

**A TAX SYSTEM THAT
WORKS FOR AUSTRALIA**
REFORM OPTIONS FOR EMPLOYMENT,
ECONOMIC GROWTH AND PROSPERITY

VICTORIAN GOVERNMENT SUBMISSION TO THE AUSTRALIA'S FUTURE TAX SYSTEM REVIEW

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PREMIER AND TREASURER'S FOREWORD

Getting our tax and transfer system right is crucial. A comprehensive review of the tax and transfer system, and a cooperative approach to reform, can make a big contribution to Australia's future prosperity.

Australia's tax system has evolved over many decades, often without a clear direction. In particular, changes to the mix of Commonwealth and State taxation have been incremental, without a clear vision of how we should fund the responsibilities of each tier of government. The tax system has also become increasingly complex, with the risk of successive changes causing unintended consequences.

We need to make the interaction of the tax and transfer system simpler, encourage and reward workforce participation, and ensure that our taxes support the planning and delivery of public services. Reforms in these areas can drive economic growth, stimulate employment and ensure we sustain and improve our standard of living. Together, they will set Australia up for a strong recovery from current economic conditions.

Victoria has a proud record of tax reform. In the last decade we have announced \$5.5 billion worth of tax cuts, abolished eight taxes, and made major improvements to a range of other taxes. We have honoured our commitments under the GST agreement with the Commonwealth Government to ensure Victoria has one of the most efficient tax systems in the country. We look forward to working with the Commonwealth, State and Territory Governments to continue improving Australia's tax system.



A blue ink signature of Hon John Brumby MP, written in a cursive style.

Hon John Brumby MP
Premier of Victoria



A blue ink signature of Hon John Lenders MP, written in a cursive style.

Hon John Lenders MP
Treasurer of Victoria

INTRODUCTION

The Victorian Government welcomes the Australia's Future Tax System Review. It is an opportunity to identify major taxation reforms that will drive economic growth and make the Australian tax system simpler, fairer and more transparent.

Having the best possible tax system is critical to Australia's future. Our tax system funds our schools, hospitals, police and other services, and it influences people's decisions to work, invest and save.

We are currently facing the worst global economic conditions in generations, but this should not undermine efforts at major, long-term reform. Instead, it makes reform essential. Significant improvements to our tax system can prepare Australia for a strong recovery and a prosperous future, by getting the most productive use of our resources.

As the Victorian Government has already outlined, in particular, we should focus on reforms that stimulate economic growth by:

- › stimulating employment
- › making the tax system simpler, fairer and more transparent
- › ensuring a sustainable basis for Government revenues to continue planning, delivering and improving services in the future.

This submission outlines the need for reform and proposes possible reform directions. These include improvements to existing taxation arrangements as well as more fundamental, structural changes, which would create the greatest economic benefits for Australia.

To make these changes, the Commonwealth and State Governments will need to work together. Improvements to both Commonwealth and State taxation are needed. This Review is the first time in 50 years that Commonwealth and State taxation have been seriously examined together.

It gives us an opportunity to address fundamental imbalances in Commonwealth and State taxation and expenditure, and the problems they cause. Reforms to address these imbalances should not put States and Territories under further budgetary pressure. Instead, they should ensure States have secure revenue and flexibility to plan and deliver services, and to respond to shocks and crises.

The Victorian Government looks forward to a discussion with the Commonwealth, other States and Territories, and the community on the best ways to improve our tax system. To prepare this document, we have already conducted stakeholder meetings and engagement. By working together we can achieve ambitious taxation reforms that will make a significant and positive difference for Australians.

THE NEED FOR SIGNIFICANT REFORM

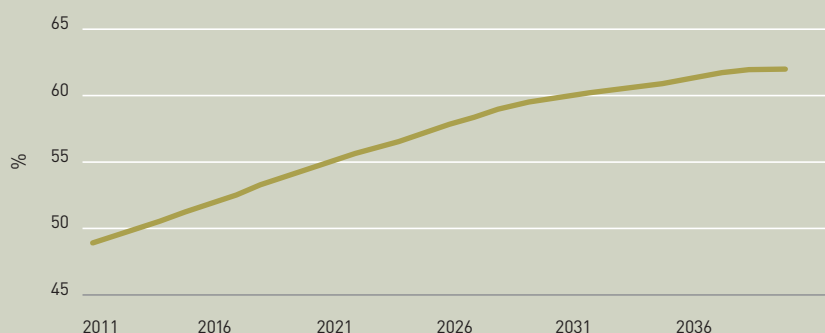
Over decades, our tax system has changed incrementally, often without a clear plan or direction, and often with unintended consequences.

This has caused several major problems. It has made the tax system less fair, imposing high effective marginal tax rates on people earning low incomes. It has made the tax system too complex, wasting time and resources, and creating loopholes. Finally, the tax system does not support sustainable planning and delivery of the services Australians need.

BARRIERS TO WORKFORCE PARTICIPATION AND PRODUCTIVITY

Encouraging people to enter and stay in the workforce is critical to Australia's future. Employment not only helps make individuals healthier, happier and wealthier, it also promotes growth of the economy as a whole. Workforce participation and productivity will become even more important for Australia's long-term economic growth as our population ages and the relative size of our workforce declines (see Chart 1).

CHART 1 ▶ DEPENDENCY RATIO (NUMBER OF PEOPLE AGED UNDER 14 AND OVER 65 PER 100 PEOPLE AGED 14–65), 2010 TO 2040



Source: Australian Bureau of Statistics, Population Projections, Australia, 2006 to 2101, 2008

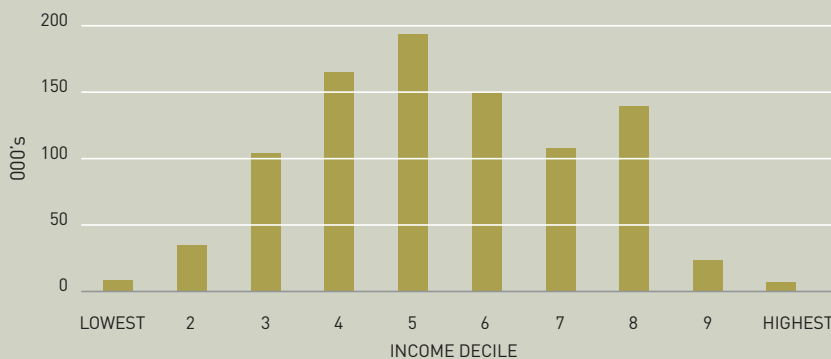
AN EXAMPLE OF A HIGH EFFECTIVE MARGINAL TAX RATE

Margaret is a secondary income earner, currently seeking work. Her partner earns \$35,000 a year and they have a ten-year-old child. The family receives Family Tax Benefit (A) and (B) and the Newstart Allowance. Margaret returns to work for 20 hours a week, earning \$20,000 a year. This means the family loses over \$8,300 in benefits and pays an extra \$2,100 in income tax. In net terms, the family only keeps around \$9,600 of their new income after tax. This is an effective marginal taxation rate of 52 per cent for the extra \$20,000 income, significantly higher than the highest income tax rate in the country.

The interaction between personal income tax and the welfare system has a big influence on whether people decide to work, and how much they decide to work.

This interaction discourages many secondary income earners, people earning low incomes and older people from entering the workforce or working more. When the withdrawal of benefits is counted, many people on low incomes, (including a large number of older Australians) face an effective marginal tax rate (EMTR) of over 50 per cent on additional income, or more than the highest income tax rate. In the longer term, this could result in underemployment, with a negative impact on national productivity and growth.

CHART 2 > NUMBER OF PEOPLE PAYING EMTRS OF OVER 50%, BY INCOME DECILE, 2009-10



Source: NATSEM's STINMOD/07A model, 2008

In recent years, the number of people facing EMTRs over 50 per cent has increased due to the interaction of the tax and welfare systems. Almost two-thirds of these people have a partner and dependent children, reflecting the widening eligibility for family assistance, such as Family Tax Benefit (A) and (B).

The impact of these high EMTRs on people's decisions to participate in the workforce and on overall economic growth is significant.

COMPLEXITY

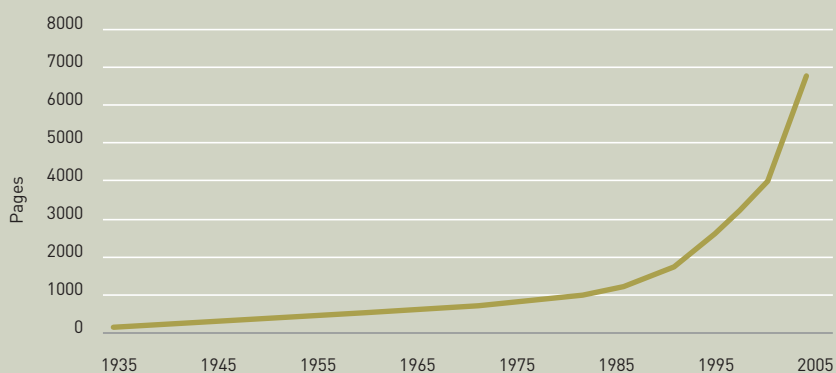
The complexity of Australia's tax system costs businesses, individuals and governments time and resources to understand and comply with its requirements.

Some complexity is necessary to ensure the tax system is fair and that there are not incentives to exploit it. However, there are a lot of opportunities to simplify taxation in Australia.

Australia is the eighth lowest taxing country in the OECD, but levies over 125 taxes, 99 of them Commonwealth taxes, 25 State taxes and one local government tax. Around 90 per cent of all tax revenue is raised through the largest 10 taxes, with the remaining 10 per cent split between the other 115 taxes.

Not only has the number of taxes grown over time, but the complexity of these taxes and the length of accompanying legislation has also grown, making them costly to administer and time consuming for taxpayers. One illustration of this trend is the exponential growth in personal income tax legislation over time (see Chart 3).

CHART 3 ▶ PAGES OF THE INCOME TAX ASSESSMENT ACT(S), 1935–2005



Source: Banks, Gary, Address to the Conference of Economists, Business Symposium, 2 October 2003

In addition to the number of taxes and their complexity, important sources of complexity in Commonwealth taxation include:

- ▶ tax expenditures
- ▶ the design of welfare payments
- ▶ the taxation of capital

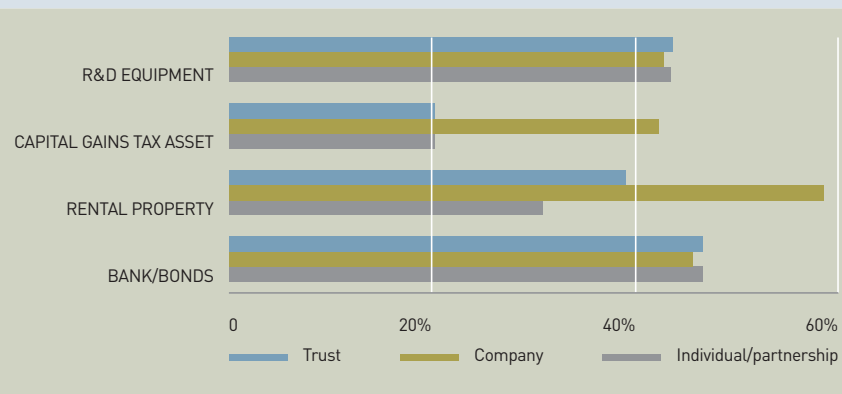
The Commonwealth tax system includes a wide variety of tax exemptions and concessions, known as tax expenditures. In total, there are around 320 items of tax expenditure, reducing tax revenue by an estimated \$74 billion in 2007–08.

These expenditures are large enough to force overall tax rates up, and they often disproportionately benefit higher income earners. They create opportunities for tax avoidance, distort behaviour, and can result in unintended, perverse incentives. For example, the current statutory formula to value vehicle fringe benefits reduces the taxable value of vehicles as the kilometres travelled increase. This encourages unnecessary vehicle use to minimise fringe benefits tax.

Australia’s personal tax and transfer system is intentionally extremely targeted. It provides around 40 transfer payments for varying purposes, which cost over \$70 billion in 2006-07. These payments include the Family Tax Benefit (A) and (B) for families with dependent children and the Age Pension. Each of these are separate payments with different income and asset tests. The definition of income and assets in these tests is often different from the tax system definition. Also, only some of them are taxed as income, adding further complexity. These payments are also administered through complex relationships between numerous Commonwealth and State Government agencies.

The taxation of capital is also extremely complex, partly reflecting the range of corporate transactions and legal structures. Capital taxation differs according to the asset (cash, property, shares), financing (debt or equity), industry (primary production, mining and intellectual property) and legal entities (partnership, company, trust) (see Chart 4). As with targeted tax concessions, differing taxation according to asset types may discourage innovation and divert investment away from its most productive use.

CHART 4 > NOMINAL EMTRS FOR AN INDIVIDUAL TAXPAYER INVESTING IN ASSETS, DIRECTLY OR THROUGH A BUSINESS ENTITY



Source: Architecture of Australia’s tax and transfer system, Commonwealth Treasury, 2008

The administration of State and Territory taxation can also be improved to make the tax system simpler, especially as a growing number of businesses operate across State and national boundaries.

Differences between State and Territory tax rates are likely to have a minimal impact on business compliance costs. However, different approaches to State and Territory tax administration do make the tax system more complex.

It is hard for businesses to calculate their State and Territory taxes when the definitions of what the taxes apply to are different, and when there are many different points of contact for questions, support and compliance issues.

The Victorian Government has done a lot to make tax administration simpler, including taking a national leadership role with New South Wales by harmonising the administration of payroll tax and, more generally, through Victoria’s *Reducing the Red Tape Burden* initiative, which is at the forefront of regulation reduction and delivers real outcomes.

Despite this progress, there is still potential to improve State and Territory tax administration, which would reduce business costs, stimulating business investment and employment.

LACK OF ACCESS TO SECURE REVENUE FOR SERVICES

A lot of tax paid in Australia is not spent by the level of government that collects it. The Commonwealth collects over 85 per cent of taxes and has access to some of the largest, broadest, and fastest-growing taxes. However, the Commonwealth is only responsible for around 57 per cent of government expenditure.

State Governments are primarily responsible for school education, health care, infrastructure, police and emergency services, and a range of other areas. Spending on these services amounts to 43 per cent of all government expenditure. Despite this, States only collect 15 per cent of tax revenues.

Net Commonwealth payments to the States remain at historic lows (as a proportion of gross domestic product) and the Commonwealth-State fiscal gap has grown in recent years, as illustrated in Chart 5. This has left Australia with a bigger gap between revenue raising and expenditure responsibilities than most comparable federations around the world (see Chart 6).

The revenue-expenditure gap results in confused accountability, blame shifting, and inefficient churn of tax revenues between levels of government. It also reduces the flexibility for States to respond to community needs, plan future investment and respond to shocks and crises. Future cost pressures, including an ageing population and climate change, will put States in an increasingly difficult position.

CHART 5 COMMONWEALTH TRANSFERS TO STATES AND COMMONWEALTH TAXATION REVENUE, % OF GDP, 1970S TO 2000S

Source: Robertson, Rory, Four facts missing from debate on Federal State financial relations, Macquarie Bank Research Bulletin, 2006

Note: 2000's average net of State taxes abolished under the GST agreement.

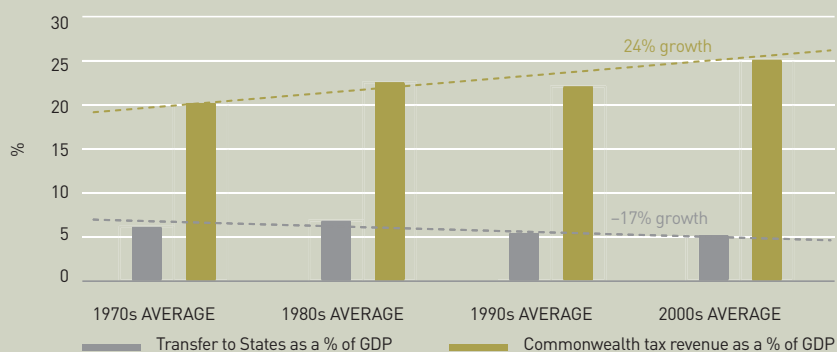


CHART 6 > VERTICAL FISCAL IMBALANCE, SELECTED FEDERATIONS, % OF SUBNATIONAL REVENUE, 2003



Source: Organisation for Economic Cooperation and Development, Economic Survey of Australia, 2006, 2006

The Commonwealth and the States have recently agreed to a new federal financial relations framework which aims to address some of these issues. However, an imbalance remains which stands in the way of significant reform to State taxation. Public submissions to the Review have highlighted State reliance on stamp duties, arguing that they limit economic activity and distort investment choices.

There would be benefits in reducing or abolishing these taxes. In addition to other concerns, they are unpredictable, responding more than other taxes to volatility in specific markets. This makes them less suitable as the basis for funding important public services, which are likely to be even more in demand in difficult economic times. State taxes are also generally slower to recover after an economic downturn.

However, it would cost between \$15 and \$20 billion to abolish State stamp duties. States cannot unilaterally cover this cost while maintaining the level of government services the community expects.

Raising this revenue through existing State taxes is not a viable option. Raising the rates of payroll tax and land tax, or applying them to more taxpayers, could place too great a burden on asset rich, income poor property owners and small business owners.

States cannot realistically raise substantial revenue through new taxes either. The High Court's interpretation of the Constitution has restricted States from imposing taxes on goods and placed some existing State taxes under threat. This leaves States with few options of finding replacement funding and would put vital services at risk. This is exacerbated in States that are unable to rely on mineral resource charges for revenue. While some user and environmental charges could make up part of the shortfall, they may be expensive to administer and may not raise significant revenue.

The Victorian Government has a strong record of substantial tax reform and has announced over \$5.5 billion worth of tax cuts since 1999 (see box on page 12). These reforms improved the efficiency and equity of the Victorian tax system and have been deliberately targeted at contributing to economic growth. However, it will be difficult to achieve further significant reform without structural reform to the Commonwealth-State tax mix.

Significant reduction or abolition of any State taxes would require States to find replacement revenue that:

- › Is large enough to ensure no reduction in the level or quality of services
- › Grows in line with the economy and the cost of delivering services
- › Is sustainable, stable and secure
- › Does not worsen the taxation-expenditure gap.

This can only be achieved through cooperation between the Commonwealth and State governments.

VICTORIA'S TAX REFORM RECORD

The Victorian Government announced and implemented substantial tax reforms between 1999 and 2008. These reforms aimed to improve economic outcomes by increasing the efficiency and equity of the Victorian tax system.

As a result of these reforms, Victoria now levies the second lowest number of taxes of any State and its tax revenue as a percentage of GSP has fallen to around the Australian average. This has been achieved while meeting the Victorian Government's commitment to a minimum annual surplus of at least \$100 million each year.

Reforms implemented include:

- › Over \$5.5 billion worth of tax cuts announced
- › The abolition of 8 State taxes (as agreed under the GST Agreement), faster than any other State, while still on Budget Balancing Assistance
- › Significant reform of land tax and payroll tax, with a reduction in the burden such as a flattening out of the land tax scale

Measures have also been introduced to improve equity by reducing the capacity for tax evasion. This ensures Government can fund services without increasing the tax burden on other taxpayers. Examples of such measures include introducing:

- › Anti-avoidance provisions in the conveyancing duty base regarding land rich property transfers and long-term leases
- › Measures that reduced the incentive for landowners to minimise their land tax liabilities through the use of trusts

In addition, compliance costs to business of dealing with State taxes across borders have been reduced:

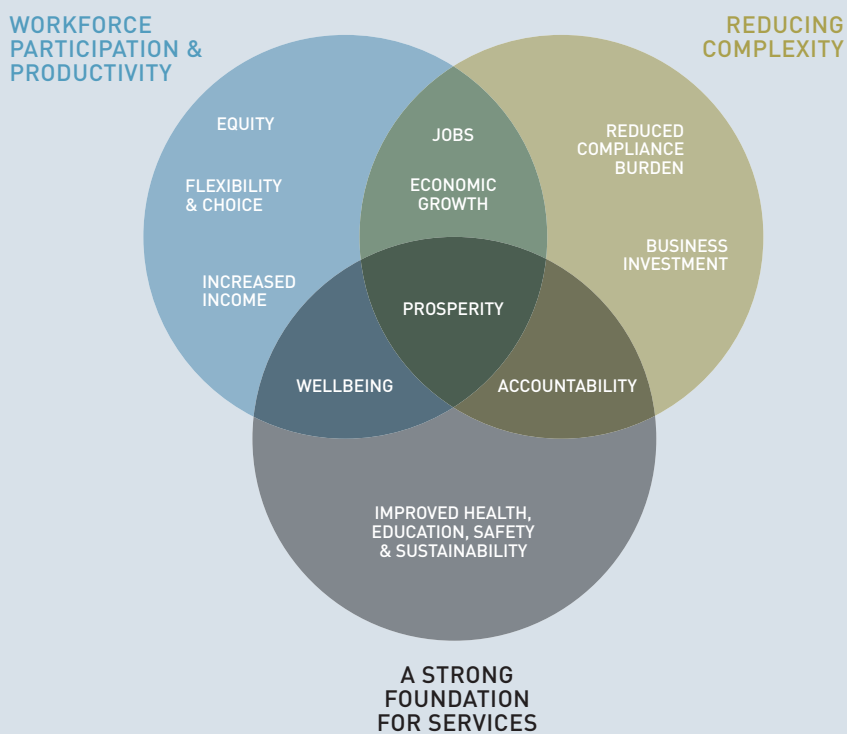
- › Standardised payroll tax employment agency provisions with other States in 2004–05
- › Harmonised payroll tax administration with the other States, commencing with New South Wales from 2007

REFORM DIRECTIONS

By working together, Australian governments can remove barriers to workforce participation, reduce complexity in the tax system, and secure funding for long-term investment in the services Australians need.

The following reform directions are not comprehensive, but focus on actions that will help us make progress towards these objectives, resulting in significant benefits for all Australians.

FIGURE 1 ▶ BENEFITS OF PROPOSED REFORM DIRECTIONS



ENCOURAGING WORKFORCE PARTICIPATION AND PRODUCTIVITY

As discussed earlier, the interactions between the income tax system and the welfare system can create high EMTRs, discouraging some people from participating in the workforce and subsequently limiting productivity improvements.

To reduce these barriers to workforce participation, the Commonwealth could consider the following reform options, which would generate significant economic benefits.

Reform options

The Commonwealth could implement reforms to improve productivity, participation and long-term economic growth by introducing targeted personal income tax rate cuts, or reviewing transfers that contribute to high EMTRs. This could include exploring adjustment of taper rates for:

- › Family Tax Benefit (A) and (B)
- › Newstart Allowance
- › Low Income Tax Offset
- › Mature Aged Worker Offset.

REDUCING COMPLEXITY

There are a number of factors that contribute to the complexity of Australia's tax system including:

- › The number and complexity of taxes
- › The number of welfare payments and their complex administration
- › The number and nature of tax expenditures
- › Difference in the taxation of capital according to asset type
- › Inconsistent State and Territory tax administration

Many features of the tax system that cause complexity were introduced for specific reasons. However, the ad hoc evolution of the personal tax and transfer system has resulted in an extremely complex system. There are around 40 cash transfers and over 300 tax expenditures in the form of deductions and offsets. At the State and Territory level, there is scope to further streamline taxation administration to make compliance easier for businesses.

Reducing complexity will require effort by both Commonwealth and State Governments. There are a wide range of options that should be considered to reduce the burden of complying with taxation and make the system simpler and more transparent.

The Commonwealth should consider reducing the number of tax expenditures, simplifying the welfare payments system and its administration, and standardising taxation of capital.

Victoria is willing to work with the Commonwealth and other States and Territories and has been actively pursuing the identification of ways to simplify the administration of State taxes and reduce compliance costs for business. In addition, there may be scope to reduce the number of State and Territory taxes, with Commonwealth cooperation, as discussed on the next page.

ACCESS TO SECURE REVENUE FOR SERVICES

Significantly improving State taxation, while making sure the tax system effectively funds the services Australians need, is a much bigger challenge. While States have some levers to pull, the Commonwealth has the sharpest instruments to affect the greatest reform. This requires structural reforms and greater cooperation between the Commonwealth and the States.

Stamp duties make up a large proportion of State revenue, but some submissions have noted that abolishing them could improve the efficiency, equity, simplicity and transparency of the tax system overall, stimulating economic growth. However, States cannot replace stamp duties entirely through existing taxes, or by introducing significant new taxes.

The Commonwealth, on the other hand, collects the vast majority of tax revenue in Australia and has access to some of the largest, most efficient and fastest-growing taxes, but is only responsible for around half of total government expenditure.

Reduced or abolished State stamp duties can only be realistically replaced with revenue currently collected by the Commonwealth Government. While this would represent the most significant shift in Commonwealth-State financial relations since the introduction of the GST in 2000, it could significantly improve Australia's economic performance.

This could be achieved in two broad ways, or a combination of both:

- › Increasing existing Commonwealth Government grants – untied and/or tied; and/or
- › States sharing of revenue from Commonwealth tax bases.

Additional Commonwealth grants

The Commonwealth Government could continue to collect tax revenue under current tax arrangements and provide grants to the States and Territories to make up for the revenue lost through stamp duty reductions. These grants could be 'tied' (for spending in specified ways) or 'untied' (where States can determine their spending priorities).

However, there are significant shortcomings to this option. Additional Commonwealth grants would increase the imbalance in the taxation and expenditure responsibilities of Australian governments. Increasing State reliance on grants would reduce transparency and accountability, which would be inconsistent with the new federal financial framework, that aims to increase public accountability.

Commonwealth grants would not be secure and may be tied to specific purposes. This would limit States' ability to plan future investment, respond to changing conditions, such as the global financial crisis and natural disasters, and plan for long-term service and infrastructure needs.

The Commonwealth sharing tax revenue with the States

An alternative to Commonwealth grants to the States is State access to Commonwealth taxes. Australia would only benefit if these taxes were stable, sustainable, secure and grew in line with the economy. In addition, any replacement revenue sources must improve on the taxes they replace. In particular, they should:

- › Not significantly distort economic activity
- › Not reduce equity
- › Not limit economic activity.

There are two ways the States could share revenue from a Commonwealth tax:

- › Revenue sharing – under this option, States would receive a fixed revenue share of a Commonwealth tax in the form of a grant, as is currently the case with the GST
- › Base sharing – States would have direct access to a tax base that is currently only levied by the Commonwealth.

Revenue sharing

Revenue sharing can be used where constitutional or administrative limitations make it easier for the Commonwealth to levy a tax, such as the GST.

Revenue sharing could also be combined with broader reforms that improve the efficiency of the overall tax system. For example, revenue could be shared by reforming taxation of natural resources. This also presents an opportunity to abolish State royalties and replace them with a broader Resource Rent Tax.

However, revenue sharing worsens the vertical fiscal imbalance and does not provide States with fiscal autonomy to plan and deliver services.

Tax base sharing

In some cases, States can constitutionally access a tax base already used by the Commonwealth. There are a range of benefits to using this approach to fund improvements to the State and Territory tax mix. It would not make the taxation-expenditure imbalance worse, and could improve it, making taxation more transparent and governments more accountable. It would also give States secure, and less volatile, revenue to plan for the future.

If base sharing were adopted, it would make sense for both taxes to be centrally administered by the Australian Taxation Office. This would ensure there are no increases in compliance costs for taxpayers and administration costs for governments. However, it would be important for State tax revenue collected by the Commonwealth to be returned to the States where it was raised. This would avoid unnecessary administrative complexity and maximise the accountability of State Governments.

On constitutional and other grounds, the personal income tax base could be an option for the Commonwealth and State tax base sharing.

Funding new Commonwealth grants, revenue sharing or base sharing

All of these options will have funding implications. The abolition of State taxes could be funded by an increase in overall Commonwealth tax rates. This could replace tax reductions in stamp duties, keeping the overall tax burden unchanged.

However, this is unlikely to be necessary. Significant reductions or the abolition of stamp duties could generate substantial additional revenue or a “fiscal dividend” for the Commonwealth over time. In particular, this would come from personal income tax and company tax, which apply to a large cross-section of the population and are linked to economic growth. In *Analysis of State Tax Reform, 2008*, Access Economics estimated that the Commonwealth could receive up to around \$4 billion in additional tax revenue if the States abolished all their stamp duties (based on 2005–06 revenue data).

Other reforms of Commonwealth taxation arrangements, for example reduced tax expenditures, could also increase Commonwealth revenue without increasing tax rates.

This new revenue could help fund new grants or revenue sharing. If base sharing were adopted, it could allow the Commonwealth to ‘make room’ for base sharing. This means the Commonwealth would reduce its tax rates to ensure there were no increase in taxation rates overall. This could occur gradually, as reforms increased Commonwealth revenue. Transition arrangements may also be needed to:

- › Ensure States’ capacity to provide public services is not put at risk; whilst
- › rewarding States that follow through on tax reform.

CONCLUSION

This submission identifies many of the most promising reforms to the Commonwealth and State tax systems. Some of these reforms can be achieved by the Commonwealth and States in isolation, but the most significant reforms will require cooperation to make sure Australia has the best possible tax mix, and that our taxes go where they are needed most.

Combined, the reform options outlined in this submission would substantially improve workforce participation, productivity and economic growth, adding billions of dollars to Australia's GDP each year.

Taking this opportunity to agree major reforms to Australia's tax system could accelerate Australia's future recovery from the economic conditions we will face in the short-term. The right reforms can help ensure our economy is dynamic and can position governments to provide the best schools, hospitals, police, infrastructure and environmental management to prepare us for the future.

The Victorian Government is ready to work with other States and the Commonwealth to identify the best tax reforms we can make, and the best ways we can work together to achieve them.

