomes.

Principles

Superannuation's sole purpose is to provide a lifetime savings vehicle, and savings should be invested to maximise returns without being subject to competing policies that would require, for example, specific asset allocation. Given this lifetime savings purpose, superannuation should receive preferential income tax treatment compared to other savings. As the Review's terms of reference rule out taxing superannuation benefits, the key taxing point must continue to be superannuation contributions.

The objectives for the taxation of superannuation savings should be to:

- provide an equitable distribution of concessions for people with different incomes, consistent with the degree of progressivity in the personal income tax rates scale;
- encourage saving for retirement;
- make it simpler for people to get access to concessions; and
- ensure the sustainability of the retirement income system into the future.

The equity, complexity and adequacy impacts of the current tax arrangements

A flat rate of tax (15 per cent) generally applies to the income of a superannuation fund, which includes contributions and earnings during the accumulation stage.

Many submissions to the Review have stated that taxing contributions at a flat rate of 15 per cent is unfair to low-income earners. They argue that many low-income earners would pay less tax if the contributions were paid as wages. They note that low-income earners receive a significantly smaller concession than high-income earners.

Based on the 2008–09 tax rates, around 1.2 million individuals do not receive a personal income tax benefit from their concessional superannuation contributions. An additional 1.2 million people receive a concession of only 1.5 percentage points (Treasury 2008). This compares with around 200,000 taxpayers (those earning more than \$180,000) who receive a concession on their superannuation contributions of 31.5 per cent.

Different types of superannuation contributions receive tax concessions in different ways. An employee effectively receives a deduction for contributions made from pre-tax income (that is, superannuation guarantee and salary sacrifice contributions). A person who is

self-employed can also claim a deduction for contributions. Contributions made from post-tax income may be eligible for the government superannuation co-contribution or superannuation spouse contribution tax offset.

Providing different concessions for different types of contributions can complicate planning for retirement. For example, to get the full value of the concessions on their saving, a person who is eligible for the superannuation co-contribution may have to make a contribution from their post-tax income and a salary sacrifice contribution.

Table A2-1 shows how the type of contribution affects the concessions from a \$1,000 contribution made by a person who earns \$40,000 a year. Such a person is entitled to a co-contribution that matches their post-tax contribution on a dollar for dollar basis, but this is capped at \$1,000. The maximum co-contribution reduces by 3.33 cents for every dollar the person earns above \$31,920. Accordingly, the person's maximum co-contribution is \$731. A post-tax contribution above \$731 is not eligible for a co-contribution, so a person should make a salary sacrifice contribution of \$269 to maximise their concessions.

Table A2-1: Value of tax concession for a \$1,000 contribution

	\$1000 salary-sacrifice contribution	\$1,000 post-tax contribution	Split contribution (\$731 post-tax, \$269 salary-sacrifice)
Value of tax deduction (salary-sacrifice)	\$355	Nil	\$95
Value of co-contribution (post-tax contribution)	Nil	\$731	\$731
less: tax in fund	\$150	Nil	\$40
Total value of concession	\$205	\$731	\$786

Note: The value of the deduction depends on the person's marginal tax rate (30 per cent), Low Income Tax Offset phase-out plus the 1.5 per cent Medicare levy.

Source: Treasury estimates.

Submissions also argue that the current system is unfair because it does not allow employees a deduction for personal superannuation contributions. Some employees can avoid this restriction by sacrificing part of their remuneration for additional employer contributions. However, not all employers offer salary sacrificing arrangements. This creates an inequity between people whose employer provides salary sacrifice and those whose employer does not. Aged-based restrictions also mean that people cannot make superannuation contributions from age 75.

Taxing superannuation contributions in the fund reduces the value to the employee of the 9 per cent superannuation guarantee contribution rate to 7.65 per cent. This reduces the adequacy of the superannuation guarantee system in an inequitable way.

Findings

The structure of the existing tax concessions is inequitable because high-income earners benefit much more from the superannuation tax concessions than low-income earners.

The complexity of the tax arrangements imposes an unnecessary cost on individuals in gaining access to concessions. Complexity also adds to the administration costs of superannuation funds, which affect retirement incomes.

Access to concessions should not depend on an employer's remuneration policies, such as whether a person can make salary sacrifice contributions. The age limit on who can make superannuation contributions also limits access to concessions.

Taxing superannuation contributions reduces the level of superannuation guarantee contributions invested in the fund. This limits the adequacy of the superannuation guarantee in providing for retirement incomes in a way that is inequitable for low-income earners compared with other saving alternatives.

A new arrangement for taxing superannuation contributions

Recommendation 18:

The tax on superannuation contributions in the fund should be abolished. Employer superannuation contributions should be treated as income in the hands of the individual, taxed at marginal personal income tax rates and receive a flat-rate refundable tax offset.

- (a) An offset should be provided for all superannuation contributions up to an annual cap of \$25,000 (indexed). The offset should be set so the majority of taxpayers do not pay more than 15 per cent tax on their contributions. The cap should be doubled for people aged 50 or older.
- (b) An annual cap on total contributions should continue to apply.
- (c) The offset should replace the superannuation co-contribution and superannuation spouse contribution tax offset.
- (d) Compulsory superannuation contributions made by employers should not reduce eligibility for income support or family assistance payments. They should also not form part of the calculation for child support.

The taxation of superannuation contributions has a significant effect on the system's equity, simplicity and ability to encourage retirement saving. It also affects a person's retirement income and the sustainability of the superannuation tax arrangements.

The Review recommends removing the taxation of superannuation contributions within a superannuation fund and replacing it with a system that is more equitable, simple and provides higher retirement incomes.

Superannuation contributions should be taxed at a progressive but concessional rate. This would be achieved by treating employer superannuation contributions as income in the

hands of the employee, taxed at marginal personal income tax rates. A flat-rate refundable tax offset, payable to the individual, would apply to these contributions to ensure that investing in superannuation retains its preferential tax treatment over other types of saving.

The offset should be available in respect of employer contributions as well as other contributions made by, or on behalf of, a person. This would provide a more consistent treatment for all contributions regardless of their source. The offset would also apply to contributions made by people who are not employees, such as the self-employed. This would replace the deductions that currently apply to these contributions.

The rate of the offset should be set so that the effective tax rate (marginal tax rate less offset) on superannuation contributions, up to a cap, remains at 15 per cent for a person on the standard marginal tax rate. The standard rate is the rate that applies to the majority of taxpayers. Under the indicative personal income tax rates scale in Section A1-1 The structure of personal income tax, this would be 35 per cent.

Taxing contributions within the superannuation fund would no longer apply. This means that the full amount of contributions (both superannuation guarantee and salary sacrifice contributions) would be invested in the fund on behalf of the person. The effect of this change, along with recommended changes to the taxation of superannuation fund earnings, would be to increase a person's superannuation assets at retirement. For example, the superannuation assets of a person on Average Weekly Ordinary Times Earnings (AWOTE)¹¹ would increase from over \$440,000 to over \$570,000 after a full working life. (For more detail, see 'Effects of recommendations on retirement income' later in this section.)

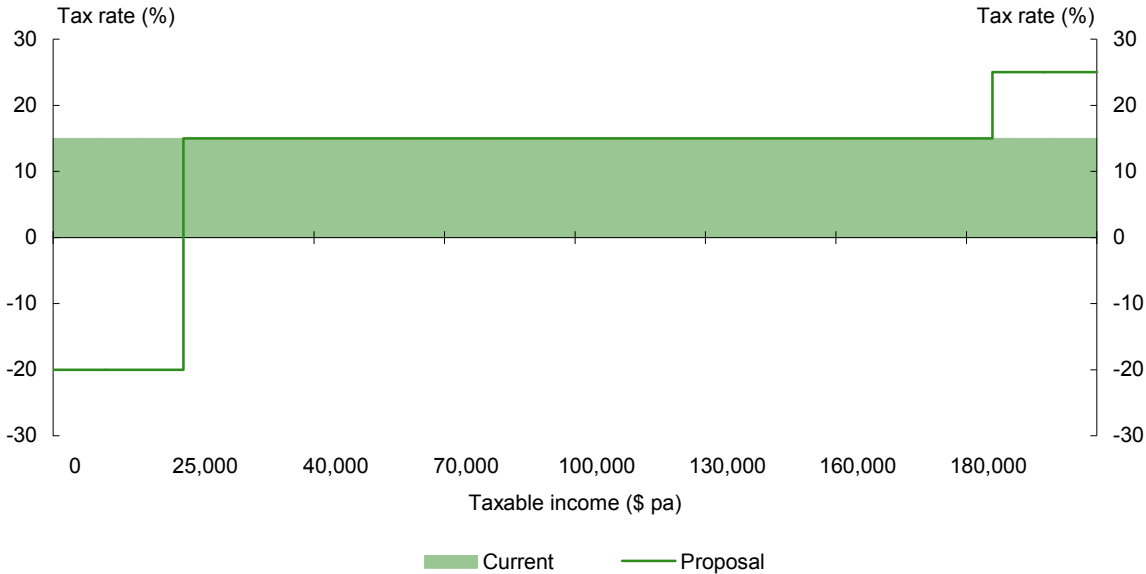
Improving the distribution of concessions

The recommendation would integrate employer superannuation contributions into the personal income tax system. This, along with the flat-rate tax offset, would increase the equity of the superannuation system by increasing the progressivity of the taxation of superannuation contributions (see Chart A2-1).

Under the recommendation, a person with income below the tax-free threshold would not pay tax on their superannuation contributions. The effective tax rate on contributions would remain at 15 per cent for the majority of income earners and increase for higher-income earners. People who have income below the tax-free threshold would pay no tax on their contributions but would still be eligible for the offset, while people on the highest tax rate would pay more than 15 per cent.

¹¹ AWOTE is currently around \$1,200 per week (\$62,400 per year).

Chart A2-1: Progressive taxation of superannuation contributions



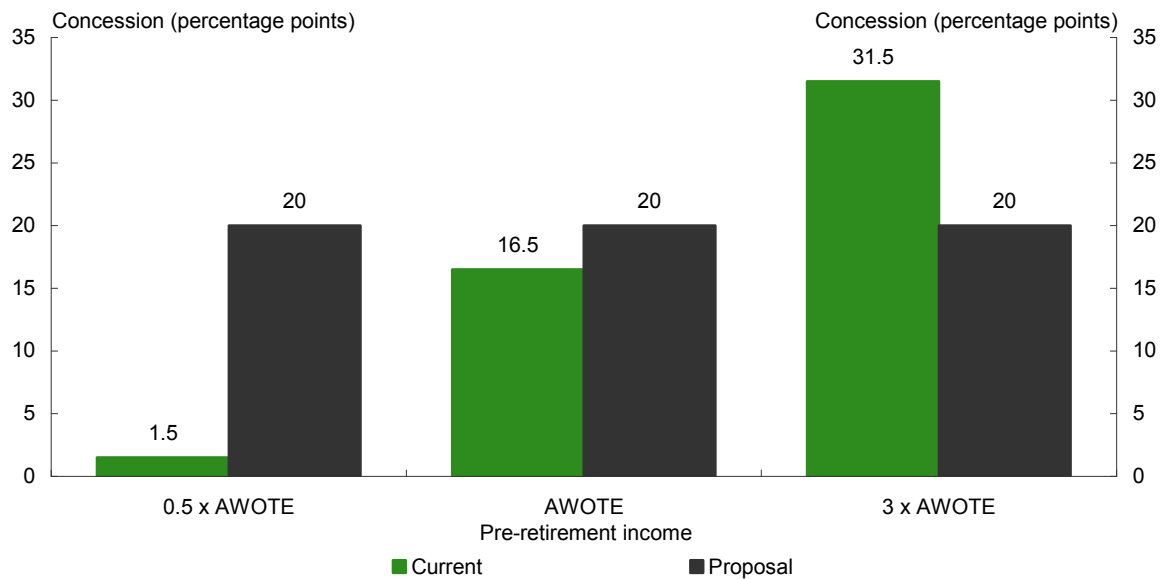
Note: This chart is based on the indicative personal income tax rates scale in Section A1-1. Source: Treasury estimates.

The recommendation provides for a similar tax result to that in OECD countries that only tax benefits at marginal tax rates (rather than contributions and earnings). In these systems, a person generally has less income in their retirement than when they were working. This means they would pay a lower average tax rate on their retirement income compared to their pre-retirement income. The offset replicates this effect by reducing the tax rate paid on superannuation contributions compared to the tax rate paid on a person’s working income.

Under the recommendation, the maximum concession a person could receive on their contributions would be the value of the offset (in this example, 20 per cent). The level of concessions for low-income earners on their employer contributions would increase significantly while the concessions for high-income earners would decrease. This would target the concessions more effectively by increasing the savings of lower-income earners (see Chart A2-2).

The OECD (2007a) considers that the distribution of concessions is an important indicator of the success of concessional saving vehicles. It found that a policy is more effective if it increases the retirement savings for people on low to moderate incomes, as high-income earners are more likely to switch their savings to the preferentially taxed vehicle. Although concessions for higher-income earners would decrease under the recommendation, the offset would still provide a substantial incentive for them to make voluntary superannuation contributions.

Chart A2–2: A more equitable concession for contributions
Based on a 20 per cent offset^(a)



(a) The chart assumes a single person who does not receive income support. The figures for the current situation are based on the 2009–10 marginal tax rate schedule with Medicare levy. In this case, a person on 0.5 x average weekly ordinary time earnings (AWOTE) has a marginal tax rate of 16.5 per cent, a person on AWOTE has a marginal tax rate of 31.5 per cent and a person on 3 x AWOTE has a marginal tax rate of 46.5 per cent. AWOTE is currently around \$1,200 per week (\$62,400 per year). Around half of workers earn less than three-quarters of AWOTE.

Note: The recommended concessions are based on the indicative personal income tax rates scale in Section A1–1.

Source: Treasury estimates.

Simplifying the system for individuals and superannuation funds

Moving to a single offset would simplify the system for many individuals. To get the maximum tax concession out of the current superannuation arrangements, many people must enter into an arrangement with their employer to make a contribution. In some cases employees are charged a fee to have these contributions made on their behalf.

Moving to an offset for all superannuation contributions would allow a person to deal directly with their superannuation fund. This would remove the third-party arrangements with employers that currently exist in the system. It would also increase the transparency of the superannuation contribution concessions by collapsing the existing different concessions into one (see Chart A2–3). This would remove the need for individuals to seek tax planning to optimise the structure or pattern of contributions. This tax planning also increases the costs individuals can face when making a decision whether to make voluntary superannuation contributions.

Chart A2-3: A more consistent treatment of superannuation contributions

Current contributions tax in fund						Proposed
Employer		Employee	Self-employed		Spouse	
Super guarantee	Salary sacrifice	Post-tax	Pre-tax	Post-tax		NO TAX
15%	15%	N/A	15%	Nil	Nil	
Current other personal income tax						Proposed
Employer		Employee	Self-employed		Spouse	
Super guarantee	Salary sacrifice	Post-tax	Pre-tax	Post-tax		MARGINAL TAX RATE (0-45%) ^(a)
Nil	Nil	Marginal tax rate (0 -46.5%)	Nil	Marginal tax rate (0 -46.5%)	Marginal tax rate (0 -46.5%)	
Current concession						Proposed
Employer		Employee	Self-employed		Spouse	
Super guarantee	Salary sacrifice	Post-tax	Pre-tax	Post-tax		FLAT-RATE TAX OFFSET
Marginal tax rate less 15%	Marginal tax rate less 15%	Co-contribution (if eligible). No concession if not eligible for co-contribution.	Marginal tax rate less 15%	Co-contribution (if eligible). No concession if not eligible for co-contribution.	Spouse superannuation tax offset	

(a) Based on the indicative personal income tax rates scale in Section A1-1.

There would also be benefits for superannuation funds. Currently, funds must know whether contributions are taxable or non-taxable as they are received. Under the recommendation, funds would treat all contributions the same, making for a simpler system to administer.

Government superannuation co-contribution and spouse offset

The government superannuation co-contribution provides an incentive for low- to middle-income earners to make additional superannuation contributions. Under the scheme, a person must make a personal contribution out of their post-tax income. The government matches this dollar-for-dollar up to a maximum of \$1,000 for people on incomes up to \$31,920 (indexed). The value of the co-contribution reduces, and phases-out completely once a person's income is \$61,920 (indexed).

Only around 20 per cent of people who would be eligible for a co-contribution currently make the necessary contribution to a fund. Many people earning less than \$31,920 may find it hard to set money aside for an additional contribution. For such people the co-contribution provides no ongoing benefit as they are unable to make a contribution every year.

The abolition of the tax on their contributions, along with the offset, would provide a more effective way to increase the retirement income of low-income earners whose main source of retirement savings is their superannuation guarantee contributions. The offset would also provide a concession for voluntary savings. Therefore, it is recommended that the co-contribution be repealed.

Taxpayers can currently also claim a tax offset if they make post-tax superannuation contributions on behalf of a low-income or non-working spouse. The maximum offset for a year of income is \$540. This offset should also be abolished and be replaced by the offset applying to all contributions.

Ensuring the sustainability of the superannuation contribution tax offset

The purpose of the offset would be to provide a concession for people who want to save for their retirement. While an offset may not be as generous as the current arrangements for some taxpayers, it is still a substantial concession. The retention of a cap on concessions is therefore necessary to ensure their sustainability. The Review recommends a cap of \$25,000 (indexed) be applied to the amount of contributions eligible for the offset. This is equivalent to the current cap on concessional superannuation contributions.

However, many people who have extended periods outside the workforce, such as carers and middle-aged migrants, may not have had the ability to make concessional contributions over a full working life. These people should be able to make additional concessional contributions when they have the capacity to do so. Currently, there are transitional arrangements in place that allow a person aged 50 and over to make \$50,000 of concessional contributions in a year. These arrangements are due to cease from 1 July 2012 when the cap will reduce to \$25,000. The Review recommends that the cap remain at double the rate of the normal cap beyond this date for people aged 50 and over (see Recommendation 18a).

A cap should also continue to apply to total superannuation contributions (currently \$150,000 a year), with the existing excess contributions tax applying to contributions above the cap. People should still be able to bring forward three years of contributions into one year before the age of 65.

Arrangements should be put in place to reduce the ability of a person to arrange their affairs to receive an offset. For example, contributions up to the value of a person's taxable or earned income should be eligible for a refund. This would discourage people from entering into short-term arrangements, such as borrowing, to get the benefit of the offset rather than increase their retirement income.

Also, the amount of offset should be available only for contributions in excess of an amount withdrawn from superannuation during the year. This would limit the ability of a person to churn amounts through superannuation purely to gain the value of the offset. For example, a person aged 65 and over has unlimited tax-free access to their superannuation. It would be possible for them to withdraw an amount from their superannuation fund, re-contribute it back into superannuation, access the concession and withdraw the contribution immediately. In this case, there would have been no increase in their retirement savings but they would be eligible for the full value of the offset.

Effect of recommendation on income

Under the recommendation, employers would withhold the amount of tax owing on the contribution from the employee's salary or wages, thereby reducing their disposable income. The offset would, however, act to reduce the impact on disposable income.

The effect would be to move the taxation of contributions from the superannuation fund to the individual. Taken in isolation from other changes to personal income tax, this would decrease their disposable income. It would, however, increase their retirement income, as the fund would no longer pay tax on their contributions. In this respect, the proposal is similar to requiring employees to make an additional compulsory contribution into superannuation.

Transitional arrangements

Some people would be able to reduce the effect of the proposal on their take-home pay by reducing their voluntary saving. For example, as the effect of the recommendations would be similar to an additional compulsory contribution, people who currently voluntarily contribute more than 9 per cent of their salary into superannuation could reduce this amount. In some cases, the reduction in contributions would offset the reduction in take-home pay without reducing their overall investment in superannuation.

Arrangements could also be put in place to reduce the immediate impact of the changes on disposable income. For example, the changes could be implemented as part of the broader plan to reform the personal tax system. Another option would be to start with a higher offset that would gradually phase down to the ongoing offset rate over a transition period. This rate could be set so there is no effect on disposable income for a person on the 35 per cent tax rate in the first year. Reducing the offset would transfer most of the effect on income through a reduction in real take-home pay increases. This would be similar to the effect on pay resulting from an increase in the superannuation guarantee rate. The amount of tax payable on contributions could also be phased down over the same period.

Effect on government payments and child support

Eligibility for government payments such as Family Tax Benefit and Newstart Allowance should not be affected by the recommendations. Eligibility for these payments should be based on a person's ability to meet day-to-day expenses from their accessible income and assets. As the superannuation guarantee contributions must be paid into a superannuation fund, they cannot generally be used to support a person with their day-to-day living expenses until they retire. Recommendation 18d proposes that arrangements be put in place to ensure compulsory superannuation contributions do not affect eligibility for government payments. For the same reasons, compulsory superannuation contributions should not be included when determining an individual's child support obligations.

The taxation of earnings

Recommendation 19:

The rate of tax on superannuation fund earnings should be halved to 7.5 per cent. Superannuation funds should retain their access to imputation credits. The 7.5 per cent tax should also apply to capital gains (without a discount) and the earnings from assets supporting superannuation income streams.

Currently superannuation earnings are taxed at 15 per cent while they accumulate in the fund, with certain capital gains taxed at 10 per cent. If benefits are paid as an income stream, such as a pension or annuity, the earnings on the assets supporting the income stream are not subject to tax.

Because superannuation is a lifetime savings vehicle, the compounding effect of interest has a significant influence on how much superannuation a person can accumulate. The taxation of earnings reduces this compounding effect. It is therefore appropriate that earnings are taxed at a low rate. For the sake of simplicity this should be at a low flat rate within the fund without reference to the marginal tax rate of fund members.

Consistent with this, the tax rate on earnings should be halved to 7.5 per cent. This would mean that the tax paid on the earnings of an average superannuation fund would be close to zero after allowing for the effect of imputation credits. This rate should also apply to capital gains (without a discount) and to earnings supporting income streams. In the event that dividend imputation is abolished in the future, the earnings tax on superannuation should be reduced to zero. The higher tax rates on earnings that act as an integrity measure to stop people streaming earnings from related parties into superannuation should remain.

Now that superannuation pay-outs are tax-free, there is no clear rationale for retaining an exemption for earnings on superannuation income streams. The exemption was necessary while superannuation pay-outs were taxable so that a person did not pay tax on the earnings in the fund and again when they took them as income. Having a consistent tax rate on all earnings would also make the superannuation taxation system more sustainable given the ageing of the population.

It has been argued that the earnings tax exemption encourages people to take their benefit as an income stream. Individuals are likely to make decisions on how they use their retirement savings that are in their best interest. Analysis on the draw-down of assets by Age pensioners has found that over the period 2000–01 to 2003–04, 30 per cent of Age pensioners retained 80 to 100 per cent of their assets, with 30 per cent increasing their assets. Only 1 in 13 Age Pensioners had drawn down more than half of their assets from the time of claiming the pension (Lim-Applegate et al. 2005).

This indicates that people already draw down on their assets in an orderly fashion. Therefore, a concession to encourage this behaviour would provide a subsidy for a decision they were already likely to make. Such concessions are more likely to change the vehicle people choose to draw down their assets rather than how they draw down their assets. Having a single tax rate for all fund earnings would also simplify the taxation of superannuation funds. Currently, superannuation funds must put in place arrangements that allow them to identify assets supporting the accumulation and draw-down phases of retirement saving. A single rate would remove the need for these arrangements and simplify the regulation of the draw-down phase by removing the need for rules regulating the draw-down of superannuation.

A single tax rate would also improve the equity of the system for members of different funds. Currently it is possible for members of self-managed superannuation funds to arrange their affairs so they avoid capital gains tax on their assets. This involves moving assets into the draw-down phase, where earnings including capital gains are exempt, before selling them. This tax minimisation opportunity is not available to members in larger funds as these members cannot control the timing of the disposal of assets.

Extending earnings tax to assets supporting an income stream would affect people who currently have an income stream. If the government wishes to limit the impact on people who have made decisions based on the existing rules, it should examine alternative ways to achieve this rather than grandfathering the existing rules. Previous grandfathering in the retirement income system made the taxation of superannuation very complex. An alternative to grandfathering would be to phase in this change over time to reduce the immediate effect. Another option would be to use the transfer system to compensate most people for the tax paid within the fund.

Effect of recommendations on retirement incomes

A person's wellbeing in retirement depends on several key factors that should be considered together: the rate of Age Pension, the rate of the superannuation guarantee, the taxation of retirement income, the retirement age, and the funding of health and aged care. Voluntary saving is also important for people who want to achieve an income higher than can be provided by the Age Pension and superannuation guarantee savings.

The review of adequacy presented in the Review's strategic report on retirement income (AFTS 2009) considered only the superannuation guarantee rate and the retirement age. The rate of the Age Pension was considered by Dr Harmer in his review of pensions (FaHCSIA 2009).

Since the Review's retirement income report, the value of the total Age Pension package has been increased by \$32.50 a week on top of indexation (to \$335.95 a week) for single pensioners and \$10.15 a week for pensioner couples on top of indexation (to \$506.50 a week).¹² The Age Pension age is also being gradually increased to age 67.

These decisions have significantly increased potential retirement incomes beyond the levels considered by the Review in the retirement income report. For example, the replacement rate — which compares a person's spending power before and after retirement — for a person on average weekly ordinary time earnings (AWOTE) increased from 63 per cent in the retirement income report to 71 per cent after the Age Pension increase (see Chart A2-4).

Finding

The increase to the Age Pension in September 2009 and the Age Pension age have considerably increased the potential retirement incomes of Australians.

Effect of recommendations on replacement rates

The Review has reassessed the potential outcomes of the retirement income system for this Report. Building on Dr Harmer's earlier review of the effect of the increase in the Age Pension on retirement incomes, the Review has reassessed adequacy in the context of the wider recommendations on what a future tax and transfer system might look like. This has provided a more complete basis on which to estimate the potential outcomes of the retirement income system.

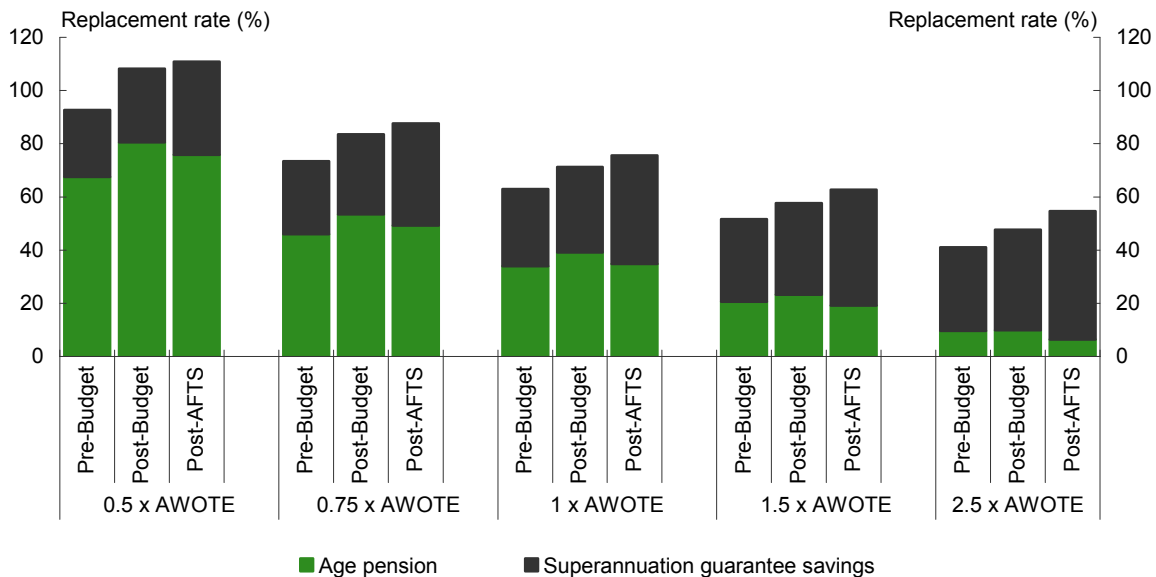
The recommendations to change the taxation of superannuation, in addition to the increase in the Age Pension, would increase retirement incomes significantly. For example, the replacement rate for a person on AWOTE would be 76 per cent compared to 63 per cent without the Age Pension increase and the tax reform recommendations. The comparable figures for a person earning 1.5 times AWOTE are 63 per cent and 52 per cent (see Chart A2-4).

These estimates are based on a person's superannuation guarantee savings and the amount of Age Pension for which they are eligible. Recommended changes to the funding of aged

¹² These amounts include the Pension Supplement pensioners may receive as an additional payment to the base pension. The maximum Pension Supplement is currently \$28.05 a week for a single pensioner and \$42.30 a week for couples. Rent Assistance is not included in these amounts.

care would also improve the standard of living of people in retirement (see Section F7 Funding aged care). Although these recommendations would reduce costs in retirement they are not reflected in the following charts as they would not directly increase the amount of retirement income a person has.

Chart A2–4: Illustrative projected replacements rates under the Age Pension and superannuation guarantee^(a)



(a) A replacement rate compares a person's spending power before and after retirement (that is, income and fringe benefits after tax is paid). For example, a replacement rate of 75 per cent would mean that a person would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement. The illustrative replacement rates are projected for a hypothetical single male. Pre-Budget outcomes are for a male who works for 35 years and retires in 2035. Other outcomes are for a male who works for 37 years and retires in 2047. It is assumed that they use their superannuation guarantee benefit to purchase a lifetime annuity at retirement. The spending power used to calculate the illustrative replacement rates are deflated by the consumer price index to 2008–09 dollars. Actual outcomes will vary depending on factors such as workforce participation, labour income patterns, investment performance, inflation, longevity and whether a person accesses their superannuation prior to Age Pension age.

Note: AWOTE is currently around \$1,200 per week (\$62,400 per year). Around half of workers earn less than three-quarters of AWOTE.

Source: Treasury projections.

The effect of the superannuation tax recommendations, in addition to the increase in the Age Pension, would be equivalent to a 15 per cent superannuation guarantee rate over a full working life for a person earning 0.75 x AWOTE (approximately median earnings) and AWOTE before the 2009–10 Budget. However, an increase in the superannuation guarantee rate to 15 per cent under the existing tax rules would retain the existing inequitable distribution of concessions.

There are a number of views within the community on the adequacy of the retirement income system. There are different ways to increase the adequacy of the retirement income system. This report recommends changing tax arrangements, which would increase retirement incomes (as well as improving equity and simplicity of the system). Increasing the rate of the superannuation guarantee would also increase retirement incomes, (but would not, of itself, improve equity and simplicity).

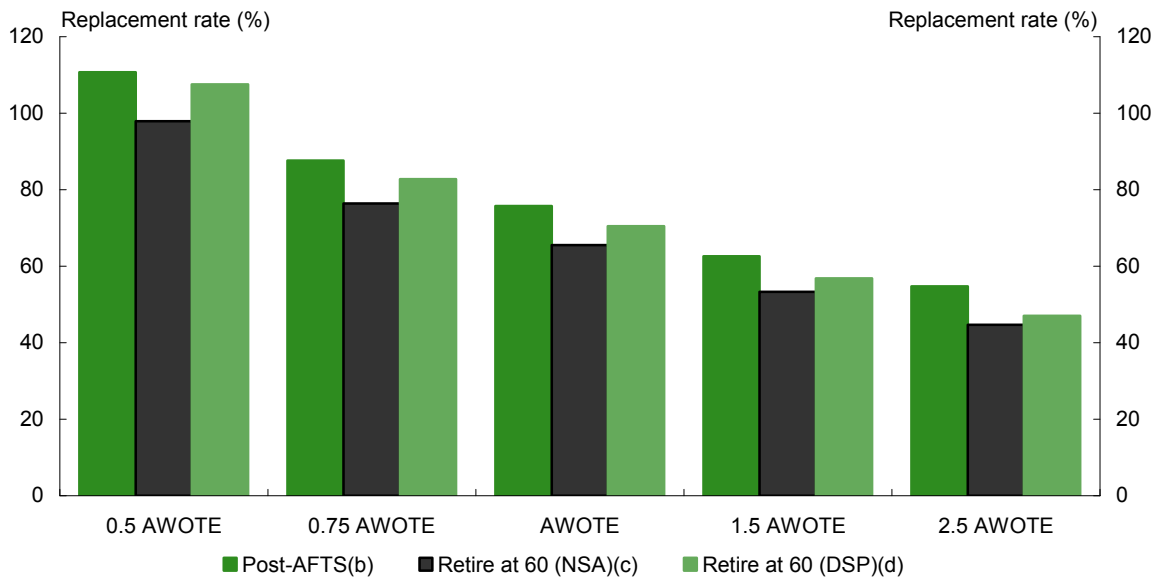
The retirement income report recommended that the superannuation guarantee rate remain at 9 per cent. In coming to this recommendation the Review took into the account the effect that the superannuation guarantee has on the pre-retirement income of low-income earners. Although employers are required to make superannuation guarantee contributions, employees bear the cost of these contributions through lower wage growth. This means the

increase in the employee's retirement income is achieved by reducing their standard of living before retirement.

The effect of this reduction in a person's standard of living before retirement is likely to fall most heavily on low- to middle- income earners who are unlikely to be in a position to offset the increase in the superannuation guarantee by reducing their other savings. However, it has been argued that the benefits from improving a person's standard of living in retirement offset the effect of the decrease in their standard of living before retirement.

It has also been argued that people will have different circumstances, such as the age they choose to retire and whether they retire as part of a couple, which can affect their retirement incomes. Chart A2-5 shows the replacement rates for a person who retires at age 60 under the superannuation tax proposals.

Chart A2-5: Illustrative projected replacements rates under the Age Pension and superannuation guarantee for a person retiring at age 60^(a)



- (a) A replacement rate compares a person's spending power before and after retirement (that is, income and fringe benefits after tax is paid). For example, a replacement rate of 75 per cent would mean that a person would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement. The illustrative replacement rates are projected for a hypothetical single male. Actual outcomes will vary depending on factors such as labour income patterns, investment performance, inflation, longevity and whether a person accesses their superannuation prior to Age Pension age.
- (b) The Post-AFTS case is for a male who works for 37 years and retires in 2047. It is assumed that they use their superannuation guarantee benefit to purchase a lifetime annuity at retirement. The spending power used to calculate the illustrative replacement rates are deflated by the consumer price index to 2008–09 dollars. Replacement rates are calculated compared to their spending power in their final year of working.
- (c) In this case the person retires at age 60 after 30 years of work and receives Newstart Allowance until Age Pension age. They withdraw their superannuation as a series of lump sums between the ages of 60 and 67 to achieve a 50 per cent replacement of their net income at age 60 until they are eligible for the Age Pension. It is assumed that their asset is not included in the means test until they reach age 67. At age 67 they purchase a lifetime annuity with their remaining superannuation. Replacement rates are calculated compared to their spending power in their final year of working.
- (d) In this case the person retires at age 60, after 30 years of work, due to disability and is paid Disability Support Pension until Age Pension age. They withdraw their superannuation as a series of lump sums between the ages of 60 and 67 to achieve a 50 per cent replacement of their net income at age 60 until they are eligible for the Age Pension. It is assumed that their asset is not included in the means test until they reach age 67. Replacement rates are calculated compared to their spending power in their final year of working.

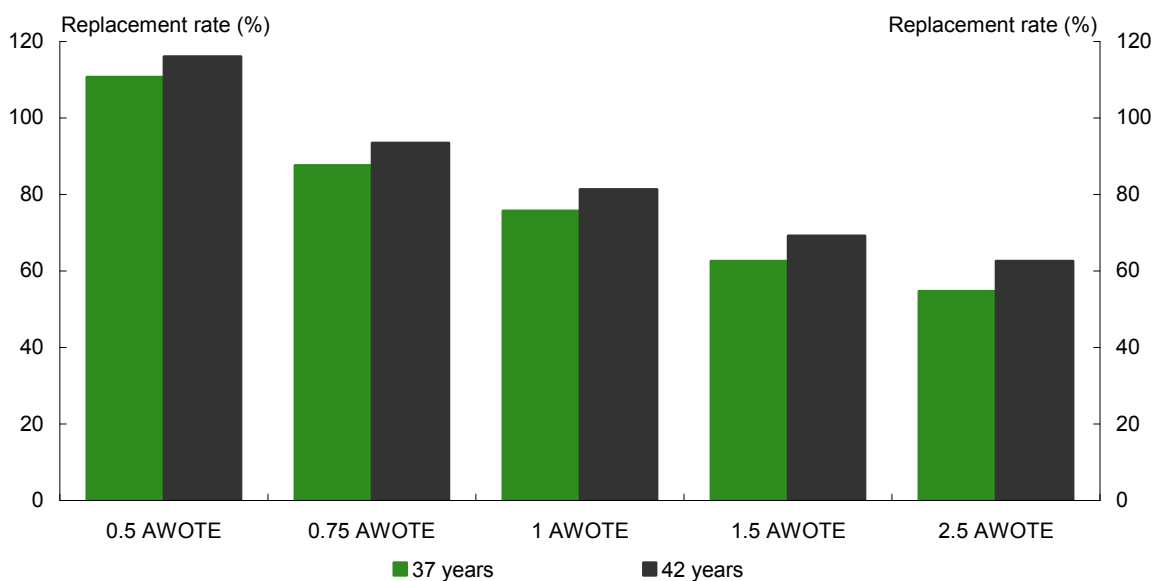
Note: AWOTE is currently around \$1,200 per week (\$62,400 per year). Around half of workers earn less than three-quarters of AWOTE.

Source: Treasury projections.

The effect of retiring before Age Pension age reduces retirement income for two reasons. The first is that a person has less time to accumulate superannuation and the second is that they must make their superannuation last for a longer period. It is projected that the retirement income system, with the tax proposals, would still provide a substantial replacement of income for people who must retire before Age Pension age. For example, an average income earner would have a replacement rate of 65 per cent if they receive Newstart Allowance and 70 per cent if they receive the Disability Support Pension.

In setting the rate for the superannuation guarantee it is appropriate to consider the average working life. For a male the full-time equivalent average working life was projected to be around 36 years (Bingham 2003). This did not take account of the effect of the recent increase in the Age Pension age. An assumption used to calculate the replacement rate in Chart A2-4 is that the person works for 37 years. Setting the superannuation guarantee rate to account for a person with a shorter working life would result in people with a longer working life saving significant amounts for their retirement. Chart A2-6 shows the replacement rates for a person who has a working life of 42 years under the superannuation tax proposals. In this case replacement rates for an average income earner increase from 76 per cent to 81 per cent.

Chart A2-6: Illustrative projected replacements rates under the Age Pension and superannuation guarantee for a person with a working life of 42 years^(a)



(a) A replacement rate compares a person's spending power before and after retirement (that is, income and fringe benefits after tax is paid). For example, a replacement rate of 75 per cent would mean that a person would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement. The illustrative replacement rates are projected for a hypothetical single male. The chart shows how changing the assumption on how long a person works affects replacement rates. In both cases the person retires in 2047. It is assumed that they use their superannuation guarantee benefit to purchase a lifetime annuity at retirement. The spending power used to calculate the illustrative replacement rates are deflated by the consumer price index to 2008–09 dollars. Actual outcomes will vary depending on factors such as labour income patterns, investment performance, inflation, longevity and whether a person accesses their superannuation prior to Age Pension age.

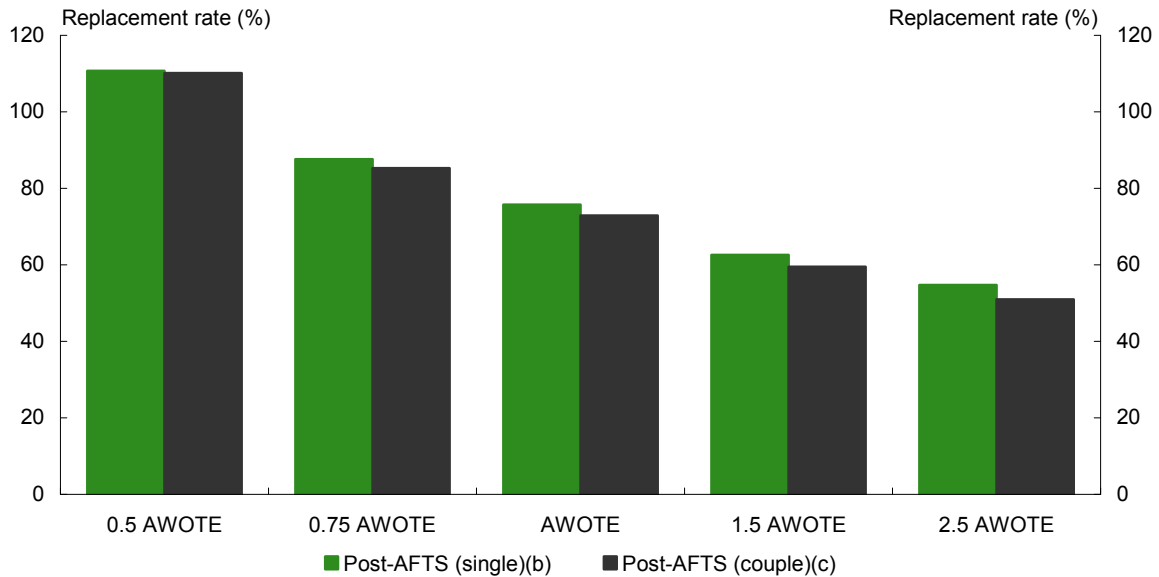
Note: AWOTE is currently around \$1,200 per week (\$62,400 per year). Around half of workers earn less than three-quarters of AWOTE.

Source: Treasury projections.

Charts A2-4, A2-5 and A2-6 only show the potential retirement incomes for a single person. However, over 70 per cent of people enter retirement as part of a couple. This affects retirement income as each person in the couple is likely to have a different life expectancy. For example, women live longer than men on average. This increases the period that retirement savings must last, thereby decreasing replacement rates. Chart A2-7 shows that

replacement rates for a household are lower than for singles. A single average income earner under the tax recommendations would have a replacement rate of 76 per cent. The couple replacement rate would be 73 per cent.

Chart A2–7: Illustrative projected replacements rates under the Age Pension and superannuation guarantee^(a)
(Household)



- (a) A replacement rate compares a person's spending power before and after retirement (that is, income and fringe benefits after tax is paid). For example, a replacement rate of 75 per cent would mean that a person would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement.
- (b) The illustrative replacement rates are projected for a hypothetical single male who works for 37 years and retires in 2047. It is assumed that he uses his superannuation guarantee benefit to purchase a lifetime annuity at retirement. The spending power used to calculate the illustrative replacement rates are deflated by the consumer price index to 2008–09 dollars. Actual outcomes will vary depending on factors such as workforce participation, labour income patterns, investment performance, inflation, longevity and whether a person accesses their superannuation prior to Age Pension age.
- (c) The illustrative replacement rates are for a hypothetical couple of the same age who both retire in 2047. The male works for 37 years. It is assumed that he uses his superannuation guarantee benefit to purchase a lifetime annuity at retirement. The lifetime annuity has a reversionary payment of 85 per cent to his spouse. The female enters the workforce at age 36 and works part-time to age 44, full-time from age 45 to age 59 and part-time from age 60 to age 67. She is assumed to use her superannuation guarantee benefit to purchase a lifetime annuity at retirement without a reversionary benefit. She lives three years longer than her spouse. Actual outcomes will vary depending on factors such as workforce participation, labour income patterns, investment performance, age differences between the couple, inflation, longevity and whether a person accesses their superannuation prior to Age Pension age.

Note: AWOTE is currently around \$1,200 per week (\$62,400 per year). Around half of workers earn less than three-quarters of AWOTE.
Source: Treasury projections.

Effect of recommendations on voluntary superannuation saving

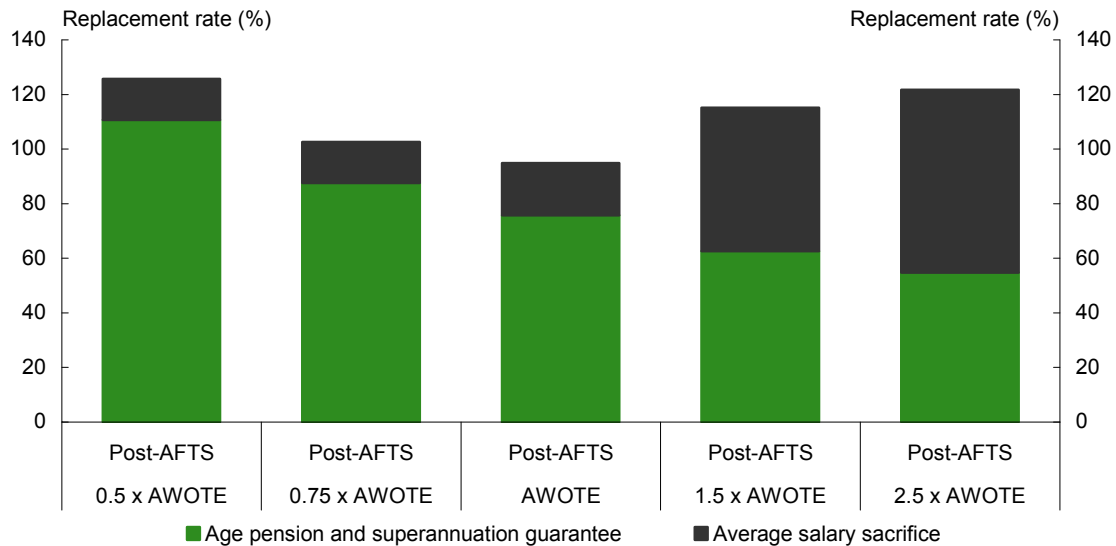
Under the recommended changes, people would continue to have a considerable incentive to save through superannuation compared to other saving vehicles. The benefits of the recommended changes for voluntary savings are shown below.

Chart A2–8 shows illustrative replacement rates for a hypothetical person making voluntary superannuation contributions under the recommended changes. While it is difficult to determine the actual effect of the changes on voluntary saving, it is assumed that the offset, and in particular the halving of the tax on earnings, would provide significant concessions compared to other savings.

The chart uses the average rate of salary sacrifice contributions for an employee based on their age and level of remuneration. It assumes they continue to make these contributions

after the changes to the taxation of superannuation and other savings. However, the maximum amount of contributions they make is capped at \$25,000 below age 50 and \$50,000 from age 50.

Chart A2–8: Illustrative projected replacement rates including the Age Pension, superannuation guarantee and average salary sacrificed amounts for employees^(a)



(a) A replacement rate compares a person's spending power before and after retirement (that is, after tax is paid). For example, a replacement rate of 75 per cent would mean that a person would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement. The illustrative replacement rates are projected for a hypothetical single male who works for 37 years and retires in 2047. It is assumed that they use their superannuation guarantee benefit to purchase a lifetime annuity at retirement. The spending power used to calculate the illustrative replacement rates are deflated by the consumer price index to 2008–09 dollars. Actual outcomes will vary depending on factors such as workforce participation, labour income patterns, investment performance, inflation, longevity and whether a person accesses their superannuation prior to Age Pension age.

Note: AWOTE is around \$1,200 per week (\$62,400 per year). Around half of workers earn less than three-quarters of AWOTE. Source: Treasury projections.

Findings

Removing the contributions tax and halving the tax on earnings would provide an opportunity to generate more retirement income from the superannuation guarantee system.

The preferential tax treatment of superannuation compared to other savings should be retained. Halving the tax on earnings would be particularly effective in increasing the returns from voluntary superannuation saving.

Effect of recommendations on overall saving

The superannuation system is a significant contributor to Australia's pool of private savings. However, the system's overall effect on national savings depends on the effect on the government's fiscal position (that is, public savings). Superannuation affects public savings by reducing future Age Pension outlays, but the cost of concessions reduces government revenue thereby decreasing public savings.

Empirical studies on the effect of taxes on household saving are constrained due to data limitations and estimation problems. Some progress has been made with respect to studies of tax policies on investment retirement accounts and 401(k) plans in the United States, but the

results of such studies are often conflicting (OECD 2007a). Typically, these suggest that taxation is unlikely to have a large impact on total saving, but some studies of the same data find that providing tax incentives leads to substantial amounts of new saving.

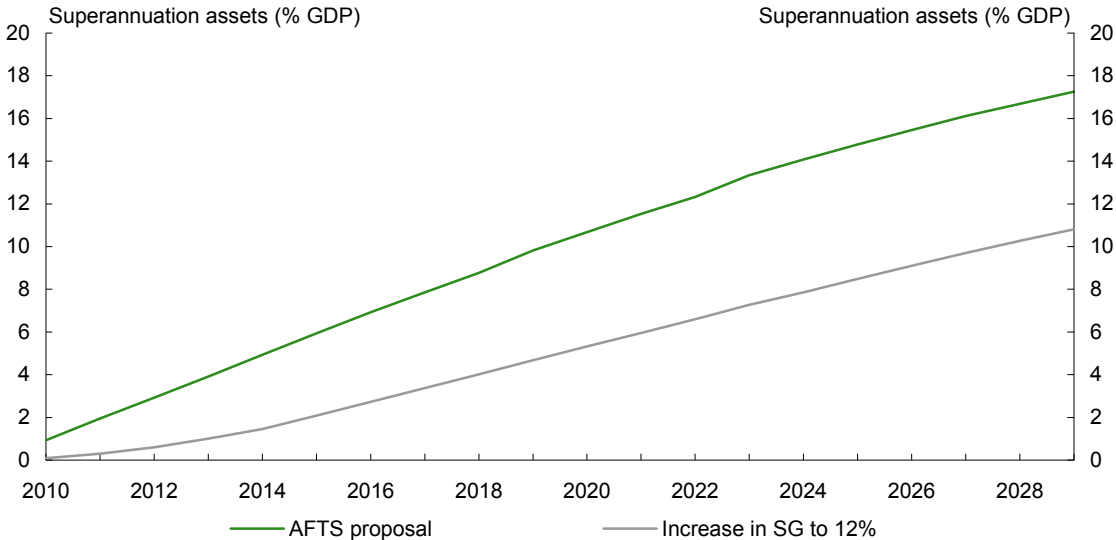
There is considerable evidence that tax differences have large effects on which assets a household's savings are invested in. Based on an examination of the literature and its own data, the OECD concluded that low-income individuals are more likely to respond to tax incentives with new saving, but high-income individuals in particular, are more likely to divert savings from taxable to tax-preferred savings (OECD 2007a).

There is also evidence that saving schemes involving commitment or compulsion tend to increase the level of saving. Research has estimated that an extra dollar of superannuation guarantee in Australia has added between 70 and 90 cents to household wealth (Connolly 2007). It is therefore argued that increasing the superannuation guarantee rate would not only increase retirement incomes but would also have national saving benefits.

The recommended changes in this report to the taxation of superannuation would also increase retirement incomes and have national saving benefits.

The recommended changes to the taxation of superannuation would increase private savings more than would an increase in the superannuation guarantee rate to 12 per cent under the current tax arrangements. These benefits would result mainly from halving the earnings tax to 7.5 per cent, which would significantly increase superannuation assets and increase private savings. Superannuation assets are estimated to increase by approximately \$590 billion (nominal dollars) by 2029 under the taxation proposals, compared to approximately \$370 billion (nominal dollars) if the superannuation guarantee were to be increased to 12 per cent (see Chart A2-9).

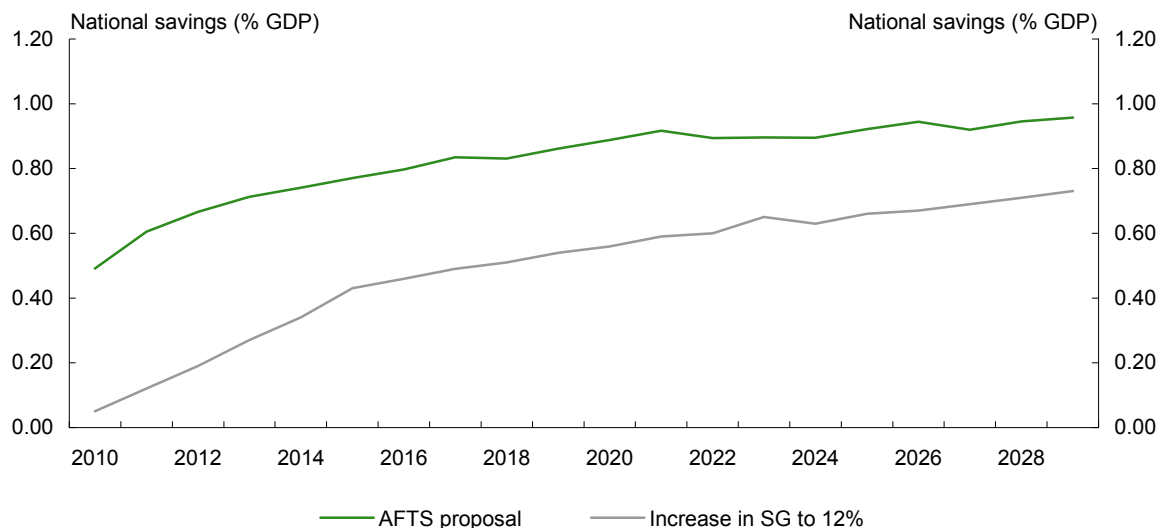
Chart A2-9: Projected increase in superannuation assets



Source: Treasury projections.

Based on the assumptions in Annex A2, both the superannuation tax recommendations and increasing the superannuation guarantee rate would increase national saving, but reduce public saving since only part of the revenue forgone in tax concessions for superannuation would be offset by a reduction in pension outlays. The recommended changes would have a greater negative effect on public saving than an increase in the superannuation guarantee to 12 per cent under the current tax arrangements. However, the transfer to private savings resulting from the recommended changes means they would have a greater positive effect on national savings than an increase to the superannuation guarantee rate to 12 per cent (see Chart A2-10).

Chart A2-10: Projected increase in national saving



Source: Treasury projections.

Findings

Superannuation is a significant contributor to Australia's savings pool.

Both the recommended changes to superannuation tax and increasing the superannuation guarantee would increase retirement incomes and national saving. The recommended changes to superannuation tax would provide a greater benefit to national savings than an increase in the superannuation guarantee rate to 12 per cent.

Other tax-related issues

Recommendation 20:

The restriction on people aged 75 and over from making contributions should be removed. However, a work test should still apply for people aged 65 and over. There should be no restrictions on people wanting to purchase longevity insurance products from a prudentially regulated entity.

Submissions to the Review have raised a number of specific tax-related issues, including who can make superannuation contributions, how superannuation is taxed on a person's death and the treatment of benefits paid from an untaxed fund.

Restrictions on superannuation contributions

Superannuation tax concessions have generally been accompanied by restrictions on who can access them. These restrictions take the form of contributions caps, work tests and age

limits. They are consistent with the primary purpose of the retirement income system, which is to smooth income over a person's lifetime rather than be a concessional estate planning vehicle.

The work test and age limits apply to people above Age Pension age. From this age, a person must work 40 hours over a 30-day period before they can make a superannuation contribution, while contributions cannot be made from age 75. The current work test is not suitable for establishing eligibility for the proposed tax offset, because its participation demands are minimal and difficult for fund trustees to monitor.

Given the very low rate of tax applied to superannuation fund earnings, compared to other savings, a restriction on people of Age Pension age accessing concessions should continue to apply. This restriction could be in the form of an improved work test or a restriction on the amount of concessions available (a lower contribution cap). However, the restriction on people aged 75 and over, who are currently prevented from making superannuation contributions, should be abolished. If restrictions on accessing concessions continue to exist from Age Pension age, there is no need for further restrictions from the age of 75.

There should be no restrictions on people wanting to purchase longevity insurance from a prudentially regulated entity. This would be an important element in making it easier for people to purchase these products (see Section A2-3).

Death benefits

The tax treatment of superannuation on the death of a person depends on a number of factors, including who inherits the asset. A benefit paid to a dependant, such as a spouse or partner, is tax-free. A benefit paid to a non-dependant is subject to a tax of 15 per cent.¹³ Some submissions argue that this leads to added complexity and inequities in how benefits are taxed. However, the superannuation tax concessions are provided so a person can finance their retirement, and that of their dependants. On balance, a tax on payments made to non-dependants should continue to apply.

Untaxed funds

People in untaxed superannuation funds, such as some public sector funds, are currently taxed differently from people in the more common taxed superannuation funds. Untaxed funds do not pay tax on some, or all, of the contributions and earnings in the fund. Benefits from these funds remain taxed to achieve a broadly equivalent tax outcome between people in taxed and untaxed funds.

Superannuation pensions paid from an untaxed superannuation fund are taxed at marginal tax rates less a 10 per cent offset. Lump sums from an untaxed fund are taxed at 15 per cent up to a threshold, currently \$1.1 million (indexed), and at the top marginal tax rate beyond that.

13 The tax is payable on the 'taxable component' of the benefit. This includes contributions and earnings that have been taxed in the fund. Tax is calculated by subtracting the tax-free component from the value of the benefit. The tax-free component is not taxable in the hands of a non-dependant. This includes amounts such as non-concessional contributions that are not taxable in the fund.

Several submissions raise concerns that members of untaxed funds pay more tax on their non-superannuation income than members of taxed funds. A pension from a taxed fund is not included in assessable income while a pension from an untaxed fund is. This means that non-superannuation income is added to a pension from an untaxed fund. As a result, the person can pay a higher marginal tax rate on that income than they would have if the pension was paid from a taxed fund.

The considerable differences between taxed and untaxed funds make it very difficult to achieve complete parity between the benefits paid from them. On balance, it is considered that the current tax treatment of benefits paid from an untaxed fund remains appropriate given the recommended changes to the taxation of superannuation contributions and earnings in taxed funds. The treatment of contributions to untaxed funds would need to be carefully considered.

Benefits for people aged less than 60

The taxation of benefits paid to people above their preservation age but under the age of 60 should not change. Taxable lump sums are taxed at 0 per cent up to a threshold (currently \$150,000) and 16.5 per cent above that amount. Taxable superannuation pensions are taxed at marginal tax rates less an offset of 15 per cent.

If, as recommended, superannuation contributions are taxed in the hands of the individual, such future contributions would be made on a post-tax basis and would not be subject to further taxation when withdrawn as a superannuation benefit.

A2–3 Responding to increasing life expectancies

As people live longer, they will require more options to manage their assets over a longer period. The retirement income system will need to become more flexible so that it can provide these options.

Principles

Policies requiring a person to invest their superannuation in a particular product, or restricting access to lump sums, should only be adopted where there is strong evidence that people are unable to make decisions that are in their best interests.

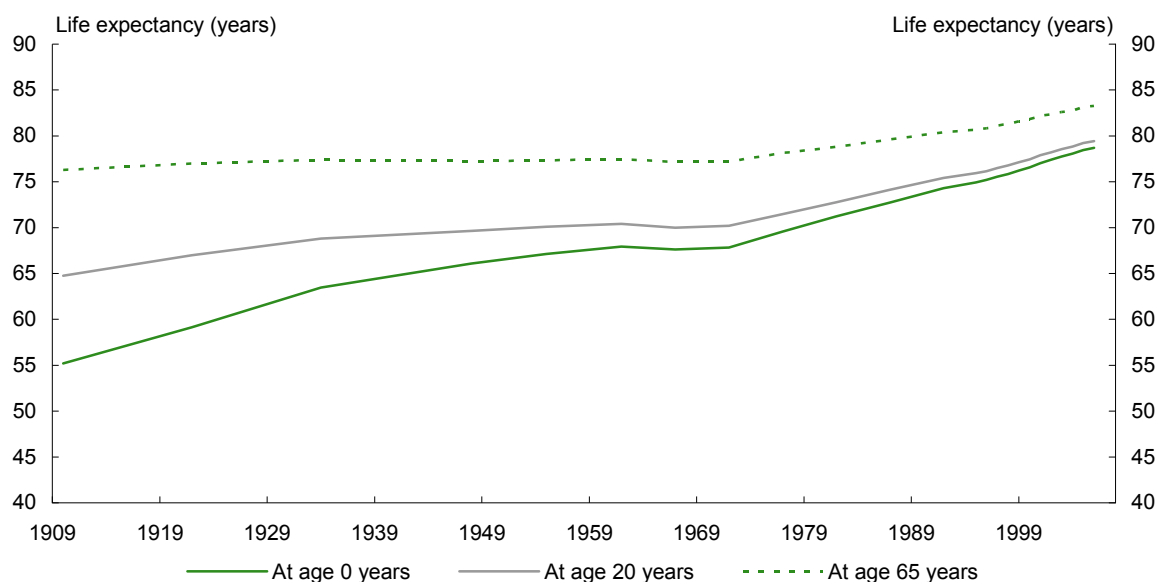
The retirement income system should be flexible to allow for the development of products that allow people to manage better their retirement income.

The public sector's primary role should be to support the private sector in the development of these products. The public sector should only enter this market where the private sector is unable to meet the needs of the community and should do so only on an actuarially fair pricing of risk.

Responding to higher life expectancies

Australians have one of the longest life expectancies in the world. Advances in health technologies have resulted in a marked increase in life expectancies since the 1970s (see Chart A2–11). This trend is likely to continue.

Chart A2–11: Average increases in life expectancy^(a)



(a) Chart shows increase in the life expectancy of males. Females have had a similar increase in life expectancy but live longer than males.

Source: ABS (2008).

On current trends, men aged 60 years in 2047 are projected to live an average of 5.1 years longer than those aged 60 years in 2007 and women an average of 4.7 years longer (Australian Government 2007a). The probability that at least one person in a married couple both aged 60 will be alive by age 80 or age 90, ignoring future mortality improvements, is 89 per cent and 47 per cent respectively (Rawlinson & Cater 2008). The retirement income system will therefore need to provide a more diverse range of products to allow people to manage a longer retirement better.

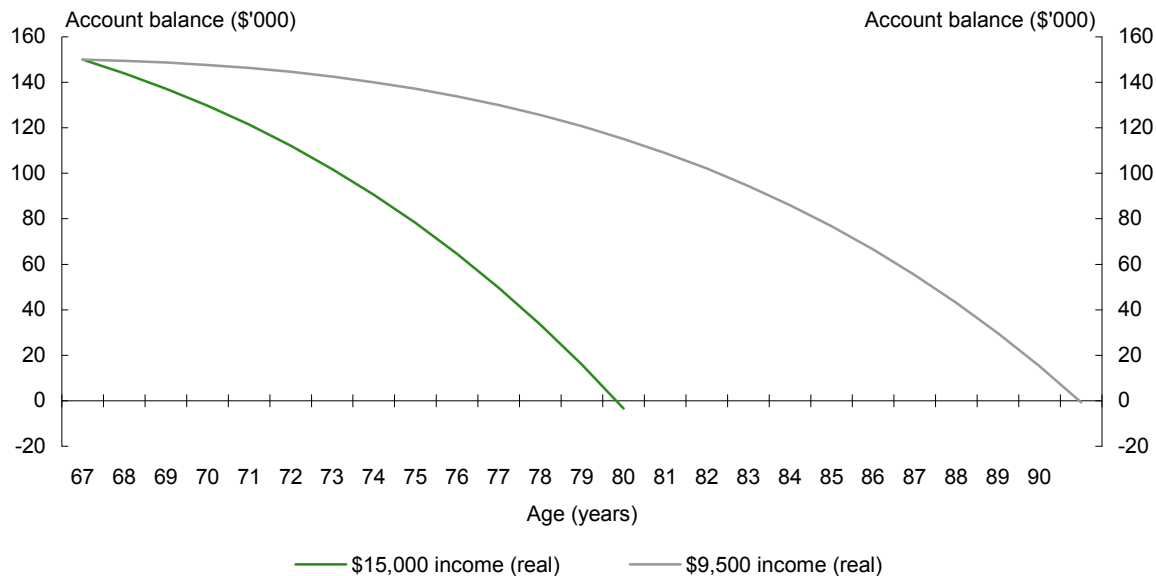
The Age Pension currently provides a basic income for people who have limited means. However, many people prefer to have the security of knowing they will always have an income above the Age Pension.

The most popular income streams in the Australian market are allocated pensions and annuities, which account for over 85 per cent of the total purchased income stream market (Investment and Financial Services Association 2007). Allocated pensions are account-based with the value of the account dependent on how much a person takes as income and investment returns. The length of time a person can draw an income from an allocated pension therefore depends on these two factors. For this reason, an allocated pension cannot ensure security of income on its own.

Chart A2–12 shows the example of a person who invests \$150,000 in an allocated pension at age 67. Their preference is to take an income of \$15,000 (indexed) a year from their allocated pension. Based on the age of their parents, they consider they may live to at least age 90. If they take an income of \$15,000 a year they will exhaust the assets in their allocated pension

by age 80. If they want their allocated pension to pay an income to age 90 they will have to reduce the income they take to \$9,500 a year. This is an ineffective way to deal with longevity risk as below average investment returns may result in a person not achieving their goal even after reducing their income. It can also reduce a person's standard of living in retirement and result in them bequeathing more assets than they wish.

Chart A2–12: Account balance of an allocated pension over time



Note: This assumes an initial account balance of \$150,000 and an average return of 6 per cent per annum. The initial income is indexed to CPI at a rate of 2.5 per cent per annum.

Source: Treasury estimates.

Products are not available in the market to cover the broad range of preferences of retirees in achieving security of income. This is a structural weakness in the Australian retirement income system.

The main product on the market that does achieve this security of income is a guaranteed income for life. However, this product is unpopular among retirees, with only 374 sold in 2007 (Plan for Life Research 2007). This is due to a number of factors, including that these products are not seen as good value. Currently, their price is high due to information asymmetries between purchasers and product providers, as well as a lack of tools available to providers to manage the risk associated with longevity insurance. For example, long-dated bonds do not exist that would assist in the management of the investment risk associated with these products.

Given the diverse preferences of retirees, a single product is unlikely to satisfy all people who wish to manage their longevity risk. This suggests a need for product innovation within the Australian market.

Submissions state that providers have been reluctant to develop new products for the Australian market due to the prescriptive rules that set out what an income stream is. These rules were designed to ensure that the earnings tax exemption on superannuation pension assets supports only products that deliver a genuine income stream.

One argument is that the rule requiring a minimum payment to be made from a pension every year does not cater for deferred annuities. The potential for changes to these rules can

increase the uncertainty faced by providers. Submissions also claim there is a lack of coordination between the regulators of the income stream market. It is argued that these issues increase the risk, and therefore cost, of developing products.

Findings

The increasing life expectancies of Australians will require a greater choice of retirement income products that can cater for the different needs of individuals in retirement.

There are not enough products that guarantee an income for the whole of a person's retirement. This is because the industry lacks tools to manage risks associated with these products, such as long-dated bonds. Also government rules restricting development of income-stream products and uncertainty about future changes in these rules inhibit product innovation.

Housing as a form of longevity insurance

Accessing the equity in the family home is another way people may choose to achieve a higher standard of living in retirement and to protect against longevity risk. Reverse mortgages allow a person to borrow against the equity in their home with the loan usually paid off when the home is sold or the home owner dies. The reverse mortgage market in Australia is still developing but has been growing over time (see Table A2-2). An alternative product has recently been introduced where a person sells a proportion of their home to an institution. The institution then has a right to claim that proportion of the proceeds on the sale of the house.

Table A2-2: The reverse mortgage market in Australia

	December 2005	December 2006	December 2007	December 2008	June 2009
Outstanding market size (\$b)	0.85	1.51	2.02	2.48	2.61
Number of loans	16,584	27,898	33,741	37,530	38,048
Average loan size	\$51,148	\$54,233	\$60,000	\$66,150	\$68,473

Source: SEQUAL/Deloitte (2009).

Payments from a reverse mortgage on a primary residence are not treated as income for tax purposes as they are considered to be a loan. The exemption of the owner-occupied home from the income support means test may discourage people from undertaking home equity conversions as it would convert an exempt asset into an assessable one. To counter this, special means test arrangements apply. The first \$40,000 of a reverse mortgage paid as a lump sum is exempt from the assets test for 90 days. Amounts over \$40,000 are assessed under deeming rules if held as a financial asset. If taken as a stream of payments, the amount drawn down is not counted in the income test. The tax and means test treatment of these products is already generous and should not be made more so.

Role of longevity insurance products

Recommendation 21:

The government should support the development of a longevity insurance market within the private sector.

- (a) The government should issue long-term securities, but only where this is consistent with its fiscal obligations, to help product providers manage the investment risk associated with longevity insurance.
- (b) The government should make available the data needed to create and maintain a longevity index that would assist product providers to hedge longevity risk.
- (c) The government should remove the prescriptive rules in the *Superannuation Industry (Supervision) Regulations 1994* relating to income streams that restrict product innovation. This should be done in conjunction with the recommendation to have a uniform tax on earnings on all superannuation assets.

Recommendation 22:

The government should consider offering an immediate annuity and deferred annuity product that would allow a person to purchase a lifetime income. This should be subject to a business case that ensures the accurate pricing of the risks being taken on by the government. To limit the government's exposure to longevity risk, it should consider placing limits on how much income a person can purchase from the government.

The development of longevity insurance products is another means — along with the taxation of superannuation and the funding of health and aged care — of improving the adequacy of the retirement income system. If a person knows they can rely on a particular level of income to support them until they die, they can make better decisions on how to manage their assets over their retirement.

The retirement income report set out some issues relating to longevity insurance that the Review Panel wanted to consider in this Report. These were whether the product should be:

- mandatory or voluntary;
- provided by the private sector or public sector; and
- guaranteed or non-guaranteed.

Mandatory or voluntary

As long as the Age Pension continues to provide a longevity insurance safety net, it is not necessary to impose a requirement that people invest in additional insurance.

A reasonable basis for policy design is the presumption that, having accumulated retirement savings, people are generally in the best position to determine how they use their assets during their retirement. Some people may prefer a higher standard of living at the beginning of their retirement, with high draw-downs from their superannuation during this time, before relying on the Age Pension later in their life. Other people may prefer a stable and

secure income over their entire retirement. A voluntary system ensures that both these groups can insure up to the level of income they want over their retirement.

Some submissions suggest that people should be required to use part of their superannuation to purchase longevity insurance. Such a requirement could help to overcome one source of market failure in longevity insurance markets related to access to information. These markets may fail to yield efficient outcomes because a person may have more information on how long they are likely to live than insurers do. This may mean that the only people who purchase these products are those who consider they are likely to live longer than average. Insurers can react to this 'information asymmetry' either by not selling the products or by pricing them at a level that discourages most people from purchasing them. This is one of the reasons for the unpopularity of life annuities.

A mandatory system would remove this market failure by ensuring that the people in the insurance pool reflect the average life expectancy within the community as a whole. This would allow insurers to sell these products at a lower price because the capital of the people who die early in their retirement supports those people who live for longer. Research by the University of New South Wales confirms this effect (Sherris & Evans 2009). Table A2-3 shows the first annual payment of an annuity in a mandatory and voluntary system.

Table A2-3: Income differences between mandatory and voluntary annuitisation

Type of annuity	First annual payment ^(a) (\$)
Compulsory annuitisation, immediate annuity(b)	8,965
Voluntary annuitisation, immediate annuity	7,942
Compulsory annuitisation, deferred annuity(c)	71,408
Voluntary annuitisation, deferred annuity	44,181

(a) The payment is based on an annuity purchased by a male from the private sector with \$100,000. Longevity is based on the improvements to mortality that have occurred in the past 5 years. It assumes no indexation and is valued using the end June 2009 yield curve from government bonds quoted on Bloomberg. The values are in nominal dollars.

(b) The immediate annuity commences at age 67.

(c) The deferred annuity is purchased at age 67 and commences at age 85.

Source: Sherris and Evans (2009).

However, overcoming this market failure by mandating the purchase of longevity insurance can come at a cost to people who are in poor health or have lower life expectancies, such as Indigenous Australians. Such people would be disadvantaged by a mandatory system as they would effectively be subsidising people who live longer than average. It may be possible to provide a different pricing structure for these people to accommodate their lower life expectancies. However, even if these arrangements existed, a mandatory system is likely still to be seen as punitive to these people.

Another argument for a mandatory system is that it would reduce the risk that people exhaust their assets quickly in order to receive an Age Pension. However, the research by Lim-Applegate et al. (2005) suggests that people in retirement are conservative in how they draw down their assets. This may be as a result of them attempting to self-insure against longevity risk.

On balance, the Review does not recommend a mandatory system for longevity insurance. A mandatory system would constrain the ability of people to make their own decisions on how they use their superannuation to fund their retirement. The evidence suggests that people make conservative decisions on how they use their assets in retirement. Also, the existence of

the Age Pension already provides longevity insurance for a significant proportion of the population.

Findings

There are some arguments for requiring people to purchase longevity insurance. These include addressing information asymmetries that exist between the purchaser and provider and ensuring that at least part of a person's superannuation is used for retirement.

However, a mandatory system would have a detrimental effect on people with lower than average life expectancies. The Age Pension will continue to provide longevity insurance for the majority of retirees.

Public or private sector

The Review Panel considers that the development of a voluntary market for longevity insurance will require input from the private and public sectors. The private sector is in a better position to develop products that best meet the preferences of individuals. However, the public sector may be in a better position to deal with the significant counterparty risk associated with longevity insurance. The public sector could also provide more tools to assist in the development of longevity insurance products.

International experience

In other countries, new products are being developed that provide an alternative to typical annuity products where a person purchases an income for life. In the United States, a person can purchase a guaranteed income based on the value of an investment account similar to an allocated pension from a set time. These products differ from typical annuity products in that the amount of income and the start date are not fixed. While the minimum amount of income is fixed, it can increase depending on investment returns. The income only commences when the value of the account falls below the income guarantee. The level of guarantee also tends to be supported by hedging arrangements by the provider. This differs from typical annuities, which are supported by capital that the provider must hold under prudential regulation. A similar product has recently been introduced into the Australian market.

Deferred annuities, which provide an income from a certain age, are also becoming more prevalent. These annuities allow a person to lock up part of their retirement savings to generate an income when they are entering the latter stages of their retirement. This provides a person with more certainty in how they manage the rest of their assets before the commencement of the deferred annuity.

The preferences of retirees, advancements in technology and risk management techniques will continue to affect the development of longevity risk products into the future. The private sector is likely to be able to respond to these factors more quickly than the public sector.

The role of the government

The government can assist in creating an environment where the industry has greater flexibility and confidence to develop longevity insurance products.

Removing restrictive rules

A product must comply with certain rules to be treated as a superannuation pension or annuity. The prescriptive nature of these rules, such as a requirement for specific annual payments and limits on indexation, can constrain product development.

The recommendation to tax all superannuation fund earnings (whether or not they support an income stream) at a uniform lower tax rate removes the concession these rules were protecting (see Recommendation 19). Therefore, implementing the earnings tax recommendation would provide the opportunity to remove these rules. The removal of these rules would provide greater scope for innovation in the income-stream market and enable product providers to get products into the market more quickly. The current rule that caps the amount of payment from a transition to retirement pension should continue, however, as this protects the integrity of the preservation rules.

The removal of these rules would also make redundant the current income test assessment of superannuation pensions and strengthens the case for deeming income on account-based income streams, so they are treated like other financial assets. The proposal for means testing superannuation pensions is at Section F2 Means testing.

In many cases, people may choose not to purchase longevity insurance at their retirement age. As they grow older they may be in a better position to judge their potential longevity. However, after a person retires they may be unable to make further contributions into a superannuation fund due to the work test rules. These restrictions should not apply to contributions made to a prudentially regulated superannuation fund or life insurance company for the purpose of purchasing a longevity product (see Recommendation 20).

The government should also consider removing other legislative constraints that may inhibit the development of longevity products. However, this should not be at the cost of necessary prudential or consumer protection. Given the nature of these products, they should only be provided by prudentially regulated entities. Products that provide a guaranteed income should follow consistent prudential requirements to reduce the risk that a provider is unable to meet their obligations as they fall due.

Coordination between the regulators

Another concern raised with the Review is that there is little coordination between the various regulators of income-stream products. These regulators are: the Australian Taxation Office (ATO); the Australian Prudential Regulation Authority (APRA); the Department of Families, Housing, Community Services and Indigenous Affairs (FaHCSIA); and the Australian Securities and Investments Commission (ASIC).

Most concern was raised about the interaction between the ATO and APRA, especially in relation to whether a product meets the definition of a pension or annuity and is therefore eligible for tax concessions. While the ATO administers these concessions, it is unable to advise product providers whether their product meets the definition of a pension or annuity as this definition is in the *Superannuation Industry (Supervision) Regulations 1994*, which are administered by APRA. This definition would no longer exist if all superannuation fund earnings are taxed at a uniform rate. This would also remove the need for the ATO to be involved in the regulation of income streams.

Better management of risks

The providers of longevity insurance must deal with a number of risks in bringing a product to the market. These include investment risk, inflation risk and longevity risk.

Investment risk relates to the long-term nature of these products. In guaranteeing a future income, the provider assumes an average rate of return over the period of the guarantee. The more closely a provider can match their long-term liabilities with long-term assets, the lower this risk and the lower the price at which the product can be sold.

Inflation risk affects both the purchaser and the product provider. Inflation reduces the spending power of a person's retirement income over time. People can purchase income streams indexed to inflation to counter this risk but this increases the price of the product. Inflation risk also increases the costs of providing long-term products.

Longevity risk relates to the likelihood that the provider will have to meet pension obligations for longer than expected due to an unanticipated increase in life expectancy in the community.

Government policy can help product providers manage these risks and reduce the price of longevity insurance. In particular the government could issue a broader range of debt instruments, such as indexed and long-dated bonds. The availability of these assets would greatly assist in the development of a longevity insurance market by reducing investment and inflation risk.

The Australian Office of Financial Management announced on 7 August 2009 that it would resume issuing Treasury indexed bonds. The government should also consider issuing longer-dated bonds where this is consistent with its fiscal obligations.

The Review Panel does not consider that the government should issue longevity-indexed bonds to encourage the development of a longevity insurance market. The government already takes on the overwhelming majority of longevity risk through the Age Pension. Longevity bonds would increase the government's exposure to this risk. This is consistent with the findings of the OECD (2007b), which found the prospects for a successful, large-scale market in longevity-indexed bonds did not seem favourable due to the already high level of longevity risk already on government balance sheets.

A longevity index shows the number of years that, on average, a member of the population at a particular age is expected to live. The index can be used to establish a market in which providers can hedge part of their longevity risk. Such an index has been set up by J.P. Morgan for the United Kingdom market (known as the LifeMetrics index). The government could help to develop a longevity index by making available the data necessary to create and maintain one (see Recommendation 21b). This is consistent with an OECD (2007b) finding that governments, through their national statistical institutes, could help private market participants produce longevity indices. Sherris and Evans (2009) suggest that the government would be in the best position to produce such an index.

Tax and means test concessions

There have also been calls for the government to provide tax or social security concessions to encourage people to purchase longevity insurance. Specific concessions for longevity risk products are not supported as they could distort the market.

If specific concessions did exist, there would need to be rules setting out the characteristics of these products. The government would effectively need to approve new products that may fall outside these rules by making legislative changes. The longevity insurance market is likely to be very innovative. Placing legislative restraints on product design would be an unnecessary and costly constraint on innovation.

However, given the unique nature of deferred annuities, there is a case that they should only be means tested when they start to pay an income, unless a person can access the capital before this time. Further details on the proposed means test treatment of superannuation pensions and annuities are in Section F2 Means testing.

Government-provided products

In purchasing a longevity risk product, the purchaser is taking on the risk that the provider will be unable to meet their obligations. Prudential regulation provides some protection against this risk. However, other factors could affect this counterparty risk.

One of these risks is systemic longevity risk, where advances in health research or changes in lifestyle result in unexpected increases in life expectancy for the entire community. Significant changes in life expectancy may go beyond what is catered for in prudential regulation. This might affect a provider's ability to meet its current and future obligations.

The government should consider whether these risks are such that it should enter the market and sell products that provide a guaranteed income stream (see Recommendation 22). For example, the government could use the existing Age Pension infrastructure to allow a person to purchase an immediate annuity. The government should also consider selling a deferred annuity that, if purchased, would give retirees greater certainty over the period they have to draw down their assets. People should be able to purchase these products with superannuation as well as non-superannuation money.

Several submissions state that the government should not sell these products. They argue that the government may not provide these products at an actuarially fair price. This might result in low-income households who do not purchase this product subsidising higher-income households who are more likely to do so. This may also result in the private sector leaving the market (which could result in less product innovation).

As the government already takes on the majority of longevity risk through the Age Pension, if it were to offer these products it should limit the amount of additional longevity risk it takes on. It could, for example, limit the value of the annuity and place a cap on the amount a person could invest in a deferred annuity. The government would need to develop an appropriate business model that would ensure the products are sold at a price that accurately reflects the risk the government would be taking on.

Findings

The development of a longevity insurance market will require involvement by both the private and public sectors. The private sector is better placed to develop products that meet the needs of retirees. The public sector can assist in developing these products by providing more tools that the private sector could use to limit the risks associated with the products.

The public sector may be better placed to deal with the counterparty risks that exist with these products. However, the government would be taking on more longevity risk by entering this market.

Guaranteed or non-guaranteed

Products can either be guaranteed by the provider or non-guaranteed. The income from a non-guaranteed product would depend on the investment returns on the assets supporting the pool and the mortality experience of the people in the pool.

The government should not restrict the types of products that could be sold. Longevity insurance should form part of a portfolio of products people can use to finance their retirement. Placing restrictions on products, such as requiring them to be guaranteed or non-guaranteed, reduces the potential range of products that could be included in this portfolio.

A2–4 Improving people's awareness of the retirement income system

Recommendation 23:

The government should help make people more aware of the retirement income system, and therefore better able to manage their superannuation, by increasing the regularity of superannuation guarantee contributions, making it easier for people to manage their superannuation and providing people with a single point of contact for government agencies.

- (a) Superannuation guarantee contributions should be paid at the same time as wages. This should be introduced over time so businesses can adjust their cash flows. As a first step, larger businesses (that is, businesses required to lodge their business activity statements on a monthly basis) should be required to pay superannuation guarantee contributions at least monthly.
- (b) Employers should report superannuation contributions to their employees when a contribution is made.
- (c) There should be a method of linking superannuation records, such as client identifiers like the tax file number, to make it easier for people to manage their superannuation.
- (d) A superannuation portal where people can interact with government agencies and get information on retirement incomes should be developed. Over time this portal should evolve, subject to suitable safeguards, so that people can manage all their superannuation through one channel.

Principles

People should be able to engage with the superannuation system and manage their superannuation as easily as possible. In order to do so, they need to be aware of how the retirement income system works with their money. The system should take into account that superannuation contributions are part of an employee's remuneration and people should be able to manage their superannuation in an efficient manner.

People should be able to interact easily with the government agencies that administer the retirement income system.

A person's level of awareness of the retirement income system will affect the outcomes they get from it. While it is difficult to make people take a greater interest in the system there would be benefits in making it easier for people to become more engaged with their superannuation.

Measures to increase engagement include: increasing the regularity of superannuation guarantee contributions; creating a more effective means for people to prove their identity to superannuation funds; and introducing a single superannuation portal that people can use to manage their relationship with government agencies.

The relationship between members and superannuation funds is also important for increasing awareness and engagement. This relationship forms part of the *Review into the governance, efficiency and structure and operation of Australia's superannuation system* being undertaken by Mr Jeremy Cooper (the Cooper Review).

Findings

There are certain aspects of the retirement income system that can hinder people from becoming more engaged with it. These include government regulations that provide for:

- superannuation guarantee contributions to be paid separately from wages; and
- complex identification requirements for people with multiple accounts that can make it difficult for people to manage their superannuation.

The relationship between individuals and superannuation funds is outside the scope of this Review and falls within the scope of the Cooper Review.

Superannuation guarantee contributions are part of an employee's remuneration but, unlike wages, they are only required to be paid once every three months. This may make it difficult for people to see that superannuation is part of their wage. In addition, many employers are not required to advise their employees that they have made a superannuation contribution on their behalf.

Superannuation guarantee contributions should be made at the same time as an employee is paid their wage. The growth of electronic commerce since the introduction of the superannuation guarantee in 1992 has made it easier for employers to make more regular contributions. However, this requirement should be phased in over time to give smaller businesses time to adjust their cash flows.

As a first step, larger business could be required to make superannuation guarantee contributions at least monthly. A business could be regarded as a large business if it is required to lodge its business activity statement on a monthly basis. This could also form part of a future extension of the standard business reporting protocols (see Section G4 Client experience of the tax and transfer system). Like other remuneration, employers should be required to advise their employees when a contribution is made.

Although people cannot access their superannuation until they retire, it should be easier for them to manage it while it accumulates. Advances in technology will assist in this process. However, electronic management of superannuation accounts will depend on the person being able to prove they are the owner of that account. The government should implement a mandatory identifier for superannuation (possibly including the existing tax file number). This would also act as proof of identity, making it easier for people to manage their superannuation, to merge multiple accounts into one account and to open new accounts. It would also assist in reducing the number of lost superannuation accounts.

Access to information is another way of improving engagement with the system. As a trusted source of information for the community, the government should establish a superannuation portal. The portal would provide a single point where people could access information from, and interact with, relevant government agencies on retirement income matters, including the Age Pension. It would also provide access to general retirement

information, such as that already available on the FIDO website administered by ASIC and the National Information Centre on Retirement Investments.

Over time, this portal could evolve to provide more specific information relating to a person's superannuation accounts. This could allow a person to view all their accounts in one place, open and close accounts and move money between funds. These capabilities would depend on the introduction of a mandatory electronic signature or identifier to provide a link between accounts.

It would be important, however, to ensure that if a government portal is used to access private superannuation accounts, appropriate means are employed to ensure that account holders are aware that superannuation is not a government product, is not guaranteed by the government and is not otherwise endorsed by the government.

There would be adjustment issues for both employers and the superannuation industry as a result of these recommendations. These would include updating software and other administration systems. Therefore, the recommendations should be further developed in consultation with employers and the superannuation industry.

A2–5 Other retirement income issues

Superannuation funds and infrastructure

Superannuation funds play a significant role in the economy as a provider of capital. Some submissions have argued that superannuation funds could play a greater role in investment in infrastructure in Australia.

The Review Panel notes that the Cooper Review will consider the issue of superannuation fund investment in infrastructure assets and whether things should be done to facilitate greater investment in this asset class. In principle, barriers (if any) that prevent superannuation funds from making suitable investments in infrastructure should be removed. The Cooper Review is the most appropriate forum to consider this.

However, specific tax concessions should not be provided to superannuation funds to encourage such investment.

Superannuation guarantee for contractors

In its retirement income report, the Review Panel recommended against extending the superannuation guarantee to the self-employed due to the diverse and varying risks and circumstances of business and entrepreneurship. However, the Panel stated that it wanted to consider further the treatment of contractors within the superannuation guarantee system.

It can be very difficult to distinguish whether a contractor is engaged in an arrangement that is similar to an employer–employee relationship or on a genuine independent contractor basis. Embedding this distinction in legislation would set an arbitrary line between those inside and outside the superannuation guarantee arrangements. This would allow people to arrange their affairs to remain outside the superannuation guarantee and would result in greater complexity for genuine contractors.

The definition of an employee also affects issues outside the superannuation guarantee system, such as tax, industrial relations and workers' compensation schemes. It is difficult to make recommendations on the superannuation aspects of this question without understanding how they may affect these other areas.

The Taskforce on Reducing the Regulatory Burden on Business, chaired by Mr Gary Banks, recommended that the definition of 'employee' and 'contractor' in the *Superannuation Guarantee (Administration) Act 1992* (SG Act) be aligned with the provisions that apply for PAYG withholding purposes (Australian Government 2006). The SG Act has a broader definition of employee. The taskforce found that the fact the two definitions were not aligned was resulting in a high level of non-compliance with the superannuation guarantee. The Board of Taxation also found that the distinction between employee and independent contractor for superannuation guarantee purposes was leading to higher compliance costs and was acting as a deterrent to employing staff (Board of Taxation 2007).

The Banks Taskforce found that most employers were well aware of their PAYG withholding obligations. For this reason it recommended aligning the SG Act definition of employee with the PAYG definition to reduce compliance costs and also help to overcome the problem of unwitting non-compliance. Aligning the definitions would also be consistent with the proposal to bring superannuation contributions within the PAYG withholding system. This would make it easier for employers to adjust to this proposal.

The Taskforce recognised that altering the superannuation guarantee definition would mean that some contractors currently covered would fall outside the system. However, it considered that the effect would be small. This impact should be considered in any decision to align the definitions.

Preservation ages for mandatory retirement occupations

Recommendation 24:

The preservation age for Service Pensioners should remain at 60 as it is already legislated to align with the eligibility age for that pension. An increase in the preservation age should apply to people who currently have a legislatively prescribed retirement age.

In the retirement income report, the Review Panel recommended that the preservation age should be increased to 67 years to align it with the Age Pension age. In making this recommendation, the Panel stated that it wished to explore other issues associated with this alignment, including the effects on people in occupations with mandatory retirement ages and on Service Pensioners.

As noted in the retirement income report, the preservation age provides an important social signal about retirement expectations. Increasing access ages for retirement benefits is also consistent with many other OECD countries. Iceland, Norway and the United States have increased the access age to 67 years, and Denmark and Germany are in the process of increasing the access age to 67 years while the United Kingdom is increasing the access age to 68 years.

While certain occupations may have mandatory retirement ages below age 67, a community-wide standard for the preservation of superannuation savings is fundamental to

preserving the link between retirement expectations and the preservation age. Also, retirement from one occupation does not necessarily mean retirement from the workforce.

Any exceptions to preservation age legislation for particular groups or occupations would be inconsistent with:

- the Review Panel's view that retirement ages should reflect increasing life expectancies; and
- the actions of successive governments to abolish employment practices that potentially discriminate against older workers.

On this basis, there should be a consistent preservation age across all occupations. The recommended increase in the preservation age beyond 60 is not proposed to commence until 2024. This should provide sufficient time for organisations to adjust their mandatory retirement ages where appropriate.

The already legislated increase in the preservation age to 60 will align the preservation age with the eligibility age for the Service Pension. Therefore recipients of this pension should still be allowed to access their superannuation from age 60.

Annex A2: Assumptions used in this section

The Treasury uses two models, RIMHYPO and RIMGROUP, to measure the outcomes of the retirement income system. The replacement rate analysis in Section A2-2 (Chart A2-4 to Chart A2-8) has been calculated using RIMHYPO. The national saving analysis (Chart A2-9 and A2-10) has been calculated using RIMGROUP.

Replacement rate analysis

RIMHYPO produces retirement income projections for a hypothetical individual or couple, including all relevant combinations of life events, government policies and retirement income sources. It captures, in detail, the legislative structure defining the interactions between superannuation, taxation and social security legislation.

The growth assumptions used in this model reflect long-term trends.

- Inflation is 2.5 per cent per year, reflecting the mid-point of the Reserve Bank's medium term inflation target of 2 to 3 per cent, on average, over the cycle.
- Wages grow at 1.6 per cent per year in real terms, reflecting 30 year averages.
- Superannuation fund earnings are 6.5 per cent per year, reflecting 30 year averages.

The projections presented in Section A2-2 involve a range of additional assumptions. These assumptions are designed to provide a balanced view of possible outcomes for individuals. Actual outcomes could be higher or lower depending on the specific circumstances of the individual.

The base case is for a single person, who starts work in 2010 at age 30 years, and retires in 2047. A 37-year working life is an average working life for a primary earner, including periods outside the workforce (for example, study, care or travel). The replacement for the base case scenario is shown in Chart A2-4.

The base case assumes the hypothetical individual retires in 2047 and lives for a further 22 years (a total life expectancy of 88 years). This is based on Treasury projections of age-specific probabilities of death for each year of age, calculated using the 2005–2007 life-tables and various historical life tables published by the Australian Bureau of Statistics. The projections factor in improvements in mortality factors.

The base case assumes the person does not make any additional contributions to superannuation, beyond the superannuation guarantee. The exception to this is Chart A2-8, which presents replacement rates for an employee who salary sacrifices at the average rate for people in their age and level of salary and wage remuneration (including salary sacrificed amounts as remuneration).

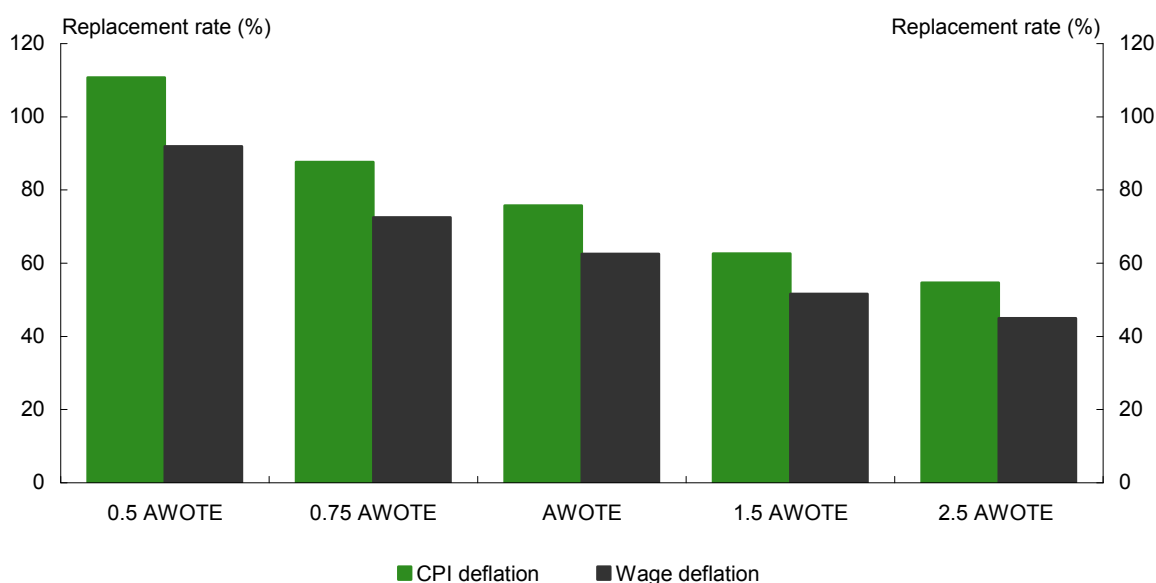
The base case assumes the person does not access their superannuation before Age Pension age. The exception to this is Chart A2-5, which assumes a person retires at age 60. In this alternative base case, the individual is assumed to access either Newstart Allowance or Disability Support Pension and then draw down their superannuation to achieve a 50 per cent replacement rate of their income at age 60. At age 67 they purchase a lifetime annuity with their remaining superannuation.

Many people will work longer than 37 years. People who work longer than 37 years are projected to receive higher replacement rates. Chart A2–6 shows the replacement rate for a person with a working life of 42 years (that is, they commence work at age 25 in 2010 and retire in 2052).

The base case assumes that individuals use their superannuation to purchase a hypothetical lifetime annuity, which is indexed by wages. This is different to the traditional assumption used in Treasury analysis, that the individual uses an allocated pension to draw down their savings over their expected lifetime. A lifetime annuity indexed by wages has the most comparable characteristics to the Age Pension. This assumption reduces replacement rates compared to the projections generated by the allocated pension scenario.

The projections use consumer price inflation to determine the purchasing power an individual retains in retirement. Adjusting for consumer price inflation indicates whether an individual's real standard of living is maintained over time. Some groups argue that wages are a better indicator of living standards. Using wages reflects an individual's living standards relative to the (rising) living standards of workers, rather than their ability to purchase a particular set of goods and services. Chart A2–13 presents the base case replacement rate projections for the AFTS proposals using both methodologies.

Chart A2–13: Illustrative projected replacement rates under the Age Pension and superannuation guarantee, deflated by wages and consumer prices^(a)



(a) A replacement rate compares a person's spending power before and after retirement (that is, income and fringe benefits after tax is paid). For example, a replacement rate of 75 per cent would mean that a person would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement. The illustrative replacement rates are projected for a hypothetical single male who works for 37 years and retires in 2047. It is assumed that they use their superannuation guarantee benefit to purchase a lifetime annuity at retirement. The spending power used to calculate the illustrative replacement rates are deflated by the consumer price index or wages to 2008–09 dollars. Actual outcomes will vary depending on factors such as workforce participation, labour income patterns, investment performance, inflation, longevity and whether a person accesses their superannuation prior to Age Pension age.

Note: AWOTE is currently around \$1,200 per week (\$62,400 per year). Around half of workers earn less than three-quarters of AWOTE.

Source: Treasury projections.

National saving analysis

The national saving analysis has been calculated using RIMGROUP. RIMGROUP is a comprehensive cohort projection model of the Australian population which starts with a

population and labour force model, tracks the accumulation of superannuation in a specified set of account types, estimates non-superannuation saving and calculates tax payment and expenditures, social security payments including pensions and the generation of other retirement incomes. The projections are done for each year of the projection period separately for each birth year gender decile cohort.

The key assumptions in the analysis underlying Charts A2-9 and A2-10 are:

- Increases in compulsory saving are offset by a reduction of 30 per cent in other saving. This applies to the increase in contributions resulting from the removal of contributions tax as recommended in this Report and the increase to the superannuation guarantee rate to 12 per cent.
- Increases in saving resulting from halving the earnings tax rate are offset by a reduction of 5 per cent in other saving.
- In analysing the effects of a potential increase in the superannuation guarantee rate to 12 per cent, total remuneration has been kept constant in the base and new policy runs. The increase in superannuation guarantee contributions has been directly offset by a decrease in the growth of gross cash wages.

A3. Wealth transfer taxes

Key points

A bequest tax would be a relatively efficient means of taxing savings. Decisions to save taken solely to fund consumption later in life would be unaffected. But decisions to save motivated by the desire to leave a bequest would be affected and this would impose some efficiency costs. In aggregate, though, bequest taxes are not likely to introduce large biases into donor behaviour. A bequest tax could increase labour supply and savings by recipients and prospective recipients, though the effects would be limited.

Such a tax could also be a progressive element of the tax and transfer system. Because the distribution of wealth in Australia is so uneven, most of the revenue available from a bequest tax could be raised from the top 10 per cent of households by wealth.

A tax on bequests would fit well with Australia's demographic circumstances over the coming decades. Over the next 20 years, the proportion of all household wealth held by older Australians is projected to increase substantially. Large asset accumulations will be passed on to a relatively small number of recipients. On the other hand, a bequest tax would be complex. There would be a need for anti-avoidance provisions, including a tax on gifts. There would, inevitably, be significant administration and compliance costs.

A tax on bequests should not be levied at very high rates. People should not be unduly deterred from saving to leave bequests. A substantial tax-free threshold combined with a low flat rate beyond that point would be an appropriate structure for a bequest tax. Bequests to spouses should be concessionally treated.

Another design issue is whether to tax the whole of the donor's estate or the inheritances received by individual recipients. There are arguments on either side, but on balance, they probably favour taxing each estate as a whole. A large number of other design issues would need to be considered. The more concessions and exemptions in the bequest tax, the greater its complexity and the greater the risk to efficiency and equity goals.

The Review has not sought to recommend the introduction of a bequest tax at this time, but believes that there should be full community discussion and consultation on the options.

A3-1 How a tax on bequests measures up

A central question for any tax system is whether, and how, to tax savings. The Review sees a role for the taxation of savings in Australia's future tax system but one that is more neutral between different forms of saving and that imposes smaller efficiency costs than the existing system (see Section A1-3). One element of the future taxation of savings could be a bequest tax; that is, a tax on the assets a person leaves behind at their death.

A bequest tax levied at a low flat rate, and designed to affect only large bequests, could be an efficient and equitable component of Australia's future tax system.¹⁴

Efficiency

Most taxes introduce biases into economic decisions and thus impose efficiency costs on society overall. But a tax on bequests would impose lower efficiency costs than many other means of taxing savings. The motives for leaving bequests have important impacts on the biases that the tax would bring to savings behaviour and, consequently, on the efficiency costs of the tax.

Principle

The tax system should aim to raise revenue with low efficiency costs — while also taking into account issues of equity, simplicity, sustainability and consistency with other policy objectives. Consideration should be given to any tax that would raise revenue with low efficiency costs and no large adverse effects on other tax policy considerations.

While altruism towards recipients, predominantly children, is an important motivation for leaving bequests, there are two other important scenarios.

First, many bequests are unplanned. The length of a person's life is uncertain and in many cases a donor saves not to leave a bequest but solely to ensure their own financial security. If they live for as long as they expect to, they consume their savings and pay tax as they do so. If they die early, however, a substantial amount of savings may remain. These savings are usually bequeathed to someone, but bequeathing the assets is not the purpose for which they were acquired. In this sense, the bequest is unplanned.

Second, some bequests may be a form of compensation for services provided by a recipient to the donor. For example, an elderly donor may leave a bequest to a neighbour who has devoted time and effort to caring for them.

How taxing bequests would affect donors

An important consideration in designing a tax on savings is to limit the extent to which the tax encourages people to consume now rather than save and have their savings taxed in future (see Section A1-3). Taxing savings at the time of death largely avoids such biases, as a person has at that point finished saving in order to consume later in life. Taxing bequests would, however, have some impact on donor saving decisions — and, therefore, some efficiency costs — depending on the donor's motive for accumulating wealth.

- Saving undertaken solely to ensure the donor's financial security would not be affected by a bequest tax because it is motivated by the donor's concern for their own wellbeing, not the desire to leave a bequest.

14 This report uses 'bequest tax' as a generic term applying to any tax levied on assets at death. An 'estate tax' is levied on the whole of the donor's estate. An 'inheritance tax' is levied on the inheritances received by individual recipients. An 'accessions tax' applies on a cumulative basis to the gifts or inheritances received by an individual throughout their life. 'Donor' is used for the person who leaves a bequest or makes a gift and 'recipient' for the person who receives a gift or bequest.

- Economic theory suggests that the impact of a bequest tax on saving for altruistic motives is uncertain. The tax means that the donor must forgo more consumption to deliver the same after-tax benefit to the recipient. This discourages saving. However, it also means that the range of consumption and bequest options open to the donor has been diminished. Whether this will induce the donor to save less or more will depend on their individual preferences. If the donor is determined to leave a post-tax bequest of a certain size, the tax may encourage them to save more. If they are more concerned about their current consumption, they may save less.
- For the same reasons, the net impact of a bequest tax on the saving of donors who are seeking to compensate recipients for services rendered is not clear in theory.

Many donors are likely to be moved by a combination of these motives, so that estimating the impact of a bequest tax is essentially an empirical matter. There is no doubt that the bequest motive has some impact on savings decisions. Life insurance choices and patterns of giving before death show that altruism has some effect on donor choices. On the other hand, there is a considerable body of evidence that precautionary savings, which result in unplanned bequests, account for a significant proportion of savings (Parker & Preston 2005). As purely precautionary savings would be unaffected by a bequest tax, it is unlikely that taxing bequests would greatly affect donor savings (Gale & Perozak 2001).

This suggests that a bequest tax would be more efficient than some other means of taxing savings — particularly taxation of the returns to saving as they accrue (see Section A1-3).

Recipients would work and save more

Because they do not receive, or do not expect, such a large post-tax inheritance, recipients and prospective recipients tend to work more and save more in the presence of a bequest tax. Evidence from the US suggests that receipt (or expected receipt) of an inheritance reduces labour supply, although the impact is not great (Holz-Eakin et al. 1993). Consequently, the improvement to labour supply that would arise from reducing post-tax bequests through a bequest tax, while positive, is likely to be small.

Double taxation is not good or bad in itself

Bequest taxes are sometimes opposed on the grounds that they involve double taxation: much of the income saved to build up the bequeathed assets has been taxed at the time it accrued to the donor. 'Double taxation' is not good or bad in itself. Any system that taxes economic flows at more than one point will involve an element of double taxation. For example, the current system taxes an individual's labour income as it accrues and taxes the part that is consumed a second time, through the GST. There is no reason to try to avoid such double taxation by adopting a system with a single tax. A system that raised all its revenue from a single household income tax would impose very large costs on taxpayers despite the absence of double taxation. The important thing is to design and implement a system that raises enough revenue while limiting the costs of doing so.

Finding

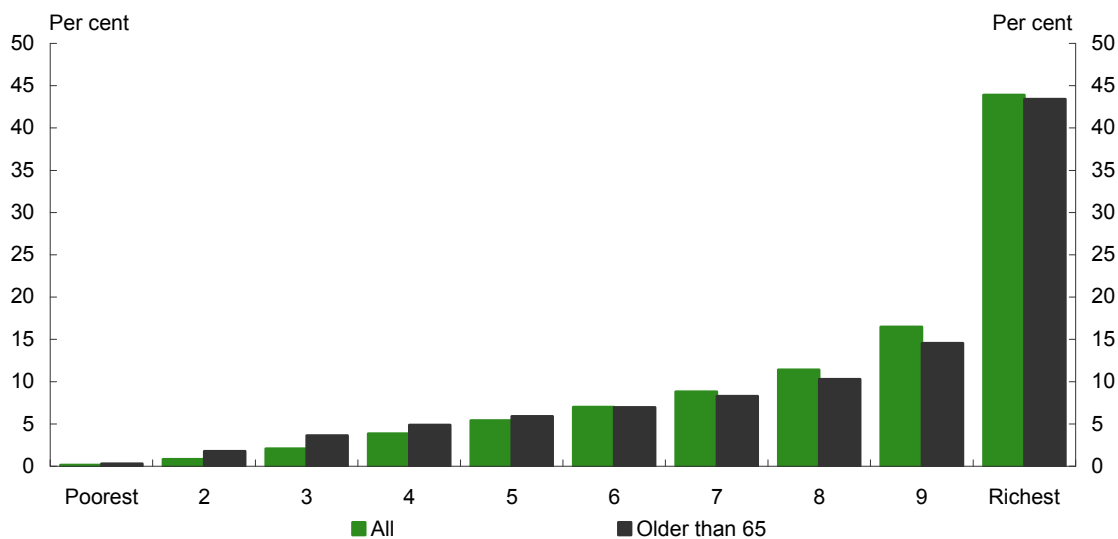
The efficiency of a bequest tax depends on the motivation of the donor and the benefits the donor and recipient receive. Taxing unplanned bequests is particularly efficient, as people would not change their behaviour to avoid the tax. Taxing planned bequests involves efficiency costs but these are relatively low.

Equity

A bequest tax could be seen as improving horizontal equity — that is, it could help ensure that people in the same economic situation pay the same amount of tax. If two people have the same economic resources and are similar in all relevant respects, apart from the fact that one earned a particular sum as an employee and the other inherited the same sum, it may be regarded as inequitable that tax falls only on the person who earned the sum as an employee. In general, a bequest tax taxes income from unrequited transfers rather than from work and saving.

A bequest tax could potentially be a highly progressive element in the overall tax system. The richest 10 per cent of households headed by a person aged 65 or older hold 43 per cent of such households' total wealth, while the top 20 per cent hold 58 per cent (see Chart A3-1). As the distribution of wealth is very uneven, a bequest tax could apply only to the largest wealth holders in Australia and still raise a large proportion of the available revenue. Such a tax would make the wealth distribution a little more even but no feasible rate of tax would have a major impact in this regard.

Chart A3-1: Percentage of total household wealth by wealth decile, Australia, 2005-06



Note: 'Older than 65' denotes households headed by a person at least 65 years old. 'Older than 65' figures show the distribution of wealth held by older households.
Source: ABS 2007, unpublished data.

Another important equity issue is the parity of treatment between married and unmarried donors. The primary goal of a bequest tax is to raise revenue while moderating the passing of economic resources between generations. This suggests that concessional treatment should be extended to bequests received by spouses. These are not intergenerational transfers, and if bequests to spouses were fully subject to a bequest tax, the assets of a couple

would usually be taxed twice before reaching the next generation, while the assets of a single person would not.

Principle

Overall, a well-designed bequest tax would improve equity as it would help to distribute opportunities more evenly across the community.

Simplicity

A core theme for the Review has been to reduce complexity in the tax and transfer system. The introduction of a new tax on savings would inevitably involve some new complexity, and present at least some tax-planning opportunities for taxpayers approaching the end of their lives. Tax planning need not be illegal nor immoral, and in many cases it constitutes rational behaviour on the part of the taxpayer. But it contributes nothing to the wellbeing of Australians overall. Rather than creating value, it is entirely concerned with how much value should be transferred from the taxpayer to the government.

Any estate, inheritance or accessions tax would need to be accompanied by a means of taxing gifts, as an anti-avoidance measure. Otherwise, many donors would be able to avoid the tax by transferring their assets to the intended recipients shortly before the time of death. Other anti-avoidance provisions would also be necessary, although these may not need to differ greatly from existing provisions in other areas of the tax law.

US experience with its estate tax suggests that the best available tax planning is able to remove around one-third of a medium-size estate from the estate tax net (Schmalbeck 2001). Many of the expedients that minimise tax are undesirable to donors on other grounds; for example, they may oblige the donor to relinquish control of their assets many years before their death. Leakage from the US estate tax base is significant but falls well short of wholesale avoidance.

It is important to remember that the Review is proposing consideration of a bequest tax that falls only on the largest estates or inheritances. The large majority of estates or inheritances would not be subject to tax. Nevertheless, it is clear that the introduction of a tax on bequests would involve provisions of significant complexity. The tax base would need to be defined, avoidance countered and rates specified. This complexity and its attendant costs must be weighed against the efficiency of the tax in raising revenue and the contribution it could make to the redistributive goals of the tax and transfer system, its sustainability and its policy coherence.

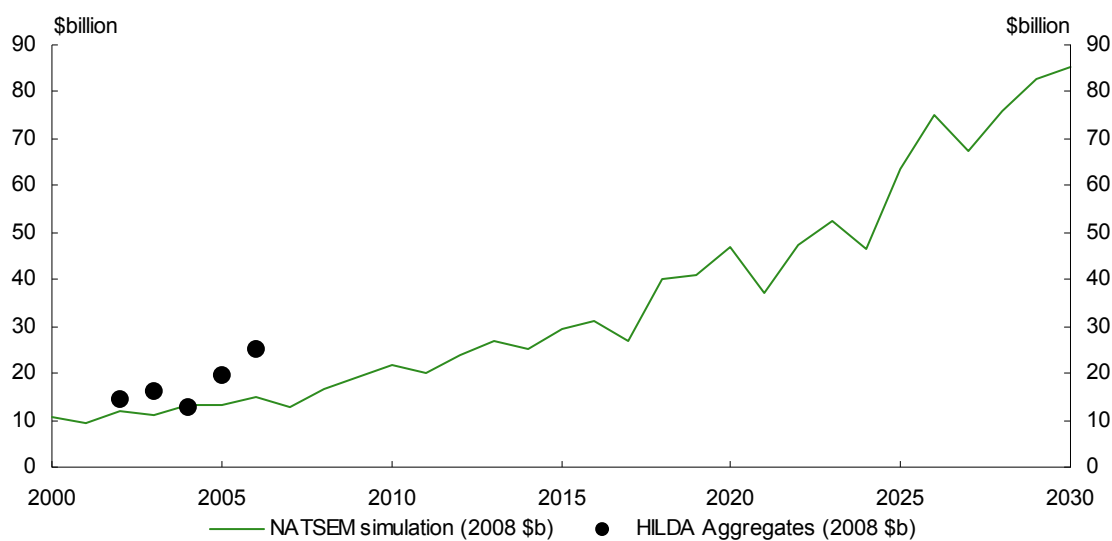
Finding

The introduction of a new tax on bequests would involve some new complexity, and present some tax planning opportunities for taxpayers approaching the end of their lives. This additional complexity must be weighed against the efficiency and equity arguments in favour of taxing bequests.

Sustainability

Ideally a tax base should be sustainable, in the sense that it should continue to yield a predictable revenue stream over time. A tax on bequests would fit well with Australia's demographic circumstances over the next 40 years. Between 2003 and 2030, the proportion of all household wealth held by older Australians is projected to increase from 22 per cent to 47 per cent (Kelly & Harding 2003). Mortality rates among early baby boomers will begin to increase significantly from around 2015. Large asset accumulations will be passed on to a relatively small number of recipients. As a result, the amount of bequests passed on in Australia is estimated to rise from \$22 billion in 2010 to \$85 billion in 2030, in real terms (see Chart A3-2). This amounts to a projected increase from around 2 per cent of GDP to around 4 per cent.

Chart A3-2: Projected bequests, Australia, 2000–2030



Source: Kelly and Harding (2003) updated by Kelly. HILDA aggregates compiled by Kelly.

It is also worth noting that with longer life spans, children are inheriting from their parents much later in life, when they are often already well-established financially, so that the bequest is of decreasing importance as an economic support for children in early adult life.¹⁵

Finding

A tax on bequests would fit well with Australia's demographic circumstances over the next 40 years. Between 2003 and 2030 the proportion of all household wealth held by older Australians will more than double. Large asset accumulations will be passed on to a relatively small number of recipients, many of them in middle age.

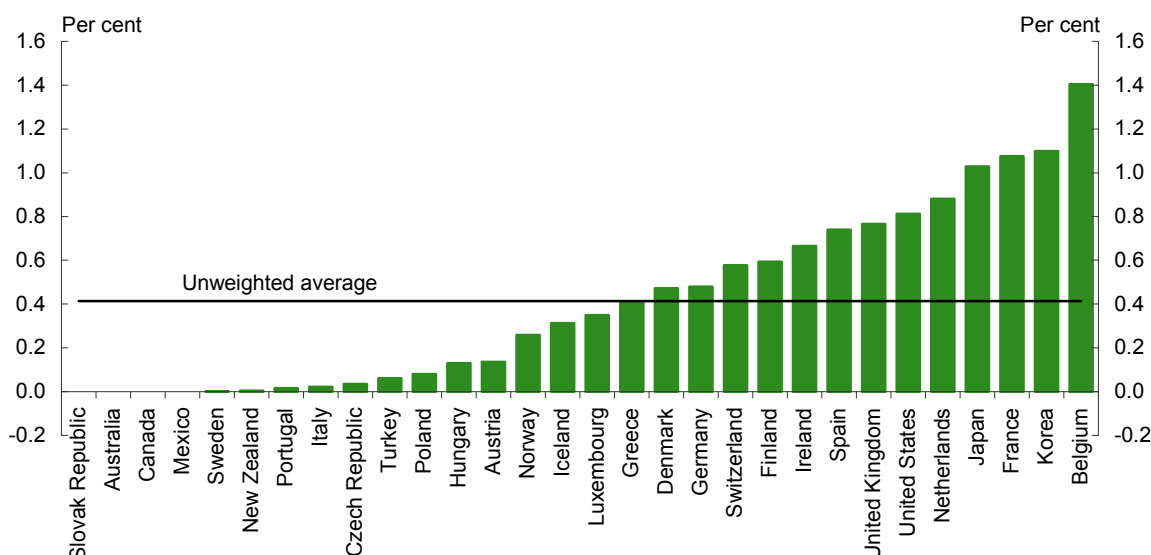
¹⁵ Based on current mortality rates, a boy born in 2007 can expect to live 79.0 years while a girl can expect to live 83.7 years (ABS 2009i). The figures for children born in 1965–1967 were 67.6 and 74.2 respectively (ABS 2008).

A3-2 The current system has some impact on bequests

All States and the Australian government imposed death duties until the late 1970s. At that point, they began to be phased out. Avoidance had not been tackled systematically and thresholds had not been adjusted, so that moderate-size estates became liable for the taxes, which became very unpopular. State bequest taxes also suffered from competition between the States, with most duties abolished in the ten years after Queensland abolished its duties in 1977.

Internationally, many OECD countries impose wealth transfer taxes — mostly taxes on estates or inheritances — though in no country are these taxes a major source of revenue. On average, OECD countries raise 0.41 per cent of total tax revenue from such taxes (see Chart A3-3). If this percentage were replicated in Australia, wealth transfer taxes would have raised about \$1.4 billion in 2007-08.

Chart A3-3: Estate, inheritance and gift taxes, OECD, 2007
Per cent of total tax revenue



Source: OECD (2009).

In Australia today, no taxes are charged on transfers of wealth by bequest or gift. However, some parts of the tax and transfer system impact on bequests for other policy purposes.

Superannuation benefits paid to a non-dependant are subject to a tax of 15 per cent (see Section A2-2).

Means testing of residential aged care assistance effectively operates as a tax on some estates (see Section F7 Funding aged care). For example, on average 26 per cent of the cost of high-level residential aged care services is met from fees to care recipients (DoHA 2008). By law, the size of these contributions varies with the user's income and assets, yet the service standard a user enjoys does not vary with their contributions. Where contributions are made from private savings, the imposition of means testing effectively reduces the value of their estate.

If an asset subject to capital gains tax (CGT) is transferred by bequest, CGT on the gain that has accrued in the hands of the donor is not payable at the time of transfer, but if the recipient later disposes of the asset, CGT is generally payable on the whole of the gain from the time of acquisition by the donor to the time of disposal. This is not a tax on bequests but the realisation of tax on income accrued in the person's lifetime.

A3–3 Parameters for a possible tax on bequests

Recommendation 25:

While no recommendation is made on the possible introduction of a tax on bequests, the Government should promote further study and community discussion of the options.

A large number of design choices would need to be made if a bequest tax were adopted. This Report does not make recommendations on these issues — further work is needed before a fully articulated proposal could be considered. It is, however, possible to suggest parameters for the most important design features.

A tax on the whole estate or on individual inheritances?

A tax on bequests may be an estate tax, an inheritance tax or an accessions tax.

An estate tax applies to the whole of an individual's estate, regardless of how many recipients there are. It could be designed to favour bequests to spouses or to other categories of recipient: bequests to such recipients could be concessionally valued or could receive a flat percentage discount. It would be relatively easy to apply, as the whole of the estate would be taxed as one unit.

An inheritance tax applies separately to each inheritance received by an individual. If a progressive rate scale were adopted for either an estate or an inheritance tax, the adoption of an inheritance tax would provide more incentive for donors to split their estates between recipients to reduce the total tax payable on the estate. To collect the same revenue from the same base of bequeathed assets, the rates for an inheritance tax would need to be higher than the rates for an estate tax. An inheritance tax accords better with an income tax system, as it taxes the bequest in the hands of the recipient rather than in the estate of the donor. An inheritance tax may be more horizontally equitable than an estate tax, in the sense that two people who receive the same amount of inheritance will generally pay the same amount of tax, regardless of the size of the estate from which the inheritance comes.

An accession tax taxes all gifts and inheritances received by a particular person on a cumulative basis. It takes account of the fact that some recipients receive a number of substantial inheritances over the course of their lives, though at the cost of some complexity. In particular, it requires the tax authorities to maintain a record of gifts and inheritances received over the course of a person's lifetime. It could also involve adjusting past receipts for inflation. Among OECD countries, only Ireland has implemented an accessions tax.

While there are arguments on both sides, an estate tax may be the best model for Australia. It avoids the lifetime complexity of an accessions tax and is simpler to administer than an inheritance tax. It accords with a tax system structure under which income savings are

subject to relatively uniform low rates of tax and it removes incentives for donors to split up their estates to minimise the tax payable.

The breadth of the base

A bequest tax would be simpler to administer and more economically efficient if it had a broad base, with no exemptions or concessions for particular asset types. Concessions for particular asset types would greatly complicate the design of the tax and would open up avenues for tax planning and avoidance. A comprehensive base would include all financial and non-financial assets, including owner-occupied housing, offset by outstanding liabilities. If a person's net assets were less than the threshold, no tax would be payable.

Setting sensible rates

A tax on bequests could have its own rate scale, which is the approach taken in most OECD countries, or some portion of the inheritance could be included in the recipient's income for income tax purposes. The Review recommends moving away from a comprehensive nominal income benchmark towards a system where capital income is taxed at relatively uniform rates lower than the rates applying to labour income. It would not, therefore, be consistent to include inheritances in the recipient's other personal income. Instead, a separate rate scale would be appropriate.

It would not be appropriate to specify a rate scale for an estate tax at this time: more analysis would be necessary before that could be done. Nevertheless, some parameters are clear. Given the very uneven distribution of wealth among Australian households, a tax that fell only on large estates would raise much of the revenue available. It would, therefore, be appropriate to set a substantial tax-free threshold, so that the large majority of estates would not be affected. The threshold should be indexed to wages to preserve its value in terms of community standards.

The tax could also be aligned with means testing for income support payments so that the holder of a high-value estate, assessed on a household basis, would not be eligible for means tested income support or family payments. Importantly, the tax base would include the value of owner-occupied housing.

Beyond the threshold, a fairly low flat rate would be desirable. A bequest tax should not be designed to prevent the transfer of wealth between generations, but as an efficient and equitable means of generating a relatively small proportion of total tax revenue. Too high a rate would run the risk of inducing large changes in donors' saving decisions and would encourage more aggressive tax avoidance.

Other design issues

Any option for taxing bequests and gifts would require consideration of:

- the cash flow implications for estates held predominantly in the form of illiquid assets;
- the treatment of bequests to charities, which are concessionally taxed in many countries;
- how the tax would interact with capital gains tax;
- how the tax would interact with the taxation of superannuation benefits on death;
- the treatment of non-resident donors and property located outside Australia; and
- the design of a gift tax to accompany the bequest tax. This would raise a number of difficult questions about what range of gifts from parents to children – which may take the form of Higher Education Loan Programme payments or contributions to student living expenses – would be included.

B — Investment and entity taxation

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B1. Company and other investment taxes

Key points

Globalisation carries profound implications for Australia's tax system and for the taxation of investment in particular. In a world of increased capital mobility, company income tax and other taxes on investment have a major impact on decisions by businesses on where to invest, how much and what to invest in and where to record their profits.

Australia has been successful over recent decades in attracting foreign capital to finance relatively high levels of domestic investment. While the continuing growth of China and India, and the consequent strength in Australia's terms of trade, should ensure continued strong investment in Australia's resources sector, attracting investment in other sectors may become more challenging.

Reducing taxes on investment would increase Australia's attractiveness as a place to invest, particularly for foreign direct investment. Reducing taxes on investment, particularly company income tax, would also encourage innovation and entrepreneurial activity. Such reforms would boost national income by building a larger and more productive capital stock and by generating technology and knowledge spillovers that would improve the productivity of Australian businesses and employees.

Continuing to reduce biases in favour of particular assets by aiming for a broader, more uniform company income tax base would ensure that investment is allocated to its most productive uses. Reducing biases against risk-taking would also encourage entrepreneurial activity, which is important for economic growth. Features of the current system may bias investment and other business choices towards less productive outcomes. In turn, this may reduce productivity and economic growth.

For the longer term Australia should look more closely at moving to a business level expenditure tax. A few countries have adopted this alternative form of company income tax base in recent years, following widespread academic study. The Review has considered how Australia should respond to these policy developments. Adopting an expenditure tax base would change the dynamics of how Australia attracts international capital and overcome some of the problems of income taxes. However, it would inevitably give rise to other issues.

B1–1 Costs and benefits of company and other investment taxes

Increased capital mobility over recent decades has focused attention on the effects of taxation on investment decisions. This trend is likely to continue, and while tax is only one of several factors that affect investment decisions, it is likely to be increasingly important.

Despite the increasing cross-border flows of capital, Australia will continue to exhibit some characteristics of a closed economy. Thus, the impact of investment taxes on economic outcomes in both open and closed economies needs to be carefully considered in the development of tax policy.

This section outlines broad principles that should be considered in relation to the taxation of investment and recommends some specific reforms and future directions. The related issue of the taxation of the savings of Australian residents is dealt with in Section A1 Personal income tax. How the taxation of companies and other business entities interacts with the personal income tax system, including the role of Australia's dividend imputation system, is dealt with in Section B2 The treatment of business entities and their owners.

The role of company and other investment taxes

Australia's main investment tax is company income tax, which applies to the return to equity (retained earnings and capital contributed by shareholders) in companies. Company income tax can be seen as taxing the normal return to equity, as well as any above normal returns (or economic rents) generated by an investment.

Through dividend imputation, company income tax effectively acts as a withholding tax on company profits that represent a return to either the savings of Australian investors or the labour of owner-operators of businesses that operate through companies. Equity investments undertaken by unincorporated enterprises or individuals are typically financed from domestic savings, and taxed through the personal income tax system.

In the absence of a company income tax of some form, Australian residents who are shareholders in or owner-operators of companies could significantly reduce the personal income tax they pay by retaining income in companies. Company income tax therefore operates as an integrity (or backstop) measure for the personal income tax system to limit the deferral or avoidance of income tax.

For foreign equity investors in Australia, company income tax generally acts as a final tax, supplemented by dividend withholding tax on distributions paid to non-residents. In limited circumstances tax is also paid on capital gains, in the case of non-portfolio holdings in a 'land rich' company or on Australian sourced 'ordinary income'. Company level taxes are therefore the primary means of taxing foreign equity investments.

By contrast, the returns to debt in the form of interest are a deductible expense for a company or unincorporated business. Interest received by the lender is, however, taxed as income for Australian resident investors or by means of interest withholding tax for foreign investors.

Principle

Company income tax is needed to raise revenue on the normal return, as well as economic rents, earned by foreign capital invested in Australia and to maintain the integrity of income tax as it applies to Australian residents.

The economic impact of investment taxes

While the impact of the overall level of taxation on economic growth remains the subject of debate, there is reasonable evidence that the composition of taxes does affect growth. In particular, there is growing evidence that a shift away from company income tax towards greater reliance on taxing other less mobile factors of production, or on consumption, has the greatest potential to increase GDP and growth (see Part 1).

Income taxes on investment, specifically source-based taxes, can lead to lower domestic productivity by increasing the required pre-tax return from an investment (the cost of capital) and reducing the incentive to invest. This can result in a smaller domestic capital stock, which often leads to lower productivity and lower wages.

The impact of company income tax on capital accumulation depends on the openness of the economy. The more open the economy the more of an impact company income tax has on potential capital accumulation, as the level of capital investment is no longer constrained by the level of domestic savings.

Simulation analysis by Johansson et al. (2008) found that reducing the statutory company income tax rate from 35 per cent to 30 per cent would lead to an increase in the investment to capital ratio of around 1.9 per cent. The study found that the effect of company income taxes is strongest on industries that are older and more profitable (and so have larger tax bases). Younger and smaller businesses (such as start-ups) were found to be less affected, possibly because they are less profitable or because they benefit from concessional tax arrangements.

Johansson et al. (2008) also found that the positive impact of reductions in the company income tax rate diminishes as the tax rate is lowered. Countries with a relatively high company income tax rate are therefore likely to experience a larger positive effect from a given percentage point reduction in the tax rate than other countries.

In addition, where the income tax base differs from economic income, investment decisions may be biased towards less productive assets where concessions apply, or people may be discouraged from entrepreneurial activity. These distortions to the composition of investment can lower productivity.

Company income tax can affect productivity in a number of ways (Johansson et al. 2008).

- Where effective tax rates vary across assets, investment can be directed towards less productive uses.
- Through its effect in discouraging foreign direct investment, taxes on investment can adversely affect technology transfers and knowledge spillovers.
- Taxes on investment may also reduce investment in innovative activities, by reducing the after tax return.¹

¹ This can be exacerbated for more risky investments where the tax system places limitations on the use of losses.

- Complexity of the tax system can also reduce productivity by absorbing resources that could be reallocated to more productive uses. In addition, tax system complexity may also deter foreign direct investment.
- Company income tax can also distort financing decisions. This can affect productivity by distorting the allocation of investment across industries, favouring those sectors that can more easily access debt, relative to those that have to rely more on equity, such as those that invest more in intangibles.

Using firm level data, Johansson et al. (2008) found that over 10 years the effect of a reduction of the corporate tax rate from 35 per cent to 30 per cent would lead to an increase in the average yearly total factor productivity rate of 0.4 percentage points for firms in industries with median profitability. The analysis suggests that the negative effect of company taxes is uniform across firms of different size and age, except for firms that were both small and young.²

How source-based taxes reduce investment

A small open economy, like Australia, does not have any noticeable impact on the international interest rate or the rate of return required by international investors. If the government imposes a source-based income tax, the pre-tax return to domestic investment will have to increase in order to generate the same post-tax return that could be earned by investing in another country with a lower tax rate.

As a result, some investments with a lower rate of return will not be undertaken, domestic investment will fall and less capital will flow into the country. This will continue until the pre-tax return has risen sufficiently to compensate investors for the effect of the source-based tax.

There is substantial econometric evidence that company income taxes affect foreign direct investment. A review of a wide range of empirical estimates concluded that a one percentage point increase in the marginal effective tax rate causes a 4 per cent fall in the stock of inbound foreign direct investment (de Mooij & Ederveen 2008).

Other studies have also suggested that foreign direct investment may be more responsive to changes in the tax rate as the gap between a country's tax rate and those of other countries increases. For example, foreign investment may be more sensitive to tax where the country's tax rate is significantly above average (Bénassy-Quéré et al. 2003).

Who carries the burden of company income tax?

At first it may appear that the burden of company income tax effectively falls on shareholders, who receive a lower post-tax return on their investment. But this view ignores the possibility that the tax could be shifted to consumers through higher prices, workers through lower wages, or other types of capital through lower returns as capital shifts out of the corporate sector in response to the lower post-tax return from corporate equity.

2 The results refer to a sample of firms extracted from the Amadeus (Bureau van Dijk) database (covering European OECD member countries) and the Worldscope (Thomson Financial) database (covering non-European OECD countries).

In a small open economy with perfect capital mobility, the burden or incidence of a source-based tax is shifted onto labour and land. As the source-based tax applies only to domestic investment, foreign investors can avoid the tax by moving their capital offshore. If a source-based tax is imposed or increased, capital flows out of the country until the pre-tax return increases by the full amount of the extra tax. This leads to less capital in the economy, less machinery, plant and research and development per worker and per hectare and therefore lower productivity of labour and land. In turn this means lower wages for workers and lower rents for the owners of land. In this simple model the burden of the source-based tax is fully shifted onto less mobile local factors of production.

Furthermore, because productivity is reduced, the tax burden on less mobile factors may be greater than the tax revenue collected. The obvious conclusion of this is that, given certain stringent assumptions, a small open economy should not levy source-based capital income taxes because they reduce national income (Gordon 1986).

While there is general agreement that at least some of the burden of company income tax is shifted onto labour, the extent of this is less clear. Economies are not fully open and capital is not perfectly mobile. Hence, the short-run and long-run effects are likely to differ. The US Congressional Budget Office (1996) has drawn some general conclusions from a survey of the literature:

- In the short-term, the burden of company income tax probably falls on shareholders or investors in general, but because investments are taxed differently, it may fall on some more than others.
- In the long-term, the burden of company income tax is unlikely to fall fully on corporate equity. This is because the company income tax is likely to affect investment decisions.
- In the very long-term, the burden of company income tax is likely to be shifted in part to labour, if the corporate tax dampens capital accumulation.

Hassett and Mathur (2006) find that a 1 per cent increase in the corporate tax rate is associated with a close to one per cent drop in wage rates. Felix (2007) estimates that a 10 percentage point increase in the corporate tax rate reduces annual gross wages by 7 per cent. Arulampalam, Devereux and Maffini (2009) estimate that around 75 per cent of any increase in source-based taxes on corporate income is passed onto workers in lower wages in the long run.

While these econometric findings are not without their limitations, they are broadly in line with the estimates derived from the use of computable general equilibrium models.³

Principle

In setting the company income tax rate and base, consideration should be given to its real incidence on shareholders, workers, land owners and other capital owners.

There is no 'fair' share of company income tax in isolation of these effects on individuals.

³ Gentry (2007) provides a comprehensive discussion of these and related studies on the incidence of the company income tax.

The taxation of economic rents

The analysis of where the incidence of company income tax falls is based on investments earning the normal return, or the going market return on capital. But many investments earn economic rents; that is, profits in excess of a market return. For debt, the normal return is the market rate of interest on debt for the relevant risk class. For equity, the normal return is the required market rate of return on stocks with the relevant risk characteristics.

In a closed economy, taxing the normal return will reduce the level of saving and therefore investment; however, a tax on economic rents would not normally bias investment decisions.

In an open economy, the impact of a tax on economic rents will depend on the mobility of the rent. Economic rents can be characterised as either firm-specific (or mobile) or location-specific. Investment generating mobile rents (arising from factors such as management know-how, a brand or a businesses' possession of a particular technology) can be moved from one jurisdiction to another. Location-specific rents may arise from exploitation of natural resources, existing fixed investments (such as factories), agglomeration (where businesses obtain benefits from co-location such as economies of scale), attractive local infrastructure, public services and institutions or consumer preference for domestically produced over imported goods.

For a mobile rent, source-based taxes can reduce investment. Investors will simply shift the investment to a lower tax jurisdiction so they can receive a greater share of the rent. In contrast, a source-based tax on a location-specific rent will not distort investment decisions.

Source-based taxes and profit-shifting

A high rate of source-based company income tax relative to other countries — including a tax on economic rents — creates an incentive for multinational groups to shift taxable profits from Australia to low-tax foreign jurisdictions.

In the absence of anti-abuse provisions, this can be done by shifting debt and the associated deductible interest payments and other expenses including management and intellectual property costs from foreign affiliates to Australian members of the multinational group (thin capitalisation) and by manipulating transfer prices and royalties for intra-group transactions. For example, a foreign company that purchases goods from an Australian subsidiary for much less than the goods are worth would reduce the subsidiary's taxable income.

Most advanced countries have specific rules to prevent or limit transfer pricing and thin capitalisation, which, while increasing the costs of tax administration and compliance, are an important means of defending source-based investment taxes. Withholding taxes can also tax profits shifted through interest payments or as royalties, although typically at lower rates than the company income tax rate.

Despite these rules, there is ample international empirical evidence that multinationals are able to shift at least part of their profits to countries with low statutory tax rates (de Mooij & Ederveen 2008). The possibility of international profit-shifting therefore remains an important constraint on tax policy in an open economy.

Australia's dividend imputation system may reduce the incentive for Australian multinationals with a large domestic shareholder base to shift profits offshore, because these companies have an incentive to pay tax in Australia in order to pay fully franked dividends.

Why retain source-based taxation?

The analysis of the costs and benefits of source-based taxation suggests that small open economies, such as Australia, should not levy source-based capital taxes. However, in practice, despite the trend towards lower company income tax rates, they are far from zero. There are a number of reasons for retaining source-based capital taxes, and the company income tax in particular.

First, the argument that small open economies should not impose source-based taxes relates to taxing the normal return to capital. As previously discussed, where an investment generates a location-specific rent, the rent can be taxed without deterring the investment, making it a relatively efficient tax base. As a resource rich country with a well-educated workforce, effective regulatory regimes and a relatively large existing capital stock, Australia has substantial location-specific rents. Australia's geographic isolation may also give rise to some economic rents due to high transportation costs, while limiting the scope for others (such as those derived from economies of scale associated with serving large markets). Rents may also arise from preferences for Australian products that are differentiated from imported imperfect substitutes.

Second, although the international mobility of capital has grown, capital is still not perfectly mobile. This is particularly true of equity markets. Investor portfolios are still biased towards domestic assets, perhaps because investors are less familiar with foreign financial markets, have less control over foreign investments and would need to manage foreign exchange risks. Firms often face significant adjustment costs if they want to relocate business investment across borders. These factors allow governments some scope for imposing source-based investment taxes without causing significant capital flight.

Third, source-based capital taxes may also be justified on the basis of the 'treasury transfer' effect. For example, a foreign country taxes its residents on their global income may provide a credit for source-based taxes paid in Australia. A reduction in Australian company income tax would result in a lower foreign tax credit in the country of residence, leaving the foreign investor's worldwide tax liability unchanged. A reduction in Australian tax therefore results in revenue shifting from Australia to the other country with no increase in the level of investment in Australia.

The extent to which the treasury transfer effect applies in practice is unclear. Most countries are moving away from worldwide income taxation. For example, the United Kingdom and Japan, which previously practised worldwide taxation, have recently moved to dividend exemption systems. This means that most income from equity investments in Australia is exempt from tax. However, the United States, which has around 23 per cent of foreign direct investment in Australia, still has worldwide taxation. But even for countries that still tax worldwide income, the ability to avoid or defer taxation can reduce the value of credits and may limit the extent of the treasury transfer effect.

As discussed previously, the company income tax also operates as an integrity (or backstop) measure for the personal income tax system.

Principle

In setting the effective company income tax rate, a balance needs to be struck between:

- the benefits of a lower rate in attracting internationally mobile investments or capital; and
- the benefits of a higher rate in reducing opportunities for domestic residents to defer or otherwise reduce tax on their personal income, and in taxing the returns to less mobile investments or capital.

Targeted responses to international tax competition

The previous section suggested that there is a case for taxing different types of investments at different rates depending on their international mobility.

Many countries tax investments according to their mobility. For example, resources, which generate location-specific rents, are typically taxed at higher rates, while more mobile investments such as research and development are often concessionally taxed. In Ireland, the manufacturing and traded services sectors are subject to a preferential corporate profit tax rate, while developing countries often use tax holidays to attract international investment, and many countries have adopted tonnage taxes for international shipping.

The most effective tax instrument for attracting investments generating economic rents that are also highly mobile is a reduction in the tax rate. This would reduce the amount of tax applying to the firm-specific economic rent that the investment generates. However, reducing income tax rates for particular investments would also reduce tax on the normal return to those investments relative to other investments, potentially distorting investment allocation.

An alternative approach is to allow eligible investments to be written-off at an accelerated rate. This reduces the tax on the normal return to the investment as opposed to the firm-specific rent, and so is likely to have greater downside costs due to inefficient allocation of investment and the potential for also distorting production decisions within a sector.

Another problem with targeted tax concessions is the difficulty of determining which sectors or investments they should apply to, particularly in terms of identifying activities or sectors with significant firm-specific rents. Where tax concessions are inappropriately targeted they will further adversely distort resource allocation. As such, the use of targeted provisions needs to be based on strong supporting evidence and must be balanced against the distortions they create to investment allocation and the additional compliance and administration costs.

Principle

Differential tax arrangements for particular sectors or types of investment, as a response to international tax competition, should not be adopted given the potential effects on resource allocation, except in limited circumstances where there is strong evidence to support their use.

International tax coordination

Early efforts at international tax coordination centred on eliminating the double taxation of cross-border investments. Bilateral tax treaties became the primary means of reducing the risk of double taxation, and of reducing other tax barriers to cross-border investment such as tax discrimination and compliance costs.

The focus of international tax coordination has now changed. Concerns now centre on the potential impacts of international tax competition and a ‘race to the bottom’ in company and capital income tax rates, in the face of a worldwide decline in company income tax rates in recent decades and the potential for international tax evasion.

Competing reductions in source-based capital taxes may arise because the supply of capital to an individual country is more responsive to taxation than the global supply of capital. From a global perspective, however, the consequence of individual countries’ decisions to reduce capital income taxes may be an inefficiently low level of capital taxation that limits their ability to finance public services and undertake redistribution.

This characterisation of the effects of international tax competition is not, however, universally accepted. International tax competition is one of the many brakes on increasing taxes, and some argue that this limits the over-expansion of government. There may also be countervailing factors that limit company income tax rate reductions. For example, as economies become more open and the proportion of domestic companies owned by non-residents increases, governments may have an incentive to raise company income taxes on the basis that this exports, or at least appears to, part of the tax burden to foreign investors.

A radical form of international tax coordination would see countries relinquishing source taxation altogether and only imposing residence-based taxes. However, the constraints on national sovereignty implied by such an approach make it highly unrealistic. An alternative approach would be to permit countries to retain source-based taxation but on a harmonised basis. Tax harmonisation of company income taxes has been discussed within the European Union for a number of years, although with little apparent progress to date.

Estimating the potential benefits or costs from international tax coordination is challenging. Standard tax competition models, which assume a large number of small, homogeneous countries, fixed national populations with identical tastes and preferences, and perfectly mobile capital flows, predict that all countries will unambiguously benefit from tax harmonisation (Zodrow 2003). However, these results are challenged by other models.

For example, the ‘new economy geography’ model considers the case where there are two types of countries: those with agglomeration rents (typically large) that can support high levels of investment taxation and provide high levels of public service as desired by their citizens; and smaller, low-taxing countries that do not have these agglomeration rents. In this model, tax harmonisation is not beneficial. It reduces the ability of smaller countries to compete for mobile capital and the ability of larger countries to provide the level of public services desired by their citizens (Zodrow 2003).

Attempts have been made to estimate the impacts of tax harmonisation within a region, in particular Europe. Harmonisation within Europe has been estimated to lead to a modest increase in *total* welfare, with an increase in GDP of around 0.1 to 0.4 per cent. However,

these benefits are estimated to be unevenly distributed between individual countries, with losers as well as winners (Griffith, Hines & Sørensen 2009). The likely divergence in outcomes, and the fact that the winners are typically those countries that achieve harmonisation by reducing tax rates and revenues (making compensating transfers problematic), suggest the potential for tax harmonisation is limited on a worldwide basis.

Harmonising worldwide investment tax bases and rates may therefore be an unrealistic goal, even if it is of potential benefit to Australia (which is unclear). But given the potential costs of a worldwide trend to very low company income tax rates, Australia should not aim to radically cut its company income tax rate ahead of other countries. Furthermore, as discussed previously, the lower the existing company income tax rate and closer it is to that of other countries, the lower the likely benefit from additional reductions.

Reflecting the difficulties and uncertain benefits of deeper forms of tax coordination, recent global developments have largely had more limited objectives. These have included shoring up countries' abilities to impose residence taxation by improving the exchange of information between tax administrations. This more limited approach permits countries to craft their individual tax systems to reflect differences in factor endowments and productivities, and national preferences towards redistribution.

The global economic crisis has led to unprecedented action to improve international standards of transparency and information exchange. This work is undertaken through the Global Forum on Transparency and Exchange of Information, which Australia currently chairs. Since April 2009, more than 90 tax information exchange agreements have been signed and over 60 tax treaties have been negotiated or renegotiated to reflect improved standards on transparency and exchange of information.

Australia's tax treaties provide for exchange of information, and to date Australia has entered into nine tax information exchange agreements with several more being negotiated.

Principles

Australia should not be at the forefront of any 'race to the bottom' in company income tax rates.

International tax coordination is required to support cross-border income taxation, particularly the effective exchange of information to allow for the enforcement of taxes on the savings income of residents.

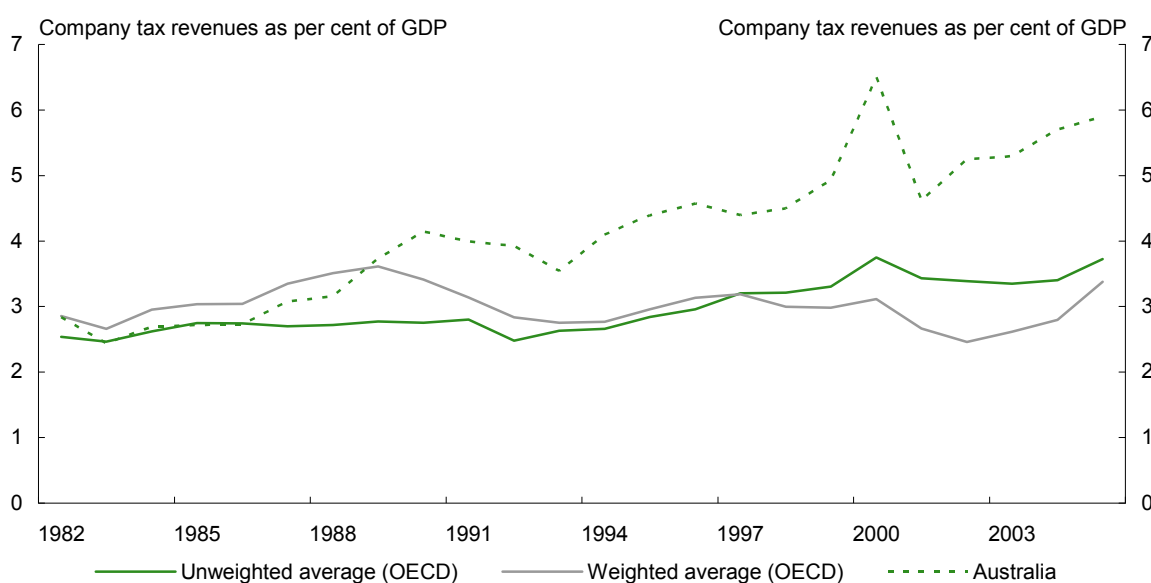
B1-2 Australia relies heavily on company income tax

At the international level, Australia's tax system stands out for its relatively high reliance on company income tax.

From 1982 to 2007, the OECD average (unweighted) corporate tax to GDP ratio increased from around 2.5 per cent to 3.7 per cent (see Chart B1-1). This increase may reflect a number of factors, including increasing profitability and structural changes (for example, a decline in the agricultural sector and an increase in the finance sector's share of the economy).

The increase in the corporate tax to GDP ratio has been more pronounced in Australia. After following the average OECD trend in the early 1980s, the company income tax to GDP ratio increased from around 2.7 per cent in 1985 to 5.9 per cent in 2005. Many of the explanations applying to other countries are also likely to explain the growth in the company income tax to GDP ratio for Australia. For example, the factor share of the corporate sector (the ratio of GOS to GDP) increased from 16.6 per cent in 1980–81 to 23.9 per cent in 2005–06 (Clark, Pridmore & Stoney 2007).

Chart B1–1: Corporate tax revenues in the OECD 1982–2005



Source: Loretz (2008), with additional data from author.

Australia's company income tax revenue as a proportion of GDP (5.9 per cent) is the fourth highest in the OECD and much higher than the OECD average (3.7 per cent). This reflects a number of factors including:

- Australia's company income tax revenue, as measured for these purposes, includes taxes on superannuation funds levied on contributions and earnings (which are effectively taxes on individuals' savings) and petroleum resource rent tax revenue.
- Levels of incorporation differ across countries, and the classification of income from companies may differ. For example, tax revenue from 'S corporations' in the United States appears as a tax on individuals.
- Levels of corporate sector profitability differ across countries. For example, the profitability of Australia's corporate sector is typically high because it includes economic rents arising from Australia's natural resources.
- There may also be an incentive for domestically-owned companies to pay tax in Australia in order to pay fully franked dividends under Australia's imputation system (see Section B2 The treatment of business entities and their owners).
- Australia has a relatively broad based company income tax, with limited concessional write-off arrangements compared to many OECD countries.

Finding

Australia has a relatively high reliance on company income tax compared to other OECD economies. This reflects, in part, classification differences in disaggregating company income taxes and Australia's abundance of natural resources, a high level of incorporation, the corporate sector's high level of profitability, the dividend imputation system, and a relatively broad company income tax base.

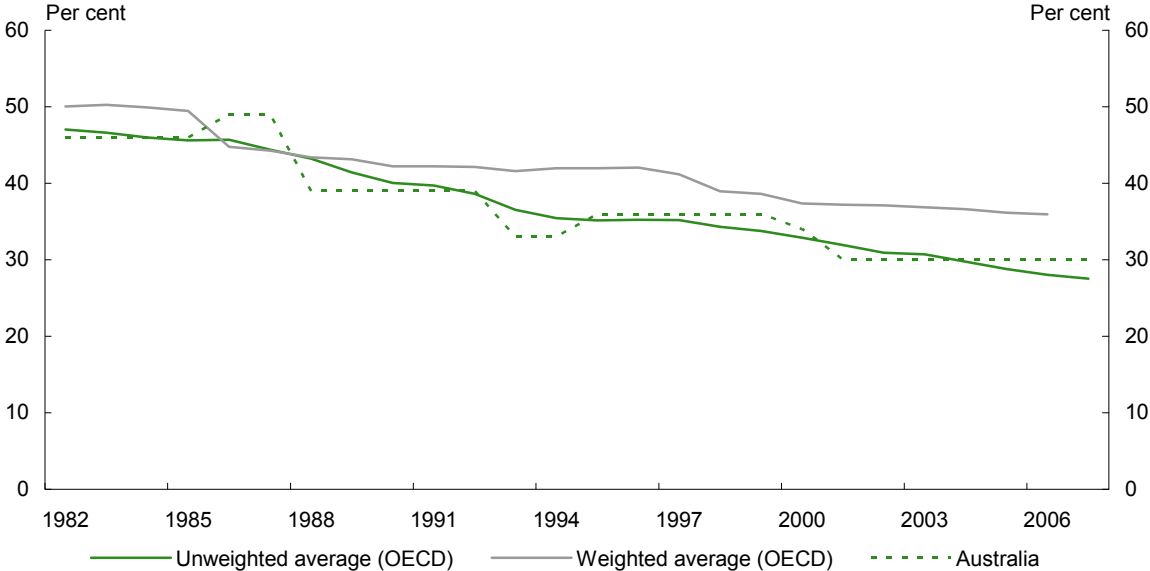
Company income tax rates have been falling worldwide

Company income tax rates have fallen across the OECD over the past 30 years (Chart B1-2). The fall in the average statutory corporate tax rate across the OECD has been fairly continuous. The unweighted average company income tax rate fell from around 47 per cent in 1982 to around 28 per cent in 2007. The weighted average (which is heavily influenced by the United States, Japan and the United Kingdom) has fallen to a lesser extent, from around 50 per cent in 1982 to 36 per cent in 2006.

The unweighted average tax rate has been falling faster than the weighted average because smaller economies have been reducing rates faster than larger economies. This is unsurprising as larger economies such as the United States have more scope to set their corporate tax rate based on domestic considerations.

Australia has, until recently, followed this trend, with the company income tax rate falling from 49 per cent in the mid-1980s to its current rate of 30 per cent in 2001.

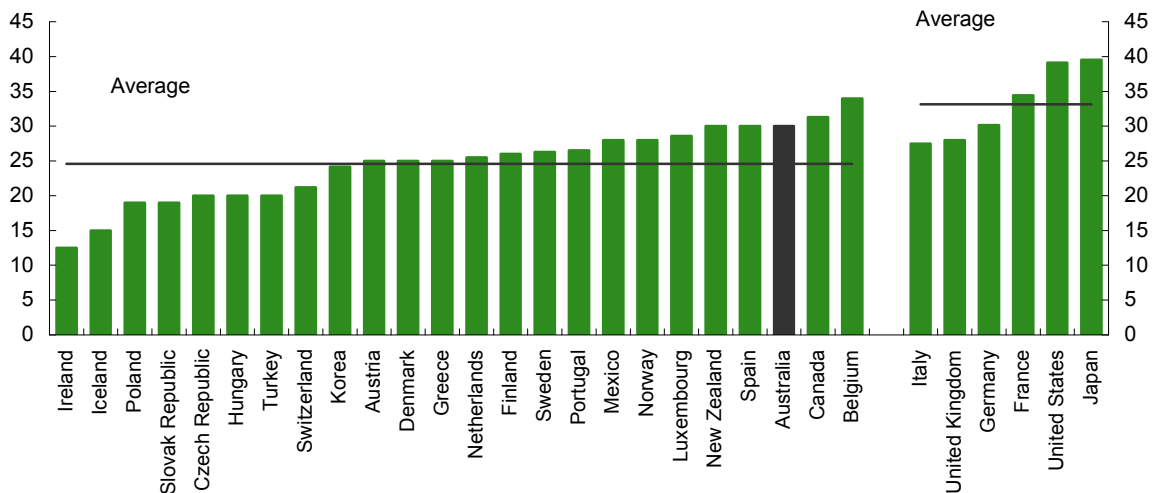
Chart B1-2: Statutory corporate tax rates in the OECD 1982-2007



Source: Loretz (2008), with additional data from author.

Unlike Australia's company income tax rate, the unweighted average rate has continued to fall. In 2001, when Australia reduced its statutory company income tax rate to 30 per cent, it had the ninth lowest rate in the OECD. Australia now has one of the highest corporate rates among small to medium OECD countries, and at 30 per cent is well above the average for small to medium OECD countries (around 25 per cent) (see Chart B1-3).

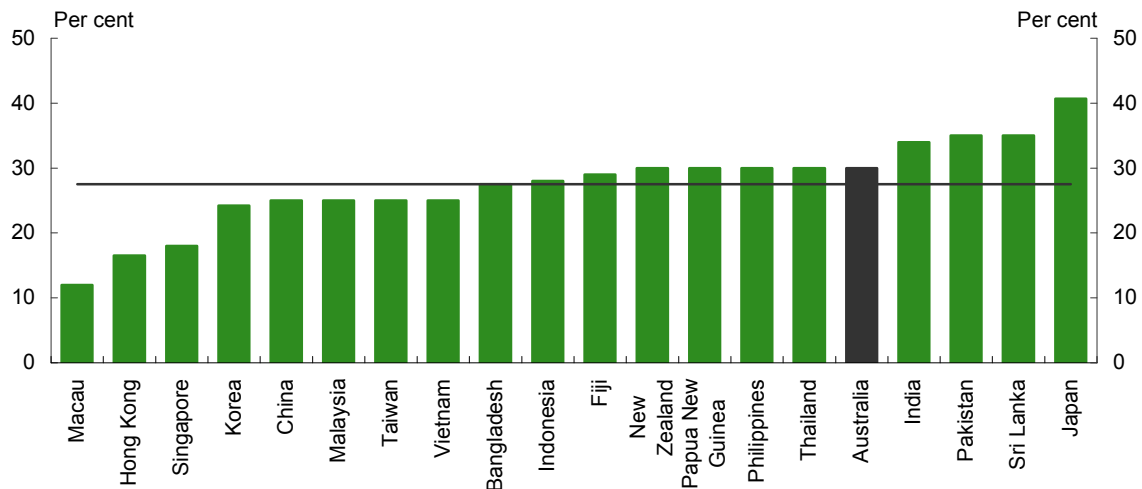
Chart B1-3: Statutory corporate tax rates, OECD countries 2009



Source: OECD (2009d).

Australia’s company income tax rate is also relatively high compared to other countries in our region (see Chart B1-4). Australia’s current company income tax rate is significantly higher than Hong Kong (16.5 per cent) and Singapore (18 per cent) and marginally higher than the average for the Asia-Pacific region (27.5 per cent).

Chart B1-4: Statutory company income tax rates, Asia-Pacific countries 2009



Source: KPMG (2009).

While reductions in company income tax rates have been characterised as a ‘race to the bottom’ among OECD countries, reforms to company income tax have often also involved structural improvements to those tax systems.

For example, the decline in statutory company income tax rates across the OECD over the past 30 years has been accompanied by a broadening of the company income tax base. Australia has followed this trend, most notably by including capital gains (1985–86) and income from the life insurance and gold mining industries (1990–91). At the same time, Australia abolished the general investment allowance (1988–89) and the accelerated depreciation regime (1999–2000).

If reducing rates and broadening bases has reached or is reaching a natural limit, further rate reductions would have a significant cost. While this raises some uncertainty over the likely future path of company income tax rates internationally, it could be expected that continued pressure to attract mobile capital will lead to further reductions in rates over the longer-term.

That said, given the fiscal pressures arising in most developed countries from the global financial crisis, the ability for many countries to significantly reduce their company income tax rate may be limited, at least in the medium term.

Effective company income tax rates have also been falling

While base broadening has, to some degree, offset the cuts in statutory corporate income tax rates, measures of the effective marginal tax rate and effective average tax rates, which take into account the statutory rate as well as elements of the tax base for a hypothetical project, have declined.⁴

Charts B1-5 and B1-6 present the trends in effective marginal tax rates and effective average tax rates respectively. Both measures have followed a similar downward trend, suggesting the broadening of the tax base did not fully offset the fall in statutory tax rates. The fall in effective marginal tax rates is less pronounced than the fall in statutory rates and effective average tax rates, indicating that countries may have reduced effective average tax rates to attract more profitable businesses (Devereux et al. 2002).

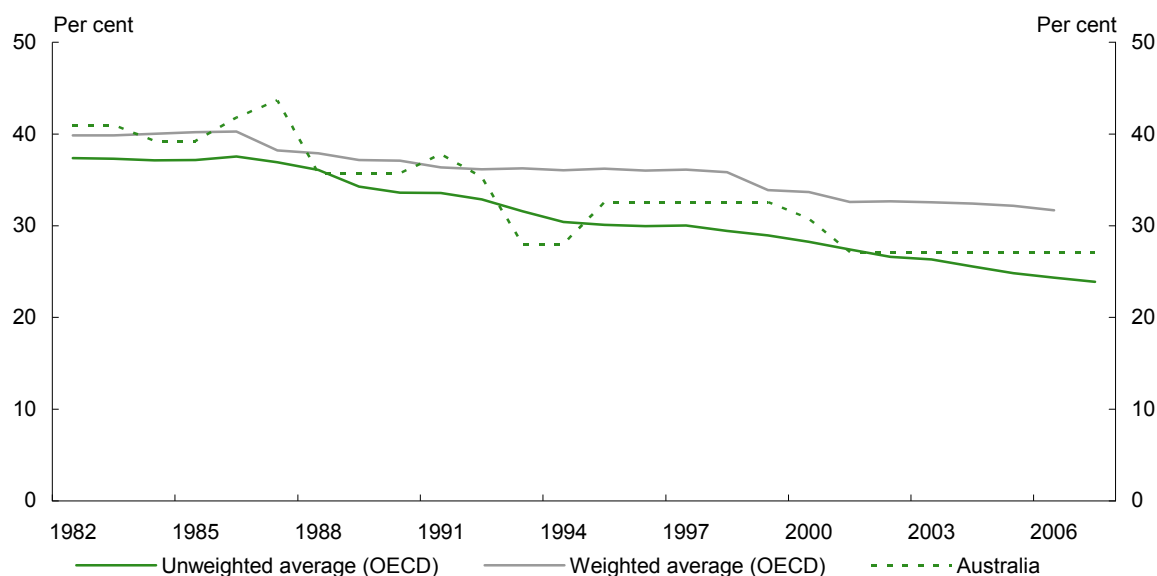
Australia has followed this trend with both marginal and average effective tax rates falling over the past 25 years.

Chart B1-5: Effective marginal tax rates in the OECD 1982-2007



Source: Loretz (2008), with additional data from author.

4 The effective marginal tax rate measures the tax burden on an investment just earning the same return as an alternative investment; the effective average tax rate measures the tax burden for an inframarginal investment with an economic rent.

Chart B1–6: Effective average tax rates in the OECD 1982–2007

Source: Loretz (2008), with additional data from author.

Finding

Australia's company income tax rate, which currently stands at 30 per cent, is high relative to other comparably sized OECD countries. The average rate for small to medium OECD economies is currently around 25 per cent.

B1–3 The future of company income taxation

Longer term options

The increasing globalisation of the Australian economy raises questions about the appropriateness of the existing company income tax system and the dividend imputation system.

In this light, a number of options were considered for the fundamental reform of the company income tax system. These options, which have received widespread attention in the international tax policy debate, particularly in recent years,⁵ can be characterised by the location of the tax base, and the type of income subject to tax (see Table B1–1).

There are three possible locations of the tax base:

- income from where the investment takes place (source-based taxation);
- income, wherever earned, of a company resident in a country (residence-based taxation); and
- the sales (net of costs) in the country where the goods or services are consumed (destination-based taxation).

⁵ See, for example, the Mirrlees Review (www.ifs.org.uk/mirrleesreview).

There are also three types of income that can be subject to tax:

- the full return to all capital (equity and debt);
- the full return to equity; and
- economic rents.

Table B1–1: Alternative options for taxing company income

Location of base	Type of income subject to tax		
	Full return to capital	Full return to equity	Economic rent
Source country	Comprehensive business income tax	Conventional corporate income tax with exemption for foreign source income	Source-based business expenditure tax (such as an allowance for corporate equity or capital and source-based cash flow tax)
Residence country		Conventional corporate income tax with credit for foreign taxes	
Destination country			Destination-based business expenditure tax (such as a full destination-based cash flow tax and a VAT-type cash flow tax)

Source: Based on Devereux and Sørensen (2006).

The existing company income tax is essentially a source-based tax on the full nominal return to equity.⁶ As noted previously, there is a case for small open economies, such as Australia, to reduce source-based taxes on the normal return. Of the remaining options, the comprehensive business income tax taxes the full return to capital (debt and equity), albeit at a possibly low marginal rate, and the various forms of business expenditure tax exempt the normal return from tax, only taxing economic rents.

The comprehensive business income tax is based on an income tax system, but with the difference that interest expenses would no longer be deductible. Removing the deductibility of interest removes the distortion between debt and equity. The broadening of the tax base could facilitate a reduction in the company income tax rate, but this would reduce its effectiveness as a backstop to the personal income tax system. As a significant amount of debt is currently untaxed, this option would also increase the cost of debt financed investment. There would also be significant transitional issues for highly leveraged businesses.

Business level expenditure taxes can be imposed on either a source or destination basis. A source-based tax, such as an allowance for corporate equity or allowance for corporate capital, would tax all economic rents generated in the country where the investment takes place. Under a destination-based tax, only economic rents used for consumption in the domestic economy would be subject to tax.

Business level expenditure taxes also provide greater neutrality between debt and equity. In addition, these systems also reduce pressure around the timing and recognition of income and expenses. For example, under an allowance for corporate equity the timing of capital allowances becomes less important. Such systems are also neutral in relation to the effects of inflation. In effect, such systems would reduce distortions across asset types which could

⁶ Australian resident companies are technically taxed on their worldwide income with an exemption for profits from permanent establishments and non-portfolio foreign dividends.

assist in promoting efficient resource allocation and may also provide opportunities for further simplification of the company income tax system. The case for these systems has been outlined for the Review by Auerbach (2010) and Sørensen & Johnson (2010).

A resource rent tax based on an allowance for corporate capital model is recommended for the taxation of resource rents (see Section C1 Charging for non-renewable resources).

However, in contemplating the replacement of company income tax with an expenditure tax, a significant concern for the Review is that there has been limited or no practical use of such taxes for this purpose.⁷ Replacing the current company income tax system with one of these alternatives would therefore involve considerable risks. For example, the practical implications from a tax administration and compliance perspective are unknown. From an international context there may also be opportunities for tax arbitrage if Australia is one of only a few countries using a system.

On balance it is therefore recommended that Australia maintains the existing company income tax system, at least in the short to medium term.

For the longer term, a continuing trend of increased openness and greater capital mobility suggests consideration needs to be given to eventually moving away from the dividend imputation system as a means of integrating the personal and company income tax systems. A business level expenditure tax would provide an alternative means of integration, though not the only one (see Section B2 The treatment of business entities and their owners).

In addition, in light of the potential benefits of business level expenditure taxes there is likely to be increased interest internationally in them as a replacement for company income taxes. Such a system may suit Australia and is worthy of further consideration and public debate. It is possible that other economies will move towards such systems over coming years and it could be in Australia's interest to join this trend at an early stage. An example of a blueprint for the reform of Australia's company income tax system, based on the allowance for corporate equity, is presented in Sørensen and Johnson (2010).

Recommendation 26:

The structure of the company income tax system should be retained in its present form, at least in the short to medium term.

A business level expenditure tax could suit Australia in the future and is worthy of further consideration and public debate. It is possible that other economies will move towards such systems over coming years and it could be in Australia's interest to join this trend at an early stage.

⁷ No country has replaced their company income tax system with a destination business cash flow tax. The allowance for corporate equity has been adopted by Belgium (2005) and Latvia (2009) and was also used in Croatia for a short period of time.

Reducing company income tax would boost investment across the economy

As discussed previously, economic theory and growing empirical evidence support a shift away from company income tax towards taxes on less mobile factors as a means of increasing investment, GDP and growth. Over the past 25 years, company income tax rates across the OECD have fallen, and until more recently, Australia has followed this trend. However, Australia's current company income tax rate is now high relative to similar sized OECD economies.

The company income tax rate should be reduced to encourage investment in Australia, particularly highly mobile foreign direct investment. In the long-run this would increase income for Australians, by building a larger and more productive capital stock and by generating technology and knowledge spillovers that would boost the productivity of Australian businesses.

In the long-term, a larger and more productive capital stock would not only result in higher growth but is also likely to result in higher wages. A lower company income tax rate would also reduce incentives for foreign multinationals to shift profits out of Australia.

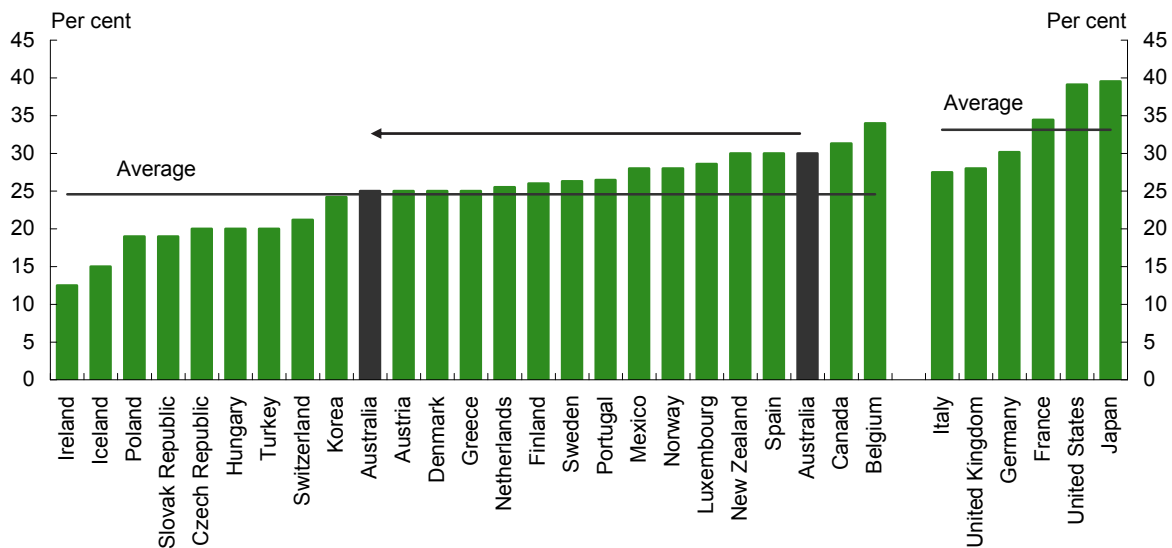
Given the continued expected growth of China and India, Australia should continue to be able to attract investment into its resource sector. However, other sectors of the economy may find attracting investment more challenging. Reducing the company income tax rate may help other sectors attract investment.

Against this, company income tax currently has an important role in ensuring the community receives a return for the exploitation of Australia's non-renewable resources. Reducing the company income tax rate in the absence of other measures would lead to lighter taxation of Australia's location-specific rents. But it would be more effective to tax such rents directly, through a uniform resource rent-based tax, as recommended in Section C1 Charging for non-renewable resources.

The benefits of a reduction in the company income tax rate also need to be considered against potential interactions with the personal tax and transfer system. For example, a reduction in the company income tax rate would increase incentives for domestic residents to defer taxation by retaining income in a company.

Taking account of these considerations, the company income tax rate should be set on the lower side of the average rate in small and medium OECD economies, while balancing other considerations such as interactions with the personal tax-transfer system (to minimise incentives to defer or avoid taxes on labour and savings).

A move over the short to medium term to a company income tax rate of around 25 per cent would be consistent with this approach, and allow for the transition to that lower rate to take account of fiscal and economic circumstances over that period (see Chart B1-7). Given that company income tax also acts as a tax on profits derived from Australia's non-renewable resources, improved arrangements for charging for the use of non-renewable resources should be introduced at the same time.

Chart B1–7: Restoring Australia’s relative company income tax rate ranking

Source: OECD (2009d).

A number of submissions to the Review have also recommended a concessional tax rate for small companies. A lower company tax rate targeted at small companies would only benefit companies and owners that are in a position to accumulate funds in the company. Furthermore, it would target a company income tax rate cut at those businesses most likely to be earning a return to the personal efforts and savings of owner-managers, thereby negating the backstop functions of company income tax while attracting little additional investment or otherwise improving productivity. It could also benefit non-business accumulation, such as rents and profit retention.

Certain tax arrangements or concessions may need to be adjusted in response to a reduction in the company income tax rate. This would include adjusting the level of the research and development tax credits (in respect of the loss offset component) and maintaining the current effective 10 per cent tax rate for offshore banking units.

Recommendation 27:

The company income tax rate should be reduced to 25 per cent over the short to medium term, with the timing subject to economic and fiscal circumstances. Improved arrangements for charging for the use of non-renewable resources should be introduced at the same time.

B1–4 Refining the business income tax base

To avoid a misallocation of resources that can reduce productivity, the business income tax base — for both companies and other entities — should be as broad as possible with few exemptions and concessions. Where income is measured incorrectly for tax purposes, investment may be directed towards less productive assets that would not be viable in the absence of the tax bias. There are also likely to be benefits from minimising biases around other business choices, such as the choice of business entity (see Section B2 The treatment of business entities and their owners), risk taking and financing choices.

However, the uniform taxation of all investments and business choices may not always be efficient. It may be more efficient to tax some investments more highly, such as those that earn economic rents that are specific to Australia, while other specific investments could be taxed more lightly if they generate spillover benefits that improve the wellbeing of Australian society more generally.

Furthermore, given the difficulties in calculating real income the administration and compliance costs of trying to tax business income uniformly may exceed the benefits.

Taxing investments more consistently

Measuring income correctly can be difficult

If the tax system measures income incorrectly, this can bias the level and pattern of investment. Difficulties include adjusting for inflation and measuring changes in real asset values (depreciation, capital gains and stock valuation). All of these issues can result in biases to firms' investment decisions.

Inflation aside, incorrectly measuring the rate of economic depreciation for tax purposes may favour investment in less productive assets. This reduces productivity and economic growth. However, it is hard to measure economic depreciation accurately.

Rates of economic depreciation will depend on a number of factors including the type of asset, how it is used and where it is used. At best, capital allowance provisions provide an approximation of economic depreciation measured as the change in value of a machine or building over an accounting period. The practical problem is how to reduce biases given real-world uncertainties.

Some deviations from economic income may correct market failures

In some circumstances deviations from economic income may have some merit, where this can correct for market failures.

Innovation and technological progress by businesses can take the form of product innovation or process innovation to increase efficiency and productivity. Such progress therefore encompasses a vast array of factors in the economy, including workforce skills, management, venture capital, technology uptake, work reorganisation, and research and development.

Where the research and development of a firm generates spillover benefits for others, the social returns from research and development may be greater than the private returns. A tax-preference or government expenditure that appropriately targets such spillovers may therefore be beneficial and improve overall productivity.

But where a subsidy is inappropriately targeted, such incentives can bias the allocation of resources in the economy and actually reduce productivity.

As innovation policies have recently been the subject of review, detailed consideration has not been given by the review to the arguments and evidence for encouraging research and development. While contestable, there is some evidence to support the use of subsidies or concessions to encourage research and development. For example, research and development expenditure has been found to be highly sensitive to tax incentives (Johansson et al. 2008).

Principle

The business income tax base should be as comprehensive as possible to ensure investment is allocated to its most productive uses. This must be balanced against the benefits of correcting market failures and the practical difficulties in achieving a completely uniform treatment of different investments.

Current depreciation arrangements are distortionary

The tax treatment of assets varies considerably under the current tax system. Differences arise from difficulties in determining economic income and from a history of discrete government decisions.

The overall impact of the income tax system on resource allocation and investment decisions is unclear. Tax concessions arise from tax exemptions and concessional rates, tax offsets or the deferral of tax liabilities. There are also tax arrangements that effectively impose an additional charge on the taxpayer, such as limitations on the use of losses, while special provisions, such as income averaging, are needed to minimise other adverse affects of the tax system.

Many of these arrangements interact with each other. For example, there are a number of special provisions that apply to different uses of agricultural land. These include special tax arrangements for investors in forestry managed investment schemes and agricultural managed investment schemes and accelerated write-off for establishment costs of carbon sink forests. In these cases the inconsistent treatment adds to the complexity of the tax system and is also likely to distort land use allocation.

One way to examine the potential impacts is to compare effective tax rates across different sectors. Markle and Shackelford (2009) estimate effective tax rates by industry using financial statement information for a number of countries. Their country-specific estimates show significant variation in effective tax rates across sectors. For example, for Australia they find the highest effective tax rate is in the financial services and retail trade sectors (27 per cent) and the lowest in the information and mining sectors (14 and 17 per cent respectively). As shown in Table B1-2, the results for Australia are typical of those across the other countries surveyed.

Table B1-2: Effective tax rates by industry, selected countries (domestic)

	Australia	Canada	Japan	United Kingdom	United States
All industries	24	24	39	26	26
Construction	23		36	21	25
Financials	27	13	36	26	15
Information	14	19	35	21	19
Manufacturing	25	24	38	25	28
Mining	17	17			22
Other	24	23	41	26	30
Professional	19		36	24	21
Real estate	23		40	26	24
Retail trade	27		44	27	34
Transportation	22		39	25	24

Source: Markle and Shackelford (2009), Table 4.

While other factors have an important influence on the allocation of investment in Australia, tax disparities tend, at the margin, to cause resources to move into less-productive

investments in tax-favoured industries at the expense of more-productive investments in less-favoured industries. Overall productivity performance will be held back if there is over-investment in one tax-favoured sector at the expense of investment in other sectors that may be potentially more productive.

Tax disparities could also influence the way in which the economy may respond to a lowering of the company income tax rate. Industries with an already low effective tax rate could be expected to be less responsive than those with relatively high effective rates, all other things being equal.

Some assets are concessionaly taxed

Following the recommendations of the Review of Business Taxation, Australia's capital allowance regime moved to a system based on the effective life of the asset (uniform capital allowances). The aim of effective life depreciation is to provide a neutral treatment across depreciating assets, aligning the rate of depreciation for tax purposes more closely with economic depreciation. This should reduce the distortions induced by tax across different assets, but a number of distortionary arrangements still remain.

For a small number of assets the effective life is capped or alternative capital allowance provisions apply. Statutory effective life caps currently apply to tractors, harvesters, trucks, buses, aircraft, helicopters and gas transmission and production assets.

These accelerated capital allowance provisions may result in significantly lower effective marginal tax rates for eligible investments relative to assets whose capital allowances are based on effective life. However, in some cases the statutory effective life cap may offset the impact arising from the fixed declining balance parameter being too low.

Another area of departure is the capital allowance rate for capital works, such as buildings and structural improvements. Taxpayers can claim a deduction for capital works at either 2.5 per cent (over 40 years) or 4 per cent (over 25 years) of the construction expenditure.

The rate depends on when construction started and how the capital works are used. The United Kingdom is phasing down allowances for industrial buildings, on the grounds that its tax system already recognises the depreciation of buildings and structures in other ways – through tax relief for the costs of repairs and insurance, and by directly recognising any actual depreciation (or appreciation) through the capital gains tax system (HM Treasury 2007).

Certain expenditure can be written-off immediately, even though it should be capitalised into an asset and depreciated over its effective life. For example, expenditures relating to the creation of intangibles like goodwill (discussed further below), certain repairs and maintenance and exploration expenditure (which can be immediately written-off even when exploration activity is successful or may still prove successful).

A number of submissions also suggest that longer-life assets should be written off at faster rates. However, under the current arrangements, where capital allowance deductions are based on historical cost, the system will favour more durable assets in the presence of inflation (Auerbach 1979). That said, the actual impact is less clear when other elements of the tax system are also considered. For example, to the extent longer-life assets are more

risky, the current imperfect loss offset provisions (discussed below) may discourage investment in them.

Investment in intangibles is generally favoured

Investment in creating goodwill and other intangibles is currently taxed more generously than investment in many tangible assets. Expenditures incurred to create 'new' goodwill, such as marketing costs, are immediately deductible for tax and accounting purposes even though the economic benefits persist over time.

In contrast, acquired goodwill and other intangibles are taxed under the capital gains tax provisions. They cannot be depreciated for tax purposes, and gains (or losses) are taxed only when the asset is sold and the gain or loss realised. This treatment applies because of the practical difficulties under an income tax system in estimating the value of goodwill when it is acquired and the annual change in value.⁸ While acquired goodwill cannot be written-down for tax purposes, where it declines in value, any expenditure incurred in maintaining its value is immediately deductible. In many cases, this will approximate economic depreciation.

Under the capital gains tax provisions, any reduction in the value of previously acquired goodwill is effectively deducted when a business is sold. This is because the value of acquired goodwill is included in the cost base for measuring any capital gain or loss.⁹ If acquired goodwill were amortised, it would be deductible earlier, whereas gains from the creation of goodwill or any increase in the value of acquired goodwill would not be recognised until realisation. Allowing acquired goodwill to be written-off would therefore increase the overall tax preference in favour of intangibles.

The current arrangements are complex

A number of submissions also highlighted the complexity of the current capital allowance arrangements and the record keeping requirements associated with them.

The complexity of the existing system largely reflects the fact that Australian businesses use many different types of assets in their operations, each of which has its own effective life. Under the uniform capital allowances rules there are 40 different effective lives based on the Commissioner's current determination. Effective lives are provided for over 3,700 assets, of which around 400 are general use assets not specific to any particular industry or sector.

Complexity is also increased because special or preferential arrangements apply to certain assets or types of taxpayer. As discussed, buildings have their own specific arrangements, falling outside the uniform capital allowance system, while low-value assets, with a value of \$1,000 or less, can be pooled together and depreciated at 37.5 per cent per year, and certain assets costing \$300 or less are immediately deductible. Separate capital allowance arrangements are also available for small business.

8 Difficulties in measuring the acquisition cost of goodwill arise because goodwill is typically measured as the residual amount remaining after values have been allocated to other assets. In some circumstances this can create an incentive to manipulate value allocations to provide the most favourable tax treatment.

9 Where goodwill is sold at a loss, as with all capital losses, it can only be used to offset a capital gain.

Findings

While previous reforms to Australia's capital allowance arrangements have reduced distortions to investment decisions and some aspects of complexity, there remain a number of distortions that may encourage investment in less productive assets and the system remains complex.

Investment in creating intangibles is currently taxed more generously than investment in many tangible assets, reflecting the inherent difficulties in valuing intangibles.

Enhancing productivity and simplifying the capital allowance arrangements

The current capital allowance arrangements could be enhanced and simplified without significant adverse implications for resource allocation. A simplified system should be designed in such a way as to provide broadly the same capital allowance deductions as under the current law, but under a simpler, more streamlined arrangement.

Any simplification of the current regime risks biasing investment decisions by providing capital allowances that are less closely matched to economic depreciation. But given the difficulties in measuring the true decline in the value of an asset, it is unclear how significant any biases would be relative to the current arrangements.

In particular, the existing low-value pool should be abolished, and instead all assets with a value of less than \$1,000 should be immediately deductible for all taxpayers — apart from those eligible for the small business concessions, who can already write off assets with a value of less than \$1,000 and for whom an increase in this threshold is recommended (see 'Arrangements for small business (including sole traders)' below). This would reduce record keeping requirements by removing the need to maintain a low-value pool.

Consideration could separately be given to grouping assets with a related purpose or use, and having a single capital allowance rate for all assets in the group, based broadly on the effective life of assets within that group. For example, all information technology equipment could be grouped together.

To improve overall productivity, existing concessional arrangements should also be reconsidered, including statutory effective life caps, capital works (including buildings), exploration expenses and the taxation of agriculture and forestry more generally. But any review of the existing concessional arrangements, including effective life caps, would need to be mindful of the effective depreciation rate for tax purposes relative to the actual rate of economic depreciation and other related elements of the tax system.

Recommendation 28:

The capital allowance arrangements should be enhanced and streamlined to ensure effective rates more closely match rates of economic depreciation, and to reduce administration and compliance costs overall. This should include:

- (a) allowing low-value assets (assets costing less than \$1,000) to be immediately written-off; and
- (b) reviewing the impact of special provisions applying to different investments in agriculture and statutory effective life caps and other concessional write-off provisions.

Arrangements for small businesses (including sole traders)

To simplify and provide more certainty over the taxation arrangements for small business entities (including sole traders) in particular (and to provide a cash-flow benefit to such businesses), the threshold for determining a low-value asset for small businesses should be increased to \$10,000. This would allow small businesses to immediately write-off most of their asset purchases.

Arrangements for small business should be simplified further by allowing any remaining depreciating assets (other than buildings) that are not immediately written-off to be grouped in a single pool (rather than the two existing pools), with the entire pool written off at a single declining balance rate.

In addition, the operation of the pool could be further simplified by removing the requirement for small businesses to calculate a balancing adjustment on sale or disposal of an asset. This would remove the requirement for small businesses to keep track of individual non-immediately deductible assets. Instead, capital allowances would continue for the asset pool, but any proceeds from the sale of an asset would be included in the taxpayer's income.

Combined with the recommendation to streamline and improve access to the small business capital gains tax concessions (Recommendation 17), and the Standard Business Reporting program, these measures would result in a significant simplification for small businesses.

Access to these small business tax concessions, and others under the small business tax framework, should also be extended by increasing the current \$2 million turnover 'small business entity test' to \$5 million.

Recommendation 29:

The capital allowance arrangements for small business should be streamlined and simplified, by:

- (a) allowing depreciating assets costing less than \$10,000 to be immediately written-off; and
- (b) allowing all other depreciating assets (except buildings) to be pooled together, with the value of the pool depreciated at a single declining balance rate.

Recommendation 30:

The small business entity turnover threshold should be increased from \$2 million to \$5 million, and adjustments to the \$6 million net asset value test should be considered.

Supporting an appropriate level of risk-taking

Risk-taking can be discouraged by the treatment of losses

The tax system treats gains and losses differently. The current tax system limits the refundability of losses, while all gains are taxed as they are realised. This reduces incentives to undertake risky investments, as denying full loss offset reduces the expected return from, and therefore increases effective tax rates on, risky investments.

Where losses are not fully refunded or where gains and losses are taxed at different rates, as under a progressive tax rate scale, these asymmetries will tend to discourage risk taking including entrepreneurial activity. Restrictions on loss utilisation may also lead to pressure for concessions to attract investors to investments that are disadvantaged as a result of the restrictions. If such concessions are targeted towards specific types of investments, they risk further biasing investment allocation.

Limitations on the use of losses may in particular disadvantage small businesses and firms engaged in risky investments, with start-up or closing down expenditure and without other income to offset losses against. In 2006–07, small businesses accounted for almost half of all carried forward tax losses in Australia.

This bias against small business may lead to greater market concentration, because larger more diversified businesses may have a higher expected post-tax return when they have other income to use against a loss against. It may also result in inefficient takeover activity, where entities carrying losses forward are valued more highly by entities that can utilise those losses.

Restrictions on loss utilisation also limit the ability of the tax system to serve as an automatic stabiliser during a downturn. This is because the tax value of deductions is not recouped by companies until they have income to offset losses against.

However, despite its theoretical benefit, full loss offset is rarely seen in practice.

In the same way that profits are highly mobile and can be shifted between countries in response to high statutory tax rates, full refundability could attract losses into a country at a substantial cost to revenue — without necessarily improving the climate for investment. While loss restrictions are an imperfect substitute for effective integrity provisions, they limit the benefits of tax avoidance schemes. They also limit the benefits arising from any income mismeasurements, such as immediate deductions for capital expenditure and accelerated capital allowance arrangements.

Loss restrictions, such as continuity of ownership tests, also prevent losses from being transferred to new investors who may value them more highly because of differences in tax rates. Further, loss restrictions may limit the extent of a bias in favour of debt financing by

companies and, in respect of trusts, may reduce the scope to exploit differences in the tax rates of trust beneficiaries.

Principle

The treatment of business losses should reduce biases against risk taking by treating income and losses symmetrically. This must be balanced against problems arising from the mismeasurement of losses from difficulties in measuring economic income, artificial loss creation schemes or from other forms of tax avoidance.

The current tax system treats gains and losses asymmetrically. Gains are taxed as they accrue while losses are not refunded but can be carried forward and used against future income, subject to certain tests. There are two main tests to determine whether or not a loss can be utilised: the continuity of ownership test and the same business test.

Despite these tests, a considerable degree of loss utilisation is in effect permitted other than through the loss carry-forward provisions. For example, sole traders and partnerships are able to flow through their losses to owners, and wholly-owned corporate groups are allowed to offset losses in one subsidiary against income from others under the consolidation regime.¹⁰ Recent changes to research and development tax arrangements will also improve loss utilisation.¹¹

A number of submissions to the Review have also noted that the current loss utilisation rules add significant complexity and uncertainty to the tax system.

Finding

The current tax system treats gains and losses asymmetrically. This treatment may have an adverse effect on risk taking and entrepreneurship.

Limiting biases against risk taking

The benefits from reducing the existing tax bias against risk-taking, and at the same time increasing the degree to which business income tax arrangements act as an automatic stabiliser, emphasise the value of improving the current income tax treatment of losses.

The Review has not attempted to evaluate fully all options for improving loss arrangements, given that careful account also needs to be taken of the risks associated with the mismeasurement of losses. Given that the latter depends on other policy choices, including further reforms to enhance the comprehensiveness of the business income tax base (see Recommendation 28), taxpayer behavior and the effectiveness of the tax administration, the right balance between these competing considerations may vary over time and sometimes require reassessment.

¹⁰ The Government has recently announced measures to further restrict the deductibility of business losses for high-income individuals.

¹¹ A key aspect of the announced changes is the move away from accelerated deductions to a system of tax credits (offsets). This neutralises the existing bias in the tax system associated with the treatment of losses. In effect, the offset to be provided consists of two parts: a loss offset (at 30 cents in the dollar) and a subsidy to encourage innovation (at 10 or 15 cents in the dollar).

Companies should be able to offset losses made in a particular income year against taxable income from the preceding year. This would allow companies to receive an immediate tax refund to the extent the company paid tax in the previous year. Without this, the timing of the income year can lead to over-taxation as it does not consider expenditure that falls narrowly outside the income year. While there would be some increase in complexity, the change would also improve the ability of the tax system to serve as an automatic stabiliser, particularly for small companies, and reduce reliance on ad hoc relief for businesses under stress (Abhayaratna & Johnson 2009).

As taxpayers can time the realisation of capital losses, it is recommended that this proposed loss carry-back be restricted to revenue losses. Further, due to Australia's imputation system, provisions would also be required to prevent losses from being offset against prior year tax payments that have been distributed to shareholders as imputation credits. To address this, it is recommended that the carry-back arrangements be limited to the amount of franking credits retained in the company.

Loss carry-back provides limited benefits to start-up businesses, small businesses and businesses engaging in high risk activities. There is no single solution for providing a better loss treatment for these businesses and activities. Recommendation 32 represents a targeted approach in regard to exploration, an activity that involves relatively small start-ups undertaking high risk investments. Other such opportunities could be further considered. There may also be merit in reviewing the continuity of ownership and same business tests to give greater weight to simplicity and certainty objectives.

Recommendation 31:

Companies should be allowed to carry back a revenue loss to offset it against the prior year's taxable income, with the amount of any refund limited to a company's franking account balance.

Flow-through treatment for exploration

The Australian Government asked the Review to consider a proposal to promote exploration investment by adopting flow-through share schemes for smaller operators in the gas, oil and mineral exploration industries. The issues raised by the proposal illustrate some of the issues associated with the treatment of losses and, related to that, the measurement of income.

The current treatment of tax losses puts small exploration companies at a competitive disadvantage relative to larger, more diversified companies and to business investments in other sectors. This is because losses generated by exploration companies often cannot be used to offset other taxable income. At the same time, the immediate deduction for exploration expenses generates non-economic tax losses when exploration is successful.

The impact of providing special arrangements for losses incurred as a result of exploration activity has not been fully evaluated by the Review. While the current treatment of losses may disadvantage exploration relative to other investments, targeted provisions for expenditure on resource exploration could reverse that bias and favour investment in exploration at the expense of other, potentially more profitable, investment opportunities.

Canada has adopted a flow-through share scheme arrangement under which income tax deductions associated with exploration are, in effect, made available to shareholders. Other

tax credits, at the federal and provincial levels, are also available for qualifying investors, including a 15 per cent credit for expenditure associated with new resources or fields.

Submissions to the Review have proposed the following features for a flow-through share scheme:

- An exploration tax credit would be allowed to resident shareholders of Australian companies for Australian exploration expenditure incurred by those companies.
- The credit would be available at the company income tax rate (currently 30 per cent), possibly with an uplift and would be refundable.
- Credits could not be distributed to shareholders where the company itself pays company income tax (effectively limiting the scheme's availability to small companies).
- Dividend imputation rules would be drawn on where possible (including anti-streaming and anti-credit trading rules).

While the current tax treatment of losses creates a tax bias against small explorers, the flow-through share proposal, as described, may over-correct the bias. Even without an uplift, a 25 or 30 per cent credit would provide a significant tax incentive for superannuation funds to invest in a sector when any returns would only be taxed at 7.5 per cent (see Recommendation 19).

There are no strong grounds to believe that exploration generates unusually large positive spillovers that would justify a subsidy. Exploration does produce information of public value, and explorers are required to make such information publicly available. However, nearly all activities generate information that is of benefit to others; for example, that a particular business model does or does not work.

Further, as the flow-through share design is targeted at resident shareholders (to improve marketability) rather than at the company level, it makes the design of a flow-through scheme more complicated and therefore is likely to result in higher administration and compliance costs. It would also not assist in attracting investment from non-resident investors.

The existing tax bias arising from the treatment of losses could be addressed by using a targeted, company-level approach to increase loss utilisation. For example, it would be possible to allow the company to choose to defer taking a deduction in respect of exploration expenditure (effectively allowing loss transfers) or, preferably, to provide a refundable tax offset for designated expenditure set by reference to the company income tax rate and with appropriate adjustment to franking account rules. The detailed design of the rules would need to be the subject of further consideration and consultation.

Recommendation 32:

If earlier access to tax benefits from exploration expenses (relative to other expenses) is to be provided, it should take the form of a refundable tax offset at the company level for exploration expenses incurred by Australian small listed exploration companies, with the offset set at the company income tax rate.

Reducing financing distortions

Financing choices of business can be distorted

Most company income tax systems, including Australia's, tax the full return to equity only, with interest payments deductible from the company income tax base. This provides companies with a tax incentive to finance investment with debt rather than equity capital. The debt-equity distortion may, however, be reduced where companies are unable to use deductions for interest payments, such as where a company is in a loss situation.

Over reliance on debt makes companies more vulnerable to insolvency and to economic shocks, and may have implications for macroeconomic stability. Providing a deduction for debt and not for equity financing may also discriminate against smaller businesses, and knowledge-based industries that invest more heavily in intangibles. Such businesses may have more difficulty borrowing.

The treatment of debt and equity for tax purposes is complex and creates opportunities for tax avoidance. This has been compounded over recent years with the increased innovation in financial products, often devised to exploit the difference in the tax treatment of debt and equity. As a result of this innovation, the traditional distinction between debt and equity has become even less clear. Increased globalisation has also increased opportunities for tax arbitrage, particularly where countries take different views as to whether a particular instrument qualifies as debt or equity.

The implications of the tax treatment of debt and equity depend in part on the source of finance for specific businesses. The following sections consider the implications for businesses with and without direct access to foreign capital.

Businesses that rely on domestic finance

To the extent that capital is not perfectly mobile, as may be the case particularly for small unlisted domestic firms, financing decisions may be influenced by taxes on capital income (dividends, capital gains, interest) at the personal level.

Where businesses do not have access to international capital — that is, they may effectively operate in a closed economy — the tax preference in favour of debt relative to equity at the company level may be offset by Australia's dividend imputation system. However, even with dividend imputation and with a closed economy assumption, investments financed by retained earnings are likely to be favoured over new equity, because of the concessional taxation of capital gains.

When earnings that would otherwise have been used to pay dividends (and been taxed in the hands of the recipient) are retained in the company, the value of equity increases and shareholders are rewarded with an accrued capital gain which is taxed preferentially on realisation at reduced rates. The shareholder can therefore delay paying tax until the share is sold and the gain realised.

As dividends and interest income are taxed at full marginal rates for domestic savers, investments financed by new equity and debt need to earn a higher return relative to investments funded by retained earnings. This higher return is required to compensate for the tax penalty they face relative to concessional tax capital gains.

However, while smaller companies and businesses may not have direct access to foreign capital, much foreign debt capital is raised by Australian banks or financial institutions who then on-lend to the business sector generally. The cost of equity capital for larger firms, to the extent that it is set by access to international equity, will also influence the cost of equity for smaller firms. Hence, even for this sector or group of businesses, the biases outlined for businesses with access to international finance will still be relevant.

Businesses with access to international finance

Where the marginal source of finance is the international capital market, the deductibility of interest from the business income tax base would appear to favour higher levels of debt, driven by the company or relevant income tax rate.

Interest deductibility biases the capital structure of a business towards higher levels of debt — increasing its risk exposure. Distorting these choices may discourage businesses from adopting the best approach to managing other factors associated with their capital structure. To the extent that interest withholding tax applies on the payment of interest to the non-resident investor, it may moderate the bias against equity.

For a multinational company investing in Australia through an Australian subsidiary, the allocation of debt or equity capital to that subsidiary may be motivated in part by tax planning considerations, and not directly affect risk exposure given parent guarantees over any debts of the subsidiary.

Australia's thin capitalisation and transfer pricing rules aim to safeguard against excessive interest charges being allocated to the Australian subsidiary, either by restricting deductibility for businesses that operate at above a specified level of gearing or by policing the interest rate. In this regard, the thin capitalisation rules can be seen as placing a limit on the degree to which the normal, risk-adjusted, return from an investment in Australia can be excluded from Australian tax (by being characterised as a return on debt) and the extent to which it is taxable (as the return on equity). The transfer pricing rules can be seen as a means of restricting the ability of firms to avoid tax on supernormal returns. Together, these rules play a role in ensuring what is judged to be the appropriate level of tax is collected from investment in Australia.

At an economy wide level, the overall bias in favour of debt — together with the incentive provided by dividend imputation and the capital gains tax discounting rules for domestic residents to hold domestic equity — might be reflected in a relatively high share of debt finance in the capital account of the balance of payments. For an individual firm, debt financing can exacerbate vulnerability in the profit and loss statement when revenue falls, as the debt servicing costs are essentially unavoidable, short of default — unlike dividend payments. The increased vulnerability of firms would be expected to magnify the impact of financial shocks and other sources of macroeconomic instability.

Tax-induced distortions to financing decisions should be reduced to avoid encouraging firms to rely excessively on debt finance and to avoid biasing other financial decisions, such as dividend payouts. However, outside of the business level expenditure taxes outlined previously, it is difficult to reduce distortions to financing decisions.

Principle

Thin capitalisation and transfer pricing rules should continue to be used as mechanisms to ensure that what is judged to be the appropriate level of tax is collected from investments in Australia.

The current treatment of foreign debt is complex and distortionary

Interest paid on foreign debt is deductible against the company income tax base (subject to the thin capitalisation rules) but the non-resident lender may be subject to interest withholding tax. While interest withholding tax is applied notionally at a rate of 10 per cent, in aggregate the effective tax rate is around 3.5 per cent given the wide range of available exemptions (see Table B1-3).

Table B1-3: Interest withholding tax rates and exemptions

Foreign debt	Interest withholding tax rate (IWT)
<i>Exemption dependent on borrower</i>	
Australian investor borrows from non-resident lenders through a publicly offered debenture issue, non-equity share or syndicated loan	Exempt
Australian branch of foreign bank borrows from its parent	5% IWT on notional interest (based on LIBOR)(a)
Australian bank borrows from non-resident retail investors (retail deposits, in Australian parent)	10% IWT
Offshore banking unit (borrows offshore and on-lends offshore)	Exempt
Australian Government bonds	Exempt
State government bonds	Exempt
<i>Exemption dependent on lender</i>	
Australian investor borrows from foreign financial institution	Exempt for institutions located in US, UK, Norway, France, Finland, Japan, South Africa and New Zealand (cf. tax treaties) (b). Otherwise, 10% IWT
Australian investor borrows from sovereign wealth fund	Exempt (exemption administered by ATO)
Australian investor borrows from foreign superannuation fund that is tax-exempt in its country of residence	Exempt
<i>No exemption available</i>	
Other related party borrowings	10% IWT

(a) London Interbank Offered Rate.

(b) This exemption is being extended to other countries over time.

Although interest withholding tax is imposed on the non-resident lender, it is likely to be passed onto Australian borrowers by way of higher interest rates on their borrowings — increasing their cost of capital and reducing domestic investment. In large part this is likely to depend on whether the non-resident lender is able to receive a credit for the interest withholding tax paid in their home jurisdiction.

The extent to which interest withholding tax is a creditable tax is unknown. As most countries tax interest income on a residence basis, the formal creditability of interest withholding tax would be expected to be relatively high. But, there are a number of situations where it may not be creditable, or, even where credits are available, they may not be valued in whole or part by the lender.

A potential benefit of interest withholding tax is reducing the tax bias, in respect of international capital, in favour of debt over equity. However, the extent and nature of the exemptions available mean that in practice this benefit is likely to be minor.

In turn, those exemptions generate distortions of their own that appear more significant. In particular, the current arrangements are likely to influence how Australian businesses and households access foreign debt capital, potentially distorting competition between financial service providers and reducing the stability of the financial system, and leading to a misallocation of that capital away from its most productive uses in favour of less productive investments that have better access to debt.

While it is difficult to estimate how large these potential costs may be, the current rules potentially favour domestic financial institutions raising funds offshore through wholesale markets rather than retail deposits, increasing their vulnerability in periods of financial turmoil. They also favour borrowing directly from banks in certain countries, over banks in other countries or the Australian branches or subsidiaries of foreign banks generally, favouring less commercially competitive forms of intermediation.

An important benefit of the current interest withholding tax arrangements is that they act as a brake on tax avoidance schemes by residents, such as the routing of income through offshore structures with the income then returned in a tax exempt form (such as a foreign non-portfolio dividend received by an Australian company). Interest withholding tax can reduce the tax benefit of such schemes, and also generate information for use by tax authorities.

Interest withholding tax also limits the tax advantage to multinationals from thinly capitalising their Australian subsidiaries or branches or paying interest at excessive rates. In this respect, interest withholding tax supports the thin capitalisation and transfer pricing rules.

Finding

Foreign capital invested in Australia in the form of debt is subject to low effective tax rates, primarily through interest withholding tax. That tax currently helps safeguard the taxation of foreign equity and of resident savings. But it may negatively affect the financial sector by distorting the way foreign debt is accessed.

Reducing distortions in how foreign debt is accessed

Distortions in the access to and intermediation of foreign debt could be reduced by generally not applying interest withholding tax to interest paid to non-residents by financial institutions operating in Australia.

While the precise boundaries of the exemption require separate consideration, it is expected that this targeted interest withholding tax exemption would cover authorised deposit-taking institutions such as banks, building societies and credit unions, as well as other financial institutions (such as money market corporations).

The exemption would not, however, extend to debt accessed through the corporate treasury of a multinational group. This would ensure that interest withholding tax would remain payable on the related party debt of Australian businesses other than financial institutions.

The exemption would also not apply to insurers or fund managers, who are engaged in investing in financial instruments rather than being a source of debt capital for Australian businesses.

For non-resident retail deposits in Australia, the compliance and integrity issues arising from this recommended exemption would need to be further considered. For example, retaining interest withholding tax on such deposits would avoid increasing incentives for resident savers to claim non-resident status. While some compliance costs are imposed by requiring Australian financial institutions to withhold tax from interest paid on retail deposits, financial institutions are already required to operate tax file number withholding.

Australian businesses that are not financial institutions would continue to be able to access the existing exemptions for publicly offered debentures and certain debt interests. But consideration should be given to streamlining these rules.

There may also be scope to remove interest withholding tax on a bilateral basis in tax treaties, as recently agreed between the United States and Canada. Tax treaties, by providing scope for the effective exchange of information, may guard against the risks of potential tax avoidance by resident savers which could arise where unilateral abolition is pursued.

Recommendation 33:

Financial institutions operating in Australia should generally not be subject to interest withholding tax on interest paid to non-residents.

Recommendation 34:

Consideration should be given to negotiating, in future tax treaties or amendments to treaties, a reduction in interest withholding tax to zero so long as there are appropriate safeguards to limit tax avoidance.

Managing the investment of foreign savings

Tax can affect the ability of Australian business to manage foreign savings

Multinational companies, managed funds and related corporate and investment management services can be seen as providing a service to manage domestic and foreign savings by investing it domestically and overseas.

For such entities in Australia, taxing their foreign source income (whether by company income tax or withholding taxes) as it flows to non-resident investors could effectively act as a toll on non-residents using Australian rather than foreign managers. The toll would be on top of any general source-based tax on the profits from the service of managing capital. It would create a bias against the Australian provision of such services, potentially allocating resources away from their most productive use.

The location of managed funds and related services is particularly likely to be sensitive to such taxes. Given the ease with which savings can be reallocated between different funds, any tax on the income flows to the underlying investors can significantly affect the ability of Australian-based operations to compete. A small amount of Australian tax on the underlying

conduit income, or the risk of such tax, can give rise to a very high effective tax rate on the value added by the Australian based activity.

Conceivably, aspects of Australia's commercial environment, including political stability, effective legal system, governance arrangements and a reasonably well-developed and sophisticated financial services sector, could generate location-specific rents for such business services. However, other factors, such as the relatively small size of Australian financial markets and geographical isolation, are likely to mean that these rents are low.

Many of these features are also found in other countries, and funds management and related services, in particular, are likely to be highly mobile and operate in highly competitive environments. There is therefore a case for not taxing the foreign source income of Australian entities, companies or funds, as it flows to or is realised by non-resident investors, while still taxing the Australian source income arising from the management activity in Australia.

While there is an in-principle case to generally exempt such conduit income, there are a number of competing considerations that also need to be taken into account. Conduit income tax relief may not be appropriate where, for example, it disproportionately increases administration or compliance costs, or compromises the ability to appropriately tax resident savings or (to the extent it is desirable) the Australian source income of non-residents, or is inconsistent with international tax coordination objectives or norms.

The highly mobile nature of some financial services also provides, in theory, a case, not only for not taxing conduit income, but also reducing the source-based taxation of the highly mobile activities undertaken by Australian intermediaries. Australia's offshore banking unit regime is an example of this approach. However, reducing the source-based taxation of highly mobile activities gives rise to the potential misallocation of domestic investment and practical difficulties, including problems with targeting any concessions. Preference should therefore be given to broader structural responses such as minimising taxes on conduit income.

Principle

To avoid penalising the management of foreign savings in Australia, investment taxes should not apply to the conduit income of Australian companies and managed funds. This needs to be balanced against practicality, international constraints and ensuring the taxation of resident savings or source-based investment taxes are not compromised.

The treatment of conduit income is mixed, particularly for managed funds

The conduit income of Australian multinationals is largely exempt from Australian investment taxes. This is achieved by the exemption provided to dividends received by an Australian company from a foreign company in which it has a significant (non-portfolio) holding, and the capital gains tax exemption that can also apply to the sale of such interests. These arrangements are consistent with an international trend to exempt non-portfolio dividends received from foreign companies from company income tax.

Further, dividends paid to foreign shareholders out of conduit foreign income are expressly excluded from dividend withholding taxes, and capital gains tax does not generally apply to

sale by non-residents of shares in Australian companies. The trend in Australia's tax treaties of reducing withholding taxes has also acted to reduce tax on conduit income.

Exceptions to the non-taxation of the conduit income of Australian companies arise from the taxation of foreign source interest, royalties and portfolio dividends, and controlled foreign companies rules that in effect tax returns from the non-business investments of offshore subsidiaries. These exceptions limit opportunities for residents to defer taxation of the returns to their savings.

For Australian managed funds, though, the situation is less satisfactory. Managed funds established as trusts are currently treated on a flow-through basis for tax purposes, with some exceptions. As a consequence, the tax system should be largely neutral in its treatment of savings invested directly or indirectly through an Australian managed fund.

However, in practice, the taxation of Australian managed funds is more complex. Firstly, it is governed by a mix of trust law and tax law concepts. Secondly, there is a reliance on both case law and statutory rules. These complicating factors have given rise to uncertain tax outcomes.

In particular, considerable uncertainty remains around the treatment of investments offshore or cross-border dealings. As submissions indicate, this largely arises from ambiguity around the meaning of 'Australian source'. For example, reliance on common law can result in income being given an Australian source merely because a contract is executed in Australia, notwithstanding that the contract concerns non-Australian assets and non-resident owners. In some cases, issues also arise around whether having fund-related services performed in Australia gives rise to Australian residency or a permanent establishment in Australia.

Finding

Current taxation arrangements for Australian managed funds create uncertainty around the treatment of conduit income, reducing the competitiveness of Australian managers of global savings.

Improving the treatment of foreign income

Source and residence can be nebulous concepts, which make improving existing arrangements challenging. There is also a risk that any reforms to current arrangements may reduce the taxation of resident savings or profits of non-residents from Australian operations (where it is desirable that those profits be taxed).

These difficulties notwithstanding, the existing tax treatment of managed funds and related entities should be improved to provide greater certainty and minimise the risk of conduit income being taxed. As reforms will raise complex and technical issues, the details of these reforms require separate consideration.

Recommendation 35:

Taxation arrangements applying to Australian managed funds and related services should be improved to provide greater certainty that conduit income will not be subject to Australian tax.

B2. The treatment of business entities and their owners

Key points

In Australia, partnerships and, to a significant degree, trusts are taxed on a flow-through basis. While this remains broadly appropriate, the general trust tax rules are complex and give rise to uncertainty. Accordingly, those rules should be rewritten and updated.

Companies are taxed as separate entities from their shareholders, but the imputation system avoids the double taxation of corporate profits. As dividend imputation still provides a number of benefits, including improved neutrality around financing and entity choices, and also has integrity benefits, it should be retained in the short to medium term.

The benefits of dividend imputation will, however, decline as Australia becomes more integrated into the global economy. Therefore, for the longer term, consideration should be given to alternatives to imputation as part of a broad reconsideration of company income tax arrangements.

To preserve the integrity benefits and integration outcomes of dividend imputation, imputation credits should continue to be provided only for Australian company income tax paid. Likewise, dividend streaming and franking credit trading practices should, in general, continue to be prohibited.

As part of closer economic relations between Australia and New Zealand, consideration could be given to the appropriate degree of harmonisation of business income tax arrangements between the two countries. Bilateral mutual recognition of imputation credits would be one element of this broad examination.

B2-1 Approaches to taxing the income of business entities and their owners

The organisational forms or entities used for business activities depend on a country's legal arrangements and commercial practices. In Australia, businesses operate through companies, general and limited partnerships, and different types of trusts, as well as directly by individuals as sole traders.

Each of these entity types has advantages and disadvantages. For example, the limited liability of companies and their governance arrangements may make them better suited to conducting risky activities. Trusts, which separate legal and beneficial ownership, offer the benefits of asset protection. Operating as a sole trader is simpler than operating through a separate entity, reducing legal and accounting costs.

Income tax can apply to both the owners of a business and the business entity itself (except in the case of sole traders). This raises the prospect of double taxation, which may give rise to

high effective rates of tax. However, in some cases, even where income tax is paid at the owner and business levels, the total income tax paid may be less than if the business was operated by a sole proprietor subject to personal income tax only.

Where double taxation is seen to be undesirable, it can be dealt with in a number of ways, including by flow-through treatment (where the income of the entity is attributed annually to the owners), taxing the owners only on distributions received and on changes in the value of the business, and taxing both the owners and the business separately but in an integrated way. These approaches can also be combined; for example, a flow-through approach can be combined with entity taxation in certain circumstances.

If tax outcomes were the same regardless of the choice of business entity, the tax system would allow businesses to adopt organisational forms that are commercially preferred. While estimating the economic cost of inconsistent tax treatments of business entities is difficult, Gordon and MacKie-Mason (1997) found that taxes do affect the choice of organisational form, though non-tax factors dominate. There is also evidence that reductions in company income tax rates cause income to shift to the corporate sector (de Mooij & Ederveen 2008).

Flow-through treatment has considerable advantages in achieving outcomes consistent with a personal income tax system based on a progressive rate scale. However, there are situations where separate entity treatment may be more practical — in particular, for large businesses where ownership rights are frequently traded. Also, where such businesses are conducted through a company owned by non-residents, there are constraints on Australia's ability to tax the profits of the company other than on a separate entity basis.

Other features of the tax system may also affect how different entities should be taxed. For example, concerns over tax losses arising from mismeasurement of business income (which may occur where capital expenditures are immediately deducted) may justify imposing limits on loss flow through (see Section B1 Company and other investment taxes).

Commercial practice and needs, along with the non-tax legal and regulatory environments, are also relevant in considering the appropriate tax arrangements for different entity types. For example, in Australia, unit trusts have been the entity type most commonly used for managed investment vehicles, whereas in other countries companies may also be used. The nature of managed investment vehicles, which invest the savings of investors with very different tax profiles into domestic and foreign assets, places a premium on certain tax features, such as a flow-through treatment and certainty in tax outcomes.

Principles

Income tax arrangements for different types of business entity and their owners should be broadly consistent to limit biases in choice of business structure, while taking account of diverse circumstances and requirements.

Relationship between company and personal income tax

The difficulties associated with taxing large and complex companies under a flow-through approach mean that companies are typically taxed separately from their owners (shareholders). As shareholders are also taxed on company profits when received as

dividends (or as capital gains), an issue arises as to how the company and personal income tax systems interact.

Where the income taxation of companies and shareholders is not integrated (often referred to as a 'classical' company income tax), company profits are taxed once at the company level and then again in the hands of shareholders through personal income tax.

A classical company income tax system, by favouring unincorporated businesses, can bias individual choices around how a business is structured. It can also affect the allocation of activity between the corporate and unincorporated sectors, in turn potentially affecting overall investment allocation. And it can affect choices by individuals about investing their savings in shares. Classical company income tax systems may also distort company level financing and distribution decisions, encouraging the use of debt over equity and the retention rather than distribution of company profits.

The use of debt can give rise to a tax-induced bias in financing decisions because profits taken as interest are not taxed at the company level. This bias can give rise to non-tax costs, although this may not always be the case. For example, if the owner of a company – whether an individual owner of a small company or a multinational company with its subsidiary – is the sole provider of capital, a degree of integration can be achieved through contributing capital to the business primarily as debt, with few non-tax costs. However, for companies with more diversified sources of capital, the tax bias towards debt may result in excessive leverage, which can give rise to significant non-tax costs such as the increased risk of financial distress.

It is the potential biases arising from classical company income tax systems that make a case for shareholder tax relief. That relief can be implemented at either the company or shareholder level, or both (see Table B2-1).

Table B2-1: Types of shareholder tax relief

Company level		Shareholder level	
Type of relief	Description	Type of relief	Description
Dividend deduction	A full or partial deduction for distributed profits. (Akin to the approach taken with interest.)	Dividend exclusion	Proportion of dividend is excluded from taxation.
Credit	A full or partial credit to the company for distributed profits.	Credit	A full or partial credit for dividends received.
Reduced rate	Company income tax rate reduced.	Dividend imputation	A full or partial credit for dividends received to the extent company income tax was paid.
Expenditure tax	Deduction for normal return to capital. (Akin to the approach taken with interest.)	Reduced rate	Reduced tax rate for dividends received.
		Allowance for shareholder equity	Deemed normal return on shareholding excluded from taxation.

A high degree of integration can be achieved by providing shareholders with a credit (in full or part) for company income tax paid, as under dividend imputation. A semi-integrated or semi-classical approach would see tax relief provided to shareholders through other means; for example, through providing a tax credit not related to actual company income tax paid,

taxing dividends at a low rate, or having partial or full exemption of dividends from tax. Alternatively, relief could be provided at the company level by reducing company income tax in a number of ways.

More radically, expenditure tax approaches at either the company level (such as an allowance for corporate equity) or the shareholder level (an allowance for shareholder equity) could be adopted.¹²

The effects of providing shareholder-level tax relief

There are three broad views about the effects of providing shareholder-level tax relief, and the extent of relief that is appropriate: the 'new view', the 'traditional view' and an 'open economy view'. These views are not mutually exclusive, and each can be relevant for some firms and may vary over time with changes in economic conditions. A wide range of largely non-Australian empirical studies has provided mixed support for all three views.

The new view holds that in certain circumstances, and even in a closed economy, taxes on dividends may be irrelevant to a firm's investment decisions and to the choice between funding investments from retained earnings or debt. Under this view, the value of a company is equal to the present value of post-tax dividends. Shareholders are therefore indifferent as to whether they retain their earnings in a company or receive dividends. Introducing shareholder level tax relief may simply result in an increase in the market value of companies, providing windfall gains to existing shareholders, and have no impact on a company's cost of capital and, hence, its investment decisions.

The traditional view holds that dividend taxation does affect business choices. This can occur because newly established companies do not have retained earnings and have more difficulties accessing debt. A tax bias against raising new shareholder equity therefore creates a bias against start-ups. Shareholders may also have a preference for receiving company profits as dividends rather than capital gains, as regular dividend distributions may indicate the health of the company and can counteract suboptimal reinvestment of profits by company managers.

The open economy view takes account of the openness of the economy to international investment and capital, and the trend over time to more integrated international capital markets. As discussed in Section B1 Company and other investment taxes, for a small open economy where capital is perfectly mobile, the cost of capital for domestic companies is determined internationally. A source-based tax, such as the company income tax, increases the pre-tax return demanded by international investors and so increases a company's cost of capital.

In contrast, resident shareholder taxes do not increase or decrease the pre-tax return demanded by non-resident savers and therefore do not affect a company's cost of capital or its investment decisions. Shareholder tax relief would likewise not affect a company's cost of capital. However, taxes on dividends and capital gains could still affect residents' decisions about where to invest their savings.

¹² These approaches are outlined in Australia's Future Tax System conference paper by Sørensen and Johnson (2010).

As noted in Section B1, despite the trend towards increased openness in trade and international capital mobility, Australia will continue to exhibit some characteristics of a closed economy. Thus insights about how taxes affect economic outcomes in both open and closed economies need to be taken into account.

While this discussion assumes that company profits arise from the investment of capital, profits may also represent a return to the efforts of the owners, for smaller companies in particular. For these profits, it is the combined company and shareholder level taxes that represent the tax on that return to labour. This must be taken into account when integrating the taxation of such companies and their owners.

Principles

The interaction of the company and personal income tax systems should avoid introducing biases to company financing arrangements, other business decisions and the allocation of household savings. In doing so, an important consideration is the openness of the economy.

B2–2 Current entity arrangements have strengths and weaknesses

A high level of tax integration between entities and their owners

In Australia, companies are the most significant type of business entity in terms of net assets and net income. For the 2006–07 income year, there were 750,275 companies (of which 1 per cent were public companies); 355,345 partnerships and 272,535 trusts identified for income tax purposes. Just over one million individuals reported net business income in their tax returns, reflecting sole traders (ATO 2009).

Partnerships are generally taxed on a flow-through basis, so that each partner is taxed similarly to a sole trader. Generally, the income and losses of a partnership flow through to the partners in proportion to their interests in the partnership. Where a partner leaves a partnership, they are taken to dispose of their share in the underlying partnership assets. This can create some complexity due to the interaction of the capital gains tax and partnership rules.

Trusts can be used as an alternative structure for conducting business activities. Trusts are largely taxed on a flow-through basis, with the income of a trust allocated to its beneficiaries based on their 'present entitlements'. However, losses do not flow through to beneficiaries. Where there is income of the trust to which no beneficiary is presently entitled, it is taxed in the hands of the trustee at the top personal income tax rate plus the Medicare levy.

In contrast to the treatment of partnerships and trusts, companies are taxed separately from their shareholders.¹³ Under the dividend imputation system introduced in 1987, resident companies are able to attach (frank) imputation credits to dividends paid to shareholders.

¹³ Limited partnerships, public trading trusts, widely held unit trusts that do not limit their activities to eligible investment businesses, and corporate unit trusts are also taxed like companies.

The imputation credits represent tax paid by the company on behalf of the shareholders. Resident shareholders receiving franked dividends are taxed on the dividend and the attached credit, but their liability is reduced by the amount of the credit. From 1 July 2000, excess imputation credits have been refundable for individuals, superannuation funds and charities.

Some variation in tax outcomes according to type of entity

While the tax treatment of the entity and its owners is highly or fully integrated for all types of entity, in practice there is some variation in: how business income is taxed (with a more favourable treatment of capital gains and foreign source income for unincorporated entities), access to losses, and potential tax deferral benefits from retaining income in a company (see Table B2-2).

These variations can distort business choices, and encourage more complex structures than would otherwise be used.

Table B2-2: Tax treatment of income attributable to individual resident owner

	Sole trader, partnership	Trust	Company
Taxable income	Taxed at individual's personal rate.	Taxed at individual's personal rate.(a)	Taxed at individual's personal rate.(b)
Tax-preferred income	Tax preference retained.	Partial claw back as a capital gain (unless non-fixed trust).	Claw back occurs when taxed as an unfranked dividend.
Capital gains of entity	50 per cent of gain is taxed at individual's personal rate.	50 per cent of gain is taxed at individual's personal rate.	Taxed at individual's personal rate.(c)
Foreign source income	Taxed at individual's personal tax rate with a credit for foreign tax.	Taxed at individual's personal tax rate with a credit for foreign tax.	After foreign tax income taxed at individual's personal tax rate.
Losses	Can be used against other income.(d)	Quarantined in trust to be carried forward.	Quarantined in company to be carried forward.

(a) If there is trust income to which no beneficiary is presently entitled, it is taxed to the trustee at the top personal tax rate plus the Medicare levy.

(b) Retained profits taxed at 30 per cent, but taxed at individual's personal tax rate when distributed, with credit for company income tax paid.

(c) A tax concession broadly equivalent to the capital gains tax discount is provided to investors in listed investment companies.

(d) Subject to non-commercial loss provisions being satisfied.

Source: Treasury (2008).

Trust tax rules are complex, uncertain and result in inappropriate outcomes

The general rules governing the taxation of trusts rely on a mix of trust law concepts (which mostly derive from case law) and tax law concepts (which derive from case law and statute). Differing views on key concepts, such as 'present entitlement', 'income of the trust estate' and 'share', create uncertain tax outcomes for taxpayers, increasing compliance and administration costs.

For example, there are differing views as to whether the income of the trust estate refers to net accounting profit, distributable or gross ordinary income, or whether it can vary according to the terms of the trust deed. In addition, the interaction between the income of the trust estate (which relates to present entitlement) and the net income of the trust (the basis for a beneficiary's tax liability) can be problematic; for example, when it comes to the treatment of capital gains derived through a trust. Recent court cases have also given rise to uncertainty around whether income retains its character as it flows through a trust.

Findings

Partnerships and, to a significant degree, trusts are taxed on a flow-through basis, which can achieve a high degree of integration. Although companies are taxed on a separate entity basis, a similar degree of integration is achieved through the imputation system. There is, however, variation in how some types of income are taxed through different entities.

Current income tax rules applying to trusts are complex and uncertain.

Ways of improving trust rules

To reduce complexity and uncertainty around their application, the general trust tax rules should be updated and rewritten. While the trust tax rules have been examined recently by the Board of Taxation, that review focused specifically on how the rules applied to managed investment trusts rather than trusts in general (Board of Taxation 2010).

Recommendation 36:

The current trust rules should be updated and rewritten to reduce complexity and uncertainty around their application.

B2–3 The future of dividend imputation

International trend away from imputation

Australia and New Zealand are now the only two OECD countries to operate dividend imputation systems.

Countries that have abandoned dividend imputation systems include the United Kingdom (in 1999), Germany (in 2001), Finland (in 2005) and Norway (in 2006). While the move away from imputation for European countries can be partly explained by European Union legal issues, the trend has also been evident in Asian countries. Both Singapore (in 2003) and Malaysia (in 2008) have abolished their imputation systems.

Notwithstanding the move away from imputation, there has been no clear trend to reduce or remove shareholder level tax relief (see Table B2–3). The United States, whose federal company income tax rate has remained at 35 per cent since 1993, introduced dividend tax relief in 2003. While some countries that have low company income tax rates (such as Ireland and Switzerland) also have classical company income tax systems, other countries exempt resident shareholders from further tax (for example, Singapore and Hong Kong).

Table B2–3: International approaches to shareholder and company interactions

	Dividend received by resident from domestic company	Dividend received by resident from foreign company
New Zealand	Operates imputation system. Imputation credits are not refundable.	Taxed at shareholder's marginal tax rate, imputation credits not available.
United Kingdom	Dividend tax credit provided. Tax rates on dividends are lower than tax rates on other income.	Same treatment for foreign dividends.
United States	'Qualified' dividends taxed at 15% for high rate taxpayers; 0% for low rate taxpayers.(a)	Same treatment for foreign dividends if paid from a company resident in a country with which the US has a comprehensive tax treaty.
Germany	Substantial shareholders (interest greater than 25%) taxed on 60% of dividends at marginal rates (only 60% of expenses deductible). Other shareholders subject to final withholding tax of 26.38% on gross dividends.	Same treatment for foreign dividends.
Hong Kong	Exempt.	Same treatment for foreign dividends.
Singapore	Exempt.	Same treatment for foreign dividends.
Ireland	Classical taxation — taxed at shareholder's marginal tax rate without credit for company income tax paid.	Same treatment for foreign dividends.

(a) These arrangements are legally due to expire on 31 December 2010, when, absent further legislative changes, dividends will be taxed at normal marginal rates.

Source: Treasury.

Most developed countries fall in between the extremes of classical and full exemption systems, providing partial dividend exemption, partial tax credit, lower rates of tax for dividends, or a combination of these. Unlike dividend imputation, these approaches do not depend on company income tax having been paid on the profits from which the dividend is paid.

More radical forms of shareholder tax relief have been adopted in Belgium and Norway. Belgium operates a classical tax system but avoids double taxation largely by applying a business level expenditure tax — the allowance for *corporate* equity. Norway provides shareholder tax relief through an allowance for *shareholder* equity. This is similar to the allowance for corporate equity, except that relief is provided at the shareholder rather than the company level.

Companies are not always taxed as separate entities. For example, the United States operates a special regime for 'S corporations', which are legally companies but taxed as flow-through entities if certain conditions are met. The United States also operates a 'check the box' regime, under which a limited liability company that is not publicly traded can elect for either partnership or company treatment.

While the Australian and New Zealand imputation systems do not provide tax relief for dividends received from foreign companies, many other countries provide equal treatment for dividends received from domestic and foreign companies. For example, a United States taxpayer receiving a dividend from an Australian company would receive the same shareholder relief — a reduced tax rate on that dividend — as for a dividend received from a United States company.

Dividend imputation provides benefits

Australia's imputation system provides a more neutral treatment of incorporated and unincorporated domestic businesses and has less impact on company financing and

distribution choices than the classical company income tax arrangements that applied before dividend imputation was introduced in 1987.

Dividend imputation may also encourage domestic business investment by reducing the cost of capital for domestically owned companies. This depends on the extent to which domestic rather than foreign providers of capital set the cost of capital for these companies. To the extent that domestic providers set the cost of capital, imputation may bias Australian companies owned by residents towards investing in Australia rather than overseas.

Dividend imputation and the cost of capital

In general, a company will only make an investment where the expected return on that investment at least covers the rate of return required by the providers of the company's capital, both debt and equity. In a closed economy, it could be expected that imputation would reduce the cost of capital, at least for new equity. However, where an economy is open to foreign capital and such capital is readily available, the cost of capital will be influenced by international capital markets.

Imputation is likely to have a more positive effect in reducing the cost of capital for smaller and unlisted Australian companies, particularly when they are starting up or raising new equity. These companies typically have more limited or indirect access to international capital and, therefore, a higher reliance on residents' savings. However, although they may not have direct access to foreign capital, the cost of capital for larger firms that do have access will also influence that of smaller firms. Hence, even for smaller and unlisted Australian companies, international capital markets matter.

One way to gauge the impact of imputation on the cost of capital for larger, listed companies is through studies of the market value of imputation credits (see Table B2–4). While these studies report varying estimates, taken together they support the conclusion that imputation has a real but muted impact on the cost of capital for listed companies, and that the availability of foreign equity capital influences the cost of capital and market valuation of listed Australian companies.

Table B2–4: Empirical estimates of the value of distributed franking credits

Study	Method	Study period	Estimated value of distributed credits (cents in dollar)
Cannavan, Finn and Gray 2002	Options analysis(a)	1994–1999	≈ 50 (pre-45 day rule(b))
			≈ 0 (post-45 day rule(b))
Hathaway and Officer 2004	Dividend drop-off(c)	1986–2004	50
		Post-2000	60
Beggs and Skeels 2006	Dividend drop-off(c)	1986–2004	57 (2001–04)
Strategic Finance Group 2007	Dividend drop-off(c)	1998–2006	20–40

(a) The value of the imputation credit is inferred from the relative prices of futures contracts and the individual stocks on which they are based.

(b) The 45 day rule requires that ordinary shares must be held for at least 45 days around the date of dividend entitlement otherwise the shareholder is not entitled to any imputation credits. The shares must be held 'at risk' so if the shareholder removes a substantial part of the price risk (for example, through hedging), imputation credits may be disallowed.

(c) The value of the imputation credit is inferred from the amount by which the price of a share changes when it goes ex-dividend.

Source: Australian Energy Regulator (2008).

Table B2–4 shows the market valuation of one dollar of imputation credits distributed by listed companies. By way of comparison, such studies typically find that one dollar of distributed cash is valued at 80 cents in the dollar (Australian Energy Regulator 2008). That the estimated values for imputation credits are less than for cash suggests that imputation has less of a beneficial impact on domestic investment than could be assumed, but is more relevant than an application of a simple open economy perspective would imply.

The study by Cannavan, Finn and Gray (2004) estimates that the market value of imputation credits was reduced to zero when rules preventing franking credit trading (the '45 day rule') were introduced. These rules prevent non-resident shareholders from effectively obtaining a benefit from imputation credits by selling them to resident shareholders who can use them. The fall in the value of imputation credits with the introduction of the 45 day rule (which reduced the benefits of franking to non-residents) is consistent with an open economy perspective under which international capital markets set the cost of capital and value of shares for Australian companies.

Another way of testing the impact of imputation credits on the cost of capital for Australian companies is to look at survey evidence about how companies make decisions. A 2004 survey of Australian listed companies found that only 13 of the 77 companies that responded to the survey made adjustments for imputation credits in project evaluation, including in respect of company estimates of their cost of capital (Truong, Partington & Peat 2005). Only three respondents attached a value of more than 50 per cent to imputation credits.

For those companies that did not take account of imputation credits in their investment decision-making, reasons included: difficulties in setting an appropriate tax credit value for all shareholders; that the value of imputation credits was already factored into the share price; and irrelevance to non-resident shareholders.

Dual-listed companies

Differences in the valuation of the Australian and non-Australian companies in a dual-listed company structure may also reflect the impact of imputation, and may suggest that imputation reduces the cost of capital for Australian companies. For example, Bedi, Richards and Tennant (2003) showed that for BHP-Billiton, a dual-listed company, the Australian shares traded at a 5 to 10 per cent premium to the United Kingdom shares. Such a premium may suggest that the market does value imputation credits.

However, the evidence is not clear cut. Not all dual-listed companies have traded at a premium on the Australian arm. Empirical studies have struggled to explain the observed long-term premiums for dual-listed companies, even taking account of tax factors. Further, dual-listed structures in effect allow for dividend streaming, and so may not provide conclusive evidence that imputation credits are generally valued.

Dividend imputation provides integrity benefits

Dividend imputation also provides integrity benefits. For Australian companies with largely resident shareholders, company income tax acts as a prepayment of the personal income tax liabilities of shareholders on future dividends. The benefit to companies and their shareholders of avoiding or deferring company income tax is therefore reduced. This can increase company income tax revenues and reduce the need for anti-avoidance rules in general.

Tax administration and compliance costs are also reduced as companies spend fewer resources on trying to minimise tax paid. There is anecdotal evidence that some Australian companies bring forward tax obligations and eschew avoidance activities to generate franking credits. This appears particularly true of companies with a history of paying fully franked dividends.

For companies with foreign operations and a significant proportion of resident shareholders, imputation provides an incentive to shift foreign profits into Australia. This allows them to pay dividends from creditable Australian company income tax rather than non-creditable foreign tax. Similarly, imputation discourages domestically owned companies from shifting profits offshore.

The integrity benefits of imputation may partly explain why Australia's company income tax collections are high compared to other countries (see Section B1 Company and other investment taxes). While evidence of these integrity benefits is largely anecdotal, a recent quantitative cross-country study estimated that the presence of a dividend imputation system in a country gave rise to increased company income tax (Markle & Shackelford 2009).

The revenue outcomes discussed above reflect changes in gross company income tax paid. However, in looking at the benefits of imputation it is also necessary to consider the net gain to revenue. As increased company income tax payments generate more imputation credits that in turn reduce personal income tax collections, the net gain to revenue from imputation will be less than the gross gain. The net gain to the revenue from the integrity benefits includes:

- the time value of bringing forward tax from the personal to the company level;
- the absolute gain arising when imputation credits generated from the gross company income tax revenue gain are wasted (for example, because some shareholders are non-residents); and
- the revenue gained from taxable income increasing as foreign tax expenses are reduced (as Australian multinationals allocate more profits to Australia).

In considering the overall efficiency of the tax system, the net revenue gain from imputation is only of benefit if it is a relatively efficient source of revenue. It is difficult to assess whether this is the case, though the revenue and national income gains from encouraging the minimisation of foreign taxes are beneficial.

Finding

Dividend imputation provides a number of benefits to Australia, including improved neutrality around financing and entity choices. It also has integrity benefits that have allowed for fewer anti-avoidance rules.

Dividend imputation may create biases

Biases from the non-credibility of foreign taxes

Under dividend imputation, resident shareholders in an Australian company that invests offshore generally do not receive imputation credits on dividends paid out of the profits from that investment. Dividends and capital gains from such investments are generally exempt from tax in the hands of Australian companies, and imputation credits are not provided for any foreign company income or withholding tax paid.

As imputation credits are not permitted for foreign company income tax and other taxes such as foreign dividend withholding tax, resident shareholders in an Australian company receive the equivalent of a deduction, rather than a credit, for foreign taxes paid. Dividends paid out of net company profits (after deducting foreign taxes) are taxed in full without credit. The same is true for residents who hold shares in a foreign company, though they may receive a credit for foreign dividend withholding tax.

From the perspective of Australian companies, the non-credibility of foreign taxes may increase the required return for offshore investment, discouraging such investments and encouraging a domestically-orientated investment focus. From the perspective of Australian shareholders, the tax benefit of franked dividends may encourage them to invest more of their savings in Australian companies that invest domestically in preference to other Australian or foreign companies or other assets (a savings portfolio bias).

An assessment of the consequences of these tax biases depends on whether a more traditional view of dividend taxation is adopted or whether more weight is placed on the increasing openness of the economy (see Table B2–5). In practice, given the evidence on the effect of imputation on the cost of capital of Australian companies, the actual effects are likely to fall somewhere in between the consequences suggested under each perspective and to depend in part on firm-specific characteristics.

Table B2–5: Biases created by the non-credibility of foreign taxes and their potential consequences

Nature of potential bias	Consequences under traditional or new view	Open economy perspective
Bias against offshore investment by an Australian company	Cost of capital for an Australian company investing offshore may be increased, encouraging domestic over foreign investment. Bias may be optimal from a national efficiency perspective.	Cost of capital for Australian company for investments offshore is unaffected, as it is determined by international capital markets. Bias of no consequence to the allocation of investments between countries and, hence, the level of investment in Australia.
Portfolio bias against investment, by Australian resident or superannuation fund, of their savings in an internationally orientated Australian company or in a foreign company	Return to shareholder affected by company and shareholder-level taxes. Bias in favour of investment of savings in domestically focused Australian companies, but the bias is reduced the lower are foreign taxes on the offshore investment. Depending on financial policies of a company, the bias may be reversed.	Return to shareholder affected by shareholder level tax. Bias in favour of investment of savings in domestically focused Australian companies. Reduces gross inbound and outbound flows of capital; net capital flows remain unchanged.

According to the traditional or new view

To the extent that the tax bias against offshore investment actually has an effect, it may be beneficial from a national perspective. This is because paying foreign tax does not benefit Australians. Rather, it reduces the net return to Australians of the offshore investment of domestic savings. In contrast, paying Australian company income tax on a domestic investment helps fund transfers and public services. By restricting imputation to Australian company income tax and not giving a credit for foreign taxes, Australian companies treat foreign tax as a cost, so aligning their private interests with the national interest.

One qualification to this national interest argument is that it assumes there are no potential spillover benefits from offshore investment by Australian companies. It also assumes that direct investment offshore is a substitute for, rather than a complement to, domestic investment, whereas there is evidence that for some industries or types of firm this is not always the case (Desai, Foley & Hines 2009).

The non-credibility of foreign taxes also gives rise to a potential portfolio bias for resident savers against owning shares in companies that invest offshore. However, whether there is actually a bias against holding shares in a foreign company or internationally focused Australian company depends on the level of foreign taxes applying to the company and its financial and distribution policies. Where the level of foreign taxes is low, and shareholder taxation is deferred, the bias against offshore investment may actually be reversed.

According to the open economy perspective

These results do not hold to the extent that the cost of capital (in Australia and overseas) is set by international capital markets. In that case, resident shareholder tax relief has no impact on the firm's cost of capital. Hence, the non-credibility of foreign taxes does not give rise to a bias against offshore investment by Australian companies. The portfolio savings bias becomes more evident, however, as differences in company income taxes between countries are offset by differences in company profitability.

Biases from restricting imputation to shareholders of Australian companies

Imputation is, for the most part, limited to Australian companies. Shareholdings in foreign companies, even those that conduct business in Australia and pay Australian company income tax, do not give rise to imputation credits. As well as creating the savings portfolio bias discussed above, this feature of the imputation system may discourage Australian companies from shifting their residence offshore.

The extent to which companies have an incentive to remain resident for tax purposes depends on the proportion of resident shareholders to total shareholders, and of domestic income to total income. As the proportion of non-resident shareholders or foreign income rise, the benefits of maintaining residence in Australia fall. For example, a resident entrepreneur with an internationally focused company could have an incentive to shift the residence of both themselves and their company offshore.

An exception arises in the case of Australian shareholdings in New Zealand companies with Australian operations. In this case, the New Zealand company is able to provide imputation credits to Australian shareholders for Australian company income tax paid, in proportion to the shareholders' ownership of the company. The same applies in the case of New Zealand shareholders of an Australian company with New Zealand operations. This rule provides neutrality in company location decisions between Australia and New Zealand.

Complex rules have been adopted in response to the biases

As different types of shareholders are taxed differently on their dividend income, the value they ascribe to imputation credits will vary. This sets up incentives for franked dividends to be paid to those shareholders that value them the most.

In particular, as non-resident shareholders cannot directly benefit from imputation credits (other than to avoid dividend withholding tax), there is an incentive for companies to stream unfranked dividends to non-residents and franked dividends to resident shareholders.

Non-residents who would otherwise receive franked dividends also have an incentive to enter into arrangements (franking credit trading) that see those dividends paid to resident taxpayers, in return receiving compensation in a tax-effective way for the loss of the cash dividend and for allowing the use of the imputation credit.

As a consequence of these incentives, the imputation system requires its own complex anti-avoidance rules to prevent dividend streaming and franking credit trading. These rules apply inconsistently; they do not prevent streaming through the use of dual-listed companies.

Finding

The benefits of dividend imputation have declined as the Australian economy has become more integrated into the global economy. In particular, benefits in relation to financing neutrality have fallen, while the bias for households to over-invest in certain domestic shares has increased. Furthermore, imputation has its own complex integrity rules.

B2–4 Reform directions for dividend imputation

Recommendation 37:

Dividend imputation should be retained in the short to medium term, but for the longer term, consideration should be given to alternatives as part of a further consideration of company income tax arrangements.

Recommendation 38:

A flow-through entity regime for closely held companies and fixed trusts should not be adopted for now, but would merit further consideration if there is a move away from dividend imputation in the long run.

Recommendation 39:

While dividend imputation is retained, imputation credits should continue to be provided only for Australian company income tax. Dividend streaming and franking credit trading practices should, in general, continue to be prohibited.

Recommendation 40:

If increased integration of the Australian and New Zealand economies is desired, a broad examination of the appropriate degree of harmonisation of business income tax arrangements between Australia and New Zealand should be undertaken.

Alternatives to dividend imputation should be considered for the future

Dividend imputation continues to deliver benefits for Australia, particularly for smaller firms and those operating in the more closed segments of the economy. However, a continuation of the trend of increased openness, rapid growth in cross-border investment flows and greater capital mobility will reduce the benefits of imputation in the longer term. Consideration therefore needs to be given to long-term reform options that provide a better fit with the global economy but which still retain the positive aspects of imputation (see Recommendation 37).

For a small, open economy that is increasingly integrated with international capital markets, providing tax relief only on dividends paid to resident shareholders will become less effective in reducing the cost of capital for companies (and hence of reduced benefit in encouraging investment) or in providing a neutral treatment of debt and equity. The bias for domestic savings to be invested in the shares of Australian companies will increase, limiting opportunities and increasing risk to households from poorly diversified savings portfolios.

Reform could involve switching tax relief from the double taxation of dividends from the shareholder level to the company level. Doing so would provide the same outcomes for resident shareholders as the current system, but would further reduce tax on non-resident shareholders. In effect, there would be a move to greater reliance on the taxation of residents' savings income and less reliance on source-based investment taxes. This switch would further encourage investment in Australia and reduce Australian companies' reliance on foreign debt. It would also reduce biases in the allocation of residents' savings.

To achieve such a switch, consideration could be given to a partial integration system that is common overseas, while at the same time reducing the company income tax rate. A more radical approach, which has greater potential gains but is largely untested overseas, would be a move towards a company or business level expenditure tax. This option for long-term reform is outlined in Section B1 Company and other investment taxes.

A flow-through entity regime for closely held businesses

The Australian Government asked the Review to consider a proposal to allow small, closely-held companies and fixed trusts the option to effectively be treated as partnerships for tax purposes. Under this approach, income and losses of the company or trust would be assigned to shareholders and beneficiaries regardless of whether they were distributed. The proposal received mixed support in submissions.

The proposal has the potential to reduce the compliance burden for micro-enterprises, as the many sets of rules associated with the current separate entity treatment of companies and some elements of the treatment of trusts would not apply. For example, flow-through taxation would make redundant the deemed dividend rules relating to non-commercial loans from a company to shareholders. The proposal could also allow some multiple entity structures to be simplified.

Flow-through would also allow the tax losses of an entity to be transferred to its owners, who could then offset the losses against other income, rather than leaving the losses trapped in the company or trust. A flow-through regime could therefore also have the benefit of improving loss symmetry, a potentially useful policy outcome if measured tax losses correspond to economic losses (see Section B1).

While flow-through approaches to the taxation of business entities have general merit, flow-through entities could become yet another option for business to consider or another component of an even more complicated business structure. New rules would be required to determine eligibility for, and the consequences of, flow-through treatment, and transitions into and out of such arrangements. Where flow-through treatment is provided for businesses falling below a size threshold, the prospect of losing flow-through treatment could deter small businesses from expanding.

Experience with optional regimes suggests that they can significantly complicate the tax system while doing little to reduce compliance costs (see Section G5 Monitoring and reporting on the system). Research in the United States, where a number of company or company-like flow-through entities are available, has found that the income tax compliance costs of operating a flow-through vehicle are marginally greater than the costs for a normal company (under a classical company income tax) and around one-and-a-half times the costs of a general partnership (DeLuca et al. 2005).

While flow-through companies and related entities are extensively used in the United States, they were developed in the context of a system that at the time provided no credit at the shareholder level for company income tax paid. In Australia, dividend imputation provides reasonably effective integration between shareholders and companies, so the case for running multiple systems is weaker.

However, as part of any consideration of a long-term move away from dividend imputation, adoption of flow-through company and entity arrangements may be a useful means to provide appropriate outcomes for smaller businesses (see Recommendation 38).

Dividend imputation should retain its current features

So long as dividend imputation is retained, pressures on how it operates will continue to increase as the economy becomes more open and cross-border investment flows grow. In this regard, and generally reflecting the long-standing concerns of the business community, submissions to the Review have proposed altering the current imputation system to provide increased recognition for foreign taxes or to permit dividend streaming.

The primary argument for these proposals is to reduce the imputation bias against offshore investment. However, as discussed, to the extent that there is a bias, it may be beneficial to Australia. The case for change, therefore, is problematic in general and current policy settings should remain in place (see Recommendation 39). In addition, the proposals raise further specific issues that are discussed below.

Providing a tax credit for foreign tax is problematic

Submissions to the Review have proposed providing a credit for foreign investment taxes paid by Australian companies on the basis that this will remove impediments to Australian companies expanding overseas. Credits for foreign taxes could take the form of either an imputation credit for actual foreign company tax paid or a uniform credit that is not linked to actual foreign tax payments.

Since companies seeking to expand offshore would typically be larger and more mature, they should have better access to international capital than other businesses in the domestic economy. Providing imputation credits to resident shareholders for foreign tax paid would

not directly assist them in raising foreign capital and so could have limited impact on their cost of capital and their potential for offshore expansion. It would, however, increase resident shareholders' post tax returns from their savings.

This argument may not apply in all cases. For example, there may be small, newly formed internationally or regionally focused businesses that look to expand offshore relatively soon after starting up. If such companies have only a few owners, there could be an incentive for the owners to relocate both themselves and their companies offshore. This is because a change of residence could reduce the total Australian and foreign tax bill at the company and shareholder levels. Providing increased recognition of foreign company taxes could go some way to reducing or reversing these incentives.

Providing a credit for foreign taxes paid by an Australian multinational could also have the benefit of removing a bias that encourages households and superannuation funds to invest more in domestically-orientated Australian companies than they otherwise would. At the same time, for investors wanting greater exposure to investments in foreign countries, it would create a bias favouring investments in Australian multinationals over foreign companies.

However, providing credits for foreign taxes would reduce the integrity benefits of the imputation system. By extending imputation to foreign taxes, the incentive for Australian companies to pay Australian tax would be reduced. Similarly, domestically owned companies would have greater incentives to shift profits to low-tax foreign countries, putting additional pressure on rules to prevent international profit shifting.

Providing a credit is difficult in practice

If imputation credits were provided to resident shareholders for actual foreign company income and withholding taxes paid by Australian companies, there would be increased administration and compliance costs associated with identifying creditable foreign taxes. Companies would need to identify and potentially track foreign taxes paid by foreign subsidiaries. The Australian Taxation Office would also need to be able to verify those payments, which would be difficult.

Given these practical difficulties, imputation credits provided for foreign taxes would not be refundable. Companies and shareholders would be required to account separately for refundable and non-refundable imputation credits, further increasing complexity and compliance costs.

A potentially simpler alternative would be to provide a non-refundable tax credit for dividends paid to resident shareholders by Australian companies out of designated foreign income not subject to Australian company income tax. Companies already track foreign income under the conduit foreign income rules. However, in this case credits could be provided to resident shareholders for dividends paid out of foreign income not subject to foreign tax.

Tax harmonisation with New Zealand and the mutual recognition of imputation credits

The merits of Australia and New Zealand recognising each other's imputation credits has been the subject of previous consideration by both governments, and has been proposed in submissions to the Review.

Mutual recognition of imputation credits would involve providing imputation credits for foreign taxes on a reciprocal rather than unilateral basis. Australian shareholders of Australian and New Zealand companies investing in New Zealand would be eligible to receive a credit for New Zealand company income tax paid. A similar arrangement would apply for New Zealand shareholders.

Mutual recognition would have the potential to improve the allocation of investments between the two countries, increasing productivity, and potentially reducing barriers to competition between Australian and New Zealand companies. It could also reduce incentives for firms to engage in profit shifting between Australia and New Zealand, probably to New Zealand's net benefit.

Some of the issues raised by bilateral mutual recognition are similar to those that would arise if Australia were unilaterally to increase recognition for foreign taxes. To the extent that the cost of capital for firms is set internationally, the benefits and costs of bilateral mutual recognition in respect of investment allocation would be reduced. Mutual recognition would also entail additional complexity and administration and compliance costs, though tax administration issues would be more manageable.

There is currently a significant imbalance in trans-Tasman investment. New Zealand direct and portfolio investments in Australia, as at 31 December 2008, totalled \$14.3 billion (\$4.5 billion and \$9.8 billion respectively). In contrast, Australian investment in New Zealand totalled \$36.2 billion (\$32.5 billion and \$3.7 billion respectively) (ABS 2008a). Hence, mutual recognition would impose higher revenue costs on Australia than on New Zealand. However, any imbalance in direct revenue costs is not of itself an argument against mutual recognition. Revenue costs do not necessarily represent transfers from Australia to New Zealand. They can also reflect reduced taxes imposed by Australia on the savings of its own residents (and vice versa).

The case for mutual recognition has also been raised in the context of developing closer economic relations between Australia and New Zealand. This is because mutual recognition could have a role in furthering broader policy objectives and achieving greater integration of the two economies.

If increased integration of the Australian and New Zealand economies is desired, the starting point for an assessment of the issues and possible benefits should be broader than just mutual recognition. Consideration would better start with a broader assessment of the appropriate degree of harmonisation of the two countries' business income tax arrangements (see Recommendation 40). That broader assessment would also take into account company income tax settings and related arrangements such as capital gains tax, the treatment of foreign source income, and the taxation of financial arrangements.

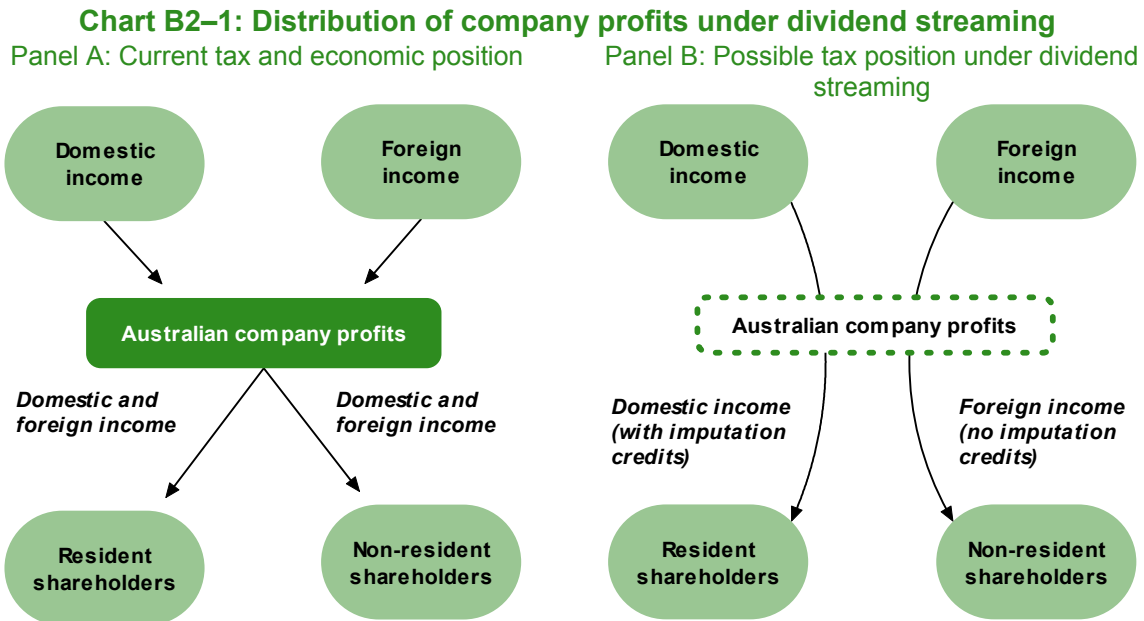
Mutual recognition would be one element of this broader examination, which could also take account of possible long-term reform directions in Australia.

Dividend streaming of foreign source income

The current rules prevent dividend streaming; that is, the payment of franked dividends to those shareholders who benefit from them the most (typically residents) and unfranked dividends to other shareholders (typically non-residents). Submissions to the Review have proposed allowing the streaming of unfranked dividends, paid out of a company's foreign

source income, to non-resident shareholders. However, there are good reasons to prevent dividend streaming.

There are a number of variants of dividend streaming, but all would have the potential effect that a shareholder's tax interest in company profits would be different to their legal and economic interest. This would be inconsistent with the integration objectives of imputation. For tax purposes, non-resident shareholders would be assumed to have an interest in the company's foreign income ahead of its other income; whereas their economic and legal interest would typically be in both the domestic and foreign source income of the company (see Chart B2-1). A similar divergence would arise for resident shareholders.



Dividend streaming could reduce the tax burdens faced by resident or non-resident shareholders, but for those benefits to be realised, the company would need a mix of resident and non-resident shareholders and of (taxed) domestic source and (untaxed) foreign source income. To maximise the benefits of dividend streaming, companies would need to get the right proportions of resident and non-resident shareholders, and of domestic and foreign income.

Hence a small, rapidly expanding and domestically owned company seeking to invest offshore would not benefit unless it changed its ownership structure. Those companies best able to benefit from streaming – those that have a mix of resident and non-resident shareholders and investments – would be likely to have access to international capital and be less reliant on domestic financing. Hence, their cost of capital would more likely be set internationally, reducing the potential benefits from streaming.

By maximising, for any given amount of company income tax paid, the credits available to frank dividends to resident shareholders, dividend streaming would also reduce the incentives to pay company income tax. It would therefore reduce the integrity benefits of the current rules.

Dividend streaming by foreign multinationals

Another possible variant of dividend streaming would be to permit foreign multinationals with a secondary listing on the Australian stock exchange to stream the imputation credits from their Australian subsidiary to the resident shareholders in the parent company.

The benefits of doing so could be to encourage secondary listing on the Australian stock market by firms with significant operations in Australia, increasing demand for Australian financial services. Further, by increasing the degree of connection of foreign companies with Australia it could conceivably reduce any bias against investing in Australia stemming from its geographic isolation.

However, it is not clear that permitting dividend streaming in this way would have these effects, or that the tax-driven stock market activity generated would be worthwhile. In addition, under the current imputation system, a multinational with Australian shareholders and operations has an incentive to take up Australian (or New Zealand) residency. Permitting dividend streaming by foreign multinationals would remove this incentive.

The current imputation system encourages residents to over-allocate savings into domestically focused Australian companies, which may limit the scope for geographic risk diversification. Permitting streaming by foreign multinationals could offset this bias by encouraging Australians to own shares in these companies. However, in turn, the bias against investing savings in internationally focused companies (both Australian and foreign) would worsen.

B3. Tax concessions for not-for-profit organisations

Key points

Not-for-profit (NFP) organisations make a highly valued contribution to community wellbeing and receive government and community support for their activities.

Much of the support provided to the NFP sector comes from tax concessions, including income tax exemptions, GST credits and exemptions, capped exemptions from (or rebates of) fringe benefits tax, and tax deductible gifts.

- This system of tax concessions is complex, and does not fully reflect current community values about the merit and social worth of the activities it subsidises.

NFP organisations face inconsistent state and federal regulation, which may deter them from undertaking legitimate fundraising activities and may undermine public confidence in the sector.

The High Court of Australia's 2008 decision in the *Word Investments* case has significantly increased the scope for NFP organisations to undertake commercial activities.

- The income tax and GST concessions generally do not appear to violate the principle of competitive neutrality where NFP organisations operate in commercial markets. However, the fringe benefit tax concessions provide recipient organisations with a competitive advantage in labour markets.

Where NFP clubs operate large trading activities in the fields of gaming, catering, entertainment and hospitality, the rationale for exempting receipts from these activities from income tax on the basis of a direct connection with members is weakened.

These issues could be addressed through: the establishment of a national charities commission to monitor, regulate and provide advice to all NFP organisations; reconfiguring the FBT concessions to alleviate competitive neutrality concerns while retaining government support for the NFP sector; and better targeting the application of the mutuality principle.

B3–1 Why tax concessions are available to NFP organisations

Not-for-profit (NFP) organisations make a highly valued contribution to community wellbeing in the areas of community and welfare service, religion, education, sport and recreation, environmental protection and animal welfare. The defining feature of NFP organisations is that they are constituted to distribute surpluses in accordance with their objectives, and are precluded from returning profits or surplus assets to members.

NFP organisations receive government and community support for their activities, in recognition that:

- NFP organisations supply goods and services with broad public benefits that may not otherwise be provided by private businesses. These benefits may be direct (such as providing legal advice to the homeless) or indirect (such as organising community sporting activities).
- NFP organisations are often more effective service providers than government or for-profit organisations, given their unique relationship with the community. An increasing number of traditionally government activities are being outsourced to NFP organisations.
- The activities of NFP organisations often supplement, or complement, existing government programs.

Much of the support provided to the NFP sector is delivered through tax concessions. These concessions are an important and longstanding source of financial support for the NFP sector, and assist NFP organisations to further their philanthropic activities and objectives.

Principle

Tax concessions for NFP organisations should be simple and transparent, reflect community needs and values, and encourage activities that provide broad public benefits. They should not undermine competitive neutrality where NFP organisations operate in commercial markets.

B3–2 Existing NFP tax concessions and regulatory arrangements are complex

Tax concessions

The tax concessions available to NFP organisations include income tax exemptions, a higher GST registration threshold, the ability to make supplies GST-free in certain circumstances, GST input credits, capped exemptions from (or rebates of) fringe benefits tax (FBT), and the ability to receive tax deductible gifts (see Table B3–1). Not all NFP organisations receive all concessions – generally the concessions depend on the particular public benefit purposes of the organisation.

Table B3.1: Main tax concessions for major types of NFP organisations^(a)

	Value (\$m) (2008–09)	Charities	Public benevolent institutions(b) and health promotion charities	Deductible gift recipients	NFP and public hospitals, and public ambulance services
Income tax exemption(c)(d)	*	Yes	Yes	–	Yes
GST concessions	*	Yes	Yes	Yes	Charities only
FBT exemption (\$17,000)	260	–	–	–	Yes
FBT exemption (\$30,000)	715	–	Yes	–	–
FBT rebate(e)	20	Charitable institutions only	–	–	–
Deductible gifts	1,080	–	Yes	Yes	Yes

(a) Entities may have more than one status (for example, a charity could also be a deductible gift recipient).

(b) There are over 11,000 public benevolent institutions in Australia, including organisations such as: Anglicare Australia Inc; Australian Federation of Disability Organisations Ltd; Australian Red Cross Society; Parents, Families and Friends of Lesbians and Gays Inc; Refugee Council of Australia Inc; and Society of St Vincent de Paul Pty Ltd.

(c) Many NFP organisations are taxable, but are entitled to special rules for calculating taxable income and lodging income tax returns and are able to access special rates of tax.

(d) Income tax exempt entities that do not meet the broad definition of a NFP organisation, such as municipal corporations, local governing bodies, constitutionally protected funds, and public authorities constituted under Australian law, are not discussed in this section.

(e) Certain non-government NFP organisations are eligible for this concession.

* The value of the concession cannot be quantified.

Sources: ATO (2007) and Treasury (2009).

This system of tax concessions is unnecessarily complex. At a federal and state level, the concessions are set out in at least 40 separate pieces of legislation, administered by 19 separate agencies (National Roundtable of Nonprofit Organisations 2007). This imposes significant compliance costs on NFP organisations.

The complexity of the concessions is exacerbated by their outdated application. For example, the classes of NFP organisation eligible for public benevolent institution status are based on the preamble of the *Charitable Uses Act 1601* ('Statute of Elizabeth'). The narrow interpretation of 'benevolence' derived from the Statute of Elizabeth excludes activities that have evolved to be valued by the community, such as animal welfare, international aid and development, and the promotion of human rights. The current hierarchy of concessions does not fully reflect current community views about the merit and social worth of different activities, or respond flexibly to special circumstances (such as natural disasters).

Regulation

NFP organisations also face significant complexity in relation to their regulatory arrangements, particularly where they operate in more than one jurisdiction. Submissions to the Review have expressed concern that inconsistencies between state and federal regulations may deter NFP organisations from undertaking legitimate fundraising activities, and may undermine public confidence in the sector.

Findings

The tax concessions available to NFP organisations are complex and do not fully reflect community preferences.

The regulatory framework for NFP organisations is inconsistent and opaque.

Competitive neutrality

In 2008, the High Court of Australia's decision in *Commissioner of Taxation of the Commonwealth of Australia v Word Investments Limited* [2008] HCA 55 found that a commercial business that directs its profits to charities is eligible for endorsement as a tax concession charity. The decision means that NFP organisations now have a significantly larger scope to undertake commercial activities on a concessionally taxed basis.

The Review has considered the three main tax concessions (income tax, GST and FBT) from a competitive neutrality perspective.

Income tax

Income tax exemptions enable many NFP organisations to retain untaxed profits for further investment, while for-profit organisations must invest from after-tax profits. This is the main advantage conferred on eligible NFP organisations by the income tax exemption.

Some submissions have expressed concern that income tax concessions may undermine the efficient allocation of economic resources. Economic theory provides a conceptual framework for assessing these concerns through Samuelson's invariant valuations theorem (see Box B3-1). The application of the theorem relies on a range of assumptions, including that NFP organisations seek to maximise profits. Although this may not be true of all NFP organisations, it is a reasonable assumption given their purposes.

In practice, the provision of tax concessions to NFP organisations is likely to result in an over-allocation of resources to the NFP sector. However, this bias is offset to some extent by the fact that the philanthropic activities undertaken by NFP organisations provide public benefits.

Box B3–1: Samuelson’s invariant valuations theorem

Samuelson’s invariant valuations theorem (1964) provides a conceptual framework for assessing the impact of the income tax exemption for NFP organisations on resource allocation. The application of the theorem to NFP organisations assumes that these organisations seek to maximise profits in the same way as other businesses; however, this may not be true of all NFP organisations.

The theorem states that where taxable income is the same as economic income, the discounted present value of a stream of cash flows is independent of the tax rate. In other words, the maximum amount that an individual is prepared to pay for an asset is independent of the tax rate.

Consequently, a tax on economic income will not create arbitrage opportunities between taxpayers on different rates and will not affect either relative or absolute asset values. Accordingly, it will not distort the composition or level of investment in the economy. Thus, providing that economic income is taxed, the existence of concessionally taxed NFP organisations should not distort asset allocation (or the level of investment) in the economy.

However, as the current income tax base differs considerably from economic income, and as the tax concessions for NFP organisations are linked to particular activities regarded as providing a public benefit, the concessions are likely to distort investment decisions. However, to the extent that the concessions address a market failure (that is, the under-provision of social services), they may still increase wellbeing.

In relation to pricing, NFP organisations, like for-profit organisations, will seek to maximise their profits in support of their philanthropic activities. Accordingly, it appears that the income tax exemption does not provide an incentive for NFP organisations to undercut the prices of their for-profit competitors; rather, NFP organisations follow the same pricing policies as their competitors to maximise their profits.

Finding

The NFP income tax concessions do not generally violate the principle of competitive neutrality where NFP organisations operate in commercial markets.

Mutuality

A range of NFP organisations are clubs that are not income tax exempt, because they do not qualify as operating for a tax exempt purpose. However, these clubs are subject to the mutuality principle, which is based on the notion that a person cannot make a profit from selling to themselves.

As a result, where a taxable NFP club provides services for a charge to its members, it is not considered to derive income from those members. The result is that mutual receipts are excluded from the club’s calculation of its income tax liability. Unlike the gift deductibility provisions, which require deductible gift recipients to use their income in accordance with particular philanthropic objectives, NFP clubs that benefit from the mutuality principle are free to spend their mutual receipts as they wish (subject to their objects that typically do not involve philanthropic purposes).

In Australia, many small clubs benefit from the mutuality principle, including community organisations (such as vintage car clubs), professional associations, and strata title bodies corporate. In these cases, there is usually a clear and direct nexus between the mutual purpose of the club and the services received by members.

The principle also benefits a number of very large NFP clubs with many members and high levels of turnover, which engage in trading activities in direct competition with the hotel and restaurant industries. Any mutual receipts these clubs receive, including membership fees and restaurant, bar and gambling revenues (which account for most of the total income of hospitality clubs), are tax exempt. By contrast, hotels and restaurants are assessed on all of the income they receive.

In the case of clubs with large trading activities in the fields of gaming, catering, entertainment and hospitality, a practice has emerged to establish wide membership at a nominal charge for patrons whose only substantive activities at the club are as customers of the trading activity (whether personally or by bringing 'guests'). It is not clear that the wider community should entirely forgo tax on all of these profits, although some concession could be retained, particularly to support smaller clubs.

Finding

Where NFP clubs operate large trading activities in the fields of gaming, catering, entertainment and hospitality, the rationale for exempting receipts from these activities from income tax on the basis of a direct connection with members is weakened.

GST

The GST concessions provided to NFP organisations are unlikely to impact on competitive neutrality. Unlike income tax exemptions, the commercial activities of NFP organisations are taxable under the GST legislation, unless an explicit concession applies.

Finding

The NFP GST concessions do not violate the principle of competitive neutrality where NFP organisations operate in commercial markets.

Fringe benefits tax

In effect, labour is taxed at a reduced rate for NFP organisations that are eligible for FBT concessions. These organisations can offer benefits such as mortgage repayments, laptop computers, and motor vehicle leases tax free, or at a reduced rate – concessions that are unavailable to their for-profit competitors. Consequently, NFP organisations have an advantage in attracting staff in labour markets, as they can afford to pay the market wage at a lower cost.

This bias is particularly problematic in the hospitals sector, where nursing shortages are an ongoing concern. Modelling provided to the Review¹⁴ suggests that the current configuration of the FBT concessions is contributing to wage inflation across the sector. It is estimated that

14 Modelling undertaken by Access Economics.

the concessions provide nurses in public and NFP hospitals with around \$2,800 in additional after-tax remuneration (approximately 6 per cent) compared to their counterparts in commercial hospitals, despite the similar nature of their work. Further, the concessions are not helping to increase the overall pool of nursing staff.

The impact of the FBT concessions is less clear where no direct for-profit competition exists (for example, in the provision of health services in remote areas). The removal of FBT concessions in these cases may make it difficult for NFP organisations to attract appropriately qualified staff, which may result in the downsizing or closure of programs.

Finding

The NFP FBT concessions provide recipient organisations with a competitive advantage in labour markets, by enabling them to pay the market wage at a lower cost.

B3–3 Reform directions

Recommendation 41:

Consistent with the recommendations of previous inquiries, a national charities commission should be established to monitor, regulate and provide advice to all not-for-profit (NFP) organisations (including private ancillary funds). The charities commission should be tasked with streamlining the NFP tax concessions (including the application process for gift deductibility), and modernising and codifying the definition of a charity.

Recommendation 42:

Categories of NFP organisations that currently receive income tax or GST concessions should retain these concessions. NFP organisations should be permitted to apply their income tax concessions to their commercial activities.

Recommendation 43:

NFP FBT concessions should be reconfigured.

- (a) The capped concessions should be phased out over ten years. In the transition period, the value of the caps would gradually be reduced. Reportable fringe benefits for affected employees (that is, those benefits that are readily valued and attributed) would be exempt from tax up to the relevant cap, and taxed at the employee's marginal tax rate above the cap. The market value of these benefits would be taken into account for transfer payment purposes. Non-reportable fringe benefits would be taxable for NFP employers.
- (b) The FBT concessions should be replaced with direct government funding, to be administered by relevant Commonwealth portfolio agencies or the charities commission. All NFP organisations eligible for tax concessions should be able to apply to the relevant body for funding for specific projects or for assistance with the costs of recruiting specialist staff.

Recommendation 44:

Simple and efficient tax arrangements should be established for clubs with large trading activities in the fields of gaming, catering, entertainment and hospitality. One option is to apply a concessional rate of tax to total net income from these activities above a high threshold. For clubs below the threshold, no tax would be applied to income from these activities.

Establish a national charities commission

Over the past two decades, the NFP sector has been the focus of a large number of reviews, which have consistently recommended the establishment of an independent national charities commission to address the complexity of the tax and regulatory arrangements for the NFP sector.¹⁵

The Review supports this recommendation. A national charities commission should be established to monitor, regulate and provide advice to all NFP organisations (including prescribed private funds). The commission should be tasked with streamlining the NFP tax concessions, and modernising and codifying the definition of a charity.

In addition to reducing complexity and compliance costs for NFP organisations, the commission would facilitate the collection of comprehensive data on the sector. The data collected could be used to target government support for the sector better, and would help individual donors make more informed choices about their giving.

Permit NFP organisations to undertake commercial activities

NFP organisations should have scope to conduct commercial activities freely. This approach would reduce costs associated with education, assistance, advice, disputes and litigation on the ATO's interpretation of a 'charitable purpose',¹⁶ and would reflect the principles of the High Court of Australia's Word Investments decision.

Reconfigure FBT concessions to improve competitive neutrality

The FBT concessions should be removed and replaced with a more neutral form of assistance.

However, in recognition of their importance in helping NFP organisations to deliver their services, these concessions should be phased out over 10 years to provide recipient NFP organisations with sufficient time to adjust the prices they charge for their services, and to renegotiate employment contracts and funding models.

15 Reviews include the 1995 Industry Commission study on charitable organisations in Australia; the 2001 Senate Committee inquiry into the definition of charities and related organisations; the 2008 Senate Committee inquiry into disclosure regimes for charities and NFP organisations; and the 2009 Productivity Commission study on the contribution of the NFP sector.

16 For example, the distinction between a related and unrelated commercial activity could be contentious — the Seventh Day Adventist Church has publicly argued that the tenet of vegetarianism advocated by their religion is advanced through the sale of vegetarian products by their Sanitarium business.

Transitional adjustments

During the transition period, the value of the capped concessions would gradually be reduced. Reportable fringe benefits for affected employees (that is, those benefits that are readily valued and attributed) would be exempt up to the relevant cap, and taxed at the employee's marginal rate above the cap. The value of all reportable fringe benefits should be taken into account for transfer purposes (see Section A1).

As with other employers, non-reportable fringe benefits should be taxable for NFP employers at the top marginal tax rate.

New arrangements

The benefits to NFP organisations of FBT concessions should be replaced with direct government funding. All NFP organisations eligible for tax concessions should be eligible to apply for funding for specific projects, or to assist with the costs of recruiting specialist staff. This would significantly simplify the number of classes of NFP organisation described in Table B3.1, and would facilitate the charities commission's task of codifying the definition of a charity. Where possible (particularly in relation to health), subsidies should shift to the relevant Australian government portfolio agency. For activities where there is no relevant agency, subsidies should shift to the charities commission.

The process for applying for funding, and the principles that would underpin decisions, should be subject to extensive consultation with the sector.

Enhance the operation of the mutuality principle

Simple, efficient and concessional tax arrangements should be established for clubs with large trading activities in the fields of gaming, catering, entertainment and hospitality. One option is to apply a concessional rate of tax to total net income from these activities above a high threshold. For clubs below the threshold, no tax would be applied to income from these activities.

The threshold should be supported with appropriate integrity mechanisms to prevent affected clubs from splitting their operations into smaller clubs to circumvent the threshold.

This approach would be simple for clubs to understand and apply, and would assist in better targeting the application of the mutuality principle.

Appropriate transitional arrangements should be designed in consultation with the NFP sector.

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C1. Charging for non-renewable resources

Key points

Australia has abundant non-renewable resources, which are expected to continue to command high prices driven by demand particularly from China and India.

The community, through the Australian and State governments, owns rights to Australia's non-renewable resources and should seek an appropriate return from allowing private firms to exploit these resources.

Current charging arrangements fail to collect a sufficient return for the community because they are unresponsive to changes in profits. Further, the current arrangements distort investment and production decisions, thereby lowering the community's return from its resources.

The current arrangements should be replaced with a uniform resource rent-based tax, using the allowance for corporate capital method. The tax should be imposed and administered by the Australian government.

A rent-based tax would, over time, earn for the community a greater return from the use of its resources while still attracting private investment. Such a tax would also require the government to accept a greater share of the risks than it currently bears.

To complement the resource rent tax, a cash bidding system should be introduced to allocate exploration permits.

Australian and State government fees and stamp duties on the transfer of interests in resource projects inhibit the efficient transfer of such interests and should be abolished, except those related to administrative costs.

The Australian and State governments should negotiate an appropriate inter-governmental allocation of the revenues and risks from the resource rent tax.

The Australian government should set out a time-frame to implement the resource rent tax and provide guidance at the time of announcement on how existing investments and investment in the interim will be treated. Transitional arrangements for existing projects will be critical and should be managed with an adjustment, as appropriate, to the starting base for the allowance for corporate capital.

C1–1 The community's return from the exploitation of its resources

Non-renewable resources are a significant asset of the Australian community. Australia has the world's largest economically demonstrated reserves of brown coal, lead, mineral sands (rutile and zircon), nickel, silver, uranium and zinc and the second largest reserves of

bauxite, copper, gold and iron ore (contained iron) (Geoscience Australia 2009).¹ Australia's proven oil reserves are the 26th largest in the world. Australia's natural gas reserves are the 14th largest in the world and, under current production rates, could continue to be exploited for the next 65 years (BP 2009).

Treasury expects the strong demand and prices for Australia's non-renewable resources to continue, driven by growth in India and China, and accordingly projects that Australia's terms of trade will be well above its historical average for decades to come (Treasury 2009).

Given the size and value of Australia's non-renewable resource stock and the expected strength of commodity prices, it is important that the community receives an appropriate return from the exploitation of its resources by private business.

Maximising the value of the rents from non-renewable resources

The finite supply of non-renewable resources allows their owners to earn above-normal profits (economic rents) from exploitation. Rents exist where the proceeds from the sale of resources exceed the cost of exploration and extraction, including a required rate of return to compensate factors of production (labour and capital). In most other sectors of the economy, the existence of economic rents would attract new firms, increasing supply and decreasing prices and reducing the value of the rent. However, economic rents can persist in the resource sector because of the finite supply of non-renewable resources. These rents are referred to as resource rent.

The value of a stock of resources is the net present value of the associated resource rent — that is, the expected receipts less expected costs of exploiting the resources, discounted for the required rate of return to compensate owners for the time value of money (the risk-free return) and a premium for the risk associated with investment (the risk premium return for systematic risk). This value can fluctuate over time due to changes in supply (for example, unexpected discoveries) and demand (for example, changes in consumer preferences or the development of substitutes).

The optimal rate for exploiting non-renewable resources is, in theory, determined by the required rate of return (Hotelling 1931). The owner of the resource can maximise the value of their resource stock by extracting quantities at a rate such that the expected value of the remaining resources rises over time at the required rate of return. If the resource rent is expected to rise more than the required rate of return, the owner could increase wealth by postponing production to take advantage of future higher prices or lower production and exploration costs. On the other hand, if the resource rent is expected to rise less than the required rate of return, the owner could increase wealth by bringing forward production and investing the proceeds from the sale of resources into another asset.

The owner of a non-renewable resource would therefore erode the value of the resource if exploitation is either faster or slower than the optimal production rate determined by the market's required rate of return. Arguments for exploration and production faster than this rate can fail to recognise that resources kept in the ground will generate a better return for

1 Economically demonstrated resources are identified according to two parameters: the degree of certainty of the existence (quantity and quality) and the degree of economic feasibility of exploitation (based on commodity prices, operating costs, and capital costs, including the required rate of return).

the owner if higher rents can be obtained in the future (due to future higher prices or lower exploration and production costs). Similarly, arguments to bring forward exploration and production to create jobs can fail to recognise that this may be at the expense of future jobs in the resource sector (as there is a finite stock of resources) and may have an adverse impact on other sectors in the economy from which labour and capital are diverted.

Charging for the exploitation of non-renewable resources

As owners of natural resources on behalf of the community, the Australian and State governments should seek to obtain an appropriate return from resource exploitation under public or private production. In Australia, governments have traditionally allowed private firms to exploit non-renewable resources in return for a charge (see Box C1-1 Alternative ways of capturing a return for the community).

Where governments allow private businesses to exploit non-renewable resources, governments can charge for the resources through either taxes or auctions (also known as ‘cash bidding’), or a combination of both. Providing private businesses with the right to exploit the community’s non-renewable resources is akin to selling a public asset. Resource taxes and auctions of exploration permits are therefore different from most other sources of tax revenue in that they are a charge for the sale of a public asset.

A well-designed tax will generally be more effective than auctions as a primary way of charging for the right to exploit non-renewable resources. Nonetheless, an auction system is a useful mechanism for supplementing a well-designed tax because auctions can enable the relevant jurisdiction to allocate exploration permits to the most efficient producer without distorting exploration decisions. Further, auctions can be used to collect upfront any expected rent above that anticipated to be collected by a tax. In effect, an auction can serve as a safety valve, mitigating any expected advantage to the winning firm that may arise if the tax system mismeasures the resource return (Danish Hydrocarbon Tax Committee 2001).

Box C1-1: Alternative ways of capturing a return for the community

Governments have a range of options for obtaining a return from resource exploitation under public or private production.

- Public production allows the government to control exploration and production expenditure, but may lower the return to the community if public enterprise is less efficient at resource exploration and production due to a lack of expertise and market discipline.
- Outsourced production allows the government to benefit from market pressure and external expertise, but may suffer from the principal-agent problem as the interests of private producers are not necessarily aligned with the community’s.
- Joint ventures with private producers allow the government to benefit from market pressure and expertise, and align the interests of private producers with that of the community by providing private producers with a share of the resource rent. But this lowers the community’s share of that rent.

Box C1–1: Alternative ways of capturing a return for the community (continued)

- Auctions of exploration permits collect value (under private production) based on market expectations about the value of the resource rent rather than the actual resource rent. Auctions will not collect the full expected value of resource rents if bids are tempered by concerns that the government will increase taxes in the future or if auctions are poorly designed.
- Resource taxes applying to private production can promote efficiency if they are designed properly. But, like joint ventures, they give away a share of the rent and thereby a share of the community's return. If designed poorly, resource taxes can distort investment and production decisions and thereby erode the return to the community.

Principles

Through the Australian and State governments, the community owns rights to non-renewable resources in Australia and should seek an appropriate return from these resources.

A well-designed resource tax is more effective than an auction as a way of charging the private sector for the right to exploit non-renewable resources. But auctions can complement resource taxation by allocating exploration permits to the most efficient producer without distorting exploration decisions and by collecting upfront any expected rent above that anticipated to be collected by the resource tax.

Addressing exploration spillovers

Exploration can provide benefits to businesses other than the business undertaking the exploration (a positive spillover), in the form of valuable information to holders of exploration permits in neighbouring areas or businesses considering exploration in these areas. These spillover effects may provide an incentive for businesses to delay exploration so that they can benefit from information provided by others. Businesses can overcome this problem by entering into arrangements that share the cost of exploration with holders of exploration permits in neighbouring fields. Alternatively, the government could overcome the spillover problem through the management of exploration permits; for example, by only issuing exploration permits for areas where there are no neighbouring exploration fields. Limited tenure on exploration permits would limit the extent of delay in undertaking exploration.

There can be a 'public good' justification for the government to be involved in the provision of pre-competitive geological data, in collecting and providing public access to geological data flowing from exploration, and in publishing the results of geological research (Industry Commission 1991). Such information assists efficient private exploration and provides input into resource planning and land management.

Beyond this, it is unlikely to be desirable for the government to provide concessions from a resource tax in order to encourage exploration and production faster than the commercial rate or encourage exploration in specific geographical areas. There is no evidence of significant market failures in field exploration (Industry Commission 1991). Providing concessions is likely to reduce the overall return to the community from its natural resources.

Principle

Concessions should not be provided to encourage exploration and production at a faster rate than the commercial rate or to encourage exploration in specific geographical areas.

Choosing the appropriate type of resource tax

There are three main types of tax that can be used to charge for the exploitation of the community's non-renewable resources:

- A **rent-based tax**, under which the government collects a percentage of the resource project's economic rent (see Box C1-2 Rent-based taxes).
- An **income-based tax**, under which the government collects a percentage of a resource project's net income, thereby taxing economic rent as well as the normal return to capital invested in a resource project.
- An **output-based royalty**, under which the government collects either a charge per unit of output (a specific royalty) or a percentage of the gross value of output (an *ad valorem* royalty).

Resource taxes can be evaluated according to three broad criteria: economic efficiency; the size, variability and timing of the return received by the government; and administration and compliance costs.

Economic efficiency

The more economically efficient a resource tax is, the less investment and production decisions are distorted. A more efficient tax is less likely to make an otherwise commercially viable project unviable and less likely to create a bias toward less or more risky investments.

Box C1-2: Rent-based taxes

A rent-based tax imposes a tax on economic rents over time by collecting a share of a measure of profit. Alternative forms of rent-based taxes include:

- A **Brown tax** — a cash flow tax levied at a constant percentage of the difference between receipts and expenditure, or net cash flow (Brown 1948). Where there is a negative cash flow, the government refunds the tax value of the negative cash flow to investors and thereby contributes to its share of the costs of investment at the same rate as it shares in receipts. This allows the government to collect a share of the rent equal to the tax rate (see example in Annex C1 Relationship between the rate of tax on land and a tax on economic rent).
- A **Garnaut and Clunies Ross resource rent tax** — a cash flow tax levied at a constant percentage of the annual positive net cash flow (Garnaut & Clunies Ross 1975). It is similar to a Brown tax, but does not provide a cash refund for the tax value of negative cash flows. Instead, negative cash flows are carried forward with interest (the uplift rate). The petroleum resource rent tax (PRRT) is an example of such a tax.

Box C1–2: Rent-based taxes (continued)

- An **allowance for corporate capital (ACC)** — a cash flow equivalent tax levied on profit measured as net income less an allowance (Boadway & Bruce 1984). The allowance compensates investors for the delay in the government's contribution to the cost of investment due to the slower recognition of expenses through depreciation and the lack of an immediate refund for losses.

These rent-based taxes seek to tax the economic rent associated with the underlying activity, irrespective of the form of financing. They do not therefore provide a deduction for interest or financing costs incurred at the investor level.

Under certain conditions, these taxes provide equivalent outcomes, except in respect of the timing of cash-flows received (and paid) by the government (see Annex C1 Relationship between the rate of tax on land and a tax on economic rent).

A well-designed rent-based resource tax is less likely to distort investment and production decisions. This is because rent-based taxes do not apply to the normal rate of return to investment in projects. The government achieves this by effectively contributing to costs at the same rate as it shares in receipts from resource production.

Essentially, under a resource rent-based tax, the government is a silent partner whose share in the project is determined by the tax rate. However, each partner contributes something additional to the partnership — private firms contribute rents associated with their expertise and the government contributes rents associated with the rights to the community's non-renewable resources. These rents are also shared according to the tax rate.

By contrast, output-based royalties discourage investment and production because they are levied irrespective of the costs of production. Consequently, investors receive a lower post-tax return from a more expensive operation because costs are not recognised for tax purposes. This is particularly important for risky projects. Output-based royalties can therefore result in some economically viable projects not proceeding.

Under an income-based tax, while the government contributes a share of the project's costs by allowing a deduction for the depreciation of assets (where the project has receipts sufficient to cover expenses or where a loss offset is provided), it also taxes the normal return to investment in the project. Taxing the normal return distorts investment and production decisions and thereby erodes the value of the resource rent.

The use of output-based royalties or an income-based tax can be expected to result in fewer discoveries, less output from discovered deposits and earlier closure of projects than otherwise. Therefore, they erode the value of resources for the community while still giving away a share of the resource rent.

Rent-based and income-based resource taxes involve governments accepting risk

The government cannot accurately measure rents by targeting a charge on cash flows above the required return, which varies among projects and is difficult to measure. Instead, the government must, in theory, share in the risk of a resource project in order to correctly tax rent and avoid distorting investment and production decisions in the process. The

government can achieve this by recognising the cost of investment for tax purposes and, in effect, contributing a share of project costs at the same rate as it shares in receipts.

Under an output-based royalty, the government does not share in the risk of the project because it does not recognise the costs of investment for tax purposes. Under a typical income-based tax, the government shares in some of the risk associated with the project, but only recognises expenditure where it can be offset by revenue.

By contrast, under a rent-based tax the government shares in the risk of the project. It can do this in two ways. The government can provide an immediate refund for the tax value of expenditure (under a Brown tax). Alternatively, it can allow expenditure (whether in the form of a loss or of a measure of corporate capital) to be carried forward with interest for tax purposes and utilised as a deduction against future income.

Using the second approach, the government would need to compensate investors for the delay in utilising the deduction by effectively paying interest on the value of the expenditure carried forward. The interest rate (akin to the uplift rate of the petroleum resource rent tax or the allowance rate for an ACC) should be set at a rate to make investors indifferent as to whether they receive the tax value of deductions in the current year or later. It therefore needs to compensate investors for the time delay and the risk that the government will not contribute to its share of the costs. If the government promises to provide a refund for the tax value of losses at the time a project is closed (full loss offset), the appropriate interest rate is the government bond rate (see Box C1-3).

Box C1-3: The appropriate rate to compensate investors for the lack of an immediate tax refund under a rent-based tax

The appropriate uplift or allowance rate to compensate investors for the lack of an immediate tax refund is independent of the riskiness of the project where the government promises to provide a refund for the tax value of losses at the time a project is closed or a full loss offset (Fane & Smith 1986).

The uplift or allowance rate does not need to reflect the required rate of return of the project, which includes a risk premium that varies according to the project and is therefore difficult to measure. Where the government provides a full loss offset, the riskiness of the project is irrelevant as the delay is equivalent to a loan from a business to the government.

If a full loss offset is not provided, investors will be uncertain about whether they will receive the full tax credit in the future. In this case, the appropriate uplift or allowance rate would need to include a premium to compensate investors for the risk that they will never receive the tax value of the deduction. The appropriate rate would depend on the 'risk characteristics of the project and the financial structure of the firm only to the extent that these factors affect the probability that the tax credits will never be redeemed' (Fane 1987).

Box C1–3: The appropriate rate to compensate investors for the lack of an immediate tax refund under a rent-based tax (continued)

For example, if the government allows losses to be transferred from one resource project to another within a company but does not allow residual losses to be refunded, the appropriate uplift or allowance rate would need to compensate investors for the risk that a particular *company* will never be able to utilise the value of the tax deduction. A proxy for this is the company's bond rate, which includes a premium to compensate for the risk that the company will default. If the government does not allow losses to be transferred from one project to another nor residual losses to be refunded, the appropriate uplift or allowance rate would need to compensate investors for the risk that a particular *project* will never be able to utilise the value of the tax deduction. A proxy for this is the (hypothetical) project bond rate, which includes a premium to compensate for the risk that the project will default on a loan because it does not have income.

However, it is not practicable to determine the appropriate uplift or allowance rate for each company or, still less, each project. In the absence of this, a uniform allowance rate would over-compensate less risky projects or companies and under-compensate more risky projects or companies. A uniform allowance rate would therefore provide an incentive for successful firms to delay production so that they can carry forward losses to take advantage of the excessive uplift rates. Providing a full loss offset overcomes these problems.

Sovereign risk

Sovereign risk is the risk that investments will be reduced in value by future changes in government policy. Sovereign risk discourages investment by increasing the required rate of return for investment. Therefore, sovereign risk can lead to an inefficiently low level of exploration and production that erodes the value of non-renewable resources.

Sovereign risk may be reduced under a system that investors perceive to be more stable over the long term. A rent-based tax is likely to be accompanied by lower sovereign risk because it collects a constant share of the rent under varying economic conditions. In contrast, output-based royalties have higher sovereign risk as the government has an incentive to make ad hoc adjustments to the royalty rates in response to changes in the value of the resource rent.

Evidence of the stability of rent-based taxes is provided by Australia's PRRT and by Norway's rent-like petroleum taxation system, both of which have been stable over many years compared to other petroleum producing countries.² For Norway, a stable resource charging system appears to have played an important role in supporting petroleum exploration and development activity (Osmundsen 2010). Activity remained strong despite a decline in the prospect of new discoveries in Norway's continental shelf.

2 Norway's petroleum tax system approximates a rent-based tax. Though based on the company income tax system, it applies an uplift to expenditure to exempt the normal return from tax and reimburses the tax value of exploration expenditure for companies in a loss position. Norway imposes a total tax rate on petroleum rents of 78 per cent, consisting of a 50 per cent rent-based tax rate and company income tax of 28 per cent, with no deduction at the company income tax level for tax paid under the rent-based tax.

The size, variability and timing of the return

Governments are concerned with receiving an appropriate share of the return to resource exploitation irrespective of future market conditions, the variability in the stream of revenue collected, and the time lag between production starting and tax revenue starting to flow.

Output-based royalties provide a relatively predictable stream of revenue from the time production commences, but as this does not vary with profits, royalties fail to collect an appropriate share of the return to resource exploitation during periods of high profitability.

In contrast, both a rent-based tax and an income-based tax vary with profits. However, governments should be better able to maximise their return over time with a rent-based tax, as its greater efficiency means that more revenue can be raised without making more marginal projects unviable.

However, a rent-based tax has the longest delay before the government collects revenue because tax is only collected once receipts cover expenses including a normal return to investment. The delay in collecting tax could create a public perception that the resource sector is not paying for its exploitation of non-renewable resources, as projects could be generating significant operating profits but not yet paying tax.

Administration and compliance costs

Output-based royalties typically have low administration and compliance costs because they are calculated as a percentage of the value of production or as a specific charge per unit produced. Hence, output-based royalties may be an appropriate charging mechanism for those non-renewable resources where the administration and compliance costs are likely to outweigh the potential efficiency and revenue gains from a rent-based tax.

An income-based tax has higher administration and compliance costs than output-based royalties, though these may be reduced if the tax is based on the existing income tax system.

Compared with these tax types, a rent-based tax is likely to have higher administration and compliance costs as it requires the calculation of a profit base that measures rent over time, even though it could make use of some aspects of the income tax system.

Principle

For non-renewable resources that are expected to generate significant amounts of economic rent, a rent-based tax is the most suitable charging mechanism, as the potential economic efficiency and revenue gains are likely to outweigh the higher administration and compliance costs of this tax compared with output-based royalties and income-based taxes.

For non-renewable resources expected to generate low rent and where the administration and compliance costs are likely to outweigh the potential efficiency and revenue gains from a rent-based tax, output-based royalties may be an appropriate charging mechanism.

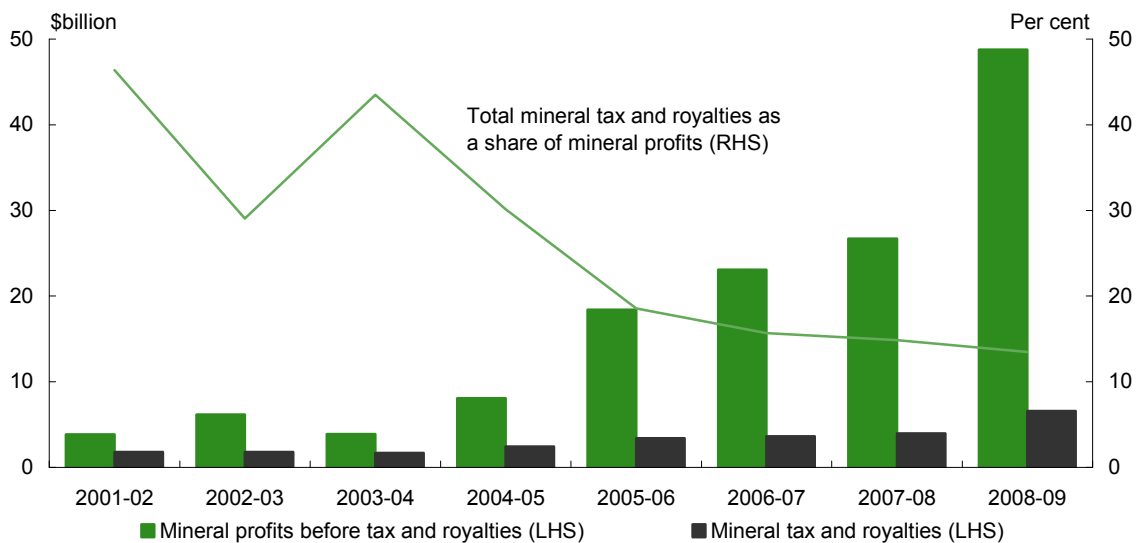
C1–2 Existing resource charging arrangements

Australia underprices its resources

In Australia, governments allow private businesses to exploit non-renewable resources and in return collect a charge for resource production, predominantly through taxation arrangements. The form of tax varies across jurisdictions. While governments have typically adopted output-based royalties, the Australian government also includes a charge on some resource rents.³ The community undercharges for non-renewable resources under both of these systems, though the causes vary.

Output-based royalties collect a greater share of the returns to non-renewable resources when profitability is low or negative and collect a smaller share of returns when profitability is high. This was particularly evident over the period from 2003–04 to 2008–09 when mineral profits increased with higher commodity prices (see Chart C1–1). The strength of prices for Australia's non-renewable resources is expected to continue for decades to come, driven by demand from China and India. While governments can increase royalty rates in response to increases in profitability, and have done so in recent years, this may discourage investment by increasing sovereign risk.

Chart C1–1: Mineral tax and royalties as a share of mineral profits^(a)



(a) Mineral profits before tax and royalties are measured using income less an allowance for corporate capital. Source: Australian Treasury estimates.

The Australian government charges for non-renewable resources extracted in offshore waters.⁴ Petroleum is the only non-renewable resource currently extracted offshore and is generally subject to the PRRT, which is levied at a rate of 40 per cent on the positive annual

3 The Northern Territory government imposes a profit-based royalty on non-renewable resources and the Western Australian government imposes a resource rent royalty on the Barrow Island project.

4 In addition, the Australian government imposes an income-based tax on resources (extracted onshore and offshore) through the income tax system and imposes a royalty on uranium extracted in the Northern Territory.

net cash flow of each petroleum project.⁵ A cash refund is not provided for negative cash flows, but excess deductions are carried forward with an interest uplift to preserve their value. Exploration expenditure can also be transferred from a PRRT project with expenditure exceeding receipts to a PRRT-paying project with common ownership from the time the expenditure is incurred. The payment of PRRT is a deductible expense in the calculation of income tax.

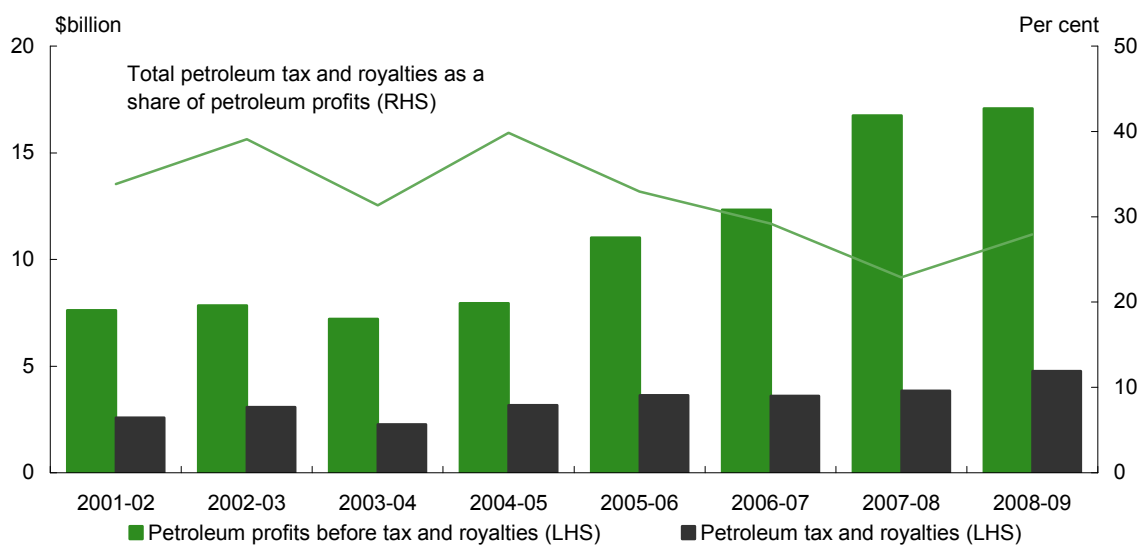
Although the current PRRT collects a more stable share of rents in varying economic conditions, it fails to collect an appropriate and constant share of resource rents from successful projects due to uplift rates that over-compensate successful investors for the deferral of PRRT deductions. For example, an uplift rate of the long-term bond rate plus 5 percentage points (currently 11 per cent in total) applies to general expenditure. On average, this rate is higher than the corporate bond rate, which is a useful proxy to compensate investors in the absence of a full loss offset.⁶ Typically, the corporate bond rate is around 7 to 8 per cent. Furthermore, the uplift rate for exploration within five years of the granting of a production licence (the long-term bond rate plus 15 percentage points, currently 21 per cent) is significantly higher than the average corporate bond rate. However, the uplift rate for exploration more than five years before the granting of the production licence (set equal to the GDP implicit price deflator, currently around 5 per cent) is lower than the average corporate bond rate.

The PRRT may also fail to collect the appropriate share of rents when the gas transfer pricing regulations are applied. The regulations provide a framework for determining the price for gas in the case of an integrated gas-to-liquids project and include a residual pricing method. Essentially, the residual pricing method applies an arbitrary cost of capital allowance uplift (long-term bond rate plus 7 percentage points) and splits in half the rents associated with the integrated process between the upstream and downstream processes.

The community's share of petroleum rents collected under the PRRT is less than the statutory PRRT rate and declined from 2004–05 to 2007–08 as industry profitability increased (see Chart C1-2). These outcomes may have arisen due to the North West Shelf project being subject to output-based royalties and excessive PRRT uplift rates.

5 Before 1 July 1986, offshore petroleum projects were subject to output-based royalties. These were replaced by the PRRT, except for petroleum extracted from the North West Shelf, which is still subject to output-based royalties. The Bass Strait project was brought into the PRRT regime in 1990.

6 In cases where expenditure is not transferable, the hypothetical project bond rate is a better proxy for the appropriate uplift rate, but this rate is typically unobservable as most debt is issued at the corporate level.

Chart C1–2: Petroleum tax and royalties as a share of petroleum rents^(a)

(a) Petroleum profits before tax and royalties are measured using income less an allowance for corporate capital. There may be differences in the timing of profits using this measure of profit compared to the PRRT measure of profit. Source: Australian Treasury estimates.

Company income tax as a resource rent tax

The company income tax system applies to rents as well as to the normal return on investment. This feature has placed a constraint on the government in setting the company income tax rate. In particular, the benefits of attracting mobile investment to Australia by reducing the company income tax rate must be balanced against the loss of tax revenue that could have been collected from location-specific investments, such as investments in non-renewable resources projects (see Section B1 Company and other investment taxes).

The reduction in the company income tax rate over the past two decades has reduced the combined statutory tax rate on resource rents. The combined statutory tax rate on petroleum resources at the company level has fallen by 9.6 percentage points (from 67.6 per cent to 58.0 per cent) since the introduction of the PRRT in 1987. While the PRRT rate has not changed, the company income tax rate has fallen by 16 percentage points from 46 per cent to 30 per cent.

To the extent resource companies are owned by Australian residents, the company income tax does not act as a final charge due to dividend imputation.

Finding

Australia's current resource charging arrangements fail to collect an appropriate return for the community from allowing private firms to exploit non-renewable resources, mainly because these arrangements are unresponsive to changes in profits.

Investment and production decisions are distorted, further eroding returns

The current resource charging arrangements, and associated mechanisms for allocating exploration permits, distort investment and production decisions and thereby lower the return to the community.

Under output-based royalties, firms are likely to invest and produce less than they otherwise would. The calculation of such royalties does not take production costs into account. This leads to less exploration, lower industry output and earlier closure of projects. In addition, some investments may not be undertaken due to higher sovereign risk – specifically the risk of governments making ad hoc adjustments to royalty rates in response to changes in profitability.

Recent examples include changes to coal royalties in Queensland and NSW. The 2008–09 Queensland budget introduced a two-tier coal royalty, with a 7 per cent rate applying up to \$100 per tonne and a new 10 per cent rate applying thereafter. This followed a change in 2002 that denied deductions for rail and transport costs when calculating the coal price subject to royalty. The 2008–09 NSW mini-budget increased coal royalties by 1.2 percentage points and excluded transport costs in calculating the royalty.

Under the PRRT, firms may invest and produce less than they would otherwise. Successful firms share their returns with government through the PRRT, but unsuccessful firms do not receive refunds from the government for the tax value of their loss. This discriminates against risky exploration and production projects. Further, there is an incentive for successful firms to delay production so that they can carry forward negative cash flows to take advantage of the excessive PRRT uplift rates described above. These delays erode the return to resources available for the community.

Current methods of allocating exploration permits may also erode resource rents

The mechanisms used to allocate exploration permits to private businesses can also erode resource rents, as they may not allocate exploration permits to the most efficient producer or may promote inefficient exploration.

The States typically assess a prospective investor on a first-come first-served basis, with a nominal application processing fee. The first-come first-served basis of allocation creates an incentive for firms to undertake exploration sooner than they would have if property rights had been clearly defined.

The Australian government allocates offshore exploration permits under a work program bidding system. Exploration permits are allocated to the firm with the preferred exploration work program. Work program bidding creates an incentive for exploration expenditure above a commercially sensible level. To win exploration permits, firms may commit to a work program that spends the expected resource rents on over-exploration. Work program bidding can dissipate all the expected rents if bidding is competitive and the tax system is efficient (Fane & Smith 1986).

Irrespective of the mechanism used or jurisdiction, exploration permits and production licences are tradeable. This enables the transfer of these rights so that the most efficient firm can explore and produce resources and thereby increase the resource rent available for the

community. However, the Australian and State governments impose some fees, not related to administration costs, and stamp duties on the transfer of interests. This imposes a transaction cost that inhibits the efficient transfer of rights to projects and may therefore erode the value of the resource rent. (For further discussion of the inefficiencies arising from stamp duties, see Section C2 Land tax and conveyance stamp duty.)

Governments issue exploration permits, retention leases and production licences with a limited tenure. Exploration permits are generally granted for periods of two to six years, with renewals being subject to reductions in the exploration area covered by the permit. Retention leases are generally granted for five years with provisions for renewal and a priority right for a production licence. Production licences can be granted for up to 21 years.

These time limits may create an incentive for firms to inefficiently bring forward exploration and production, but may also serve to restrict the incentive for firms to delay exploration and production in order to gain from the spillover benefit of information generated by activity in neighbouring fields.

Exploration tax incentives

Under the PRRT, exploration expenditure in areas designated as 'frontier' from 2004 to 2009 is eligible for a 150 per cent deduction. This concession was introduced to stimulate exploration activity in frontier areas and increase the likelihood of discovering a new petroleum province. However, the concession only benefits owners of projects that already pay PRRT, because the benefits are only available when the deduction can be used to reduce a PRRT liability. The concession does not appear to correct any market failure.

Exploration expenditure is also favourably treated under income tax. Businesses are allowed to deduct exploration expenditure immediately, regardless of whether the exploration succeeds or fails. However, for businesses without income (typically smaller businesses) the treatment of income tax losses – which are carried forward on a conditional basis and without an uplift – may discourage exploration (see Section B1 Company and other investment taxes).

Finding

Australia's current resource charging arrangements and the mechanisms for allocating exploration permits distort investment and production decisions, further lowering the community's return from the exploitation of its non-renewable resources.

C1–3 Replacing current arrangements with a resource rent tax

Recommendation 45:

The current resource charging arrangements imposed on non-renewable resources by the Australian and State governments should be replaced by a uniform resource rent tax imposed and administered by the Australian government that:

- (a) is levied at a rate of 40 per cent, with that rate adjusted to offset any future change in the company income tax rate from 25 per cent, to achieve a combined statutory tax rate of 55 per cent;
- (b) applies to non-renewable resource (oil, gas and minerals) projects, except for lower value minerals for which it can be expected to generate no net benefits. Excepted minerals could continue to be subject to existing arrangements if appropriate;
- (c) measures rents as net income less an allowance for corporate capital, with the allowance rate set at the long-term Australian government bond rate;
- (d) requires a rent calculation for projects;
- (e) allows losses to be carried forward with interest or transferred to other commonly owned projects, with the tax value of residual losses refunded when a project is closed; and
- (f) is allowed as a deductible expense in the calculation of income tax, with loss refunds treated as assessable income.

Recommendation 46:

The resource rent tax should not provide concessions to encourage exploration or production activity at a faster rate than the commercial rate or in particular geographical areas, and should not allow deductions above acquisition costs to stimulate investment.

Recommendation 47:

Existing projects should be transferred into the proposed system with an adjustment, as appropriate, to the starting base for the allowance for corporate capital. The Australian government should set out a time-frame to implement the resource rent tax and provide guidance at the time of announcement on how existing investments and investment in the interim will be treated under the resource rent tax.

Recommendation 48:

The Australian and State governments should negotiate an appropriate allocation of the revenues and risks from the resource rent tax.

Recommendation 49:

The Australian and State governments should consider using a cash bidding system to allocate exploration permits. For small exploration areas, where there are unlikely to be net benefits from a cash bidding system, a first-come first-served system could be used.

Recommendation 50:

The Australian and State governments should abolish fees and stamp duties on the transfer of interests in a resource project except those related to administrative costs.

A uniform resource rent-based tax

The current resource charging arrangements should be replaced with a uniform rent-based tax legislated for and administered by the Australian government (see Recommendation 45). This would enable the community to collect a greater and constant share of the return on its non-renewable resources. It would also promote an efficient level of output by reducing distortions to investment and production decisions as well as reducing sovereign risk over the long term.

In some areas of Australia, legal ownership of certain non-renewable resources rests with the land owner, and private rather than government royalties are charged. Where private royalties are paid to, for example, Indigenous communities, such royalties should continue unaffected. However, consideration would need to be given to how these private royalties and associated resources are dealt with under the resource rent tax.

The resource rent tax would likely involve greater variability in revenue collections than the current resource charging arrangements. This variability should for fiscal purposes be managed through a revenue stabilisation mechanism to smooth revenue over time. In periods of high profitability some of the returns should be set aside so that they can be drawn down during periods of lower profitability.

A cash bidding system should be used to allocate exploration permits, rather than using a work bidding program system or a first-come first-served system (see Recommendation 49). A cash bidding system would complement a rent-based tax by promoting the efficient allocation of exploration permits and collecting upfront any expected rent above the tax.

The cash bidding system would be operated by the relevant jurisdiction and be triggered when an application for an exploration permit is made. Exploration permits would, as now, be well defined and include environmental protection conditions, including clean-up and rehabilitation requirements.

Governments should not provide concessions to the rent-based tax in order to encourage exploration or production activity at a faster rate than the commercial rate or in specific geographical areas, and should not allow deductions above acquisition costs to stimulate investment (see Recommendation 46). Under a cash bidding system, businesses would pay less to purchase exploration permits for frontier areas where commercial discoveries are less likely and other businesses are less willing to explore.

For small exploration areas, where there are unlikely to be net benefits from cash bidding (due to poor prospects of significant competition), a first-come first-served system rather than the work program bidding system could be used to allocate exploration permits.

Setting the rate of the resource rent tax

The rate of the resource rent tax should be set to achieve an appropriate return for the community for the exploitation of its resources.

Taking into account the quality of Australia's natural resources and other location-specific rents, as well as the expected ongoing strength of Australia's terms of trade, the Review recommends that the resource rent tax be levied at rate of 40 per cent on rents from a resource project (see Recommendation 45a).

The payment of the resource rent tax would be a deductible expense for income tax purposes (see Recommendation 45f). This would result in a combined statutory tax rate on rents (at the corporate level) of 55 per cent (including the tax on rents imposed by a 25 per cent company income tax rate, minus an income tax deduction for payment of the resource rent tax). This is slightly less than the combined statutory PRRT rate and current company income tax rate.

If a rent-based tax is levied at a rate of 100 per cent, it would be similar to the government outsourcing exploration and production to private firms – the government would effectively pay all the costs and, in return, receive all the receipts from a project. This would erode the return to resources because there would be no incentive for private firms to make decisions that maximise the return. Further, a very high tax rate would increase the incentive for private firms to minimise tax by understating revenue and overstating costs. It could also lead to viable projects not being undertaken if the amount subject to tax overstates the rent due to the design of the tax law.

The value of the rent from resource production may also include firm-specific rent that arises from production by a particularly efficient firm. This rent is the value that accrues to the private firm (in excess of its expenses) above the value that would have accrued to other firms if they had undertaken the project. A high tax rate may discourage firms with firm-specific rent from exploring and producing resources in Australia where access to capital is limited and may cause them to relocate to countries that undercharge for the exploitation of their resources.

Under a rent-based tax, private firms share their firm-specific rent with the government, and the government shares its resource rents as well as other location-specific rents with the firm. These are shared according to the tax rate. As such, firms decide where to locate by reference not only to the tax rate but also to the amount of resource rent and other factors such as location-specific rents that they gain from locating in a particular country. These other factors arise from existing infrastructure, political stability, policy stability and regulatory certainty. Such features make Australia an attractive place to locate (Fraser Institute 2008).

The nature of the resource rent tax

A rent-based tax with an allowance for corporate capital (ACC) is preferred to other forms of rent-based tax because revenue collections are likely to be more stable and there is likely to be less of a lag before the government receives a (net) payment of tax (see Recommendation 45c). Although the government should be indifferent as to whether it receives a payment soon or a payment later with interest, the delay could create a public perception that the resource sector is not paying an adequate charge for the use of non-renewable resources because projects could be generating significant operating profits but not yet paying tax.

Further, it is likely to be easier for the government to budget for its contribution to expenditure and to audit expense claims under an ACC rent tax because assets are depreciated over time, rather than being allowed as a deduction immediately (as would be the case under a Brown tax).

The ACC base would comprise the resource rent tax value of project assets and unutilised losses associated with a project. A worked example of an ACC calculation is provided in Annex C1 (see Table C1-5).

The treatment of project losses

The economic efficiency and design of the resource rent tax would be improved significantly if a full loss offset were allowed (see Recommendation 45e). Providing a full loss offset means that the government would share in the risks of a resource project in proportion to the resource rent tax rate. This is a marked change from the current royalty arrangements, where the government accepts none of the risk, and from the PRRT, where the government may not accept risk when a project fails.

A full loss offset would ensure a symmetric tax treatment of gains and losses, with the government contributing to costs at the same rate as it shares in receipts. Not providing a full loss offset would lead to the mismeasurement of rent and would discriminate against riskier projects. This would prevent otherwise commercially viable projects from being undertaken and lead to inefficiently low levels of exploration and production.

Not providing a full loss offset would also complicate the choice of the allowance rate, giving rise to distortions in business decision-making. The denial of a full loss offset in the PRRT regime has given rise to a number of concessions and further distortions in the exploitation of offshore petroleum.

A full loss offset can be achieved by allowing the transfer of losses to other commonly owned resource projects or by allowing losses to be carried forward (uplifted at the ACC rate) so that they can be utilised against future income. If losses cannot be utilised against future income in this way, the tax value of residual losses (the ACC base) would be refunded when a project is closed. The ability to transfer expenditure reduces the stress on the full loss offset.

The allowance rate

Under the proposed full loss offset arrangements, businesses should be confident that they would receive the full tax credit for expenses because the tax value of residual losses would be refunded when a project is closed.

An ACC is required to compensate investors for the deferral of the tax credit, which is akin to a loan from investors to the government. The appropriate rate should compensate for the market interest that the government would have to pay for its borrowings, rather than being related to the riskiness of the project. Therefore, where a full loss offset is provided, the ACC rate should be set to the long-term Australian government bond rate (see Recommendation 45c). If a full loss offset is not provided but losses can be transferred, the ACC rate should be set to the average corporate bond rate.

Interaction with company income tax

Resource firms should continue to be subject to income tax on their exploration and production business so that the normal return on investment is taxed in the same way as for other businesses. Otherwise, equity investments in marginal resource projects, which do not generate economic rent, would not pay tax on their normal return.

As well as taxing the normal return on an investment, the company income tax applies to economic rent. To ensure that the combined statutory tax rate on rent is kept at a reasonable level in spite of any mismeasurement of rent, the payment of the resource rent tax should be allowed as a deductible expense in the calculation of income tax. Consistent with this, any refund for losses under the tax should be treated as assessable income in the calculation of income tax (see Recommendation 45f).

To keep the combined statutory tax rate on resource rents collected at the corporate level steady over time at 55 per cent, the resource tax rate should be adjusted to offset any changes in the company income tax rate (see Recommendation 45a). For example, if the company income tax rate is reduced there should be an increase in the resource rent tax rate to ensure that the combined statutory tax rate on resource rent is unchanged.⁷ This would remove a constraint on setting the company income tax rate. The resource rent tax rate would be determined by the formula:

$$t_r = \frac{0.55 - t_c}{1 - t_c}$$

where t_r represents the resource rent tax rate and t_c represents the company income tax rate.

Even with this adjustment, resource companies would still benefit from any future reductions in the company income tax rate as they would be subject to a lower tax rate on the normal return to all their operations and on the economic rent earned in their non-mining operations. Only in relation to rent from a non-renewable resource project would a company not benefit from reductions in the company income tax rate.

Changes to the company income tax base can also lower the community's return from a non-renewable resource. The total tax on resource rent (including company income tax) would fall if items could be deducted for income tax purposes at a value higher than their acquisition costs (such as through an investment allowance). In such cases, it would not be practicable to adjust the resource rent tax rate or base to offset for the concession in the income tax system. If the resource rent tax uses elements of the company income tax rules, any provision that allows an item to be deducted at a value above its acquisition cost should be inoperative in calculating the resource rent tax. This would insulate the resource rent tax from concessions introduced into the company income tax system.

Projects would be taxed separately

The resource rent tax should be calculated for project interests, rather than for each company (see Recommendation 45d). This would disaggregate the company's operations so that rents accruing to other operations would not be subject to the tax. For example, a vertically

⁷ Flexibility could be required as the company income tax rate transitions from 30 per cent to 25 per cent (see Recommendation 27, Section B1 Company and other investment taxes).

integrated petroleum company with extraction and refinery businesses would be subject to the tax only on its extraction business.

Setting the taxing point at the project level would also identify the State where the resource is being exploited. This would enable the revenue from the resource rent tax to be allocated on a State-by-State basis, if this is considered appropriate (see below).

In principle, the taxing point should be a sale of resources as close to the well head or mine gate as possible to ensure that only rents from resource extraction are subject to the resource rent tax. Liability would be calculated by reference to the taxable profit of the project (receipts from the sale of the resource minus allowable deductions). Where the resource is sold at the point at which it is produced, the receipts would be the amounts actually received. Where it is not sold at that point, the market value of the resource at that point would need to be attributed, as is the case under the existing *ad valorem* royalties.

The need to attribute a transfer price can arise if a vertically integrated company both extracts the resource and refines it or subjects it to some further manufacturing process. The bauxite to alumina to aluminium and natural gas to liquid natural gas industries are examples of vertical integration. For integrated companies, transfer pricing requirements would necessarily involve greater compliance costs.

The need to attribute a value may also arise, for example, if the resources were sold 'free on board', with the producer incurring the costs of transporting the resource to port as well as loading costs. The amounts received for the resource would be calculated as actual receipts minus the free on board costs. A number of existing State royalty regimes have similar rules.

There would also be pressure on the resource rent tax from companies engaging in transfer pricing, with both associates and others, to reduce the amount of rent subject to tax. Given the high combined statutory tax rate on resource rents relative to other income tax rates applying domestically, domestic as well as international transfer pricing would be an issue. The existing PRRT legislation includes non-arm's-length integrity rules that deal with attempts to reduce the amount of receipts or inflate the amount of deductible expenditure, with the Commissioner of Taxation able to substitute arm's-length amounts. Similar rules would be required for the resource rent tax.

All project expenditures incurred up to the point where the resource is sold or its value is taxed should be deductible for resource rent tax purposes, including exploration and closing down expenditure. Because the tax value of residual losses would be refunded, a PRRT-style carry-back rule would be unnecessary.

Under the resource rent tax, certain types of expenditure would not be deductible. While requiring further consideration, these would likely include:

- payments of interest and borrowing costs;
- payments of dividends and the cost of issuing shares;
- repayment of equity;
- payments to acquire an interest in an existing exploration permit, retention lease, production licence, pipeline licence or access authority;

- payments to acquire interests in projects subject to the resource rent tax;
- payments of income tax or GST;
- payments of administrative or accounting costs incurred indirectly with the carrying on of the project; and
- payments in respect of land and building not adjacent to the project for use in connection with administrative and accounting activities.

The PRRT has similar exclusions.

What resources would be subject to the resource rent tax?

The resource rent tax should be applied to non-renewable resources other than those expected to generate low rent where the administration and compliance costs are likely to outweigh any gains from a rent-based tax (see Recommendation 45b).

The resources that can be expected to generate net benefits to the community from being subject to the resource rent tax are:

- petroleum (including crude oil, condensate and natural gas, including coal seam gas);
- uranium;
- bulk commodities (black coal and iron ore);
- base metals (gold, silver, copper, lead, nickel, tin, zinc, bauxite);
- diamonds and other precious stones; and
- mineral sands.

Whether brown coal should be subject to the resource rent tax merits further consideration.

The State royalty systems provide a useful guide to identifying other resources that may not merit inclusion, by reference to those mineral resources currently subject to specific (volume-based) royalties.⁸ Table C1-1 lists these minerals, for which the resource rent tax may not be suitable. These resources if excluded could continue to be subject to royalties or other arrangements if appropriate.

8 Although bauxite is subject to a specific royalty in Queensland (\$1.50-\$2.00 per tonne), it is subject to an *ad valorem* royalty in Western Australia (7.5 per cent), and the value of resource rents can fluctuate as it is a globally traded commodity.

Table C1–1: Resources that may merit exemption from the resource rent tax

Barite	Fluorite	Potassium minerals and sands
Borates	Gypsum Halite	Pyrophyllite
Calcite	Lime	Quartzite Salt
Chert	Limestone	Sand, gravel and rock
Chlorite	Magnesite	Serpentine
Clays (bentonite, kaolin, structural and cement clay/shale clay)	Magnesium salts	Silica
Dimension stone (granite, marble, sandstone, slate)	Marble	Sillimanate group metals
Diatomite	Mica	Talc
Dolomite	Olivine	Vermiculite
Feldspar	Peat	Wollastonite
	Perlite	Zeolites
	Phosphates	

The transition to the resource rent tax

Existing resource projects should be subject to the new resource rent tax (see Recommendation 47).

Leaving existing projects outside of the new regime would increase administration costs by requiring multiple schemes operating in parallel. Bringing existing projects into the regime would ensure that the future expansion of existing projects would be treated in the same way as the development of new projects. This is important as a significant part of the expected growth in mining industry output is likely to come from the expansion of existing mines.

The resource rent tax would also apply to projects currently subject to negotiated special royalty arrangements, including those in place for iron ore mines, the Argyle diamond mine in Western Australia and Olympic Dam in South Australia.

Transferring existing projects into the resource rent tax system

A move to a rent-based tax would lower the perception of sovereign risk in the long term as the rent-based tax would be more stable than current resource charging arrangements. However, depending on the transitional arrangements, the transfer of existing projects into the new system may increase perceived sovereign risk in the short to medium term.

Other than to address sovereign risk concerns, the case for providing transitional assistance is far from clear. Legally, non-renewable resources remain the property of the Crown until they are exploited. As a consequence, governments have not in the past compensated resource firms for changes to resource charges. Further, investors can be expected to have taken into account potential changes to resource charges when they made investment decisions.

Governments should also not compensate investors for the change in the value of projects or companies associated with resource rights or expected benefits from future expenditure and investment. To the extent the Australian government decides transitional assistance is warranted, assistance should be directed to recognising previous expenditure and investment.

Any transitional assistance should be delivered by providing a starting ACC base, as deemed appropriate, to recognise investment made at the project level. The starting ACC base would effectively operate as a lump-sum transfer to existing projects and consequently would not distort subsequent production decisions (see Recommendation 47). For example, the starting ACC base for PRRT projects could be set equal to the value of carried-forward expenditure.

While it is generally desirable to provide a full loss offset, it may not be appropriate for losses to be refunded or transferred where they are associated with past expenditure recognised in the starting ACC base. This is because fully refunding losses on past expenditure may create an incentive for firms to report expenditure incurred for projects that have already failed. As such, losses arising from past expenditure should be quarantined from other losses and would not be refundable.

Transitional relief should not be provided through adjustments to the tax rate or other design features, or, in general, by providing a period of grace for existing projects. Such approaches would distort investment and production decisions or compromise the long-run improvement in the community's return from non-renewable resources.

The Australian government should set out a time-frame to implement the resource rent tax and provide guidance at the time of announcement on how existing investments and investment in the interim will be treated.

The resource rent tax and the States

Where State royalties are replaced by the resource rent tax, the Review recommends that the allocation of the revenues and risks from the tax be negotiated between the Australian government and the States (see Recommendation 48).

State royalty collections were \$4,756 million in 2007–08. Western Australia (52 per cent), Queensland (29 per cent) and NSW (12 per cent) raise most of the States' royalty revenue. The other States contributed only 7 per cent to the aggregate. The States' apparent reliance on mining royalties also varies, with Western Australia the most reliant (22 per cent of total State revenue), followed by the Northern Territory and Queensland (both 9 per cent). However, the horizontal fiscal equalisation process takes into account the differences in revenue-raising capacities between the States in the distribution of GST revenue (see Section G2 State tax reform). As such, all States effectively share, over time, in total resource royalties.

Options for dealing with existing State royalties on resources that would be subject to the resource rent tax include replacing State royalties or applying State royalties in parallel, with royalties credited against the resource rent tax.

Option 1: Replace State royalties and assign resource rent tax revenues to the States

Revenues could be allocated in proportion to each State's share of gross resource rent tax receipts calculated before the transfer of losses from non-tax-paying projects. This would ensure that a State's share of net revenues is not diminished because of loss-making projects in another State. Transitional arrangements could be considered to help the States manage the impact on their revenue flows of moving away from royalties.

The horizontal fiscal equalisation process would, as now, eventually achieve a more equal distribution of these resource revenues between the States.

The resource rent tax would promote efficient production and would not impose additional compliance and administration costs associated with running two systems in parallel. Each State would continue to receive a share of the revenue that reflects activity in its jurisdiction, though that revenue could be more variable and less certain than now.

Option 2: Apply State royalties in parallel, with royalties credited against the resource rent tax

If the States place a premium on certainty as to their future revenues, their existing royalty regimes could be kept in place. A firm subject to both the resource rent tax and a State royalty would be entitled to a credit for the royalty against the total liability for the tax. If in a period the credit exceeded the resource rent tax liability, the excess would be refunded.

Under this option, the States would continue to receive the revenue stream from their royalty arrangements and could be expected to benefit from increased production due to the efficiency gains from the resource rent tax. The Australian government would take on revenue risks, but benefit from the expected long-term net revenue gain. Because the State royalty payments would be creditable — and, where required, refundable — State royalties would not bias investment decisions. For example, decisions to keep a marginal mine open would have no regard to the cost of the State royalty payment.

The State royalty regimes would need to be fixed at a particular point in time to ensure that the Australian government does not automatically fund future increases in royalties.

While this arrangement would realise the efficiency gains of the resource rent tax, the net gains would be tempered by the compliance and administration costs of running dual regimes. A variant to address this downside would be to remove the need for firms to pay royalties. Instead the Australian government would make regular payments to the States based on notional royalties applied to State-based production data. This option would then be akin to Option 1, but with a different allocation of revenues and risks between levels of government.

Under this option, existing Australian government tax regimes would be replaced.

Abolish inefficient stamp duties and fees

The Australian government and the States should abolish fees and stamp duties on the transfer of interests in a resource project except those related to administrative costs (see Recommendation 50). These stamp duties and fees erode the value of resource rent available for the community because they inhibit the transfer of interests to the most efficient firm.

Annex C1: Rent-based taxes — alternative forms

This annex explains how a Brown tax (cash flow tax) collects a share of rent and how it is generally equivalent to a Garnaut and Clunies Ross resource rent tax and an allowance for corporate capital (ACC) tax.

How does a Brown tax collect a share of rent?

A rent exists where a project's receipts are expected to exceed its expenses plus the required rate of return to compensate investors for the time value of money (the risk-free return) and a premium for the risk associated with their investment (the risk premium return for systematic risk). The value of the resource rent can be measured as the net present value of the project's cash flows discounted by the required risk-adjusted rate of return.

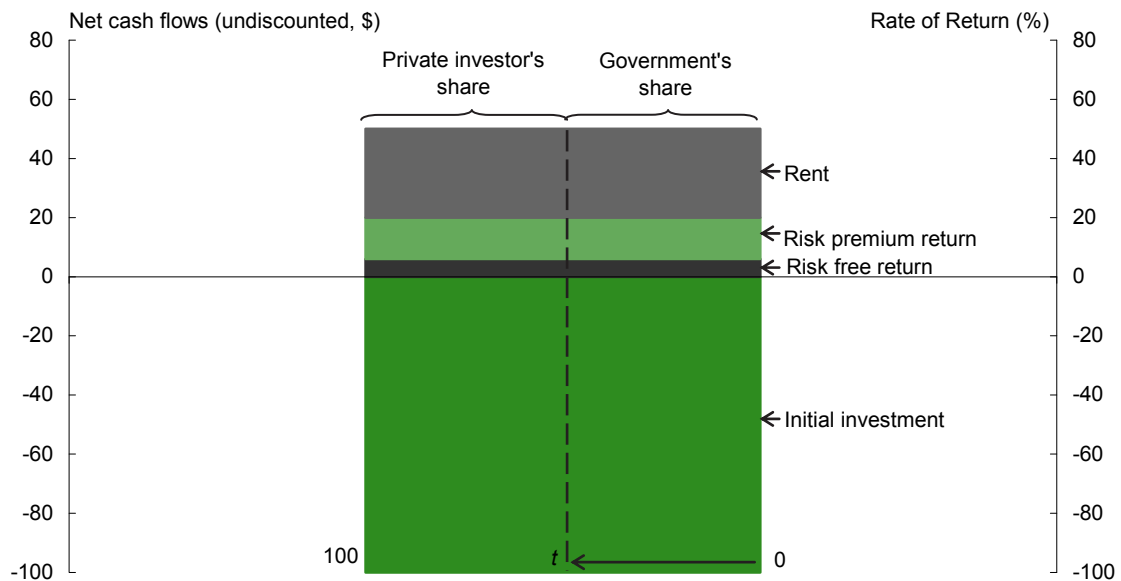
Under a Brown tax, the government is in effect a silent partner in the project, with a partnership interest equal to the tax rate. The government contributes to project expenses and shares in future receipts from the project at this rate.⁹ Consequently, its share of the value of any rent available is equal to the tax rate. In addition, the government receives cash flows associated with its share of the normal return and of good and bad luck associated with the project's riskiness.

Consider an example where an investor makes an investment, i , of \$100 and expects to receive \$150, r , at the closure of the project in one year. Assume the required rate of return for the investment is 20 per cent, comprising a risk-free rate of 6 per cent and a risk premium of 14 per cent. The expected excess return is the expected rent. For ease of exposition, assume the tax rate, t , is 50 per cent.

Chart C1-3 shows these returns from the project's net cash flows and illustrates the effective partnership arrangement established under a Brown tax. The vertical dashed line represents the tax rate, which determines the government's share of the project.

9 This contrasts with an income tax system where the government contributes its full share of expenses only once assets are fully depreciated and the project has had receipts sufficient to cover all recognised expenses. The delay in the government's contribution is equivalent to a loan from investors to the government to purchase its share of the project. However, under an income tax the government typically does not compensate investors for the time value of the loan and the risk that the government will not repay the loan if the project fails to generate enough receipts to cover expenses.

Chart C1–3: Entitlements under a Brown tax



Under a Brown tax, the government and the private investor each contributes to the \$100 investment expenditure (a negative cash flow) in year 1 – the government contributes $i \times t$ (50 per cent of \$100), or \$50, and the private investor $i \times [1-t]$ (50 per cent of \$100), the other \$50.

On their investment of \$50 each, both the private investor and the government can expect to receive a rate of return of 20 per cent, and expect to share in any rent and good or bad luck.

Where the actual return is \$150, the government and the private investor each receives their share of the \$150 receipt (positive cash flow) in year 2 – the government receives $r \times t$ (50 per cent of \$150), or \$75, and the private investor receives $r \times [1-t]$ (50 per cent of \$150), the remaining \$75.

Of the \$75 each partner receives, \$60 compensates for their investment – \$50 is the return of their initial contributions, \$3 is the risk-free return and \$7 is the risk premium return. The excess \$15 each investor receives above the \$60 they required is their share of the rent.

The present value of the government's share of the rent from the project is \$12.50 (\$15 rent received in year 2 discounted by the required rate of return), which is half the value of the project's rent (see Table C1-2). Although the investor made an initial investment of \$100, their net investment in the project is \$50 ($i \times [1-t]$), as the government refunded \$50 ($i \times t$) in year 1 to pay for its share of the partnership established through the tax system.

Table C1–2: Net present value of total investment where investor invests tax refund into an equally risky investment

	Resource project (required return = 20%)			Subsequent investment (required return = 20%)	Total investment
	Project (1)	Private (2)	Government (3)	Private (4)	Private (5)
Cash flow (\$) — Year 1	–100	–50	–50	–50	–100
Cash flow (\$) — Year 2	150	75	75	60	135
Discount rate	20%	20%	20%	20%	–
Net present value	\$25.00	\$12.50	\$12.50	\$0.00	\$12.50

The investor can reinvest the \$50 refund into another investment so that their total net investment is \$100. The table shows the net present value of the cash flows from the total private investments where the private investor reinvests the \$50 refund into another investment with the same required rate of return as the project (20 per cent), but one that does not yield any rent as it is a marginal investment. The net present value of the investor's total investment is \$12.50 (column 5).

Alternatively, the investor could have reinvested the refund into an investment with a different required rate of return, such as a government bond with a required rate of return of 6 per cent (see Table C1–3). In this case, the net present value of the cash flows from total investments remains the same, as the risk-adjusted discount rate for the subsequent investment is also lower.

Table C1–3: Net present value of total investment where investor invests tax refund into a government bond

	Resource project (required return = 20%)			Subsequent investment (required return = 6%)	Total investment
	Project (1)	Private (2)	Government (3)	Private (4)	Private (5)
Cash flow (\$) — Year 1	–100	–50	–50	–50	–100
Cash flow (\$) — Year 2	150	75	75	53	128
Discount rate	20%	20%	20%	6%	–
Net present value	\$25.00	\$12.50	\$12.50	\$0.00	\$12.50

Garnaut and Clunies Ross resource rent tax

Under a Garnaut and Clunies Ross resource rent tax, the government imposes a cash flow tax levied at a constant percentage of the annual *positive* net cash flow from the project. It is similar to a Brown tax, but does not provide a cash refund for the tax value of negative cash flows. Instead, negative cash flows are carried forward with interest (the 'uplift rate') to be claimed as a deduction and utilised against future income. The government limits its risk by not providing a refund for the tax value of expenditure when a project fails. Consequently, the uplift rate should compensate investors for the delay of the tax credit (the risk-free return) and a premium to cover the risk that the government will never repay the tax value of expenditure (or provide a tax credit) at a future date.

There is no uniform uplift rate that could accurately compensate all projects for the risk that the government will never repay the implicit loan. This is because the required uplift rate would depend on the risk that a particular *project* will not be able to utilise the tax credit at a

future date. Where the government allows projects to transfer losses to other resource projects within a company, the appropriate uplift rate would depend on the risk that a particular *company* will not be able to utilise the tax credit.

Consider the previous example again. This time the government will not contribute its share of the cost of investment until year 2 when the project has sufficient receipts to absorb expenses. For the sake of simplicity, assume that it is known with certainty that the project will be able to utilise its receipts in the second year (for example, because the government will allow the project to transfer its expenditure to other resource projects within the company and the investor is certain that there is another project within the company that can utilise the loss in year 2). In this case, the uplift rate should be equal to the government bond rate.

Under a Garnaut and Clunies Ross resource rent tax, the investor's share in the \$100 project will still be $\$50 (i \times [1-t])$ and the government's share of the project will also be $\$50 (i \times t)$. However, as the government will not contribute its share of the cost of investment immediately, the investor effectively reinvests the \$50 refund into a temporary loan to the government, which pays the interest at the long-term government bond rate of 6 per cent (which is the required rate of return for investing in government bonds).

Table C1-4 shows the tax calculation for the project. In this case, the project will make a loss of \$100 in year 1. The expenditure from year 1 will be carried forward to year 2. The government allows a deduction for tax purposes in year 2 of \$106 (comprising \$100 for the expenditure that was incurred in year 1 and \$6 for the uplift).

In year 2, the investor will pay the government \$22 in tax rather than \$75 under a Brown tax (a difference of \$53). The government thereby repays the investor \$53 for the temporary loan (\$50) and compensates the investor for the delay of its contribution under the Garnaut and Clunies Ross resource rent tax (\$3, which is equal to the \$6 uplift multiplied by $(1-t)$).

Table C1-4: Garnaut and Clunies Ross resource rent tax — worked example

Description	Item	Year 1	Year 2
Receipts	(1)	0	150
less Expenses	(2)	100	0
less Expenses carried forward from previous year	(3)	0	100
less Uplift (6% applied to prior year's expenditure carried forward)	(4)	0	6
Net profit (item 1 less items 2, 3, 4)	(5)	-100	44
Taxable profit (nil if item 5 is negative)	(6)	0	44
Tax @ 50%	(7)	0	22
Expenses carried forward (item 5 if negative)	(8)	100	0

The investor will therefore make a total investment of \$100 in year 1 and receive \$128 in year 2 (\$150 from the project less \$22 in tax). This is equivalent to the cash flows and net present value shown in column 5 of Table C1-3 where the investor reinvested the tax refund in a government bond.

This shows that the Garnaut and Clunies Ross resource rent tax is equivalent to a Brown tax in apportioning the value of the rent if the uplift rate is equal to the government bond rate and if the investor is certain they can utilise the tax value of expenditure at a future date. In the absence of this certainty, the uplift rate should also compensate for the risk that the government will never repay the tax value of the investment. Given the difficulty in

determining appropriate compensation for each project or company, equivalence breaks down.

Allowance for corporate capital tax

Under an ACC, the government contributes its share of project expenses at a slower rate than under a Brown tax. This delay occurs for two reasons. First, the government does not recognise expenses for assets immediately; instead assets are depreciated for tax purposes in line with their effective life. Second, the government does not contribute to expenses when the project is making a loss. The delay in the government's contribution to expenditure is equivalent to a loan from investors to the government. Under an ACC, the government compensates investors for this delay by effectively paying interest on undepreciated assets and unutilised losses through an allowance arrangement.

An ACC tax is only equivalent to a Brown tax where the interest payment compensates investors for the required rate of return associated with the implicit loan to the government, rather than the required rate of return for the project. The required rate of return on the implicit loan would comprise a risk-free return and a risk premium return to compensate investors for the risk that the government will never repay the tax value of the cost of the investment.

Under a full loss offset, the government promises to contribute its share of project expenses eventually, whether or not the project fails. The government could make this promise by refunding the tax value of losses (including undepreciated assets) when an unsuccessful project is closed. The government would then only need to compensate investors for the delay by paying the interest associated with government borrowing. This would compensate investors for the time value of money and the risk that the government will default on its guaranteed borrowing. A proxy for the appropriate rate is the long-term government bond rate.

Where the government does not provide the assurance of a refund, there is no uniform allowance rate that could compensate all projects for the risk that the government will never repay the implicit loan.

Consider the previous example again. This time the government will not contribute to its share of the investment until year 2, when the project's assets have been depreciated for tax purposes and the project has sufficient income to absorb expenses. A full loss offset is provided when the project is closed.

Under an ACC tax, the investor's share in the \$100 project will still be \$50 ($i \times [1-t]$) and the government's share of the project will also be \$50 ($i \times t$). However, as the government will not contribute immediately to its share of the investment, the investor effectively reinvests the \$50 refund into a temporary loan to the government, which pays an interest allowance at the long-term government bond rate of 6 per cent (which is the required rate of return for investing in government bonds).

Table C1-5 shows the ACC calculation for the project. In this case, the government allows \$60 of the \$100 expenditure for the project to be claimed as a deduction for depreciation in year 1 and the remaining \$40 to be claimed in year 2.

The project will make a loss of \$60 in year 1. This loss will be carried forward with undepreciated assets, \$40, to make the ACC base \$100 in total. In year 2, the project utilises the depreciation deduction (\$40) and losses carried forward (\$60) as well as the allowance (\$6).

The investor will pay the government \$22 in tax in year 2 rather than \$75 under a Brown tax (a difference of \$53). The government thereby repays the investor \$53 for the temporary loan (\$50) and compensates the investor for the delay of its contribution under the ACC (\$3, which is equal to the \$6 allowance multiplied by $(1-t)$).

Table C1–5: Allowance for corporate capital — worked example

Description	Item	Year 1	Year 2
Revenue	(1)	0	150
less Expenses (such as depreciation)	(2)	60	40
less Unutilised losses from previous year	(3)	0	60
less Allowance (6% applied to prior year's ACC base)	(4)	0	6
Net ACC profit (item 1 less items 2, 3, 4)	(5)	–60	44
Taxable ACC profit (nil if item 5 is negative)	(6)	0	44
Tax @ 50%	(7)	0	22
Utilised losses (item 5 if negative)	(8)	60	0
Undepreciated assets	(9)	40	0
ACC base (items 8 + 9)	(10)	100	0

The investor will therefore make a total investment of \$100 in year 1 and receives \$128 in year 2 (\$150 from the project less \$22 in tax). This is equivalent to the cash flows and net present value shown in column 5 of Table C1–3 where the investor reinvested the tax refund into a government bond. This shows that the ACC tax is equivalent to a Brown tax in apportioning the value of the rent provided that the allowance rate is equal to the government bond rate if a full loss offset is guaranteed. Similar to a Garnaut and Clunies Ross resource rent tax, if the full loss offset were not guaranteed, the allowance rate should also compensate for the risk that the government will never repay the tax value of the investment.

C2. Land tax and conveyance stamp duty

Key points

Land has the potential to be an efficient tax base for the States capable of delivering significant and sustainable revenues. Land is an efficient tax base because it is immobile; unlike labour or capital, it cannot move to escape tax. This means that economic growth would be higher if governments raised more revenue from land and less revenue from other tax bases. However, this efficiency is harmed if there are significant exemptions from land tax that encourage people to change how they use land.

Stamp duties on the transfer of commercial and residential land and buildings are a significant, though volatile, source of State tax revenue. Stamp duties are poor taxes. As a tax on transferring land, they discourage land from changing hands to its most valuable use. Stamp duties are also an inequitable way of taxing land and improvements, as the tax falls on those who need to move.

Existing land taxes are narrow, which make them less efficient and fair than they could be. Levying higher taxes on larger holdings discourages investment in land by institutional investors in rental housing. Since owner-occupied housing is exempt, land tax on residential investment properties is probably passed through to renters as higher rents.

Stamp duties on conveyances are inconsistent with the needs of a modern tax system. Land tax needs to be reformed. Broadening the base of land tax would provide a reliable and stable source of revenue to State governments. Land tax rates should be based on the value of a given property, so that the tax does not discriminate between different owners or uses of land.

C2–1 Land is (potentially) an efficient tax base

Taxes change the prices that consumers or businesses face. But a price change is not the source of the efficiency cost of a tax. The efficiency cost depends on whether people change their behaviour in response to the change in price. For example, the measure of the inefficiency of a labour tax is not how much it raises the wage cost to firms, but how many workers are not employed as a result. That is, the cost to society is the value of the activity deterred by the tax.

Land value tax is efficient because the tax reduces the price of land but does not affect how it is used, or how much is used.

Unlike capital and some labour, all land is immobile. If returns to capital or labour are higher elsewhere, those factors of production will tend to move toward those returns, but land cannot do so. This means that, in response to changes in demand, it is only the price of land that is affected, not how much it is used. The more (less) people are willing to pay to use the land, the higher (lower) the value of the land.

When a land value tax is introduced, the existing owners of land bear the burden of the tax as a reduction in land values. Potential buyers of land will reduce how much they are willing to pay for land by the value of the expected land value tax payments. That is, the value of land reflects the future after-tax earnings on land — with a tax in place, people will buy land only when they can pay less for it. Potential buyers will expect to get at least the same risk-adjusted return from land as they could from alternative investments. That is, land value tax reduces the value of the land to equalise the after-tax return to land with the return to other investments. This means that land tax does not distort investment decisions.

Someone must use the land, though; because it is immobile, it cannot be shifted out of supply. This makes land an efficient tax base. While lowering the price of land, a broad land value tax does not change how land is used. Since land value tax is paid by the owners of land regardless of what they do with it, the use of the land is not affected by the tax. The landowner cannot reduce their tax liability by changing land use — an empty block pays the same tax as an identical developed block since both blocks accrue the same 'economic rent' over time (see Chart C2-1 and a technical exposition at the Annex C2 to this Section).

Nor does land value tax change how other productive resources are combined with land. If a landowner were to try and 'pass forward' the tax to users of the land, some users (particularly highly mobile international investors) would simply reduce their use of land, lowering the demand and price for the land. When broadly applied across all uses of land, the introduction of a land value tax should not affect whether land is used for agriculture, housing or manufacturing. Even if a business (such as a farm) uses a disproportionate amount of land to produce goods and services, it will not be affected since the price of land is commensurately lower.

Land value tax therefore differs from taxes on other productive resources: taxes on labour reduce people's work effort; and taxes on capital can cause the capital to be employed elsewhere (particularly overseas). In contrast, a broad land value tax is borne by landowners and the supply of land is unchanged. Land value tax falls on the owner's 'economic rent' (see Box C2-1).

The relative efficiency of land value tax is supported empirically. A recent OECD report found that a 1 per cent switch to land or property tax (but not to taxes on transactions) away from income tax would improve long-run GDP per capita by 2.5 percentage points (Johansson et al. 2009). This study did not assess taxes on the economic rent from natural resources, which are also potentially efficient tax bases (see Section C1 Charging for non-renewable resources).

Box C2-1: Land value tax as a tax on economic rent

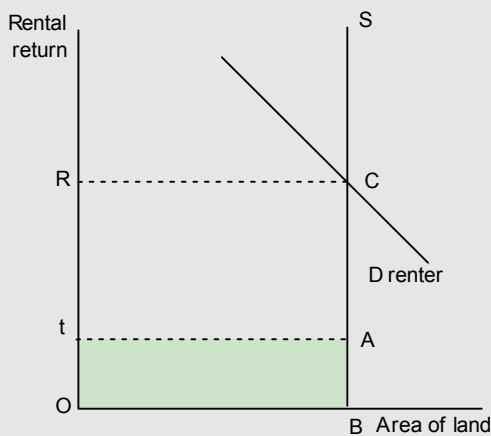
Because land is immobile, it is 'fixed in supply' (S in Chart C2-1).

The returns to the landowner tend to be made up of economic rent (area ORCB in Panel A). Changes in the price of land — that is, the annual rental return — do not change the supply of land. The demand for land (D) sets the rental return from the land (R) and the amount of economic rent accruing to the owner.

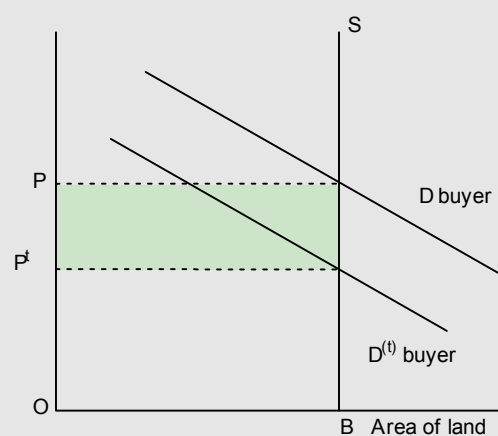
Economic rent is the return to the owner above that needed to keep the land in its current use. That is, it is the return once the owner has been compensated for the capital and labour they employ on the land. Economic rent therefore flows from the efforts of others, or simple luck. In particular, the economic rent of an owner's land increases as surrounding land increases in economic productivity (for example, from new roads built nearby), rather than the owner's investment in the productivity of their own land. Land rent is likely to increase in line with future population and economic growth, which increase demand for a fixed supply of land.

Chart C2-1: Effect of an annual land value tax

Panel A: Rents (cost of land) not affected



Panel B: Price of land falls



If an annual land value tax of t is introduced, based on the value of the land (which amounts to the same thing) then the total revenue is shown as $OtAB$ in Chart C2-1 Panel A. Since supply is fixed, the same amount of land, B , is still available at the same rent (R) — the users of land are unaffected. However, the owner now has a lower after-tax rental return of Rt .

As the capital value of the land is equal to the discounted present value of all the future expected rental returns, a lower rental return implies a one-off fall in the value of all land. Owners of land bear the incidence of the land value tax even if they sell their land in response to the tax.

Panel B shows the impact on the price of land for sale (rather than its rental return). Since the buyer knows they will be subject to land tax, their demand falls commensurately ($D^{(t)}$). As the supply of land is fixed, the present value impact of the tax is realised as a fall in price (from P to P^t). The effective rate of tax levied on owners is discussed in the Appendix.

C2–2 Some policy implications of a broad land value tax

A broad-based land value tax has a number of policy implications.

First, it is the owners of existing land that bear the burden of land value tax in the form of a one-off fall in land values when the tax is introduced. Subsequent landowners may remit land value tax, but they do not bear the expected value of the tax liability since the price of the land was lower by the estimated value of these payments when they bought it. This is relevant for how land tax reform interacts with other tax reforms and the design of transitional schemes.

Second, land value tax does not apply to the value of a property attributable to buildings and other forms of capital improvements. This means that the land valuation does not rise if a business owner builds a better factory, or a homeowner builds an additional family room. If, instead, these improvements were taxed, the tax would discourage investment and be less efficient (see Section B1 Company and other investment taxes). By not taxing improvements on land, land tax does not affect the owner's decision to invest in the productivity of their land. Instead, only the economic rent from the land is taxed. By levying a land tax, the community effectively shares in the benefit that would otherwise flow to the landowner.

Third, to be efficient land value tax must have few (if any) exemptions. The efficiency benefits of land value tax depend on the base being broad. Land value tax is efficient because land is fixed in supply. The only substitute for land is other land. However, exemptions from land tax provide some choice to owners of land on what to do with their land (and whether to pay land tax or not). If landowners can choose to use their land in an exempt activity and not pay land tax, the supply of *taxable* land is no longer fixed. This means that users of land subject to land tax will need to share some of the land tax liability if they want to use the land. For example, owners of investment properties subject to land tax need an inducement to continue letting their property, as they could otherwise sell it to someone who wants to live in it themselves and not pay land tax. This inducement comes by effectively sharing some of the burden of the tax with the tenant, who may be a business or private renter. When this occurs, the incidence of land tax does not fall only on the holders of land — it also falls on the users of the land. A narrow land tax may therefore be relatively inefficient, and arguably, inequitable.

Some exemptions from land tax may be motivated by equity concerns. In general, land tax is not a good tool for achieving vertical equity objectives. As land holdings are just one asset in a wealth portfolio, they are not a comprehensive mechanism for assessing means. Exemptions based on use are also unlikely to target equity well, as they will reduce tax for people regardless of their means. The income tax transfer system is a more effective and targeted means of achieving vertical equity between Australian residents than exemptions from land tax.

Land value taxes are relatively unusual as they are based on the underlying value of land, rather than the cash flow it generates. The value of land is dependent on the expectation of a flow of cash in the future. The method for assessing land values need to be robust to ensure land tax is efficient and fair. Much of the criticism of land tax centres around perceived arbitrary and inconsistent valuations. Land taxes can particularly appear to be inequitable where changes in land valuations appear out of step with price movements — for example,

where land tax liabilities are increasing even when market values are falling. Confidence in the system requires up-to-date, transparent and consistent assessments.

Taxes based on values can cause payment difficulties for landowners who have high value land holdings with limited cash flows. Owners may be able to use financial arrangements – such as loans or even reverse mortgage facilities – to meet land value tax liabilities. There is a role for governments to provide liquidity relief provisions that allow the deferral with interest of land value tax liabilities until the land is sold. Such arrangements currently exist for some local government rates.

As land is an immobile base, it is an appropriate source of revenue for States and local government. It is also a base where States can exercise some fiscal autonomy in setting rates.

Finally, land is likely to become an increasingly important base as the world continues to globalise. Land is a highly visible and immobile base and the tax is difficult to evade. Indeed, land tax is one of the only taxes that if levied on foreigners, is not shifted to domestic factors of production (as discussed in greater detail in Section B1 Company and other investment taxes).

Principles

Reflecting the principle that taxes for revenue-raising purposes should be on broad and immobile bases, increased use should be made of tax on unimproved land values.

Land value taxes should not include building values or be triggered by transactions as both of these can affect the use of land, which reduces the efficiency of the tax, and can be inequitable.

Land value tax rates and thresholds should generally not be varied to achieve vertical equity objectives, which are better targeted through the personal tax and transfer system.

C2–3 Current taxes on land

There are currently three taxes on land in Australia. The first is property conveyance duties (stamp duties) levied on the transfer of land and buildings. In 2007–08 they raised \$14.4 billion for State governments. A significant proportion of this revenue is raised on the transfer of building values, rather than of land. The second is local government rates levied on land (and also on building values by some councils). They raised \$10.2 billion in 2007–08. Finally, State government land tax (mostly levied on unimproved land values) raised around \$4.3 billion in 2007–08.

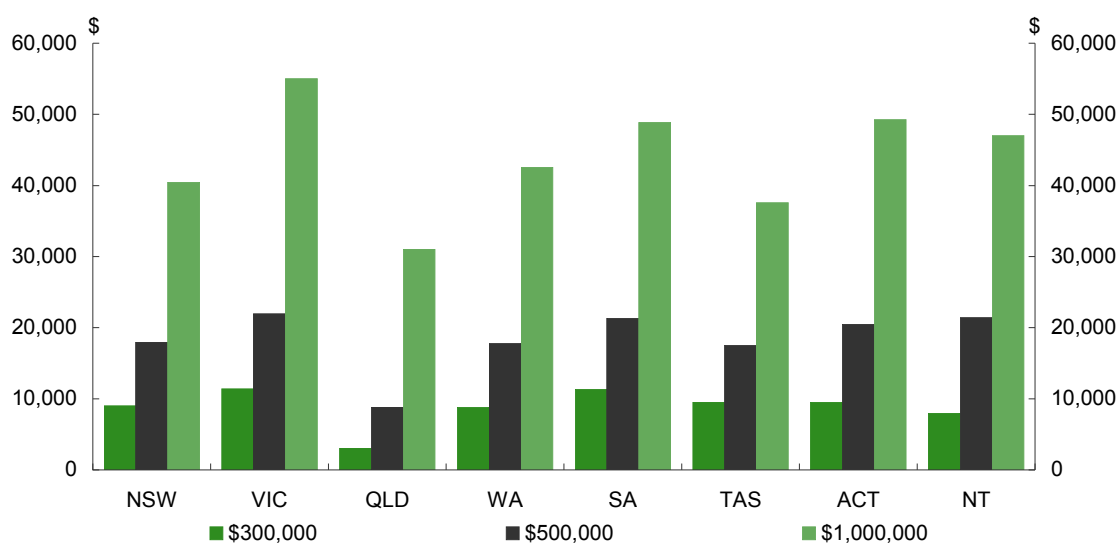
Stamp duty

Each of the States levies stamp duty on conveyances (the transfer of property), both residential and commercial. The duty is usually remitted to the State Revenue Office by the purchaser of the property, based on its reported sale price (or the market price, if that is deemed to be a fairer representation of the value). The value of the property includes the value of land and buildings.

The average rate of stamp duty across States has risen from 2.45 per cent in 1993 to 3.25 per cent in 2005, largely due to the non-indexation of the scales in the face of property value appreciation. However, rates are variable across States and different types of property. The highest rate of stamp duty is 7 per cent for residential properties valued above \$3 million in New South Wales.

Each State sets different rates and thresholds for stamp duty on conveyances, and within the one State, different rates and thresholds can apply to the purchase of different types of property. For example, the purchase of non-residential property may be treated differently to the purchase of residential property. The States adopt a progressive rate scale for stamp duty; as the value of the property increases, so does the average rate of stamp duty. Chart C2-2 shows for each State the stamp duty payable on residential properties valued at \$300,000, \$500,000 and \$1,000,000.

Chart C2-2: Stamp duty payable by State and property value



Note: Assumes residential property and that the purchaser is not eligible for a concessional rate of stamp duty.

There are programs in each of the States that provide discounted rates for first home buyers, often limited to less expensive homes. In NSW, for example, the First Home Plus Scheme provides eligible purchasers with an exemption from stamp duty on homes valued up to \$500,000 and concessions on duty for homes valued between \$500,000 and \$600,000. There are other programs that provide concessions and exemptions for particular groups, such as pension card holders.

Stamp duty is a simple tax

Stamp duty is a relatively simple tax to collect, since it is levied on the sale price, which is easily observable. Administrative simplicity was one of the main reasons why stamp duties were first introduced. The maintenance of a property right system by governments — for example, the maintenance of title deed offices — made it administratively simple to levy a tax on transactions, particularly since land values needed to be reported (see Box C2-2). However, now that broad-based taxes on income and consumption are available, the relative simplicity of stamp duty is not a strong justification for retaining the tax.

Box C2–2: A brief history of stamp duty

A stamp duty is any tax levied on a legal document, like a contract for sale of a business or land. In Australia, stamp duties were first levied by the colonial governments before federation. A physical stamp had to be attached to or impressed upon the document to denote that stamp duty had been paid before the document became legally effective. This included documents relating to many items including wages, unemployment insurance, beer, cheques, cattle and pigs. Most of these duties have now been removed. Those on the transfer of a business or real property, the registration of a motor vehicle and insurance contracts are the only significant duties remaining. While the use of adhesive stamps on documents has now been abolished, the related tax obligation has not.

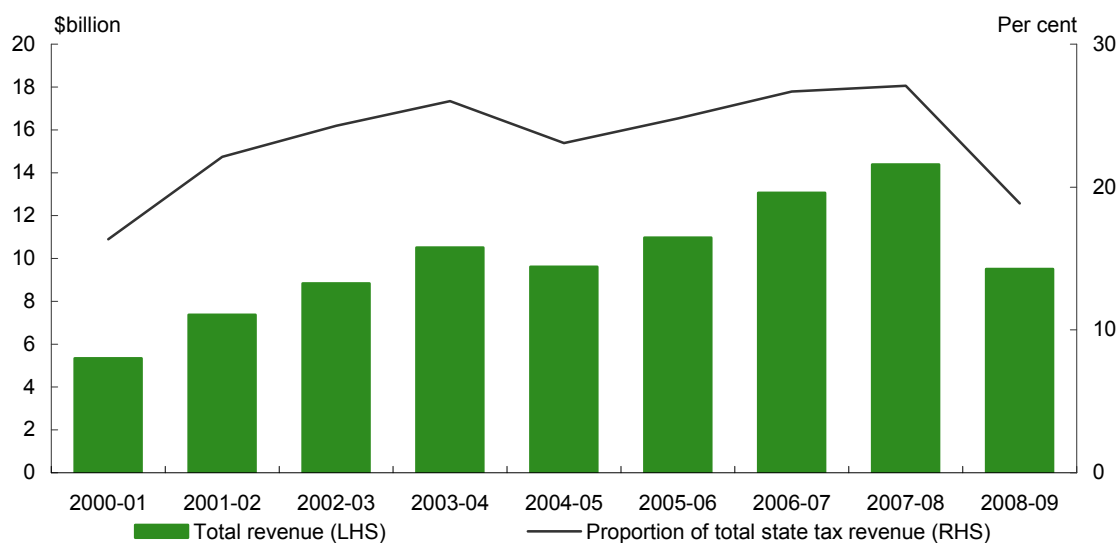
Stamp duty stamp used in Queensland in the 1950s

Source (image): Dave Elsmore, ozrevenues.com.

A large but volatile revenue source

In recent years, stamp duties on conveyances have been a significant source of revenue for the States. Indeed, in some States, stamp duty revenues have sometimes been the main source of revenue. As a proportion of gross domestic product, taxes on financial and capital transactions in Australia, which mainly comprise stamp duties, are twice the average of OECD countries.

Revenue from stamp duty is volatile. This is because the tax base is determined by two variables that can be subject to significant swings in short periods of time: the value of properties being transferred and the number of properties being transferred. For instance, around 52,000 established properties were turned over in Sydney in 2007, but only 42,000 in 2008, a fall of 19 per cent. The progressive nature of conveyance duty rates can add to this volatility. Chart C2–3 illustrates stamp duty volatility, both in terms of actual revenue and as a proportion of total State tax revenue, over the past decade.

Chart C2-3: Revenue from conveyance duty

While Chart C2-3 shows the aggregate for all States, recent experience suggests that the housing cycle can move at different times in different States, so the chart masks the volatility in revenue that can arise for individual States. For example, revenue from conveyance duty in Western Australia is expected to decrease from \$2.3 billion in 2007-08 to \$1.1 billion in 2008-09, a fall of over 50 per cent.

A tax on transferring property, not on land

Section C2-1 outlined how a tax on land value can be efficient because it is levied on an immobile base and is difficult to avoid. Stamp duties do not have these properties.

Stamp duty is triggered by the sale of a property. This creates the possibility for people to avoid stamp duties by choosing not to buy or sell property, which can result in people not living in the house they really want to live in or staying too long in a house that could be better used by somebody else. This probably results in a poor allocation of the housing stock. Though the efficiency impact of transactions taxes are difficult to estimate, one study suggests that stamp duties have efficiency costs more than ten times as great as those of a recurrent tax on the market value of houses (O'Sullivan et al. 1995).

Since stamp duty applies to the whole property value, to some extent it taxes the capital used to improve land. While land is immobile, the capital used to improve it is not. Discouraging capital owners from investing in property improvements — particularly improving and selling property — is particularly inefficient.

The most obvious way stamp duty biases decisions is that it discourages people from moving. The effect of stamp duty on the decision to move is determined by the size of the tax in comparison to the non-tax costs of moving, such as real estate agent fees, removal costs and search costs. Stamp duty can double these costs. Indicative estimates of the effective tax on the decision to sell one median sized home and buy another are depicted in Table C2-1 (based on a similar table in Hird 2007). Because stamp duty rates are progressive, the effective rate of tax is generally higher in cities with higher house prices.

Table C2–1: Stamp duty expressed as a tax on moving in capital cities

	Value of median home, June 2009 (\$)	Stamp duty payable (\$)	Other moving costs (\$)	Total cost of moving (\$)	Effective tax rate on moving (%)
Sydney	544,000	19,970	21,320	41,290	94
Melbourne	441,900	18,484	18,257	36,741	101
Brisbane	419,000	5,915	17,570	23,485	34
Perth	450,000	15,390	18,500	33,890	83
Adelaide	359,000	14,280	15,770	30,050	91
Hobart	336,000	10,990	15,080	26,070	73
Canberra	458,000	18,240	18,740	36,980	97
Darwin	537,100	26,586	21,113	47,699	126

Note: Other moving costs assume real estate agent fees of 3 per cent on the value of the home as well as a flat \$5,000 cost in all States. Stamp duty payable assumes that the buyer is not entitled to concessions such as first home buyer assistance. These estimates overstate the monetary non-tax costs of moving for those vendors who choose not to engage a selling agent or professional removalists.

Leigh (2009) finds that a 10 per cent increase in the level of stamp duty reduces the numbers of properties exchanged by 4–5 per cent if the increase is sustained over a three year period. This suggests that current rates of stamp duty prevent a substantial number of mutually beneficial housing exchanges. Reduced turnover of housing can have a significant impact on people’s lives (see Box C2–3).

Box C2–3: The real-world effects of stamp duty

Making housing transactions more expensive means that people tend to move less (Van Ommeren & Van Leuvensteijn 2005; Van Ommeren 2008). This can have a range of efficiency and equity effects, including:

- People may commute more, creating greater road congestion (Larsen et al. 2008).
- People who want larger houses may choose to renovate, rather than move; or they may buy a larger house than they need in anticipation of eventually needing the space. This could lead to a housing stock that is larger than necessary, which may have environmental consequences.
- Making housing transactions more expensive may lead to higher unemployment, as people are less likely to move to get a job, and to lower productivity, as there is greater impediment to shifting to a better-paying job (Van Ommeren 2008).
- Some groups may have less access to the housing market since they need to save to pay the stamp duty.
- Stamp duties may discourage older Australians from moving to a smaller home and reduce the amount of equity withdrawn from a home if they do downsize (Wood et al. forthcoming).

Stamp duties are a particularly bad tax on business

Stamp duties tax transactions in property, but also the value-add from capital investment. Stamp duties are a particularly inefficient tax when levied on business. This is because businesses face incentives to minimise their transactions and investment in property. For example, a business has incentive to use existing buildings rather than moving to a lower cost region and buying a new property. As businesses are more likely to be mobile than consumers, stamp duties are likely to be particularly inefficient. Consumers are worse off in

two ways — goods and services are provided using less efficient processes, and higher tax rates apply to those goods and services that disproportionately depend on property for their production.

Stamp duties are particularly complex for many businesses. Most residential properties involve one transaction within a single State jurisdiction. Business transactions in property (involving land and non-land assets) can involve changes in the ownership of people indirectly related to a transaction (such as unit dealings in a unit trust). Such complexities involve dealing in high-value commercial property transactions. For example, there are many differences between State corporate reconstruction legislation and how to treat unit trusts that are complex and influence business investment.

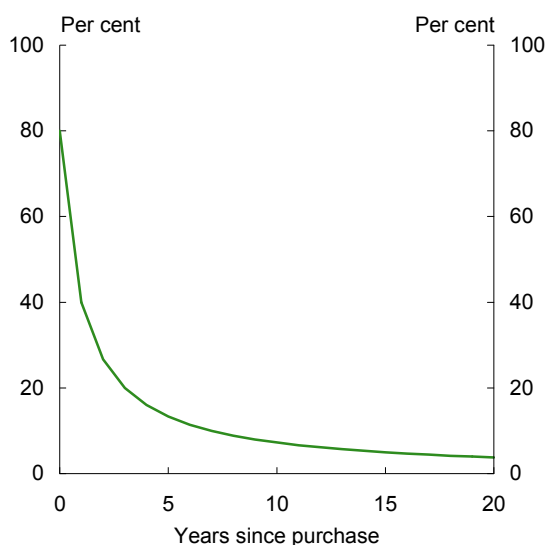
Stamp duty is inequitable

Given that higher valued properties are often purchased by people with higher incomes, it may appear equitable that the average rate of stamp duty increases as the value of the property increases. However, as property is just a part of a household's consumption and wealth, stamp duties are a poor mechanism for improving equity. The tax instead falls most heavily on people with a preference for housing consumption. For example, one person of considerable means might buy an expensive house and pay more tax, while another does not because they prefer an expensive motor vehicle.

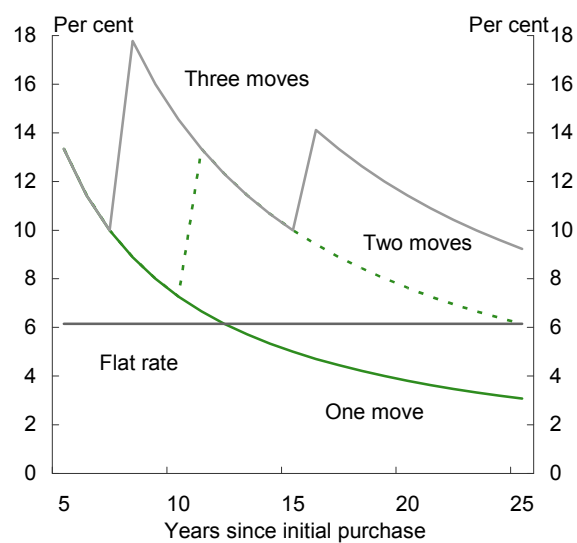
A further equity dimension to stamp duty is that it will always result in a differential tax burden depending on people's desire to move. Chart C2-4 illustrates how the effective rate of stamp duty on housing differs according to the length of time spent in a property and the frequency of moving. The stylised chart shows the effective tax rate of stamp duty as a proportion of the cumulative imputed rent (the value from living in the home) over time. The effective rate of tax declines over time as the up-front cost of stamp duty is spread over more years of occupancy. If a household sells their house and purchases another, the cycle starts over again — meaning that people have an incentive to stay in the same house.

Chart C2-4: Stamp duty effective tax rate^(a)

Panel A: Effective tax rate falls with occupancy duration



Panel B: Increased tax rate on people who move



(a) The effective tax rates are calculated as the ratio of stamp duty (assumed to be \$20,000) to the value of imputed rent over the period the property is owned (assumed to be \$25,000 per annum). In Panel B, the 'flat rate' reflects a constant tax on imputed rent, with the rate equal to the effective rate faced by a person making two moves in 25 years (which is not average but intended to be indicative).

Source: Treasury estimates.

While around half of owner-occupiers have occupied their house for nine years or less, 18 per cent of owners have brought within three years and 26 per cent stay in their home for at least 20 years. People who have to move more frequently because of their work or large changes in their life (for example, birth of children, divorce, or a new partner) will face higher rates of tax, regardless of their means.

Stamp duties also make it more difficult for credit constrained potential home buyers to access the market. For example, Wood et al. (2006) found that stamp duty accounted for around 23 per cent of up-front cash costs of renters who may be potential home buyers. Though stamp duty is an unnecessary impediment, its removal would not be likely to lead to a large increase in access to owner-occupied housing for renters of limited means.

Finding

Existing State stamp duties on property conveyancing are highly inefficient, distorting both residential and business use of property.

Stamp duty encourages people to stay in houses when they would prefer to move, contributing to longer commuting times, larger average home sizes and lower labour mobility.

Stamp duty is also inequitable as people who move more regularly – such as those needing to change homes for work – pay more tax than those who do not. Stamp duties also directly reduce access to housing for people who are credit-constrained.

Council rates

Council rates are broad-based, low-rate taxes levied on the value of land. They raised \$10.2 billion in 2007–08. Council rates are administered by local governments to fund certain services they provide, such as sanitation and planning administration (see Section G3 Local government for more details).

Land value is generally not directly observable from vacant land transactions. Valuation methodologies differ from council to council and can also differ from the method used to value land for State land tax (see Box C2–4). Some councils base the tax on the value of the land only, while others base the tax on total property value (land and buildings).

Box C2–4: Different approaches to levying ongoing land value taxes

Methods of valuing land for tax purposes vary from State to State. There are subtle differences in base definitions of value in each State, but the following broad categories are indicative.

Measures of the value of land itself

Unimproved value, unimproved capital value, land value and site value are currently the bases on which land-only taxes are determined. Each of these bases is the value of the land without ‘improvements’ (for example, buildings as well as, in some bases, draining, levelling or filling). Site and unimproved capital value are similar, as both include the value of merged improvements (such as draining) in their values, though do not include building values. All of these valuations are influenced by the effects of nearby infrastructure (such as access roads, schools and parks).

Measures of land and buildings

Capital value and capital improved value include the total market value of the land, including any buildings or other improvements.

Annual value, annual assessed value and gross rental value estimate the sum of all rental payments that are paid to the landlord in a year or would be if the property was rented. These measures give a similar tax result to capital improved value. However, they do not allow for the deduction of the costs a landlord would incur in maintaining the land.

Net annual value is also the rental value of the property but allows the deduction of landlord’s costs, including land taxes and maintenance costs.

Table C2–2: Current valuation methodologies for council rates and land tax

	NSW	VIC	QLD	WA	SA	TAS	NT	ACT
Council rates	LV	SV, NAV, CIV	UV	Rural: UV Non-rural: GRV	CV, SV, AV	LV, CV, AAV	UCV, AV, ICV	UV
Land tax	LV	SV	UV	UV	SV	LV	Not levied	UV

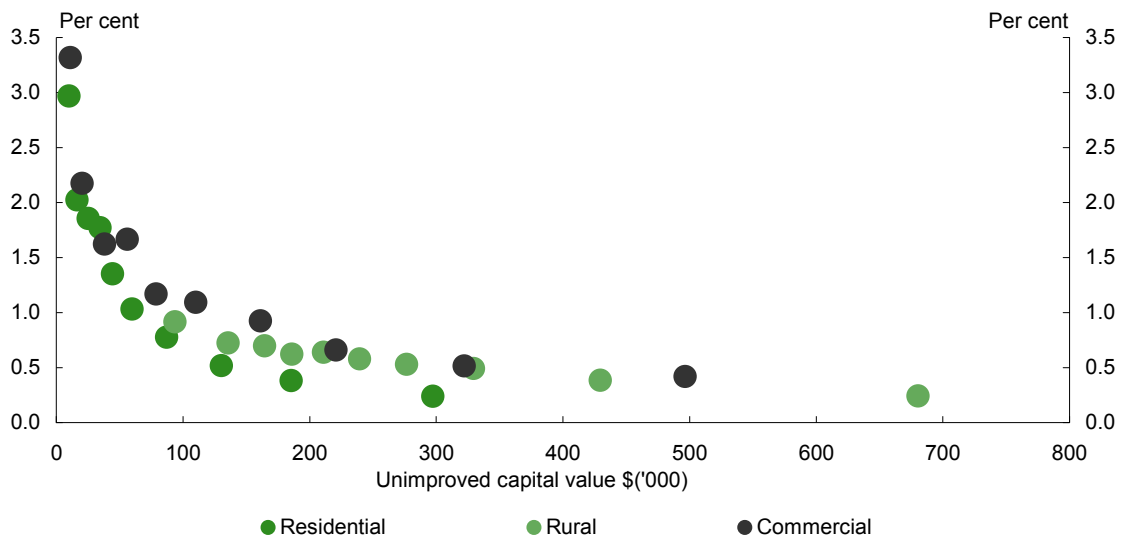
Notes: AV = Annual value, AAV = Assessed Annual Value, LV = Land Value, CV = Capital value, CIV = Capital Improved Value, GRV = Gross Rental Value, NAV = Net Annual Value, SV = Site Value, UCV = Unimproved Capital Value, UV = Unimproved Value, ICV = Improved Capital Value.

Sources: Productivity Commission (2008); Mangioni (2006); NSW Treasury (2009).

Overall, council rates are relatively efficient, simple and fair taxes. This is consistent with the indicative modelling of efficiency costs of taxes calculated for the Review (see Part 1.7). Rates are generally applied to all land uses with limited exemptions and apply equally to all properties within the council area.

However, the efficiency of council rates is likely to be reduced in councils that use improved values to assess the tax, as this discourages capital improvements. Further, councils often levy rates based on the zoning of land, with higher rates for commercial, compared to residential and rural property (see Chart C2–5). While these differential rates may be used as a proxy for imposing higher rates on higher value land, a direct method could achieve the same result without the risk of influencing the zoning process. Further, a segmented approach to land value taxation is more likely to result in the tax burden being passed to users rather than being borne by landholders. This reduces the efficiency of the tax.

Chart C2–5: Effective property rates
Rates by decile of property value (2004–05)



Source: Productivity Commission 2008.

The variation in valuation bases and methods from State to State and from council to council may be a source of complexity for landholders across different jurisdictions. For most payers, however, rates involve minimal compliance effort. The State governments' Valuer-General typically generates the valuation, the State Revenue Office (SRO) generates the assessment and, as long as the taxpayer pays the assessment, there is no risk of penalty. The low rates, lack of thresholds and limited range of concessions provide limited tax planning opportunities.

Local government rates are also a stable revenue source. This is especially when a moving average of recent valuations is used to determine the tax base, which minimise short-run fluctuations in land values. They are also a sustainable base as land values tend to climb steadily over the long run.

Land value taxes are a good base for local governments as there is a direct connection between the level of services delivered and the residents who benefit (see Section G2 State tax reform).

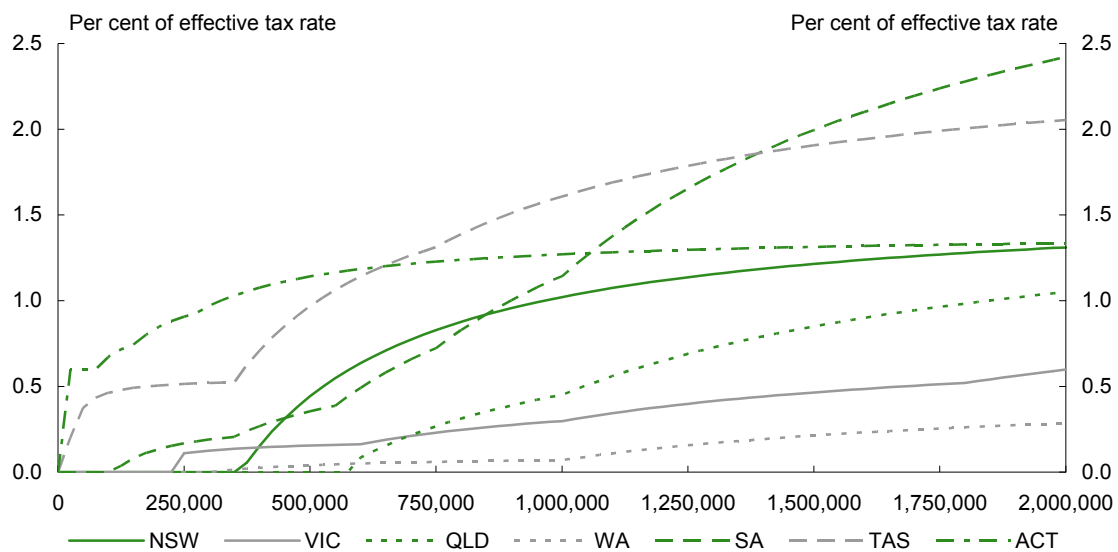
When comparing average tax rates across a State, council rates can appear regressive, as higher rates are generally levied in councils with lower property values (see Chart C2–5). This is likely to reflect the fact that many of the services provided by local governments cost the same regardless of the means of its recipients. In addition, these costs can be higher in rural or remote communities, which often have lower land values. As local government services benefit residents of particular areas, it is appropriate that their residents pay for them through rates. However, the provision of Financial Assistance Grants to all councils – even those with significant local revenue-raising capacity – may reduce the average tax rate in councils with high land values. This issue of Financial Assistance Grants is considered in greater detail in Section G3 Local government.

Land tax

Land tax is a general revenue tax levied by all States except the Northern Territory. Depending on the State, it is calculated on the 'unimproved' or 'site' value of land. Although the details, thresholds and tax rates vary between States, it generally applies only to a limited range of commercial land and investor-owned residential land. A range of land uses are exempt, including primary production, owner-occupied residential, child care and aged care. Land tax raised \$4.3 billion in 2007–08.

Land taxes are levied according to a progressive rate scale. In all States (other than the ACT), these rates are based on an entity's total land holdings. Many States also apply substantial minimum thresholds before any tax is levied. Chart C2-6 reflects the thresholds and average rates applied to land holdings in each State.

Chart C2-6: Thresholds and average rates of land tax



Note: Land tax in the ACT is determined on a value per property, not on aggregate holding.
Source: NSW Treasury (2009).

A narrow-based tax

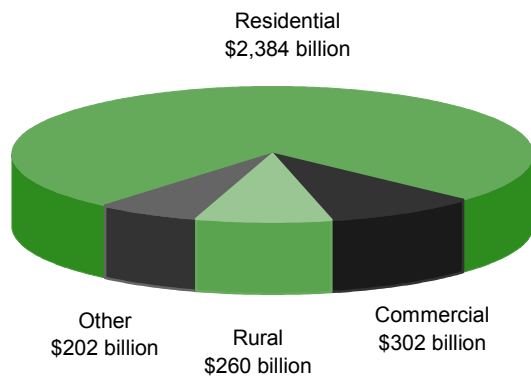
The thresholds applied to land tax and the wide ranging exemptions reduce the efficiency and equity of the tax.

The major exemption from land tax is owner-occupied housing. This exemption removes around 60 per cent of land by value from the tax base. Another significant exemption is land used for primary production. Despite the significant amount of land that this exemption covers, it represents only around 10 per cent of the total land value (see Chart C2-7 Panel A). Significantly, these exemptions have excluded from the tax base the land with the fastest recent growth in value (see Chart C2-7 Panel B).

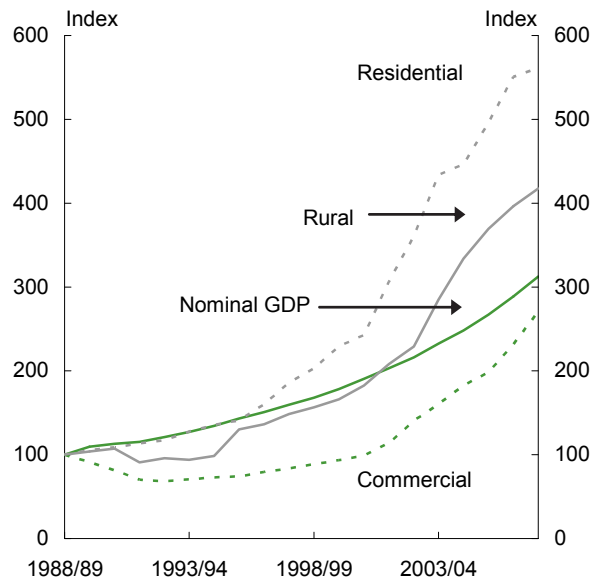
Also excluded from the base are leasehold land, State and Commonwealth-owned land and land owned and used by non-profit organisations and charitable institutions.

Chart C2–7: Land values and growth

Panel A: Land value by category (2007–08)



Panel B: Growth in aggregate land values



Source: ABS cat. no. 5204.

Substantial exemptions harm the efficiency of any tax by encouraging economic activity to move to the untaxed sector. In this regard, the large thresholds applied in some States have the effect of exempting small landholders from the tax. For land tax, the efficiency cost is also likely to be compounded by the burden of the tax shifting from landholders to land users.

The exemption is likely to have particular influence on land for residential property. The exemption of owner-occupiers rules out around 75 per cent of residential land and, for the remainder, high thresholds in some States effectively exempt many small-scale investors. As land can shift in and out of the tax base depending on who owns it, it is unlikely that the tax will be fully reflected in lower land prices for residential property. The portion of tax that is not reflected in lower land prices is borne by investors through lower returns, or by their renters through higher rent. This means the tax, to some extent, has been passed forward to workers and the owners of capital. Further, it is likely that, in the long run, much of the burden of the tax is shifted to renters, as rents adjust to ensure that investors achieve an adequate return. This may be inequitable, as renters generally have low income and wealth.

Significant exemptions also make land tax more complex to comply with and to administer.

Higher tax on aggregate holdings discourages large-scale investment in land

When the Australian colonies introduced land taxes in the late nineteenth century, higher tax rates on aggregate holdings were introduced to encourage large rural landholders to subdivide their land and sell it to settlers (Smith 2004). As rural land is no longer in the base, this rationale for higher rates on larger aggregate holdings is no longer applicable.

Today these rules lead to higher taxes on larger landholders. The most significant consequence of this approach is a bias against large investments in residential property. The land tax scales tax more heavily any corporation or individual that seeks to make a large investment in land, such as for residential housing. For the States that levy land tax on an aggregate basis, Table C2–3 depicts the different rate of tax per dwelling for a small and large investor in each State. The much larger share of rent that land tax represents places

large investors at a significant competitive disadvantage. This is likely contribute to the investment housing market being dominated by small investors.

Very few institutional investors invest in private rental housing. The aggregate holding approach deters these potential long-term investors from the market, as do a number of elements of the existing income tax system. Policies that discourage such investment are particularly perplexing given that such investors may be a better match for private tenants who desire long-term tenure.

Table C2–3: Effect of aggregation returns to rental property investment

	Sydney	Melbourne	Brisbane	Perth	Adelaide	Hobart	Average
Median home (\$'000)	544,000	441,900	419,000	450,000	359,000	336,000	424,983
Rent at 5% (\$'000)	27,200	22,095	20,950	22,500	17,950	16,800	21,249
Small investor							
Land tax per property (\$)	0	0	0	0	209	837	174
Proportion of rent	0%	0%	0%	0%	1%	5%	1%
Large investor							
Land tax per property (\$)	4,848	3,270	3,190	2,232	5,618	3,844	3,834
Proportion of rent	18%	15%	15%	10%	31%	23%	18%

Note: The small investor is assumed to hold one median priced dwelling, with 25 held by the large-scale investor. The land value is assumed to be half the value of the property. Median house price is for a 3 bedroom dwelling at June 2009. In Perth, the calculation of land tax includes the Metropolitan Regional Improvement Tax. In Brisbane, the investor is assumed to be a corporation.

Source: Real Estate Institute of Australia (2009); NSW Government (2009) and Treasury calculations.

Finding

Several features of current land taxes, in particular their narrow base, make them less efficient and fair than they could be.

By levying the tax at increasing rates on an entity's total holding, land tax discourages large-scale investment in land, particularly for rental housing.

Because owner-occupied housing is exempt, the burden of land tax on residential investment properties is probably borne by renters through higher rents.

C2–4 Directions for reform

Recommendation 51:

Ideally, there would be no role for any stamp duties, including conveyancing stamp duties, in a modern Australian tax system. Recognising the revenue needs of the States, the removal of stamp duty should be achieved through a switch to more efficient taxes, such as those levied on broad consumption or land bases. Increasing land tax at the same time as reducing stamp duty has the additional benefit of some offsetting impacts on asset prices.

Recommendation 52:

Given the efficiency benefits of a broad land tax, it should be levied on as broad a base as possible. In order to tax more valuable land at higher rates, consideration should be given to levying land tax using an increasing marginal rate schedule, with the lowest rate being zero, with thresholds determined by the per-square-metre value.

Recommendation 53:

In the long run, the land tax base should be broadened to eventually include all land. If this occurs, low-value land, such as most agricultural land, would not face a land tax liability where its value per-square-metre is below the lowest rate threshold.

Recommendation 54:

There are a number of incremental reforms that could potentially improve the operation of land tax, including:

- (a) ensuring that land tax applies per land holding, not on an entity's total holding, in order to promote investment in land development;
- (b) eliminating stamp duties on commercial and industrial properties in return for a broad land tax on those properties; and
- (c) investigating various transitional arrangements necessary to achieve a broader land tax.

Stamp duty

Ideally, there is no place for stamp duty in a modern Australian tax system. Stamp duties generate large efficiency costs, as they discourage turnover in property and tax improvements as well as land. The tax also imposes a higher burden on people who need to move, which is not equitable. The only positive feature of stamp duty — its relative simplicity — has long since ceased to justify its continued use in the face of the costs it imposes on Australian society (see Recommendation 51).

While removing stamp duty would lead to more equitable and efficient outcomes, it would create a substantial hole in State revenues. As discussed in greater detail in Section G2 State tax reform, this shortfall should be met through increased reliance on more efficient State taxes. The Australian government should consider facilitating a transition away from stamp duties, reflecting the national benefit of reforms to State taxes and the quality of the

Australian government tax bases. Another option is to reduce stamp duties incrementally, including capping the maximum rate, possibly as part of an intergovernmental agreement.

There is a case to link the reform of stamp duty to that of land tax to reduce the impact on prices and wealth caused by tax reform. Some of the reduction in stamp duty would lead to higher property prices,¹⁰ whereas increases in land tax would lead to lower land prices. The overall impact on property prices and investment is uncertain and depends on a range of policies affecting land use, but there is likely to be two effects of note. First, (depending in part on future policies affecting land use) property prices might increase because a more efficient tax system increases economic growth, some of which is captured in land rent — what was a 'deadweight' loss from stamp duty is captured in higher economic returns to the land owner. Second, land is a complement to property investment, so moving to a zero tax rate on capital investment (as stamp duty rates reduce) would increase the demand for land. International empirical evidence on the impact on building activity from switching an improved property tax for land tax is inconclusive (Oates & Schwab 1997) or mildly positive (Plassman & Tideman 2000).¹¹

Land tax

The future Australian tax system should increasingly rely on land values as a tax base.

Along with natural resources (see Section C1 Charging for non-renewable resources), land tax is the only major tax that can be levied directly on economic rent. Shifting taxes away from mobile bases toward an immobile base, increases efficiency and potentially leads to higher long-term economic growth. Further, as land values tend to be correlated with growth in the economy and population, land tax is well-suited to future demographic pressures.

Current land taxes should be reformed to make them more efficient and equitable.

Reform the assessment mechanism

Land tax should no longer be based on aggregate land holdings. As well as discouraging large-scale investment in the rental property market, this approach does not appropriately target the economic rent from land.

The simplest approach would be to levy the tax at a flat rate on the unimproved land value, irrespective of total value. This would avoid arbitrary distinctions between tax burdens based on land parcel size or the landholder's characteristics. A flat rate would also avoid the problem of 'bracket creep', which, because of existing thresholds, has raised the real effective tax rate over time. However, a flat rate would reduce the top marginal tax on many properties relative to the current land tax. Some of these are likely to be land of high value, leading to windfall gains to some landowners. One approach would be to adopt a slow transition to the new rate structure, such as only slowly reducing existing land tax rates.

Alternatively, increasing marginal rates of tax could be applied to the economic rent in land. That is, stepped rates could be based on the value of the property per square metre, starting with a zero rate on low-value land. Higher valued land with more significant economic rents

¹⁰ Leigh (2009) suggests that the incidence of the tax falls on sellers.

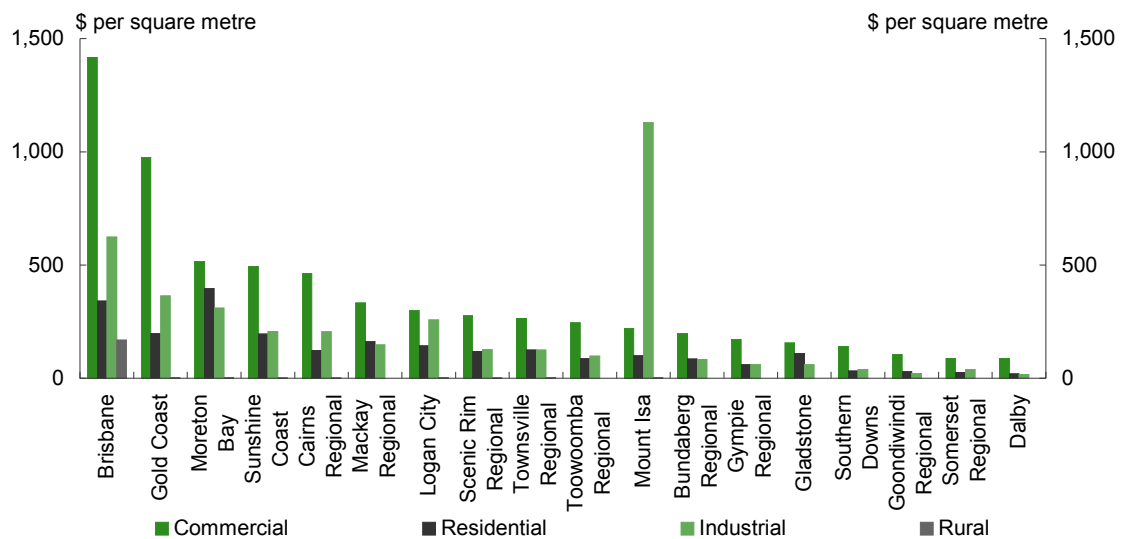
¹¹ For a survey of empirical studies see Anderson (2009).

would pay a higher rate of tax (see Recommendation 52). Higher rates of tax on economic rents do not distort economic decision-making, as higher rates on labour or capital would. Targeting higher rates in this way would allow higher rates to be levied in areas of high demand for land.

An increasing marginal rate of tax may be justified the more certainty there is that the land valuation accurately reflects economic rent, rather than returns to other factors such as capital. This is particularly important should site (rather than unimproved) value be used to administer land tax. While easier to administer, site value has some merged capital costs (such as land clearing) included in the base (see Box C2-4). This approach is justifiable in areas, such as major urban centres where merged capital represents only a small portion of their value, but may be more problematic in low-value areas.

This approach would levy a higher rate on areas with greater economic rent, which would be more accurate than by using zoning as a proxy for economic rent. As reflected in Chart C2-8, while commercial land tends to have a higher value than the residential land in the same area, this does not hold across a whole State. Commercial land in country areas is often of lower value than residential land in capital cities. Basing the tax on land value per-square-metre would also ensure more timely changes in tax in response to changes in value of the land than if the assessment were based on changes in zoning, which can occur after the land has increased in value.

Chart C2-8: Land values by zoning in selected local government areas in Queensland



Source: Queensland Department of Environment and Resource Management (unpublished).

Broaden the base

Land used for owner-occupied housing should not be exempt from the tax base. The current exemption is inequitable, as it is likely that it contributes to renters bearing some or all of the tax. Excluding owner-occupied land also reduces efficiency of the tax, by distorting land use.

Broadening the tax base to include land used for owner-occupied housing would add significant revenue raising capacity to the tax base. This would improve the overall efficiency of the tax system, by reducing the reliance on alternative, less efficient taxes (see Recommendation 53).

Land used for primary production

Uniform application of the marginal rate scale on a per-square-metre basis with a low minimum threshold is likely to result in no tax paid by most land likely to be used for primary production. However, as it is based on value, this would significantly reduce the administration and compliance burden of land tax compared to the current use-based exemption. Further, a land tax would be inefficient if it affected land use. The scope for any inaccuracy in land valuation to affect land use is likely to be greater for lower-value land or for where it is difficult to separate the value from improvements to land from its inherent value. Targeting land use toward higher-value land above a minimum per-square-metre reduces the potential for the tax to affect land use.

However, primary production land on the fringes of urban areas (such as market gardens) may find its value increasing as demand for residential or industrial development increases. The value of primary production land in this situation could increase to the point where it becomes taxable even before it is zoned for more intensive development. This outcome reflects the increase in economic rent to the owner.

By basing the eligibility for tax based on value, rather than use, primary production land would not become taxable merely because it is converted to a different use, such as from primary production to biodiversity conservation.

Income-poor, asset-rich owner-occupiers

Some taxpayers may have difficulty in finding the cash to pay their land tax every year. For example, many low-income earners may live in valuable properties but not have cash readily available to pay their land tax liability.

For low-income earners who lack the cash flow to pay land tax every year the land tax could be deferred. The amount could accrue as a debt attaching to the property, with an appropriate caveat registered at the Land Title Office and a non-concessional rate of interest applied (in line with the standard variable mortgage rate). Asset-rich, income-poor persons could then allow the debt to accumulate until they move. The debt would be acquitted at the next transfer. Deferral arrangements already apply for local government rates in South Australia. To protect people in areas of declining value, the value of any debt should be non-recourse — that is, capped at the land value realised upon sale.

Land used for commercial and industrial use

A large share of land tax is currently raised from land subject to commercial and industrial use. However, large thresholds may mean that the full incidence of land tax is not borne in lower property values and fall instead on those who use land for business. Taxes on business inputs are a particularly high-cost source of tax revenue. In combination with stamp duty, levying increasing rates on a base with large thresholds means that the taxes borne by businesses are likely to be variable and, in some case, high. This affects efficient land use, as well as increasing the complexity and uncertainty for business.

A potential reform priority could be to remove the thresholds for land used for commercial and industrial purposes in return for rationalising the rate scale and for abolishing stamp duty on those properties (see Recommendation 54).

Valuation methodology

A redesigned land tax system could be simply administered by aligning local government rates with the land tax. Ideally, landowners should receive just one bill per year covering both and have a single point of contact for enquires, debt management and compliance. More significant simplification could be achieved if all local government rates had the same base as State land tax. This would reduce administration and compliance costs for individuals and businesses that pay rates across different councils in the same State and lower the cost of valuation, which is a significant part of the cost of collecting land tax and rates.

To be efficient, land tax valuations need to reflect the ‘highest and best’ use of the land – that is, its current market value – rather than its value in actual use (Oates & Schwab 2009). So long as the tax liability reflects its best use, then the tax does not affect the decisions of the owner. If some types of land (such as agriculture) are exempt or in other ways preferred by valuation methods or land tax, then use-value assessment can delay development (England & Mohr 2003).

In major urban centres the administration of unimproved valuations has become increasingly difficult, with most States instead using site valuations. Very little unimproved land actually remains. There is declining knowledge of what land was like in its original state, and the historical information regarding fill and other improvements is increasingly difficult to determine. Consequently unimproved values continue to be regularly challenged by landowners in the courts with escalating costs for both land owners and the State (Hefferan & Boyd 2008).

To instil confidence in a system where greater revenue is raised from taxes on land values, greater investment in valuation and information collection methodologies would be warranted. This should include moving to a standard land or site value basis, using transparent and nationally consistent valuation methodologies and the updating of valuations on a consistently frequent basis to maintain alignment with movements in values.

Ensuring a smooth transition

This Review is not the first to consider a shift in the tax mix from inefficient transaction taxes towards a broader land tax base (for example IPART 2008, Productivity Commission 2004, Harvey 2001). While this would deliver substantial long-term benefits to the Australian community, the transition is clearly challenging. Transitional arrangements are important to build community acceptance and to minimise potential disruption (see Recommendation 54).

Successful transitional arrangements are likely to have a number of key design features.

First, any special transitional arrangements to a broader land tax regime should be limited to existing owners. Land tax is borne by existing owners of land when the tax is introduced. Future owners who are required to remit land tax are effectively ‘compensated’ by paying a lower price for the land. Future owners who remit tax payments only bear land tax on any unexpected capital growth in their land. Since this is associated with an unexpected windfall, there is no case for compensating future owners.

Second, the clearest need for a transition mechanism is for owner-occupied land. Existing owner-occupied landholders are likely to have bought their homes with the expectation that

they would continue to be exempt from land tax. Additionally, a shift to land tax might generate perceptions of unfairness for people who purchased their property recently and paid stamp duty. Compared to longstanding holders of land, recent buyers would not have benefited from the land tax exemption and would face higher effective tax rates on their property over the time of ownership (see Chart C2-4). Therefore, for new land tax payers, transitional mechanisms may have to take into account the time at which properties were purchased. These concerns are ameliorated somewhat by the fact that reducing or abolishing stamp duty is likely to improve the property values of all owners.

Third, transitional mechanisms need to be designed to minimise harmful unintended consequences. If transitional arrangements exempted existing landholders from a tax until they sell, they would create lock-in effects that discourage sales. These should be minimised, recognising that lock-in caused by stamp duty is an important reason for removal of that tax. Further, during the time between announcement and introduction of a significant reform to taxation, there is the potential for significant market disruption. For example, if it were announced that land tax would replace stamp duty from a specific date in the future, people might defer the purchase of property pending the abolition of stamp duty.

Fourth, transitional arrangements that reduce tax burdens to facilitate reform also reduce revenue collections. These lower revenues mean that higher rates of tax must be applied to other tax bases or spending reduced. Some of the revenue cost could potentially be met by reductions in spending that may be less effective at improving housing affordability than tax reform. The overall revenue cost should be balanced, particularly where transitional arrangements over long time periods are concerned.

Transitional mechanisms are most likely to be effective when they reflect agreement between the Australian government and all the State governments. This recognises that the Australian government has access to larger and more efficient tax bases with which to finance revenue shortfalls, and that the reform would deliver significant benefits across the country.

In deciding on an acceptable transition mechanism it would be necessary to strike a balance between revenue cost, complexity of design and the extent of shift in policy. The balance of these different considerations is best made by government at the time any reform is undertaken. Several potential transition approaches are flagged in Box C2-5.

Box C2–5: Potential transition mechanisms for land used for owner-occupied housing

A simple option for facilitating the introduction of land tax on owner-occupied housing would be to levy the tax only on land that had been acquired after a given date, while continuing the exemption for all land held before that time. However, this complete grandfathering approach retains the lock-in effect of stamp duty for existing owners – they would begin to pay land tax only if they move – and would also come at a significant revenue cost.

A more flexible way of managing the transition would be to give purchasers of owner-occupied housing a choice between paying stamp duty or paying land tax, while grandfathering existing landholders. Once a property became liable for land tax it would remain liable. Purchasers who intended to move again soon would probably choose to pay land tax while purchasers who intended to live in the house for many years would probably choose to pay stamp duty. This option would have advantages and disadvantages. It would give purchasers more options. Since home buyers could avoid paying stamp duty up-front, access to housing would be immediately improved. Existing concessions and exemptions from stamp duty could be retained. Where people opt to pay stamp duty, this would reduce the revenue shortfall from the transition to land tax. On the downside, the transition could be very protracted unless some end date were specified.

An alternative approach may involve providing a credit to be used against any future land tax liability. A credit could be based on previous stamp duty paid or on the land tax expected to be paid over a set period of ownership. A full credit could be provided to people who buy between the announcement and introduction of the tax, to prevent people deferring purchases to avoid the tax. The credit would offset their annual land tax liability until it was exhausted. A partial credit – possibly on a sliding scale based on years held – could be provided to people who had paid stamp duty in a specified period before the announcement. A sliding scale would reflect revenue considerations and the fact that the effective tax rate from stamp duty declines with length of holding period. Alternatively, a flat credit irrespective of the length of time owned or amount of previously paid stamp duty could be provided to all existing holders of land for owner-occupied housing. This approach would be simpler to administer and allow longer deferral of land tax liabilities for holders of lower value land. Compared to permanent grandfathering of existing landholders, the use of a credit scheme would bring owner-occupied housing into the tax base sooner and lead to smaller revenue shortfalls.

Finally, a phase-in arrangement could be adopted. For example, the level of stamp duty could annually step down by one-tenth of its current level and the level of land tax could step up by one-tenth of its ultimate level. Under this arrangement, for example, a house sold in the third year would pay 70 per cent of the full stamp duty on the transaction and 30 per cent of the assessed land tax each year for a specified period. This would result in some stamp duty collections occurring in the phase-in period, reducing the fiscal cost compared to complete grandfathering. Limiting the period over which discounted land tax applies, perhaps to 10 years, reflects the fact that the discount will have lock-in effects eventually. After this period, the percentage paid in land tax could gradually phase up to the full rate. Similarly, people who never transact could remain fully exempt for a period, say 15 years, with the tax then gradually phased in, in line with the time periods applied to others. This would provide a measured phase-in over a predictable period and would avoid sudden jumps in liability.

Annex C2: Relationship between the rate of tax on land and a tax on economic rent

The economics of land tax can be analysed using a relatively simple model (adapted from Oates and Schwab 2009).

Assume that the value of land (L) depends on the rental income (r) and an interest rate (ρ) over n years, so that:

$$(1) \quad L = \frac{r}{(1+\rho)} + \frac{r}{(1+\rho)^2} + \frac{r}{(1+\rho)^3} + \dots + \frac{r}{(1+\rho)^n}$$

$$(2) \quad = \sum_{s=1}^n \frac{r}{(1+\rho)^s}$$

Since land does not depreciate with time, it is reasonable to assume that the value depends on the cash flows into infinity so that:

$$(3) \quad L = \frac{r}{\rho}$$

This means that when market interest rates are at 5 per cent, land that returns a rental income of \$30,000 will sell at \$600,000 in the market. Now assume that a tax on land value (t_L) is introduced and because it is broad (and land is in fixed supply), there is no way for the landowner to pass it onto the tenant. The annual rental income to the owner (r) is reduced by $(r - t_L L)$. Substituting this into (3) we find:

$$(4) \quad L = \frac{r}{\rho + t_L}$$

The market value of land has been reduced. For example, a land tax rate of 1 per cent would see the value of land fall to \$500,000; that is, equivalent to the present discounted value of the tax liability of \$100,000. Any new buyer of the land will receive a rental income of \$30,000, out of which a tax of \$5,000 would be due. But because they only paid \$500,000, they still earn an post-tax return equivalent to the market return of 5 per cent (that is \$25,000). The purchaser is effectively compensated for the tax payments by the fall in the price of land.

This model allows the rate of a land value tax (t_L) to be compared against an equivalent tax directly on economic rent (t_r). If the two revenues are equal, then $r t_r = L t_L$ and equation (4) implies:

$$(5) \quad t_r = \frac{t_L}{t_L + \rho}$$

So at a 5 per cent interest rate, a 1 per cent land tax is equivalent to a 17 per cent tax on economic rent.

D — Taxing consumption

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D. Taxing consumption

Key points

Consumption is potentially an efficient and sustainable tax base.

Consumption taxes can be levied directly on individuals by taxing only wages or allowing deductions under income tax for savings, or indirectly by taxing sales of goods and services that individuals buy.

While Australia's main consumption tax – the indirect invoice-credit GST – is an efficient tax relative to most other taxes levied in Australia, its design is complex.

Another means of taxing consumption would be to tax the difference between businesses' cash inflows and outflows (excluding wages from outflows; that is, the value-add of labour would be taxed). So long as the tax remains broad and at a single rate, the efficiency, compliance and administrative costs associated with such a cash flow tax would be significantly lower than with other consumption taxes, including those that States levy and that form a significant part of their revenue base but are particularly inefficient, such as insurance duties.

Over time, such a broad-based cash flow tax could be used to finance the abolition of other taxes, including payroll tax and inefficient State consumption taxes. Such a tax would also provide a sustainable revenue base to finance future spending needs.

For the tax system to support Australia in making the most of the opportunities and meeting the challenges of the 21st century, it needs to raise revenue from efficient and sustainable tax bases. One of the most efficient and sustainable tax bases is consumption. A tax on consumption does not tax the normal return to capital, encouraging investment and saving. From a macroeconomic perspective, consumption is generally less volatile than income or wealth, and therefore provides a more stable revenue source. As the population ages, an indirect broad-based consumption tax is likely to become increasingly important, since it taxes the capital income of retirees as it is spent, which might otherwise largely be untaxed under an income tax.

Australia's goods and services tax (GST) is narrow compared to its potential base, taxing only 57 per cent of consumption – in contrast to the New Zealand GST, which taxes consumption on a comprehensive basis (see Section D2 The goods and services tax). Few, if any, countries have significantly broadened their main consumption tax base after introduction (Heady 2009, p. 21).

Broad-based consumption taxes are efficient

A broad-based consumption tax is one of the most efficient taxes available to governments (OECD 2008b). For a small open economy, investment is likely to be more mobile than consumption, suggesting economic growth is likely to be higher by shifting away from taxes

levied on investment. Further, a single-rate consumption tax does not distort the timing preferences of consumption for individuals. The same tax is paid regardless of whether a person consumes now or in the future, imparting no bias for or against saving.

While consumption taxes are usually levied indirectly on the sale of goods and services, a consumption tax can also be levied as a direct tax. This can be achieved by taxing personal expenditure (that is, exempting income that is saved) or through a pre-paid consumption tax (which taxes only labour income, and exempts earnings from savings).

Nearly all countries pursue consumption taxation through taxes on goods and services. Personal expenditure taxes were implemented briefly in India and Sri Lanka in the 1960s and 1970s (Shome 1995, p. 50), but the worldwide trend since then has been to tax consumption through indirect taxes such as the value added tax (Ebrill 2001, pp. 4–13). There would be few benefits and significant difficulties in implementing a direct consumption tax in Australia (see Box D–1). The rest of this section therefore considers indirect approaches to taxing consumption.

Box D–1: Problems associated with direct consumption taxes

Potential problems with introducing a direct consumption tax include:

- significant vertical and intergenerational shifts in incidence depending on whether the tax applies to consumption only from income earned after the introduction of the tax;
- equity concerns if such a tax replaced the progressive personal income tax;
- economic efficiency costs associated with higher marginal rates of tax on personal incomes, especially if this causes different rates of tax on consumption over a person's lifetime;
- difficulties under pre-paid direct consumption taxes in taxing economic rents. For example, a pre-paid direct consumption tax, such as a broad-based payroll tax, taxes only the returns to labour. If an employee invests their wages and receives a windfall return, this additional economic rent would go untaxed. An indirect tax can capture this economic rent when it is spent on goods and services; and
- loss of revenue integrity. For example, while it could be easy to understate or avoid declaring cash income on a tax return, it is much more difficult to avoid paying tax-inclusive prices on most purchases.

Consumption is a sustainable and stable base

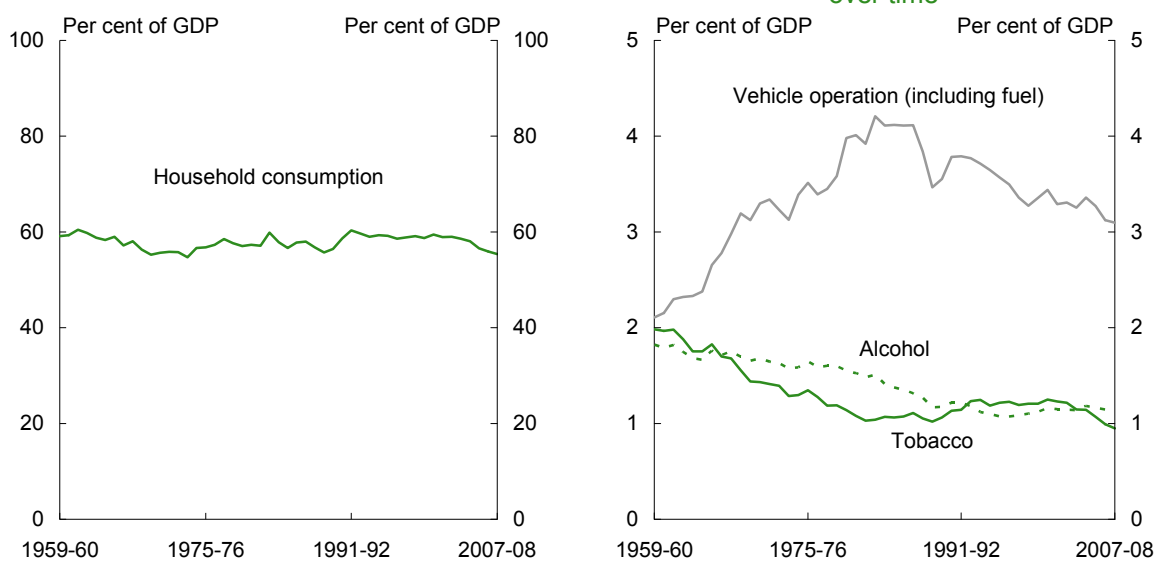
Total household consumption as a percentage of GDP has been relatively stable for a long time (see Chart D–1 Panel A). This suggests that a tax on consumption would provide a relatively sustainable revenue base that grows in line with the broader economy. The GST is slightly less robust because it does not cover the full consumption base. The Productivity Commission (2005, p. T11.5) found that by 2044–45 GST revenues may decline slightly as a share of GDP because tax-exempt consumption such as health care is expected to grow.

This finding highlights the desirability of having a broad-based consumption tax rather than narrower taxes on specific goods and services. Narrower-based taxes — such as those on the consumption of fuel, alcohol and tobacco — are not stable, as expenditures on such goods have not remained stable over time. (Chart D-1 Panel B highlights how specific consumption taxes can be variable.) Underlying changes in consumption of specific goods and services can be influenced by tax, as well as changing consumer preferences, new technology or government policy. Together, these factors can affect the production and consumption of different goods. Taxes on specific products can be used to deliver desired social or market outcomes (see Section E Enhancing social and market outcomes), while the broad-based consumption tax provides a sustainable revenue source.

Chart D-1: Stability of household consumption expenditure shares over time

Panel A: Household consumption over time

Panel B: Expenditure on selected commodities over time



Source: ABS (2009a). Consumption expenditure includes indirect taxes.

A broad-based consumption tax should be part of a fair tax and transfer system

The principal equity objection to a broad-based consumption tax is that it is regressive — that is, households that spend more of their income (typically households at the lower end of the income distribution) pay more tax as a proportion of their income than households that spend less of their income (typically households at the higher end of the income distribution). This appears to contravene the principle of vertical equity — that those with more capacity to pay (here viewed according to income) should pay relatively more tax.

Viewed from the perspective of lifetime consumption opportunities, consumption taxes are less inequitable. In many cases, a person saves in order to consume more at a later point in time. Provided these savings are spent on taxed commodities, their lifetime tax burden is not reduced by virtue of savings in the earlier periods. Their consumption tax is smoothed over a lifetime, rather than concentrated on the years in which it is earned.

Nonetheless, a single-rate consumption tax can play no part in redistributing income to those who consume a greater proportion of their income (that is, typically households at the lower end of the income distribution) from those who consume less (that is, typically households at

the higher end of the income distribution). The transfer system, together with progressive personal taxation, is better suited to this task, and should be the primary means through which the government influences the distribution of income in the economy (see Section A1 Personal income tax).

In part, the transfer system responds automatically to changes in consumption taxes that raise prices, because transfer payments linked to the consumer price index will also rise. However, given that consumption patterns do vary across income groups, some changes to the consumption tax system might require more targeted assistance.

A broad base and single rate of tax is simplest

A consumption tax system designed to minimise compliance and administration costs would probably impose high rates of tax on easily measured goods (such as fuel and tobacco) at easily controlled points (for example, a large factory or a national border). However, to raise an amount of revenue sufficient to sustain revenue needs of the 21st century, the rates of tax needed on such a small number of goods would introduce large biases into production and consumption decisions in the economy.

An efficient, broad-based consumption tax necessarily draws in very large numbers of taxpayers. As such, a premium should be placed on simplicity. A single rate of tax that does not require taxpayers to discriminate between different forms of consumption is likely to be the simplest approach, as well as being highly efficient (see Box D-2: Efficiency and simplicity).

Future directions

Recommendation 55:

Over time, a broad-based cash flow tax — applied on a destination basis — could be used to finance the abolition of other taxes, including payroll tax and inefficient State consumption taxes, such as insurance taxes. Such a tax would also provide a sustainable revenue base to finance future spending needs.

Recent reforms of indirect taxes in Australia have seen the GST replace a number of inefficient indirect taxes, such as the wholesale sales tax, financial institutions duty, debits tax and a range of stamp duties. Australia also has a pre-paid consumption tax levied on a narrow base (payroll tax) as well as a number of narrow-based taxes on particular products (such as insurance duties). Many of the indirect taxes levied by the States apply both to businesses and consumers (such as stamp duty on motor vehicles and insurance).

It would be possible to replace the current narrow state taxes base with a low, single-rate, broad tax on the difference between inflows and outflows of cash (excluding wages; that is, the value-add of labour would be taxed) of businesses. In large part this could simply be added to existing tax reporting obligations of businesses. By exempting business export sales, this tax would apply to the consumption base.¹ By using existing tax reporting

1 That is, goods and services are taxed where they are consumed, not where they are produced.

mechanisms, a new cash flow tax could more readily be based on the automated systems increasingly used by businesses.

A cash flow tax (see Section D1 A cash flow tax) that applies a single rate of tax to the net cash flow position of an entity would perhaps be the simplest possible utilisation of the consumption base, as it does not distinguish between different goods and services, or between different types of taxpayers. Such a cash flow tax could have very low administration and compliance costs if it utilised existing GST systems, such as the business activity statement. One concern is that the cash flow tax does not have the integrity due to the self-enforcement incentives of the invoice-credit method GST (see Section D2 The goods and services tax).

The introduction of a tax on cash flows would be a significant change to Australia's tax system requiring additional analysis and community consultation.

Box D–2: Efficiency and simplicity

To be efficient, the consumption tax base should be spread across most forms of consumption. Provided that decisions about labour supply are independent of purchase decisions, and provided income tax is set efficiently, a single-rate tax on all goods and services is more efficient than different taxes on different commodities (Atkinson & Stiglitz 1976, p. 65). The earlier Ramsey (1927) rule of setting tax rates for products according to their own-price elasticity of demand does not hold when income effects are taken into account, and the price of one commodity affects demand for others (Cnossen 2009).

Corlett and Hague (1953) suggested that the ideal consumption tax would tax all consumption at a single, *ad valorem*, rate. However, in practice not all consumption is derived from goods and services that can be taxed – for example, it is practically impossible to directly tax leisure. In theory this means that a single rate of tax may be less efficient than setting higher tax rates on those goods and services consumed as complements to untaxed goods. In fact, Corlett and Hague first proposed such a tax system for complements to (untaxed) leisure. Another significant untaxed commodity is home production – generally consumption taxes increase the incentive to produce (untaxed) goods and services at home (Sørensen 2009, p. 30).

However, in practice taxing goods or services on the basis of complementarity with leisure would be difficult to implement. This reflects the fact that most goods and services can be used for leisure or work, so to tax consumption only it would be necessary to know what purpose the person purchasing the product intended to use it for. Further, the need to impose multiple rates would cause significant administration and compliance costs. As any efficiency gains from such an approach are likely to be small, in most cases these would be outweighed by compliance costs.

Rather than moving away from a single tax rate, selective subsidies aimed at redressing work disincentives are likely to be more effective. For example, child care subsidies can ameliorate the tax system's incentive to provide child care at home (see Section F4 Child care assistance). Further, additional taxes on specific commodities can still be an effective tool to obtain specific social or market objectives other than revenue-raising.

D1. A cash flow tax

Key points

A simple cash flow tax (CFT) designed to tax private consumption as broadly as possible could be an important element of Australia's tax system into the 21st century.

A CFT could tax the difference between an entity's cash outflows (purchases) and cash inflows (sales). Cash outflows related to labour remuneration would not be deductible. To ensure that the tax fell on consumption in Australia, exports would not be taxed, but imports would be. While financial flows (such as interest payments) would not be included in a simple CFT, they should be taxed through an equivalent tax on the domestic consumption of financial services.

A broad-based CFT at a single rate could replace many other taxes on consumption, while significantly reducing tax compliance costs, particularly for small business. The CFT could also provide a sustainable source of revenue to fund government services, while significantly reducing tax-induced biases to consumption choices.

D1-1 An alternative approach to taxing consumption

A cash flow tax can be a simple way of utilising the consumption base

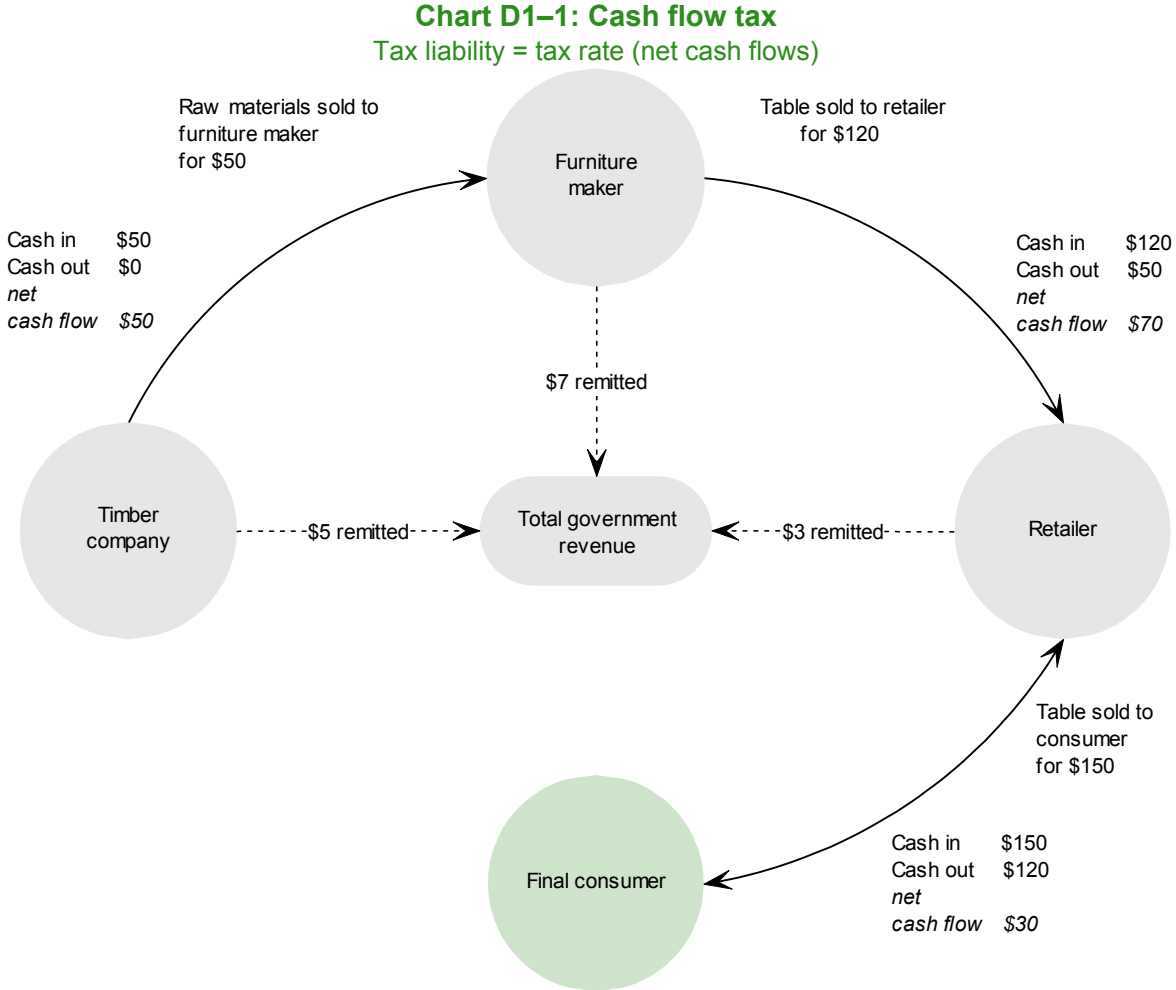
There are a number of ways to impose a consumption tax, including the invoice-credit method (see Section D2 The goods and services tax), the 'additive' method (discussed in Section D4 Taxing financial services) and the 'direct subtraction' method, so called because the tax applies to cash receipts after payments (excluding payments for the labour services of employees) are subtracted.

The invoice-credit method (used for GST) is suitable when tax authorities cannot rely on cash flow financial statements to ensure tax compliance. This could be because of the many exemptions from the tax base, which mean that cash flows from different goods and services require different tax treatments. Under this approach, entities must use a formal tax invoice to substantiate tax liabilities and credits for all goods and services bought and sold, adding to compliance burdens on business. The additive method may be suitable in some cases (for example, financial services), but requires additional calculations, such as deducting a normal return to capital before taxing profit.

The direct subtraction method is the simplest and likely to be the most consistent with the needs of a modern economy, as it can run off standard business cash flow management practices. For example, where the GST relies on concepts such as 'supplies' and 'creditable acquisitions' that have no business meaning, a cash flow tax would rely on cash flow concepts already familiar to business.

The CFT is sometimes called a 'business activity tax' because it focuses on taxing entities, rather than outputs. For example, the United States Treasury (2007, pp. 19–38) has considered a direct subtraction business activity tax to replace business income taxes in the United States.

Unlike the transaction-based GST that taxes goods and services, the CFT is based on accounts. There would be no compliance need to show CFT on invoices, as this would not be needed to support a deduction (or an input tax credit under GST) for other businesses. Rather than adding up tax payable or refundable for each individual sale or acquisition (as necessary for an invoice-credit GST), a taxpayer would apply a single rate of tax to their net cash flow position (see Chart D1–1). The broader the cash flows included in the base, the simpler the tax is for those in the system.



This example shows a 10% CFT rate.

Under the CFT, taxable cash inflows would include inflows such as sales but not revenue from exports, as goods and services consumed outside Australia should not be taxed under an Australian consumption tax. Likewise, imports of goods would be taxed at the border.

Deductible cash outflows would make no distinction between capital and non-capital expenses, but would exclude cash payments related to labour remuneration (as the value of labour, unlike the value of most other inputs, would not have been subject to the tax, ensuring that there would be no bias between in-sourcing and out-sourcing labour).

Similarly, no deduction would be available for imports of services (which cannot be taxed at a border).

Principle

A cash flow tax — using the direct subtraction method — can be a simple way of taxing consumption.

Financial cash flows, such as interest or taxes, would be excluded

The broadest possible consumption tax would include all cash flows, including those related to interest payments and receipts. This is described technically as a ‘real plus financial’, or ‘R+F’, tax base. This would effectively tax the value generated in all sectors of the economy, including businesses that generate revenue by charging interest rather than selling tangible goods or services.

There would be a number of benefits from levying the CFT on an R+F base. First, it would provide a more neutral form of consumption taxation — products that rely more on the value add from financial services would not enjoy a relative price advantage to other products.

While theoretically attractive, imposing an R+F-based tax on existing businesses would affect assets that have already been financed by debt. From the perspective of a lender, interest payments and repayment of principal would become taxable in the hands of the lender after the introduction of the tax but no deduction would have been provided for the original loan. To avoid this, complex transitional arrangements would be necessary and these would severely undermine the simplicity of a CFT. This problem would be widespread as nearly all entities engage in at least some purely financial transactions during their business lifecycle.

However, as most value in the economy is generated from the production of non-financial goods and services, this problem can be avoided without significantly undermining the tax base. The solution could lie in what is known as a ‘real’ or ‘R base’ cash flow tax, which involves removing cash flows associated with financial services from the taxable base. While an R base would not be as comprehensive as an R+F base, and requires a distinction to be drawn between (untaxed) financial and (taxed) non-financial cash flows, it is nevertheless an appropriate base with which to tax the non-financial sector, particularly as most of the value add in an economy can be effectively taxed by restricting the CFT to non-financial cash flows. The sale and purchase of most goods and services would be included, but payments of principal or interest would not.

To ensure a broad and neutral consumption tax base, the value add of those sectors of the economy that could not be captured using an R base cash flow tax should instead be taxed using an equivalent tax specific to financial services. Three models for taxing the consumption of financial services are outlined in Section D4 Taxing financial services.

Cash flows relating to other taxes — for example, company tax — would not be included in an R base cash flow tax, as they are financial flows. Instead, a CFT liability would be deductible for income tax, while a CFT refund would be assessable income.

Treatment of negative cash flows

If an entity’s cash outlays exceeded its cash receipts, it would be in a negative net cash flow position. In this case, a cash refund should be provided. The effect of providing an immediate refund is to exempt the normal return to capital from tax (see Box D1-1), thereby ensuring that the tax only falls on consumption.

This introduces a potential revenue risk, as the government would be required to make cash payments to businesses that claim to be in a net refund position. The GST already operates on this basis, as input tax credits are refundable. However, unlike the GST, a claim for a refund under the CFT need not be supported by a tax invoice issued by a third party (although evidence of payments would still be needed).

Box D1-1: A cash flow tax does not tax the normal return to capital

The normal return to capital can be thought of as that part of the return from an investment that compensates the investor for loss of purchasing power (inflation) and for deferring consumption (‘the return to waiting’). In the absence of risk, a proxy for the normal return would be the risk-free interest rate.

The value of an investment is equal to the present value of the cash flows it is expected to generate. In the case of a risk-free marginal investment — that is, one that is expected only to generate a normal return — the value of the asset would be equal to the future cash flows of the asset discounted at the risk-free interest rate.

For example, if the risk-free interest rate were 5 per cent, an asset that generated cash flows of \$4,600, \$4,400 and \$4,200 in years 1, 2 and 3 respectively would be worth \$12,000.

If the investment were immediately expensed, as occurs under a cash flow tax, it would give rise to a negative tax liability (or tax refund) at the time of purchase. Where that investment generated future cash flows that were not reinvested, those cash flows would generate future tax liabilities. In net present value terms, no tax would be imposed on this investment.

	Year 0	Year 1	Year 2	Year 3
	\$	\$	\$	\$
Cash receipts		4600	4400	4200
Cash outlays	(12,000)			
Net cash flow position	(12,000)	4,600	4,400	4,200
Tax due/(refundable) at 5 per cent	(600)	230	220	210
Present value of tax due/(refundable)	(600)	219	200	181
Net tax paid on this investment (in present value terms)	0			

If the cost of purchasing this investment were immediately expensed, it would give rise to a tax benefit at the time of purchase. Where that investment generated future cash flows that were not reinvested, taxes would be imposed on those cash flows. Overall, over the life of the investment, the effect of providing a tax benefit would be that the normal return to capital would not be taxed. That is, only above-normal returns would be taxed.

Because cash outlays on capital expenditure would be immediately deductible in full, new or growing businesses would likely be in a tax loss position in the early years, with tax

liabilities arising in later years (when the business becomes profitable). They would receive an initial refund on their negative cash flow, but when they generate positive cash flows in later years they would incur a CFT liability. This is similar in effect to the government sharing the risks in the business by taking a position equivalent to a silent equity partner.

Businesses that export a significant proportion of what they produce would be expected to have a negative net cash flow for the purpose of CFT, as export sales (goods or services consumed outside Australia) would be excluded from the tax base. This means that exporters would be in a net refund position. However, this revenue loss would be balanced by taxing imports (foreign goods or services consumed inside Australia) under the CFT.

Similarly, as the CFT would exclude financial flows, businesses that provide predominantly financial services, but purchase real goods and services, would be in a net refund position under a CFT. However, coverage of the financial sector through a financial services tax (see Section D4 Taxing financial services) would ensure that the domestic consumption of financial services would still be taxed on an equivalent basis.

D1–2 A CFT could be simpler for small business

By avoiding complex exemptions and special rules, a CFT could be radically simpler than existing consumption taxes, while also improving the efficiency of the tax system. Indeed, in a similar way to individuals being able to have personal income tax returns pre-filled and sent to them as a default (see Section G4 Client experience of the tax and transfer system), a single-rate, broad-based CFT provides the opportunity for many businesses to significantly reduce their compliance costs. A CFT could be reported through a simpler business activity statement using fewer labels than the statement used for the GST.

Relying on the natural systems of businesses, such as financial or payroll systems, can reduce compliance costs (see Section G4 Client experience of the tax and transfer system). With the CFT, companies or sole traders with very simple tax affairs might use a bank account to have their CFT liability calculated automatically (see Box D1–2).

Box D1–2: Automatic tax accounts

A simple business without export flows or complex financial transactions might choose to run all their business transactions through a single ‘automatic tax account’. This service might be offered by their bank, which could automatically calculate net cash flows (excluding financial flows and payroll costs). Some banks might offer to report this liability electronically to the ATO, eliminating the need for the business to provide separate returns for the CFT.

This leaves more time for running a business, and less time to worry about tax. A similar idea was recently canvassed for tax reform in the United States (President’s Advisory Panel on Federal Tax Reform 2005, pp. 126–128).

D1–3 A sustainable tax base

The long-term sustainability and simplicity of an efficient consumption tax depends on its design and structure. The tax needs to be robust to short-term pressures to make changes to pursue other policy objectives. To be sustainable, a comprehensive broad-based tax should remain simple over time.

The current GST system achieves stability of the tax base by requiring unanimous agreement between the Australian government and the States before any changes can be made to the base or rate of GST. However, while this administrative arrangement has been effective in protecting the GST tax base, it makes it difficult to make improvements to the GST, as any government has an effective veto.

A direct subtraction method tax would not require the same institutional arrangement as a GST. Because net cash flows, rather than individual goods and services, would be taxed, there would be no need for the GST's system of invoices to enforce different tax treatments for different goods or services. The direct subtraction method would allow specific entities — such as very small businesses — to be removed from the system entirely, without making the system more complicated for those entities that remain (given that the tax makes no distinction between cash flows to or from 'registered' or 'unregistered' entities).

Finding

A destination-based cash flow tax, calculated on a direct subtraction basis, could be an efficient, simple and sustainable method of taxing domestic consumption.

D2. The goods and services tax

Key points

The GST is Australia’s principal consumption tax. To improve the operation of the GST there might be opportunities to make greater use of GST-free or reverse charging treatment for some business-to-business transactions. However, cases where the benefits outweigh the additional complexity are likely to be few, given the existing GST base and the GST’s invoice-credit architecture.

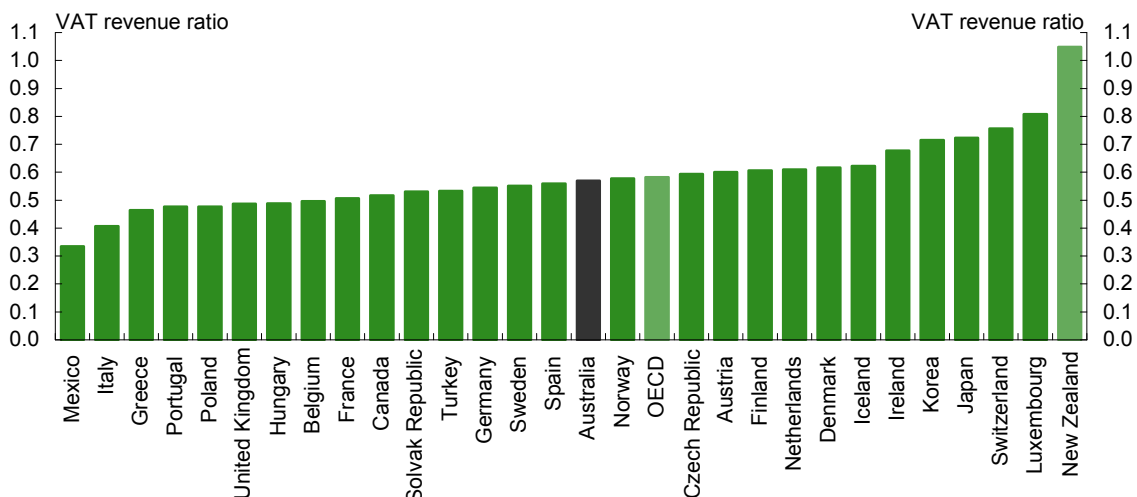
D2–1 The current GST can be complex and costly

The breadth of Australia’s GST base is around the OECD average

The goods and services tax (GST), adopted in 2000, is a type of value added tax (VAT). A VAT taxes a business’s sales, but refunds tax paid on their purchases. Consumers, who do not receive a refund, therefore bear the burden of the tax. In this way, the VAT is a type of consumption tax.

The Asprey Committee (1975) proposed a VAT to replace the wholesale sales tax and extend the consumption tax base to services. This followed European practice from the 1960s and 1970s, where VATs replaced inefficient taxes on business turnover and narrow sales taxes (Ebrill et al. 2001, p. 6). Except in the case of New Zealand’s GST, VATs around the world do not tax the consumption base on a comprehensive basis (see Chart D2–1).

Chart D2–1: VAT revenue ratio, 2005^(a)



(a) Unweighted average used for OECD. The VAT revenue ratio = (VAT or GST revenue)/([consumption (including government consumption) — VAT or GST revenue] x standard VAT or GST rate). An ‘ideal’ value added tax, which would apply at a single rate on all domestic consumption, would have a VAT revenue ratio of 1. A VAT revenue ratio above 1 can reflect investment in residential housing that is taxed on a prepaid basis (and rents are input taxed) but is not included in national accounts as consumption, or cascading effects of input taxation in the value chain.

Source: OECD (2008a).

New Zealand's GST has approached full coverage of the consumption tax base. New Zealand does this by taxing almost all goods and services, including public services. There are very few exemptions, and only for technical reasons. Australia's GST base is close to the OECD average, raising revenue from little more than half of the consumption base (see Chart D2-1).

A narrower GST does not mean it is fairer, but adds complexity

Income redistribution to make Australia fairer is primarily the job of the personal income tax and transfer system (see Section A1 Personal income tax). This means that other taxes and charges can be used in the most efficient way, reducing the overall complexity of the system. It is very difficult to target GST exemptions on some products to certain groups.

For example, while the proportion of income spent on GST-free food does fall with income, absolute actual expenditure on GST-free food is almost six times greater for the highest than the lowest income groups. Among food categories, expenditure only on powdered milk, canned meat and offal actually falls with income (ABS 2005). As a result, more than one-third of the \$5 billion exemption for GST-free food (Australian Government 2009, p. 205) benefits households in the highest 20 per cent of the income distribution. These sorts of exemptions add significantly to the complexity of the GST.

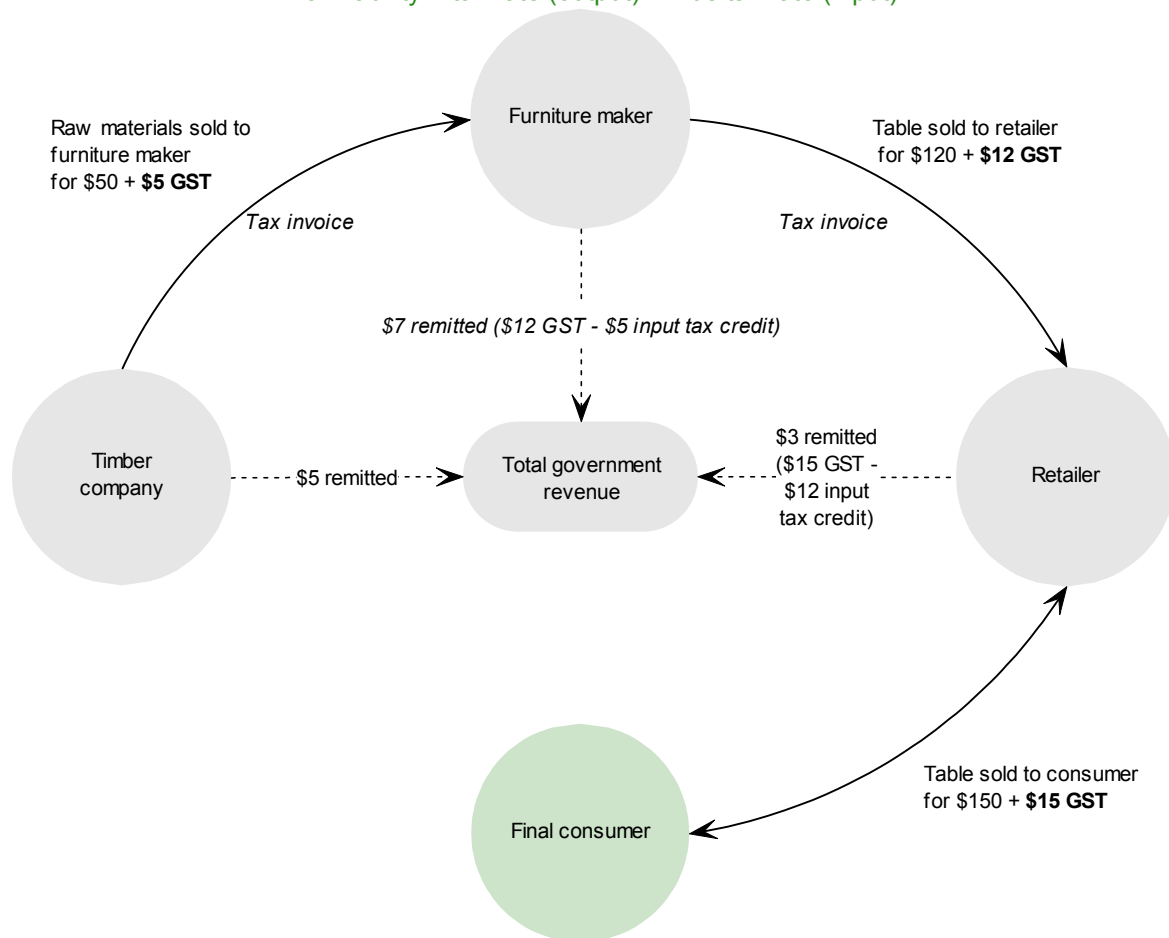
The invoice-credit method has compliance benefits but costs as well

An individual sale or purchase of a commodity can be 'taxable' (that is, tax is payable on the sale of taxable goods, and tax paid previously in the supply chain is refunded), 'GST-free' (that is, tax is not payable on the sale of GST-free goods, and tax paid previously in the supply chain is refunded) or 'input taxed' (that is, no tax is payable on the supply of input-taxed goods, but the tax previously paid in the supply chain is not refunded).

The need to determine the tax status of each sale or purchase requires the use of tax invoices to provide evidence of liability to GST or eligibility for a refund. The 'invoice-credit method' (illustrated in Chart D2-2) attributes a tax liability (for sales), or an input tax credit (for purchases) to individual transactions, for which a 'tax invoice' must be generated. The net amount is remitted to the Australian Tax Office (ATO).

Chart D2–2: Invoice-credit method consumption tax

Tax liability = tax rate (output) minus tax rate (input)



There is an argument that tax invoices make the GST ‘self-enforcing’, as a business purchaser of a taxed good or service requires a valid tax invoice from their supplier in order to receive an input tax credit. While this imposes an additional compliance burden for taxpayers, it creates an additional audit trail for the ATO.

However, the inherent compliance benefits of an invoice-credit method should not be overstated. While business consumers have an incentive to ask for a tax invoice, consumers have no need for a tax invoice, as they cannot claim a tax credit. As such, tax collected at the final retail stage is not self-enforcing. Moreover, the existence of a tax invoice may assist but does not in itself ensure compliance. A false tax invoice might be used to make a claim for a credit. A missing or absent tax invoice may be used to understate sales.

In addition, the widespread use of tax invoices as a basis of systematic cross-checking between tax paid and tax claimed, while simple in concept, is costly in practice (see Box D2-1). The ATO’s compliance program is built largely on voluntary compliance, with targeted audit activity in response to emerging risks, rather than auditing millions of routine transactions.

Box D2–1: Cross-checking invoices in practice — South Korea

South Korea introduced its invoice-credit VAT in 1977. To ensure compliance, taxpayers were required to send copies of each tax invoice to the tax authority's central computer centre for cross-checking.

These cross-checking programs reduced the number of cases where matching sales and purchase invoices could not be found, although many of the remaining cases resulted from transcription errors rather than fraud. However, the cross-checking program was cancelled after the resources costs for administrator, and the compliance costs for taxpayers, were found to outweigh the benefits.

Adapted from Ebrill et al. 2001, p. 150.

GST compliance can be costly ...

The costs incurred by business in complying with the GST arise from registration requirements, issuing tax invoices, distinguishing between different types of supplies, reporting and remitting GST to the ATO, computing and software requirements, record keeping and auditing, understanding the GST law, and impacts on cash flow.

The Board of Taxation (2007, p. 112) has highlighted GST-specific compliance issues in the course of its review of small business tax compliance costs. It found that working out exemptions and concessions is a confusing and time-consuming task. Small businesses also find it difficult to classify supplies into taxable, GST-free and input-taxed items for tax purposes, and into capital and non-capital items for the business activity statement (BAS).

The requirement to receive and retain all tax invoices for five years is also costly. In addition, the not-for-profit sector, comprising around 700,000 organisations, can incur significant compliance costs associated with the GST. While the sector receives GST concessions, compliance with the regime is reportedly difficult, at least partly because of the regular use of untrained volunteers for administration.

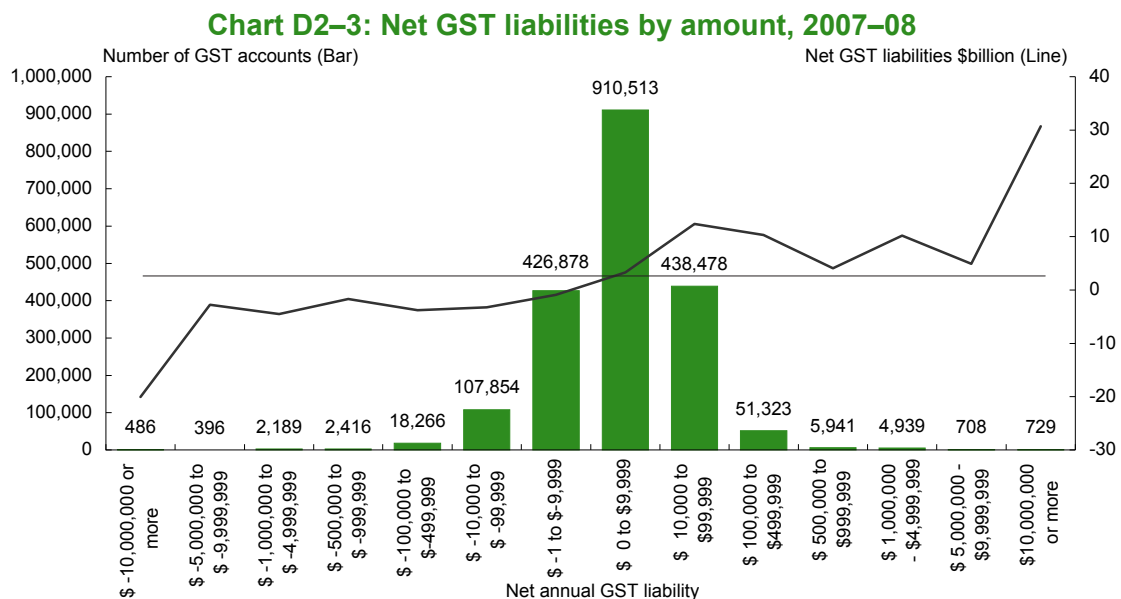
There has been no comprehensive quantitative study of GST compliance costs in Australia. A study of compliance costs in the UK suggests that VAT compliance costs decrease as a proportion of sales as sales increase, with compliance costs ranging from 0.003 per cent of taxable sales for large businesses to almost 2 per cent for small businesses (Sandford et al. 1989, p. 116). Estimates of compliance costs under a VAT system as reported by the United States Government Accountability Office (2008, p. 16) suggest that small business with sales under \$50,000 face a cost of compliance of 2 per cent of annual sales, compared with 0.04 per cent for businesses with sales over \$1 million.²

Compliance costs increase when different supplies are given different tax treatments. While most supplies are taxable, some supplies are GST-free, or input-taxed.

2 These figures are based on studies of New Zealand, Canada and the United Kingdom.

... especially for small business

In 2007–08, approximately 2.6 million entities were registered for GST, of which nearly two million lodged a BAS. More than half a million taxpayers were in a net refund position. Of those taxpayers that had a net GST liability, less than one thousand were responsible for 40 per cent of ATO GST liabilities. Almost one million taxpayers had a positive GST liability of less than \$10,000 (see Chart D2–3). This suggests that a large number of very small businesses bear the compliance costs of the GST while contributing very little to overall revenue collection.



Source: ATO 2009.

While businesses with an annual turnover below \$75,000 and non-profit organisations with a turnover below \$150,000 are not required to register, many are still voluntarily registered. In 2007–08 around half GST registrations were voluntary. This could be due to pressure from their business customers to register so they correspond with their customers' accounting systems and allow their customers to claim input tax credits.

Moreover, once a business has registered for the GST, there is often little incentive to deregister. Deregistration can be complicated, requiring a range of adjustments in relation to previously claimed input tax credits.

The take-up of a range of optional small business concessions has been very low. For example, in 2007 only 2 per cent of eligible small business (roughly 2,400 out of 110,000) used a simplified accounting method to calculate GST (Board of Taxation 2008, p. 50). This suggests that the perceived benefits of some concessions are not great.

Findings

Complying with the GST is costly for many businesses – particularly small businesses. Much of this complexity is structural, and flows from differential tax treatment of different goods and services. The smallest businesses can be under pressure to be in the GST system.

D2–2 Alleviating compliance costs on some transactions

Treat some business-to-business transactions as if they were GST-free?

One approach to reducing business compliance costs within the existing GST system would be to allow more transactions between two registered entities to be treated as if they were GST-free. It would be necessary to target those areas where the compliance benefits of providing this treatment outweigh the additional complexity of introducing yet another treatment.

This approach would not require significant changes to existing accounting systems but would treat more supplies as if they were GST-free. It would avoid some of the cash flow costs associated with the GST — that is, additional finance would not be needed to pay the GST-inclusive price, only to have the GST component subsequently returned as an input tax credit. The impact on cash flow could be particularly beneficial for acquisitions of large one-off capital items.

Some supplies are input-taxed. A business acquiring goods or services that are input-taxed receives no credit for the embedded tax. This means that the tax ‘cascades’ through the supply chain, introduces biases into production decisions and ultimately results in higher prices for business consumers and exports. The ability to treat some ‘input-taxed’ supplies as if they were GST-free for business might reduce this bias, although it would increase complexity, and would require alternative arrangements to ensure that the household consumption is taxed (see, for example, Section D4 Taxing financial services).

Greater use of GST-free treatment would involve an increased risk to revenue, as more revenue would be collected at the final sale, at which point consumers have little incentive to demand a tax invoice. In addition, the benefits would need to be weighed against the additional complexity that would arise from introducing further classifications into the GST system.

Use reverse charging more widely?

An alternative proposal would be to allow businesses to agree to reverse charge a greater number of transactions (see Box D2–2). Reverse charging is currently used to tax some imported services. Making greater use of reverse charging would have cash flow benefits for the purchasing business. However, the reverse charge approach would not remove the compliance costs associated with identifying business-to-business transactions.

Reverse charging would be similar in effect to a retail sales tax, as some transactions within the supply chain would be excluded from GST, provided that the recipient is registered for GST.

Box D2–2: Reverse charging

Under a reverse charge mechanism, the recipient of a supply is responsible for remitting GST that would otherwise be remitted by the supplier. The recipient is also entitled to claim input tax credits where it has made a creditable acquisition. Thus at the time of acquisition the recipient will be liable to remit the GST and will be entitled to claim input tax credits. The two amounts, generally, would exactly offset one another, while maintaining the normal GST revenue result. The amount of GST charged is 10 per cent of the GST-exclusive price of the taxable supply.

Under the existing Australian system, reverse charging is limited to supplies made by non-residents. Practical difficulties in remitting GST may arise where the non-resident does not have a presence in Australia. To overcome this, the non-resident supplier and the Australian recipient may, subject to certain conditions, agree that the GST on the supply should be paid by the recipient rather than the supplier. In addition, a compulsory reverse charge regime operates for some non-resident supplies of services.

The non-resident supplier is not required to issue a tax invoice and the recipient is not required to hold a tax invoice in order to claim an input tax credit. The reverse charging arrangements are intended to reduce compliance costs for non-residents.

This approach might reduce some compliance costs associated with the current GST system. It also reduces the risk to revenue of paying input tax credits where no GST has been paid. Such an approach would shift the cash flow benefits that some suppliers currently enjoy (that is, collecting GST before it is due to be paid to the ATO) to the purchasing business. This would be of particular benefit in relation to large, infrequent transactions. However, it might disadvantage others, such as primary producers, who currently receive payment for their supplies before they are liable to pay GST.

While widespread entitlement to GST-free or reverse charging transactions runs the risk of raising compliance costs and increasing revenue risks, the benefits might outweigh these risks in particular, confined circumstances. A more detailed investigation would be necessary before either strategy could be adopted.

Recommendation 56:

The government should consider making greater use of GST-free business-to-business transactions or reverse charging, provided the potential compliance cost savings outweigh the additional complexity costs and risks to revenue.

Keep excise-inclusive prices in the GST base

GST is charged at 10 per cent on taxable goods and services. In the case of excisable goods such as petrol, beer, spirits and tobacco, GST is imposed on the market price, after the imposition of excise. This leads to a 'tax on tax' situation.

Removing this 'tax on tax' would narrow the consumption tax base, reducing overall efficiency by shifting relative prices between taxed and untaxed commodities. It would further increase the costs of complying with the GST, both for businesses that supply

excisable goods and for those who purchase them. For example, if fuel excise were removed from the GST calculation, a business user of petrol would not be entitled to an input tax credit for that proportion of the price that is attributable to excise.

If a tax on specific product is used to set a price to consumers that reflects wider costs of consumption or production (as recommended in Section E Enhancing social and market outcomes), this price should be subject to GST to ensure equivalent treatment with other prices in the economy.

Finding

Excise-inclusive prices are properly included in the GST base. Charging GST only on the 'excise-exclusive' value of goods or services would add significantly to the complexity of the GST, and reduce its efficiency.

D3. Payroll tax

Key points

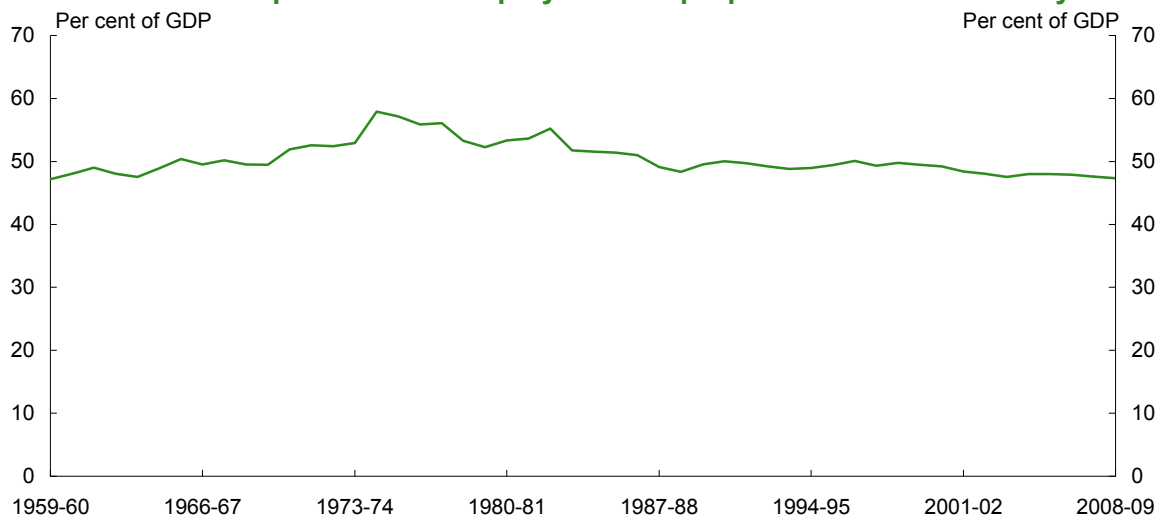
Existing payroll taxes are more complex and less efficient than they could be because of tax-free thresholds and other exemptions.

A broad-based consumption tax, such as a cash flow tax, would tax returns from labour and would provide additional revenue, providing scope to remove current payroll taxes.

D3–1 Taxing labour income

Labour income (effectively the value-added from working) is the most important tax base for developed countries (see Section A1–2 Income from work and deductions). In Australia, employee compensation (which is the largest part of labour income) has accounted for around half of gross domestic product (GDP) for the past 50 years (see Chart D3–1).

Chart D3–1: Compensation of employees as a proportion of GDP over 50 years



Source: ABS (2009a).

Because payroll taxes are generally levied on all components of employee remuneration, they are designed to tax the value-added from labour. As such, payroll taxes are similar to the labour component of Australia's personal income tax as well as the goods and services tax — they all generate revenue by reducing the real return from working.

Labour is relatively immobile, but high tax rates can deter certain people from participating in the labour market. Therefore taxes on labour income can be relatively efficient. Australia's future tax system will need to raise significant revenues from the value-added by labour. However, as Sections A1–2 Income from work and deductions and D Taxing consumption show, this value-added can be taxed in many ways.

Who bears the burden of payroll tax?

While businesses are legally responsible for remitting payroll tax, in the long run they are unlikely to bear the burden of the tax (in terms of returns to capital).

In the short run, the situation is not always as clear. Businesses demand labour so they can produce goods and services (to earn a return on capital), while workers supply labour in return for wage income. Who bears the burden of a rise in the payroll tax rate will depend on which factor (capital or labour) is relatively 'inelastic' — that is, which one has fewer options for avoiding the tax.

Different businesses will be in different situations. For example, an increase in payroll tax rates may not feed through to lower wages until wages can be renegotiated. In the short run, businesses can bear some of the burden (or receive some of the benefit) from changes to payroll tax, and many say they do (see Box D3-1).

Box D3-1: Why do businesses feel the burden of payroll tax?

Businesses often lobby governments to lower payroll tax rates or increase exemption thresholds. Why do they do this if payroll tax is actually paid by labour in the long run?

Some businesses may believe they bear the burden of payroll tax simply because they are the ones with the legal liability to remit the tax and are able to observe the compliance costs they incur. However, others may be seeking the short-term profits from payroll tax relief caused by markets taking time to adjust and shift the benefit to labour.

Exemptions have an unpredictable impact on the market. Due to the threshold exemption, for example, a taxpaying firm may be in competition with exempt firms. Each type of firm will have a different cost structure (for example, the taxpaying firms might employ more capital equipment relative to labour). When a growing business in that sector enters the payroll tax system for the first time, it may need time to adjust its cost structure and is likely to make lower profits in the short run.

The opposite may happen if the tax-free threshold rises, taking a small number of competitors out of the tax net, and giving them the chance to make additional profits in the short run. That is, if there is an unanticipated cut in the rate of payroll tax, businesses are likely to enjoy additional profits briefly until competition causes prices to fall or wages to rise.

These effects may lead businesses to conclude that they bear the burden of the tax. While not considering the timeframe issues, Carling (2008, p. 6) takes a similar view, stating that 'even though most of the economic incidence of payroll tax may not fall on employers, the illusion that it does may be so strong that it actually influences business behaviour'.

For example, a business might prefer to locate in a jurisdiction with lower payroll taxes believing this will increase the return to its capital, even if in the long run this actually results in paying employees higher wages.

The 'short run' is an imprecise concept; generally defined as the period during which capital is fixed in its current use. For example, if a business thinks that demand for its product has fallen, it may continue to produce in the short run because it is expensive to move or re-tool

the existing machinery. For a capital-intensive manufacturer, then, the short run may be more than a year. For more labour-intensive industries such as house building most machinery is rented, rather than owned, and labour can be adjusted rapidly in response to demand. For these businesses, the short run may be only a few months.

In the long run, investment will flow elsewhere and any plant or equipment will be sold. Capital is very mobile across Australia and the world, whereas workers are less mobile. As a result, a payroll tax reduces the demand for labour, lowering wages to the point where the return on capital is again equal to the world level. Capital owners such as shareholders and lenders will seek higher returns by locating their investment elsewhere. So, while a business may relocate or shut down to avoid the tax, the underlying capital invested in that business will be applied elsewhere in order to earn the prevailing after-tax return. In the long run, the supply of capital is likely to be significantly more responsive (that is, 'elastic') to the effects of a payroll tax than labour. This means that labour tends to bear the burden of such taxes rather than capital owners (Freebairn 2009; IPART 2008; Carling 2008; Ryan 1995). In the long run, payroll tax therefore has a very similar effect to the labour component of personal income tax.

There is one more significant effect of payroll tax — it is likely that *all* workers, not just those in businesses remitting payroll tax, bear the tax burden through lower wages (Freebairn 2009). In the long run, businesses will pass the burden of payroll tax onto workers, so some workers are likely to leave businesses that remit payroll tax and seek higher wages in businesses that do not. The influx of workers trying to get jobs in the exempt sector means that such businesses will not have to pay as much to attract workers. This means that workers in untaxed businesses receive lower incomes than they would have otherwise, effectively sharing the payroll tax burden (see Box D3-2).

In effect, the narrow-based payroll tax is a tax on all workers, but one that is levied in a very inefficient way because it pushes into the untaxed sector some workers who would be more productive in the taxed sector. This implies a decline in average labour productivity, reducing national income.

Box D3–2: A payroll tax on some firms can affect workers in all firms (continued)

In the short run, wages may be inflexible and large business may have sunk costs that make it costly to reduce wages or withdraw capital. But in the long run, as capital is mobile, large business fully shifts the burden of the tax to workers in the form of lower wages, and the existing LB–E0 workers in the large business sector will have their wages reduced from W_0 to W (tax). As wages in the (untaxed) small business sector are still at W_0 , the prospect of higher wages will entice some large business workers to move to the small business sector. As this movement happens, wages in both sectors converge to W_1 and employment in small businesses increases from SB–E0 to SB–E1, while employment in large businesses falls from LB–E0 to LB–E1.

There are two main results from this analysis:

- A narrow-based payroll tax (imposed only on certain employers) will reduce wages for *all* workers in the economy.
- The imposition of a narrow-based payroll tax changes the composition of employment, moving some workers away from jobs where they would be more productive (in the absence of the tax).

Principles

In the long run, the burden of a stable labour income tax, such as payroll tax, is likely to fall on workers rather than on capital.

In the short run, however, an unexpected increase (decrease) in the payroll tax burden might be borne partly by the owners of capital through lower (higher) returns.

The burden of a relatively narrow-based labour income tax, such as the current State payroll taxes, is likely to be shared between workers in the taxed and non-taxed sectors. This also means that some workers are not working in their most productive jobs, with the result that overall labour force productivity is reduced.

D3–2 Current payroll taxes are complex and narrow-based

Payroll tax is levied by all States on businesses with payrolls above certain thresholds. Payroll tax was originally introduced by the Federal Government in 1941 to fund child endowment. Since the Australian government passed control of the payroll tax to the States in 1971, every State has used this tax to meet a significant part of its revenue requirements. In 2009–10, the States expect to collect \$16.8 billion in payroll taxes, representing around 32 per cent of their own-source tax revenues.

The existing State payroll taxes are not as broad-based as they could be. Existing payroll taxes in all States include three major exemption categories (there are differences in the detail between States), including:

- threshold exemptions — these exclude businesses whose total Australian payroll is less than a certain threshold;

- activity exemptions — these exclude businesses according to their dominant activity (for example, charities, non-profit hospitals, local councils and the Australian government); and
- payment exemptions — these exclude the wages of people in certain circumstances, such as payments for maternity leave and payments made to apprentices.

Each State has a different threshold exemption as well as a different tax rate (see Table D3-1).

Table D3-1: Current payroll tax rates, thresholds and revenue estimates for 2009-10

State	New South Wales	Victoria	Queensland (a)	South Australia	Western Australia	Tasmania	Northern Territory	Australian Capital Territory
Rate	5.75%	4.95%	4.75%	4.95%	5.5%	6.1%	5.9%	6.85%
Threshold	\$638,000	\$550,000	\$1 million	\$600,000	\$750,000	\$1.01 million	\$1.25 million	\$1.5 million
Revenue	\$6,172	\$4,074	\$2,736	\$915	\$2,216	\$257	\$157	\$267

(a) Queensland differs in that it does not provide a deduction equal to the threshold for all taxpayers. Instead it 'claws back' the threshold on payrolls between \$1 million and \$5 million. Above \$5 million there is no deduction in Queensland.

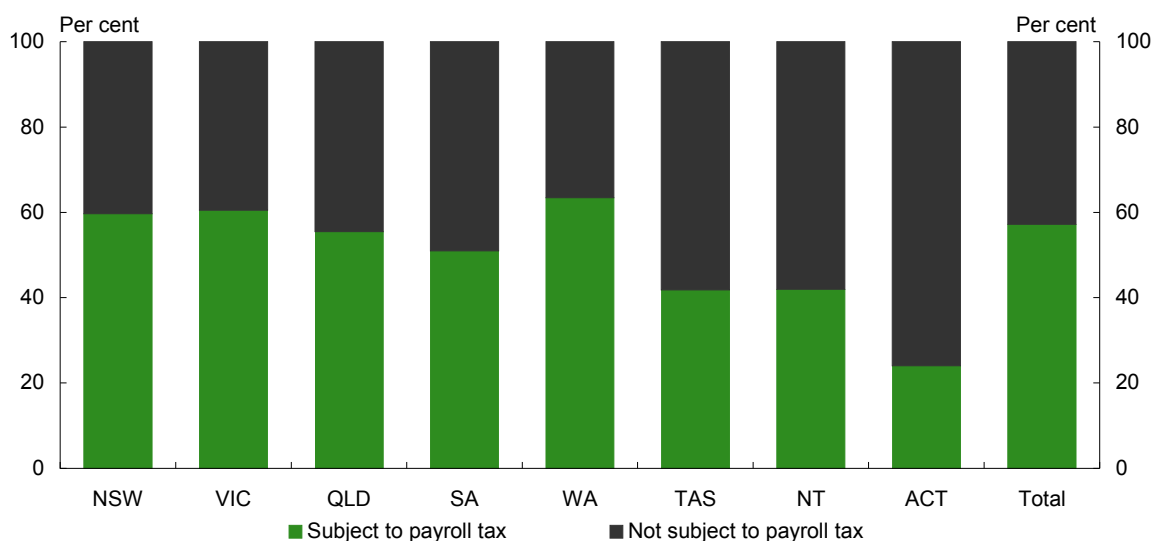
Source: State revenue offices, State budget papers (mid-year update for Qld and Vic). Rates and thresholds are as at 1 July 2009.

Arguably, the threshold exemptions operate as a barrier to business growth as the compliance and payroll tax costs provide an incentive to remain small.

The overall effect of the exemptions is that a significant proportion of employee remuneration is not subject to the tax. A comparison of current payroll tax revenues with the amount that would be collected at current rates from its theoretical base — represented by the national accounts measure of compensation of employees — suggests that around 43 per cent of employee compensation is exempt (see Chart D3-3).

State government tax expenditure data suggest that the threshold exemptions explain most of the difference between theoretical and actual payroll tax collections. This exemption reduces the efficiency of payroll tax revenue, as it distorts labour use away from its highest value use (see Box D3-2). A narrower tax base also means the tax rate has to be higher to raise a given amount of revenue.

Chart D3-3: Exemptions from theoretical payroll tax base, 2008-09



Source: Treasury estimates.

The threshold exempts most businesses from being liable for payroll tax. For example, the current NSW threshold (which is lower than most other States) exempts around 91 per cent of NSW businesses from payroll tax (IPART 2008). State government departments are generally liable for payroll tax.

Payroll tax is particularly complex across State borders

Employers face a number of complexities in complying with their payroll tax obligations.

The definition of wages for payroll tax purposes differs from that for income tax and workers' compensation.

Exempt employers must ensure they remain eligible for the exemption activity. Employers must continually identify the instances where an employee's wage, in whole or part, becomes exempt or ceases to be exempt, and move those wages into, or out of, the payroll tax calculation as required.

Businesses close to the threshold are likely to have to calculate their payroll amounts regularly to determine whether or not they have a liability to register for payroll tax.

Threshold exemptions require complex grouping rules that deem related entities to be one business for the purposes of the threshold. These rules are necessary to prevent businesses from taking advantage of the threshold by artificially splitting up their operations into a number of smaller entities.

When payroll tax became an own-source of revenue for the States, payroll taxpayers operating in more than one State were required to submit regular (usually monthly) payroll tax returns and payments to each State in which they employed people. With business increasingly operating on a national and global basis, around half of payroll taxpayers now employ in more than one State.

To prevent business from receiving a full threshold deduction in each State, the threshold deduction is applied in respect of the employer's total Australian wages, but the liability is calculated in respect of the wages paid to workers employed in that State.

Where an employee works in more than one State there are complex rules for determining which State receives the payroll tax.

In 1971 the States enacted uniform payroll tax legislation with a uniform tax rate of 2.5 per cent. Over the following years, that uniformity was gradually eroded as States changed their tax rates and thresholds, extended the base to include other forms of remuneration, introduced anti-avoidance measures and enacted specific exemptions and rebates in response to local revenue and taxation issues. Recently, through the Council of Australian Governments' 'national seamless economy' initiative, all jurisdictions have taken steps to harmonise their payroll tax legislation, which has resulted in harmonised legislation in most States. However, States still differ on the basis of thresholds and rates.

Many submissions to the Review have highlighted how the compliance costs for businesses with employees in several States are higher than necessary due to these complexities.

Apart from the impact on employers, the duplication of revenue authority infrastructure, including administration, compliance staff and IT systems, increases the administration costs of Australia's tax system.

Finding

Exemptions in the payroll tax base introduce biases into the allocation of labour across the economy and lead to complexity in administration and compliance, particularly when the exemptions differ (even slightly) between States.

Reform of payroll tax has been mixed across States

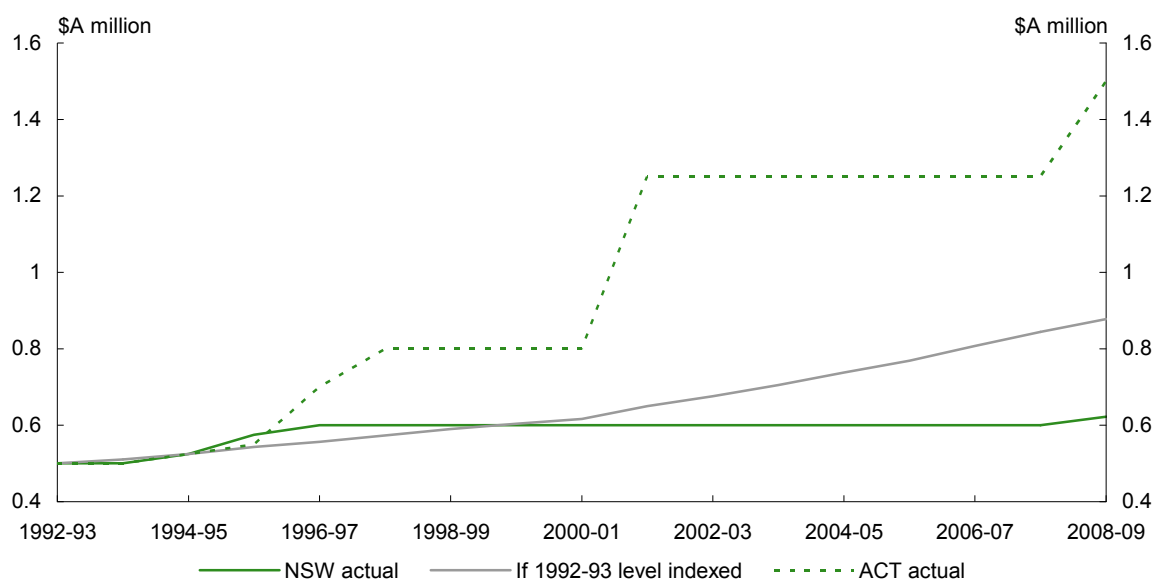
Aggregate labour income as a percentage of GDP has been relatively stable over time (see Chart D3-1) so that even the current narrow-based payroll taxes are one of the more stable and predictable sources of State revenue (IPART 2008).

Over the past 20 years, the States have moved to broaden the payroll tax base and lower the rate. The major base-broadening decisions have involved the addition to the base of non-cash fringe benefits and superannuation contributions.

In New South Wales, Victoria and South Australia, base-broadening has also resulted from average wages rising faster than the level of the threshold. For example, Victoria's threshold has risen from \$500,000 in the early 1990s to \$550,000 today. During this time, average wages have nearly doubled, so it is likely that a higher proportion of businesses are now liable for payroll tax in Victoria. This potentially reduces the efficiency costs of raising revenue from payroll tax as fewer businesses can now change their activities to avoid paying the tax.

Some other States have taken the opposite approach. Western Australia, Tasmania, Northern Territory and the Australian Capital Territory have narrowed their payroll tax base by increasing the threshold faster than the growth in wages. These States have generally been slower to reduce their payroll tax rates. Chart D3-4 compares two States with similar threshold exemption levels in 1992-93, and contrasts their actual level over time to what the threshold level would have been had it been indexed to the movement in average wages.

Chart D3–4: Level of payroll tax thresholds in two States, compared with hypothetical indexation of the 1992–93 level to average wages



Source: Treasury estimates, NSW Treasury (2009), ABS (2009f).

On average, these changes made by the States over the past 15 years have increased the payroll tax base from around 45 per cent to 57 per cent of its theoretical level across all States (see Chart D3–3). At the same time as the base has been broadened, there has been a general decline in rates. For example, Victoria has significantly reduced its rate, from 7 per cent in 1990–91 to 4.95 per cent today.

Finding

Some States have broadened their payroll tax base by limiting growth in the payroll tax threshold, while other States have narrowed their base by rapidly increasing the threshold.

D3–3 Broad-based taxes to capture the value-add of labour?

Recommendation 57:

State payroll taxes should eventually be replaced with revenue from more efficient broad-based taxes that capture the value-add of labour.

The Review has considered replacing the existing payroll taxes with a tax on employee remuneration administered through the pay as you go (PAYG) withholding system. However, a more efficient, equitable and sustainable means of taxing labour income would be a broad-based consumption tax.

Consumption is made up of labour income and any excess returns to other factors of production (such as capital). In particular, a broad-based consumption tax would be applied to all businesses selling goods and services, including the self-employed. As the base is broader than just labour income, the rate of tax would need to be lower for any given revenue target, making it more efficient and arguably more equitable than simply taxing the

labour income component only. As the base includes labour income, there is little reason to have both a payroll tax and a broad-based consumption tax operating at the same time.

Administer payroll tax through the PAYG system?

One alternative option is to collect a single-rate tax on labour income through the PAYG withholding system. As it would utilise one existing system, this would be simpler than having many payroll taxes, and avoid many of the latter's inefficiencies. Because it would be on the personal income base, there would be limited opportunities for exemptions, improving the sustainability of the base. If the States prefer that the new arrangements reflect the revenue-raising autonomy currently provided by payroll tax, it would be possible for the States to vary (within limits) the rate applied to their residents, and to disclose the amount paid by each employee on their annual notice of assessment issued by the ATO.

However, without other reforms, this approach would create incentives for some employees to become independent contractors and for self-employed people to convert their labour income into capital income (by reinvesting it in the business instead of paying themselves a wage). There might be concerns about the impact on many small businesses who might find it more difficult to attract workers. Further, some people may be concerned about the equity of a single-rate labour income tax. Finally, a number of administrative issues would need to be considered, such as how to deal with employees whose wages are below the tax-free threshold and are not currently in the PAYG withholding system.

D4. Taxing financial services

Key points

Input taxation of financial services under the GST is inefficient, reduces competition and harms Australia's position as a regional financial services centre.

Financial services should be taxed in an equivalent way to other forms of consumption. That is, the consumption of financial services by Australian households should be fully taxed and financial services used by businesses should be treated like any other business input. There are a range of options for achieving this, although the actual design of the tax should be informed by extensive consultation with the financial services industry.

A financial services tax could replace input taxation under the GST, and complement a cash flow tax.

D4-1 The case for taxing consumption of financial services

Financial services such as banking involve both the deferral of consumption and the current consumption of services to facilitate this deferral. For example, a deposit account involves both the deferral of consumption of the deposit funds and the consumption of various related or incidental services provided by the bank.

Some submissions to the Review have argued that the use of a financial service such as a loan does not involve consumption in itself, but merely provides the means to consume other goods and services (and should therefore not be included in the consumption tax base). However, the fact that the principal purpose of a service is to facilitate subsequent consumption does not mean that the service is not itself consumption.

If a person chooses to spend money to change some aspect of their consumption (for example, to bring it forward in time), they do so because the service they purchase yields additional value to them. As this increased value is reflected in the cost of the financial service, it is entirely appropriate that it be taxed as consumption. Other facilitation services, like the transport of goods, are similarly and correctly included in a consumption tax base.

An argument against the taxation of financial services is that such services are a complement to savings, and therefore taxing financial services contravenes the principle that consumption tax should not bias savings. However, this confuses savings with the future consumption facilitated by savings. The principle that present and future consumption should be treated equivalently under a consumption tax does not mean that current consumption associated with facilitating future consumption should go untaxed.

Other submissions have suggested that financial transactions be subject to additional tax to help reduce financial instability (see Box D4-1 A Tobin tax?). This would entail taxing financial services on a turnover basis, which is inconsistent with the taxation of other forms of consumption.

D4–2 The nature and consequences of current arrangements

Current treatment compared to consumption benchmark

Services to facilitate the deferral of consumption should be included in the consumption tax base, like other goods and services. That is, the value of domestic private consumption of financial services should be taxed, while financial services provided to non-residents or business should not be taxed.

However, estimates based on the existing GST system suggest that the current tax treatment of financial services under the GST over-taxes business by around \$760 million in 2010–11, while the failure to fully tax household consumption of financial services results in a \$3.9 billion shortfall from the consumption tax benchmark (see Table D4–1).

Table D4–1: Cost of input tax treatment of financial supplies

	2008–09	2009–10	2010–11	2011–12
	\$m	\$m	\$m	\$m
Households	3,580	3,710	3,890	4,090
Businesses	–690	–720	–760	–790
Total	2,880	2,990	3,140	3,290

Source: Treasury estimate, against benchmark of taxing household final consumption at 10 per cent rate.

If final financial services were taxed on a consumption basis, this would result in increased bank fees or interest-rate spreads on financial services for private consumers, while reducing fees or interest-rate spreads for business consumers, and therefore the prices of other goods and services for which financial services are inputs.

Principle

The value added by the financial services sector to household consumption should be taxed in an equivalent way to consumption in other parts of the economy, while inputs to production should not be taxed.

Box D4–1: A Tobin tax?

Many submissions to the Review have supported the introduction of a tax on foreign currency transactions, commonly known as a ‘Tobin tax’, named after Nobel prize-winning economist James Tobin (1974), who first proposed the tax in a 1972 lecture. In the wake of the global financial crisis the idea has received new attention in the international policy debate. In August 2009, Lord Turner, chair of the UK Financial Services Authority, canvassed the possibility of a similar tax on all financial transactions to promote an efficient financial sector, particularly more stable financial markets. Keynes (1936) made a similar suggestion during the Great Depression.

The goal of a Tobin tax is to dampen de-stabilising speculative financial activity. By putting ‘sand in the wheels’ of the financial system, proponents believe that financial prices (such as foreign exchange rates) would be less likely to overshoot or undershoot economic fundamentals. If de-stabilising speculative transactions are more typically short-term and high-volume, they would be disproportionately affected by the tax, even though it would be levied at a low rate, based on value, to limit its impact on real activity. More recently, proponents have argued that the revenues could be used to finance international public goods, such as the United Nations or world poverty alleviation.

Transaction taxes like the Tobin tax are generally inefficient because the tax rate rises according to how often an asset changes hands, rather than any underlying economic value. There is no ‘economic base’ for transaction taxes. In general, transactions tend to create value because they shift resources to higher-value purposes. If these prices are publicly available, the transactions also provide the public information that assists wider resource allocation in the community.

Financial markets are not perfectly efficient. Notably, the global financial crisis resulted from a widespread mispricing of risk by financial markets. However, a financial transactions tax would not directly address the sources of financial market failure, such as moral hazard arising from implicit or explicit government guarantees, incentive structures skewed toward short-term gains, and human psychology. There is no necessary correlation between trading volume and the creation of systemic risk. The tax would apply indiscriminately to transactions that are socially useful – including those that contribute to financial system stability – and those that are costly.

In fact, transaction taxes could potentially reduce financial stability. They would reduce market liquidity, which could lead to prices becoming more volatile and more prone to misalignment. They would also impede hedging activity, which can involve a large volume of transactions to disperse risk. Although the great majority of financial transactions occur between financial firms, much of this is generated by the process of reallocating risk between financial firms rather than speculation. Further, speculation is not inherently destabilising as it can sometimes help correct misalignments.

It would be difficult to prevent activity shifting to unregulated sectors or jurisdictions. Businesses would also have an incentive to structure themselves to avoid the tax. For example, large, vertically integrated businesses use fewer transactions to make the same product and would pay less tax. Even if levied at a low rate, a tax would cause some impediment to real activity (for instance, currency transactions are essential for international trade and investment) and may impede some necessary adjustments.

Current treatment of financial services under the GST is inefficient

Australia and most other countries with a value added tax (VAT) use the 'invoice-credit' approach (see Section D2 The goods and services tax). Each business incurs a tax liability for its sales and claims a credit for purchases of taxed goods and services. Taxing financial services under this system is complex and inefficient, mainly because it is very difficult to measure the value of the services provided in individual financial transactions.

In many cases, the consideration received for financial services such as a loan is not explicit, but implicit in a margin or investment return. In the case of interest, part of the interest payment is to compensate the lender for financial services associated with the loan, such as assessment, monitoring and account keeping. However, part of the interest paid to a lender is to compensate the lender for the use of the loan funds and for the risk of default. In more complex transactions, a bank may obtain consideration for the services it provides in arranging a loan by means of an implicit margin in the various financial flows making up the transaction. Determining the value of the implicit consideration for supply of intermediation services, for each party to the transaction, poses considerable challenges.

Taxing financial services can also be problematic due to the nature of the financial institution as an intermediary. A bank, for example, typically does not make a loan using just its own capital. Instead, it obtains money from another source which it then lends. Often, the bank may receive consideration by way of a margin applying to both the borrowing and lending. Properly taxing the value of the services provided to the borrower and the lender requires an allocation of value between these various parties that can be problematic to achieve. This becomes particularly complex where the supply to one party needs to be treated differently to the other (for example, if one supply is an export).

The same problem would arise for the cash flow tax (see Section D1 A cash flow tax), which would also exclude financial cash flows from the tax.

Most countries with a VAT have opted for a 'second-best' solution to taxing financial services, using 'input taxation'. This means that inputs of the service provider are taxed, but not the value they add. The purchaser of financial services does not receive an input tax credit for the GST incurred on their business inputs. The treaty under which members of the European Union impose VAT requires this approach.

While businesses receive a credit for GST on their inputs, they are not able to recover all embedded tax when they or their suppliers have input taxed financial inputs. This approach results in various biases for both businesses and consumers. These can result in efficiency costs, including:

- cascading of taxes through the supply chain, flowing through to higher prices of goods and services to consumers, businesses and exports;
- businesses organising themselves to 'self-supply' goods and services to reduce the tax payable on their inputs. This gives large, vertically integrated businesses an advantage over smaller competitors;
- complexities in apportioning the cost of inputs between taxable, input taxed and GST-free uses, including tracking the use of individual assets; and

- adverse impacts on the financial sector’s international competitiveness.

These impacts influence the way financial supply providers operate, and change the prices faced by consumers. For example, treating financial services as input taxed means that consumers do not bear the full GST and may encourage them to use more financial services over other consumption. Conversely, the relative price of financial services for business is higher, as the GST paid on other inputs is typically refunded in full.

This embedded tax is likely to be passed forward to consumers – resulting in effective tax rates above 10 per cent for taxable goods and services for which financial services are an input. Where an Australian exporter makes use of Australian financial supplies, the price of their exports – which should face no tax under a destination-based GST – can also include embedded tax from input-taxed financial services (see Table D4–2).

Table D4–2: GST with input taxation of financial services

	Non-financial goods and services Explicit price = wages + economic rent	Financial services Implicit price in interest margin
Households	10% tax on price	10% tax on some inputs into financial services
Business	GST refunded, except for embedded tax	10% tax on some inputs into financial services
Exports	GST free - some embedded tax	GST free - some embedded tax

Australia’s GST law includes additional, complex provisions to reduce some of the efficiency consequences of input-taxing financial services. While these provisions mitigate some of the inefficiencies of input taxation, they do not amount to efficient taxation of domestic consumption. These provisions include:

- introducing a reduced input tax credit equal to 75 per cent of the full input tax credit for a defined range of acquisitions that would otherwise be fully input taxed. This is a unique feature of Australia’s GST regime;
- adopting a narrow definition of what constitutes a financial supply for GST purposes;
- introducing a financial acquisitions threshold that excludes many financial supplies made by non-bank financial institutions from input taxation;
- including a special exemption for certain borrowing costs where the funds are used in making GST-free or taxable supplies, to reduce tax cascading; and
- avoiding an incentive for input taxed entities to acquire supplies from other countries by requiring those acquiring such supplies to make equivalent GST payments.

Finding

Financial services paid for through an interest margin, rather than explicit fees, cannot be taxed directly using an invoice-credit GST or a simple cash flow tax. The use of input taxation under GST potentially biases production and consumption decisions, resulting in large efficiency costs and additional complexity from special provisions designed to reduce the inefficiency.

Impact on Australia as a regional financial services centre

Other countries in the region — notably Singapore and New Zealand — have also attempted to address these problems by modifying their GST. However, neither has succeeded in treating financial services equivalently to other forms of taxed consumption. Nevertheless, these innovations may have given these countries an edge that may harm Australia's efforts to position itself as a regional financial services centre.

Singapore

Singapore input-taxes financial services but allows the service provider an input tax credit under either a 'special method' or the 'fixed input tax recovery method'.

The former requires separate reporting of the value of certain services as a proportion of total services. This adds to compliance costs. The latter calculates the input tax credit entitlement by applying a ratio to total acquisitions. The ratio is determined by the tax authorities annually, and varies for different types of banking licences. For example, banks with full banking licences, wholesale banks, offshore banks and finance companies each apply a different ratio. This is similar to Australia's 75 per cent reduced input tax credit, although in Australia this applies only to a limited range of inputs.

New Zealand

Since 1 January 2005, New Zealand's GST has allowed business-to-business supplies of financial services to be GST-free where, over a 12-month period, the recipient's taxable supplies exceed 75 per cent of their total supplies. This GST-free treatment was introduced to remove embedded tax on business inputs caused by input taxation.

This approach requires financial institutions to obtain information about the eligibility of their customers to claim input tax credits. This information is usually unnecessary under a GST. However, to reduce compliance costs, suppliers can refer to Australian and New Zealand Standard Industrial Classification codes to determine the recipients' status.

Treating business-to-business transactions as GST-free requires an appropriate way to determine eligibility for claiming input tax credits, particularly for overhead costs. There is also a revenue risk that GST-free supplies may be made for final consumption. New Zealand's GST includes additional anti-avoidance measures to address this threat.

Finding

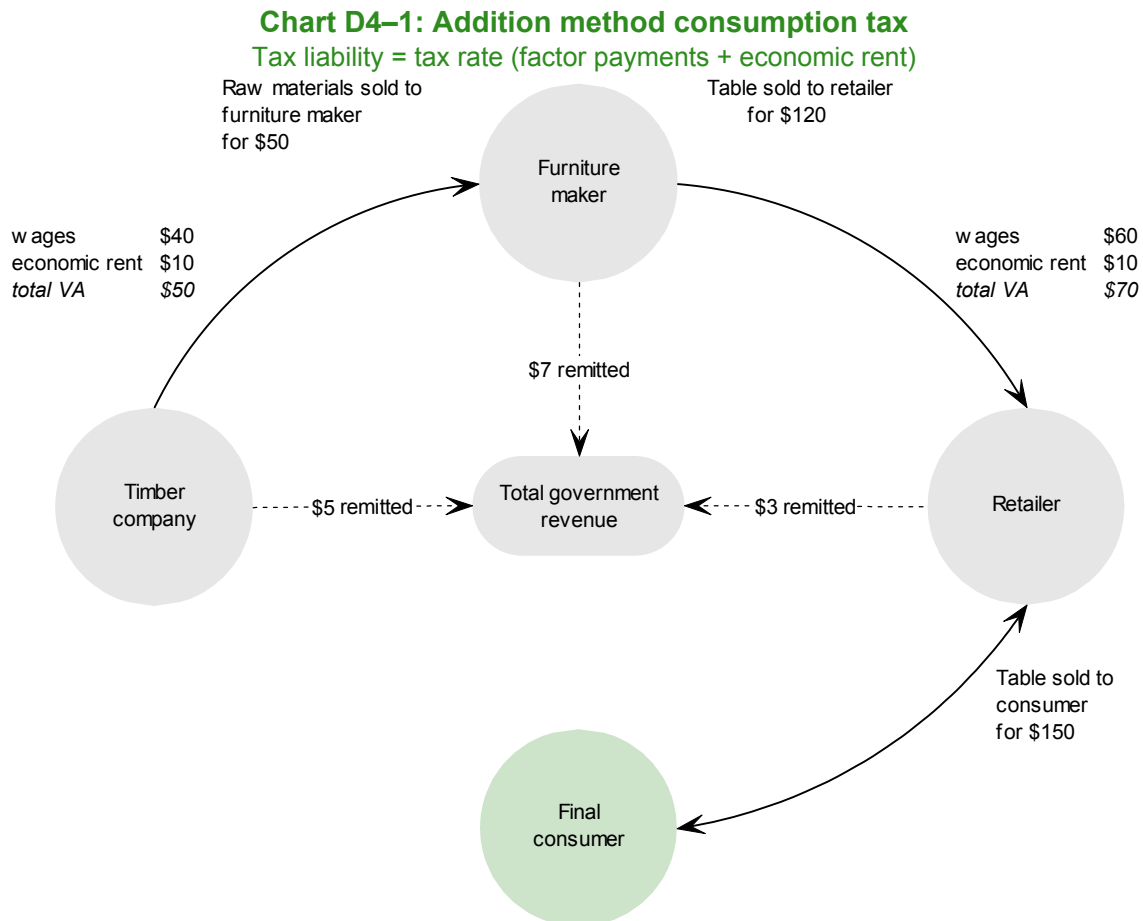
The input taxation of financial services under the GST, and associated provisions to give relief from it, are complex and affect Australia's position as a regional financial services centre.

D4–3 Alternative ways to tax consumption of financial services

Alternative methods of calculating the value of consumption of goods include an addition method, a tax calculation account method, and a reverse charging method. These could be investigated further, in consultation with the financial sector, and the most suitable method considered by government for adoption.

The addition method

Under an addition method tax, the value added is defined as the sum of each business's factors of production and its economic rent. An example for a non-financial supply chain (see Chart D4-1) shows that this is theoretically equivalent to both the cash flow (see Chart D1-1) and invoice-credit method (see Chart D2-2) consumption taxes.



For technical reasons already discussed, the invoice-credit method GST cannot efficiently tax financial services. Similarly, a simple cash flow tax that excludes financial flows (see Section D1 A cash flow tax) would not tax domestic consumption of financial products. However, the addition method can tax factor payments and economic rent from both financial and non-financial goods or services. It could therefore be used as an equivalent method of calculating the consumption tax liability.

An addition method financial services tax (FST) could be calculated from the wages and economic rent of financial institutions that are attributable to supplies to domestic consumers. To the extent that the financial institution has also received exemption from tax on inputs (for example, an input tax credit under the GST, or a cash flow tax refund), the tax base for the FST would also include inputs to ensure that the whole supply chain remains taxed.

The economic rent component could be calculated by reference to existing income tax concepts, provided adjustments are made to ensure that the normal return to capital is not taxed. For example, economic rent may be calculated on the basis of adjusted income tax liability. Adjustment would be necessary to allow a standard rate of return on equity capital,

possibly calculated using a long term bond rate, similar to proposed arrangements for resource rent taxation (see Section C1 Charging for non-renewable resources). Income tax deductions given for depreciation may require variations.

Wages could be determined using the amounts provided in PAYG summaries (including fringe benefit amounts). However, because this approach is significantly more complicated than a direct cash flow approach for real goods and services, this additive approach to taxing consumption would not extend to incidental supplies of financial services, unless their value is significant. A common definition of financial supplies would be needed to ensure that financial supplies are subject to one consumption tax, reflecting the principle that services paid for in an implicit margin should be taxed under a FST.

An FST would tax only domestic consumption

To ensure that the FST operates as a destination-based consumption tax, only the proportion of a service provider's business transacted with domestic consumers would be subject to the tax. A company that deals only with businesses or non-residents would pay no tax.

As this method operates on overall profits, wages and costs calculated annually, it avoids the problem of allocating value between the parties in specific transactions for whom the bank is acting as an intermediary. Instead, financial institutions need to determine the profits and costs of each area of activity and determine the proportion of untaxed (business and foreign) customers within this area.

To determine the proportion of economic rent, wages and inputs that should be subject to the tax, FST payers might be required to use a global method to apportion amounts between domestic consumption (which would be taxed), and other supplies to business and exports (which would not be taxed). This proportion could be calculated as total revenue less revenue from exports and business supplies (where the customer can be identified as a business), divided by total revenue.

This suggests that while apportionment may be complex, it is not insurmountable given that banks are already required to apportion their inputs (between taxable, input taxed and GST-free uses) as well as to treat export supplies differently from other supplies.³

Such an approach has not yet been adopted elsewhere. Israel applies an additive method, taxing the profits and wages of financial institutions at the same rate as its value added tax on general consumption, similar to the model proposed here. However, this is not equivalent to a consumption tax, as there is no mechanism to credit tax paid on business inputs.

In the absence of direct international experience with the tax suggested in this section, the FST would need to be designed and developed in close consultation with the financial services sector, to ensure that FST concepts and liabilities are aligned with natural business systems.

³ Financial services are generally input taxed, except when provided to a non-resident for consumption outside Australia, in which case they are treated as GST-free.

Coordination with a cash flow tax or GST

The FST provides a method of taxing one sector of the economy (the financial sector) that cannot be effectively subject to a ‘real’ or ‘R’ base cash flow tax (see Section D1 A cash flow tax). However, the proposed FST could be introduced alongside the existing GST, in order to replace current input taxation of financial services. Box D4–2 includes a worked example.

An FST would also complement a cash flow tax. Businesses acquiring financial services would not receive a deduction for their financial acquisitions under a cash flow tax, but they would pay a lower ‘tax-free’ price for their financial services.

Box D4–2: Comparing GST treatment to FST

XYZ provides financial services with a base value before tax of \$100. In providing these services, XYZ makes acquisitions valued at \$80, with the result that XYZ is adding value of \$20. All of XYZ’s inputs are subject to GST.

Table D4–3: Worked example

	No tax	GST		Financial services tax	
		Tax treatment:		Supplies to:	
		Taxable	Input taxed	Business	Domestic consumer
Cost of inputs	80	80	80	80	80
plus GST on inputs	0	8	8	8	8
less input tax credit	0	8	0	8	8
Final cost	80	80	88	80	80
Firm value-added	20	20	20	20	20
Base value	100	100	108	100	100
GST/FST payable		10	0	0	10
		(10% of base value)		(10% of value-added + inputs)	
Cost for domestic consumer	100	110	108	n/a	110
Cost for business	100	100	108	100	n/a
		(after input tax credit)	(no input tax credit)		

Amounts in bold indicate those components to which tax is applied.

The first column is where no consumption tax applies. This provides a baseline from which to consider the changes that result from the application of tax.

The next column considers what would occur if GST could be applied to financial services. As can be seen, costs effectively remain constant due to the availability of credits. The only real change occurs at the end where additional tax is borne by the consumer at the 10 per cent rate. This is the ideal outcome in taxing the consumption of financial supplies, but cannot in practice be achieved under the GST.

The third column illustrates the current input taxed treatment. This deviates significantly from the no tax and full GST examples. Costs increase as a result of the embedded tax. This increased cost is passed on to business and exports as well as to consumers.

The final two columns illustrate the effect of the FST and show how it varies with the customer base. The first shows FST on supplies solely to business, the second on supplies solely to consumers. The outcomes from the FST are the same as full taxation under the GST (the second column), but they are reached in a different way. Rather than taxing all supplies and allowing business a credit, the FST leaves supplies to businesses untaxed. Likewise, the full value of supplies to consumers is taxed by including XYZ’s value added.

Tax calculation account method

An alternative method of identifying and taxing the value added by financial services is a form of cash flow tax that includes financial flows (an R+F cash flow tax — ‘real plus financial’ — is described in Section D1 A cash flow tax). As R+F cash flow taxation applies to all inflows and outflows, it does not require the determination of the particular component of the flow that represents consumption.

However, this model has its own problems. It would impose significant compliance costs for non-financial businesses and consumers due to the extra requirements associated with levying tax and claiming credits on all finance-related cash flows. Further, there would be significant transitional difficulties in the treatment of current financial arrangements.

However, a method of cash flow taxation that addresses most of these concerns was developed for the European Union during its consideration of cash flow taxation in the 1990s. The tax calculation account system avoided the transitional and compliance cost issues by suspending the collection or refund of tax until the end of the transaction, and indexing the suspended amount by the pure rate of interest.

The EU undertook a pilot study of the tax calculation account system involving a number of financial institutions. The system was found to be viable, although there were some concerns about the information revealed by institutions on tax invoices and the compliance costs associated with the change.

Reverse charging method

A method of taxing financial services by employing a form of modified reverse charge has also been developed (see Zee 2006, p. 458 for a more comprehensive outline of this method). This method differs from an R+F cash flow taxation method as it would not involve taxing or crediting all cash flows. Instead, tax would only be imposed on interest and charges (excluding the principal). Similarly, credits would only be allowed for acquisitions and interest paid by the financial service provider. Under this method, the tax on the consumption of the intermediation service would not be automatically split, but instead would be allocated by banks between the interest charges to depositors and borrowers between whom the bank is acting as an intermediary.

Like the tax calculation account method of cash flow taxation, the modified reverse charging method makes the financial service provider responsible for addressing the tax and calculation issues. Also like the tax calculation account method, the modified reverse charge method suspends tax and credits for a period. Credits and tax are eventually netted off before being charged to the final consumer. This modification results in the recipients only paying tax on the value of the consumption involved rather than on the full value of the interest charge.

This method has been developed more recently than the tax calculation account method and has not been the subject of the same level of consideration by academics and policy-makers. However, in theory at least it is another valid method for appropriately taxing the consumption of financial services.

Finding

To remove the adverse efficiency costs of input taxation on business and exports, financial services could be removed from the GST (effectively, made GST-free). However, this would have a large revenue cost and inappropriately exempt private consumption of financial services. The Australian government, in consultation with the financial sector, could further develop an alternative method of taxing domestic consumption of financial services to replace input taxation under the GST, or to complement a cash flow tax, to ensure that consumption of financial services is treated equivalently to other forms of consumption.

Glossary and Index

Glossary

Term	Definition
Adjusted taxable income	For the purposes of certain means-tested assistance programs, taxable income is adjusted to include other income items, such as fringe benefits, certain tax-exempt foreign income amounts and net investment losses.
Ad valorem tax	A tax that is levied as a percentage of the value of a particular good or service; for example, a 3 per cent royalty on the value of gold production or an 8 per cent tax on the value of an insurance premium.
Allowance for corporate equity (ACE)	A form of business expenditure tax that provides a deduction (allowance) for corporate equity at the corporate level, equivalent to that provided for interest on debt.
Allowance for shareholder equity (ASE)	A form of expenditure tax similar to the allowance for corporate equity that provides a deduction (allowance) for shareholder equity at the shareholder's level.
Allowee	A person who receives an income support allowance (for example, Newstart Allowance or Youth Allowance), rather than a pension, such as the Age Pension or the Disability Support Pension.
Average weekly earnings	Average weekly earnings statistics represent average gross (before tax) earnings of employees. Estimates of average weekly earnings are derived by dividing estimates of weekly total earnings by estimates of number of employees.
Average weekly ordinary time earnings (AWOTE)	Weekly ordinary time earnings refers to one week's earnings of employees for the reference period attributable to award, standard or agreed hours of work. It is calculated before taxation and any other deductions (for example, superannuation, board and lodging), have been made.
Capital income	Earnings from investments and savings, including interest, net rental and business income, capital gains and dividends.
Cash flow tax	A system that taxes the difference between cash receipts and cash outgoings.
Categorical income support	Income support that is paid on the basis of eligibility conditions that divide people into groups. For example, age, disability, caring responsibilities, and those undertaking education or training.
Compliance cost	Expenses incurred in meeting the requirements of legislation or regulations. Compliance costs include a wide range of monetary and non-monetary costs.

Term	Definition
Concessional superannuation contribution	A contribution that has not been taxable as income in the hands of an individual, or for which the person has received a deduction. These contributions are currently taxable within a superannuation fund.
Corrective tax	A tax designed to make markets more efficient by exposing producers and consumers to prices that reflect the costs that they impose on others (such as pollution).
Cut-out point	The level of income or assets that results in a person no longer being eligible for a transfer payment.
Deduction	Losses or outgoings incurred in producing income or running a business that can be used to reduce assessable income.
Deeming	Assuming a rate of return on an asset regardless of its actual rate of return. Used in determining eligibility for some transfer payments.
Depreciation (economic)	The decline in the market value of an asset over its life.
Depreciation (tax)	The decline in value of an asset for taxation purposes, which may differ from economic depreciation.
Distortion	Any action or thing that reduces economic efficiency. Distortions generally arise when private action (such as price-fixing by a cartel), or public action (such as a tax imposed by government), changes an individual's or firm's behaviour.
Dividend imputation	A system that integrates the taxation of companies and shareholders by allowing companies to pass imputation credits (representing tax paid at the company level) to shareholders upon payment of a dividend. This allows the shareholder to take into account any company tax paid in respect of a dividend they receive when calculating their tax liability. For example, if a shareholder has a marginal tax rate of 30 per cent and receives a fully franked dividend (one paid out of earnings that have already been subject to the 30 per cent company income tax), they would not be required to pay any additional personal income tax.
Dividend streaming	A strategy that aims to direct ('stream') dividends with imputation credits attached to those shareholders for whom imputation credits are of most value. For example, as resident shareholders are able to use imputation credits to lower their tax liability while non-resident shareholders cannot, dividend streaming would see profits that have imputation credits attached to them paid to resident shareholders, while profits without imputation credits attached to them would be paid to non-resident shareholders.

Term	Definition
Dual income tax	A dual income tax system imposes differential rates of tax on capital and labour income.
Economic incidence	The individual or entity which bears the final burden of a tax (or receives the benefit of a transfer), after response effects, such as price and wage changes, are taken into account. This is distinct from the legal incidence of the tax or transfer. For example, the legal incidence of a consumption tax is often the supplier of goods and services who is legally required to pay the tax. However, the supplier may be able to factor in the tax they pay into the price of their products or services that they charge to consumers. This results in the consumer paying a higher price for the good or service. In such cases, the consumer bears the economic incidence of the tax through paying higher prices even though it is the supplier that is legally liable to pay all of the tax.
Economic rents	An economic rent is the excess of the return to a factor of production above the amount that is required to sustain the current use of the factor (or to entice the use of the factor). For example, if a worker is paid \$100,000 but would still be willing to work at the same job if they were paid \$75,000, their economic rent would be \$25,000.
Effective life	The period over which a depreciating asset can be used for income-producing purposes.
Effective tax rates (labour taxes)	<p>Effective Marginal Tax Rates (EMTRs) for labour measure the proportion of gross pay lost in taxes and reduced transfer payments due to a small change in gross income (for example, a change of \$1.00).</p> <p>Effective Average Tax Rates (EATRs) for labour are a measure of the proportion of gross pay that is lost to tax or reduced transfer payments due to that gross income.</p>
Effective tax rates (savings and investment)	<p>Effective Marginal Tax Rates (EMTRs) on savings and investment measure the effect of taxation on the return to an investment in a marginal project, which is one that earns no super normal profits.</p> <p>Effective Average Tax Rates (EATRs) for investment measure the effective tax burden on an additional unit of investment. EATRs can be used to examine the tax burden on investments with super normal profits.</p>

Term	Definition
Efficiency	<p>Efficiency means making the best use of resources.</p> <p>'Technical' or 'productive' efficiency means producing as many goods or services as possible from a given set of inputs.</p> <p>'Allocative' or 'economic' efficiency means putting productive resources (like labour, land or capital), to their highest value use and distributing goods and services to consumers in a way that best satisfies consumer needs and wants.</p>
Elasticity	<p>A measure of the responsiveness of one variable to changes in another. For example, the 'price elasticity of demand' refers to the percentage change in the amount of a good purchased ('demand') following a percentage change in its price. If the percentage change in demand is more than the percentage change in price, demand is said to be price 'elastic'; if it is less, demand is said to be price 'inelastic'.</p>
Entity	<p>A unit for taxation purposes. Entities include a company, trust, partnership, any unincorporated body or association, and an individual.</p>
Excise	<p>A commodity-based tax levied on the manufacture or production of selected goods in Australia (including liquid fuel, tobacco and some alcoholic beverages). Imported equivalents are subject to an excise-equivalent customs duty.</p>
Excise-equivalent customs duty	<p>An import tariff applied as the equivalent to an internal tax to ensure that goods that would otherwise be subject to excise if manufactured or produced in Australia are subject to the same rate of duty when imported.</p>
Expenditure tax benchmark	<p>A theoretical tax structure that involves levying tax on a person's consumption (or expenditure). Expenditure can be measured in a variety of ways, including as income less net new savings. This benchmark differs from <i>income tax benchmark</i>, by proposing that income from savings not be taxed.</p>
Factor (of production)	<p>An input into the production process. The four broad factors are labour, capital (including plant and equipment, buildings, skills or 'human capital' and know-how, or 'intellectual property'), land (including natural resources), and enterprise (which brings the other factors together in a productive endeavour).</p>
Family payments	<p>Australian Government transfer payments made to parents with dependent children. For example, Family Tax Benefit.</p>

Term	Definition
Flow through	A form of integration between an entity (such as a company), and its underlying owners (the shareholders). It can apply to the entire operations of the entity, such that individual shareholders are taken to have earned their relevant share of assessable income of the entity and incurred the relevant share of losses and outgoings.
Foreign direct investment	Foreign investment that conveys a significant degree of influence in the management or control of the entity in which the investment is made. In Australia, an equity interest of 10 per cent or more by a non-resident investor is defined as foreign direct investment.
Free area	The level of income or assets a person can have before a person starts to lose part of their transfer payments.
Fringe benefits	Benefits received by employees from their employer in respect of employment that are in a different form to salary and wages, such as the use of a car for private purposes.
Gift deductibility	Personal donations to some organisations may be tax deductible where they are: made to a deductible gift recipient; money or a certain type of property; made voluntarily and without material benefit to the donor; and comply with other relevant gift conditions.
Grandfathered	The preservation of the benefits of previous arrangements for those who qualify, while phasing in new arrangements for the future.
Horizontal equity	Horizontal equity refers to people in similar circumstances being treated in a similar way. For instance, by paying a similar amount of tax in the context of the tax system, or receiving a similar level of benefit in the transfer system.
Horizontal fiscal equalisation	The process by which the capacities of sub-national governments to provide services to their citizens are made more equal. In Australia, State governments receive funding from the Commonwealth through the horizontal fiscal equalisation process such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standards.
Imputed rent	The estimated rent that an owner-occupied dwelling would attract if it was rented at market rates.

Term	Definition
Income effect	If the price of a commodity (of any type) rises, there are two effects. Firstly, the real income of people who use it falls. This generally, but not always, causes them to use less of it and/or other goods. This is called the income effect. Secondly, the price of that commodity rises relative to other commodities, causing people to use less of it and more of the other commodities. This is called the substitution effect.
Income support	Transfer payments from government to low-income individuals and families to assist with the cost of living. There are two types of income support payment in the existing Australian transfer system: pensions (for example, the Age Pension or the Disability Support Pension), and allowances, like Newstart Allowance and Youth Allowance. In most cases, pensioners are not expected to work while allowees are expected to work, either immediately or (at least) soon. Pensions are paid at a higher rate than allowances.
Income tax benchmark	A theoretical tax structure that involves levying tax on all additions to an individual's ability to purchase goods and services in a given period. It taxes both the return from labour and the return from savings. A nominal income tax taxes the entire return from saving. A real income tax taxes only the return from saving in excess of inflation; that is, it taxes additions to the real quantity of goods and services the individual can purchase in a given period.
Intangible assets	Assets that cannot be seen or touched, such as goodwill, patents, software, trademarks and copyright.
Interest withholding tax	A tax levied on interest paid to a non-resident lender. The tax is withheld by the Australian payer on payment of the interest.
Legal incidence	The individual or entity legally liable to pay a tax or receive a transfer bears the legal incidence of the tax or transfer. The legal incidence often differs from the economic incidence (<i>see</i> economic incidence).
Longevity insurance	A product that a person can purchase that will pay them an income until they die.

Term	Definition
Market failure	<p>Markets fail when they do not allocate resources efficiently. There are four main causes of market failure:</p> <p>Market power, which arises when a single buyer or seller can exert significant influence over prices or output;</p> <p>Spillovers (sometimes referred to as 'externalities'), which arise when the market does not take into account the effect of economic activity on people not directly involved. For example, a firm may ignore the costs it imposes on others by polluting the environment;</p> <p>Public goods, such as national security, where enjoyment of the good by one person does not reduce the consumption possibilities available to others; and</p> <p>Incomplete or asymmetric information; for example, where an applicant for insurance knows more about the risk that they will make a claim than the insurance company.</p>
Mutual receipts	<p>The receipts that not-for-profit, member-based organisations (such as licensed clubs), collect from trading with their members. These receipts are generally treated as non-assessable, non-exempt income.</p>
Negative gearing	<p>An asset is negatively geared when its interest payments on borrowings used to finance the asset exceed the income it generates, net of other expenses. Negative gearing commonly refers to the ability to deduct such a loss against another source of income, such as wages.</p>
Not-for-profit organisation (NFP)	<p>An organisation that is not operated for the profit or gain of its individual members, both while the organisation is being carried on, and on its winding up.</p>
Offshore banking unit (OBU)	<p>An offshore banking unit provides financial intermediation services between non-residents. OBUs are concessionally taxed on such income, (currently subject to an effective tax rate of 10 per cent), and are entitled to withholding tax concessions.</p>
Offset	<p>Tax offsets directly reduce the amount of tax paid. They are different from deductions, which reduce total assessable income. Tax offsets were previously known as rebates. They can be non-refundable (that is, they can reduce a taxpayer's liability to zero, but cannot result in a refund), or refundable.</p>
Operating costs	<p>The administration and compliance costs associated with a tax.</p>

Term	Definition
Ordinary income	<p>In the tax system, ordinary income is an income measure that describes earnings such as income from labour or the return on investment, such as interest, dividends or rent.</p> <p>In the transfer system, ordinary income is an income measure used to determine eligibility for pensions and allowances. This is broader than the tax definition as, generally, it does not allow for deductions, salary sacrificed amounts and fringe benefits.</p>
Participation	Labour force participation is people in work or looking for work. The labour force participation rate is the labour force as a percentage of the civilian population aged 15 years and over.
Participation tax rate (PTR)	The proportion of gross pay lost in taxes and reduced transfer payments when a person takes up paid employment.
Personal use asset	An asset other than a collectable that is used or kept mainly for personal use or enjoyment.
Petroleum Resource Rent Tax (PRRT)	The petroleum resource rent tax applies to all petroleum projects in offshore areas, other than certain production licences subject to the excise and royalty regime. It is applied to super normal profits derived from the recovery of petroleum in a project.
Portfolio investment	Investment (including loans), that does not convey a significant degree of influence in the management or control of the entity in which the investment is made. In Australia, a foreign portfolio equity investment is defined as one where the non-resident investor has an equity interest of less than 10 per cent.
Post-tax contribution	A superannuation contribution made by a person from income on which they have already paid tax.
Productivity	The amount of goods or services that can be produced from a given set of inputs. Productivity rises when more outputs can be produced from a given number of inputs.
Profit-based royalty	A royalty levied on the net cash flow or some other measure of the profit of a project.
Profit shifting	Shifting the location of profit between entities, which are typically in different countries, without corresponding changes in real activity.
Progressive taxation	Where the average rate of tax increases as income increases.

Term	Definition
Property rights	Rights that an individual or a legal entity like a company enjoy in relation to any 'thing'; for example, the right to use (but not to sell) a particular piece of land or the right to use (and to sell) a chair.
Public good	A good where the enjoyment of that good by one person does not reduce the consumption possibilities available to others. For example, one person receiving a benefit from national defence does not reduce the ability of others to enjoy such benefits. Public goods have the characteristics of being 'non-rivalrous' – consumption of the good by one individual does not reduce availability of the good for consumption by others – and 'non-excludable' – no-one can be effectively excluded from using the good.
Rebateable employer	A non-government, non-profit organisation that is currently eligible for a rebate of 48 per cent of the amount of fringe benefits tax that would otherwise be payable.
Regressive taxation	Where the average rate of tax decreases as income increases.
Resource rent tax	A tax that applies to the super normal profits, or economic rent of a resource project.
Rulings	The Commissioner of Taxation's statements about how the tax law applies in particular cases. They include public rulings which apply to taxpayers generally, or to a class of taxpayers, and private rulings which apply to a particular taxpayer. Tax law rulings are usually legally binding on the Commissioner.
Social costs	The total costs of an activity. This includes the private cost as well as the spillover or external cost imposed on people who are not directly involved in the activity.
Specific royalty	An output-based royalty that is levied as a set charge per physical unit of production; for example, \$1.00 per tonne of marble.
Spillover	A spillover (sometimes referred to as an 'externality'), occurs when the actions of an individual or firm impose involuntary costs (or benefits) on others. That is, in addition to the private costs and benefits that accrue to the decision-maker, some costs and benefits can 'spill over' on to others.
Substitution effect	<i>See</i> Income effect.
Tangible assets	Assets that can be seen or touched, such as an oven or a building.
Tax base	The tax base is the assessed value upon which a tax is levied; for example, taxable income.

Term	Definition
Tax expenditure	A tax concession that provides a benefit to a specified activity or class of taxpayer.
Tax wedge	An economic distortion caused by a particular tax measure. For example, a tax on labour results in a wedge between the gross amount that the employer pays and the take-home pay the employee actually receives.
Thin capitalisation	An entity is thinly capitalised where it uses a high level of debt, relative to equity, to finance assets.
Transfer	A transfer is a direct government payment, grant, or in-kind benefit made to an individual or a family based on certain eligibility criteria, rather than being made in return for goods or services. State governments also provide transfers, including through concessions.
Transfer payment	A transfer payment provides direct financial assistance to individuals or families who are unable, or are not expected, to fully support themselves.
Transfer pricing	The practice of pricing related party transactions in a way that artificially shifts profits between the parties.
Trust	A trust exists when a person (the trustee) holds property on behalf of others (the beneficiaries) who are intended to benefit from the property or income of that property.
Untaxed fund	A superannuation fund that does not pay tax on some, or all, of its contributions and earnings.
Vertical equity	Vertical equity is the principle that people with low means should receive greater assistance than those with higher means, and that those with greater economic capacity should have a higher tax burden.
Vertical fiscal imbalance	The situation in a federation where the capacity of different levels of government to raise revenues does not match their expenditure responsibilities.
Volumetric taxation	A tax based on the volume of a product (for example, litres of alcohol), rather than its price.
Wealth tax	Wealth taxes can be either recurrent or levied on transfers between one party and another (for example, bequest and gift taxes). A recurrent wealth tax is levied on the entire wealth of a household or business. A tax on a specific asset class, like a land tax, is a property tax but not a wealth tax.
Withdrawal rate	The rate (also known as a 'taper rate'), at which government assistance is reduced as private income or assets increase.

Index — Part Two

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A

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- Aboriginal Australians, *see* Indigenous Australians
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