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Improving Taxes and Transfers in Australia

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IMPROVING TAXES AND TRANSFERS IN AUSTRALIA

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ABSTRACT/RÉSUMÉ

Improving Taxes and Transfers in Australia

Getting tax and transfer systems to efficiently deliver sufficient revenues to achieve macroeconomic targets, address goals in re-distribution and social welfare, encourage employment, accommodate business-competitiveness concerns and incorporate environmental issues is difficult. In Australia, slowing economic growth in the wake of the mining boom has sharpened the trade-offs and brought into focus the importance of encouraging broad-based advances in employment and productive capacity while also dealing with other long-term challenges, in particular population ageing and greenhouse-gas emission reduction. This review particularly recommends shifting away from income taxation to indirect taxation, for instance by raising more revenue from the Goods and Services Tax. The report also advises caution in some recent welfare-reform proposals, and advocates broad support for business rather than targeted subsidies and other forms of corporate welfare. As regards environmental policies, the report comments on the proposed Emission Reduction Fund for reducing greenhouse gases and supports reform to vehicle-related taxation.

This Working Paper relates to the 2014 *OECD Economic Survey of Australia* (www.oecd.org/eco/surveys/economic-survey-australia.htm).

JEL classification: H20, H21, H22, H23, H24, H25, H26, H27, H29, Q58

Keywords: taxes, taxation, transfers, subsidies, welfare, pensions, income tax, corporate tax, indirect tax, goods and services tax, carbon tax

Améliorer le système de prélèvements et de prestations en Australie

Il n’est pas facile de faire en sorte que le système de prélèvements et de prestations dégage suffisamment de recettes pour atteindre les objectifs de politique macroéconomique, de redistribution et de bien-être social, encourage la création d’emplois, réponde aux préoccupations de compétitivité des entreprises et contribue à relever les défis environnementaux. En Australie, le ralentissement de la croissance économique à la suite du boom minier a accentué les arbitrages et mis en lumière l’importance d’encourager de larges progrès en matière d’emploi et de capacités productives, tout en relevant d’autres défis à long terme, comme le vieillissement démographique et la réduction des émissions de gaz à effet de serre. Cet examen recommande en particulier de se détourner de l’imposition des revenus au profit de la fiscalité indirecte, par exemple en augmentant les recettes provenant de la taxe sur les produits et services. Le rapport met également en garde concernant certaines propositions récentes de réforme du système de protection sociale, et préconise un large soutien aux entreprises plutôt que des subventions ciblées et d’autres formes d’aide sociale aux entreprises. S’agissant des politiques d’environnement, le rapport formule des observations sur le projet de Fonds pour la réduction des émissions de gaz à effet de serre et appuie la réforme de la taxation des véhicules.

Ce Document de travail se rapporte à l’Étude économique de l’OCDE de l'Australie, 2014 (www.oecd.org/fr/economie/etude-economique-australie.htm.).

Classification JEL : H20, H21, H22, H23, H24, H25, H26, H27, H29, Q58

Mots clefs : la fiscalité, les transferts, les subventions, l'aide sociale, les pensions, l'impôt sur le revenu, impôt sur les sociétés, impôt indirect, biens et services, la taxe de carbone

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IMPROVING TAXES AND TRANSFERS IN AUSTRALIA

By Philip Hemmings and Annamaria Tuske[1]

Taxes and transfers are key tools for addressing economic, social and environmental issues, including achieving fiscal targets, creating a competitive business environment, motivating employment, and ensuring adequate levels of welfare. Given the multiple facets of tax and transfer policies, making the most of "win-win" opportunities and having a good gauge of trade-offs where these occur are keys to sound policy. In Australia, the end of the resources-investment boom, population ageing and a need for broad-based productivity growth mean effective tax and transfer systems are all the more important. This paper evaluates current policies and plans for the future and concludes with a series of recommendations.

Notable features of the system

Australia's tax and transfer system has a number of striking characteristics:

- Government spending has long been relatively low compared with many other OECD countries, and this is echoed in the relatively light overall tax burden. Since at least the mid-1990s total government revenues have ranged between 25% and 30% of GDP (Figure 1, Panel A); the OECD average is around 35%. As in many other countries, both individual and corporate tax revenues have dipped as a share of GDP following the global financial crisis (Figure 1, Panel B).
- Regular income tax on households and businesses features prominently and comparatively little revenue is collected from indirect taxes, which is less employment and growth friendly. Indeed, as a proportion of GDP, indirect-tax revenues rank among the lowest in the OECD area, while revenues from income taxes on both households and corporations are among the highest (Figure 1, Panel C).
- Spending on welfare transfers is low in international comparison. Though public social spending has risen somewhat over recent decades (Figure 1, Panel D), it nevertheless has remained clearly below the OECD average.
- As regards support for business, in common with many other countries, encouraging R&D activity is a core theme of the various programmes and incentives. However, Australian business policy has concentrated rather less than other countries on cutting the rate of corporate income tax as a means of attracting investment and has a history of subsidising struggling industries (notably automobile plants).
- Taxes and transfers are a key dimension in federal-state relations (see Chapter 2 of the 2014 *Economic Survey* of Australia). Broadly, the Commonwealth (central) government plays a greater role over taxes and transfers than do state governments; the latters' own revenues cover only about half their outgoings with federal-government grants making up the difference. In addition, practically all cash benefits to households are federally run; the states, in contrast, have considerable responsibilities in service provision, in particular much of health and education.

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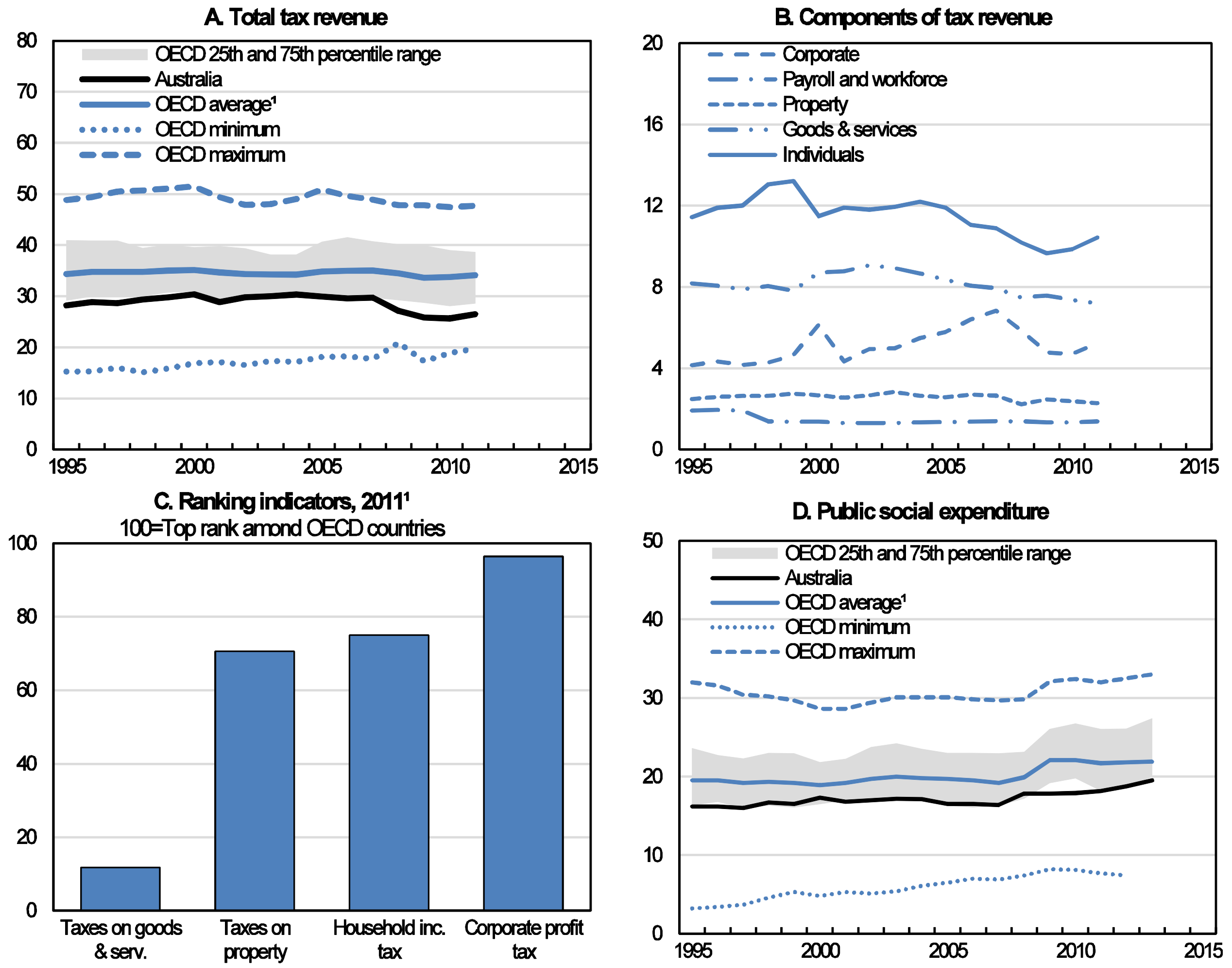
[1] Philip Hemmings is head of the Australia Desk in the Economics Department of the OECD; Annamaria Tuske is a statistican on the Australia Desk. This paper is based on Chapter 1 of the 2014 OECD Economic Survey of Australia, published in December 2014 under the authority of the Economic and Development Review Committee (EDRC). The author would like to thank Alvaro Pereira, Robert Ford, Piritta Sorsa, Vassiliki Koutsogeorgopoulou and colleagues from the OECD's Centre for Tax Policy and Administration, the Environment Directorate and the Directorate for Employment, Labour and Social Affairs for valuable comments on earlier drafts. The report also benefited from comments from the Australian authorities. Special thanks go to Anthony Bolton and Mikel Inarritu for administrative assistance.

Figure 1. **Tax revenue and social spending indicators**

As a percentage of GDP



1. The ranking indicator re-scales rankings so that 0 is the lowest ranked country and 100 is the top ranking country. The rankings are based on the shares of revenue in GDP. 2011 or latest available year, except for corporate tax which is based on the average of the previous seven years to reduce the influence of cyclical variation.

Source: OECD (2014), Tax revenue database and OECD (2014), Social expenditure database.

Key challenges

Australia's challenges for tax and transfer policy comprise several inter-related issues:

- Identifying the economically least damaging measures to raise revenue and restrain public spending to achieve deficit and debt reduction;
- Getting taxes and transfers to help growth potential by encouraging labour supply, and enhancing the climate for business activity in other respects;
- Ensuring the taxation of natural resources brings an appropriate return to the public as ultimate "owners" of Australia's natural resource wealth;
- Using the tax and transfer system to help reduce poverty and inequality;
- Improving the tax system's environmental characteristics.

The following sections first briefly discuss the present government's intended approach to taxes and transfers. Subsequent sections discuss the best way forward for policy under five headings: indirect taxation; household income tax and social benefits; taxes on property and wealth; business taxation; and evasion, avoidance and administration issues.

Recent policy developments

Under the previous administration, policy on taxes and transfers was guided by the recommendations of a major review (commonly referred to as the "Henry Review") that was commissioned in 2008 and whose final conclusions were published in 2010 (Australian Government, 2010). This Review aimed for a comprehensive assessment of taxes and transfers. However, its terms of reference excluded some important issues. Most notably, reform of the Goods and Services Tax (GST) was not considered, reflecting an electoral promise of the government of the time. Various other government-initiated reviews are underway which have relevance for tax and transfer issues, notably welfare policy is being investigated (by the *Reference Group on Welfare Reform*, Australian Government; 2014a) and so is the financial system (the *Financial System Inquiry*, which will include coverage of second-pillar pensions ("superannuation"), (Australian Government, 2014b).

The current government has signalled a significant change in tone on taxes and transfers. This is illustrated by the selected reform proposals listed in Table 1. Some of these echo the government's fiscal ambitions alongside political concerns for burden sharing; the temporary top-end tax, for instance, probably falls into this category. There are deeper structural themes too. Proposed welfare measures demonstrate a desire for stronger incentives to join and remain in the workforce (as illustrated in proposals for longer waiting times for benefit for young unemployed) and for greater financial support in the first months of parenting through expansion of paid parental leave - a flagship reform of the administration. The items in Table 1 also underscore the current government's pro-business agenda, with reduction in the rate of corporate tax, replacement of a carbon tax with subsidies to firms for reducing greenhouse-gas emissions, and scrapping a tax on supernormal profit for mining companies.

Table 1. **Key tax and transfer reforms proposed in the 2014-15 Budget**

Action	Progress in implementation (as of September 2014)
Personal income tax	
A temporary top-end tax (the Temporary Budget Repair levy), an additional 2% tax on the current top personal-income tax rate of 45% for those earnings above AUD 180 000 (i.e. about twice the average wage).	*Legislation passed (Royal Assent June 2014)*
Reversal of a hike in the universal tax-free threshold, as part of a partial unwinding of the measures that were introduced to compensate for the impact of the carbon tax on household incomes (the impact is primarily increased energy prices).	*Legislation in parliamentary process*
Unemployment benefit and activation measures	
Longer unemployment benefit waiting periods for those aged under 30; waiting periods of up to 26 weeks are proposed.	*Legislation in parliamentary process*
Subsidies to employers taking on those aged over 50 worth up to AUD 10 000 over a two-year period ("Restart").	*Program commenced July 2014*
Mandatory work experience for certain jobseekers, the Work for the Dole programme started in July 2014 across 18 high- unemployment areas. The plan is for nationwide roll-out from July 2015. A six-month wage subsidy will be available to employers for taking on those participating in the programme.	*Implementation underway*
Stronger penalties for jobseekers who refuse or persistently fail to meet requirements. Specific penalties include loss of payment for eight weeks with no option for the penalty to be waived through participation in additional activities or due to financial hardship.	*Legislation in parliamentary process.*
Family benefit	
More generous paid parental leave.* A proposal for pay-out at previous earnings (capped at AUD 50,000) for 26 weeks, plus superannuation contributions.	*Yet to enter parliamentary process*
Reduced scope of Family Tax Benefit B. From July 2015, the benefit will only apply to families where the youngest child is aged under 6 (implementation will be grandfathered for two years and Family Tax Benefit A will be increased for lone parents on the maximum rate of this benefit). In addition the maximum family income for receipt of Family Tax Benefit B will be AUD 100 000 instead of AUD 150 000.	*Legislation in parliamentary process*
Pensions	
Increase in age of access to the Age Pension, for the first pillar pension this is currently scheduled to reach 67 years by 2023; draft legislation proposes further increases (six months every two years) from 2025 to bring the age to 70 years.	*Legislation in parliamentary process*
Welfare payment indexing	
More indexing to CPI. A number of benefits are currently indexed to wages and some to more elaborate criteria (notably the Age Pension, see Table 7). The plan is to shift most indexing to CPI only.	*Legislation in parliamentary process*
Eligibility threshold freeze, a three-year freeze on the means-testing thresholds that trigger eligibility to benefit.	*Legislation in parliamentary process*
Corporate tax and business support	
Reduction in rate of corporate tax but also an offsetting new levy for large businesses that is nominally hypothecated to funding the expansion of paid-parental leave.	*Yet to enter parliamentary process*
Repeal of the "carbon tax" and introduction of a new suite of GHG-emission reduction measures (the Direct Action Plan) including subsidies for business to reduce emissions.	*Carbon tax repealed (July 2014);* *new legislation in parliamentary process*
Repeal of the mineral-resource rent tax (MRRT) that applies to coal and iron ore extraction**.**	*Legislation passed (Royal Assent September 2014)*

* Spending on this item was not actually included in the 2014-15 Budget but was nevertheless discussed in budget documentation and is a flagship reform of the government.

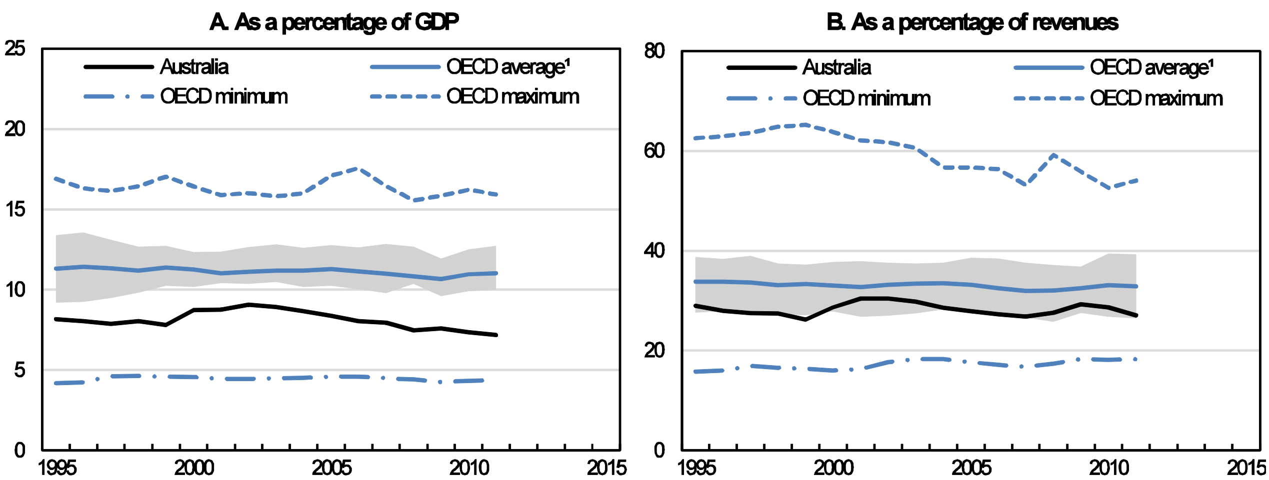
Taxation and households

Indirect tax is underutilised

Theory and evidence suggests indirect taxes are preferable to direct taxes when considering economic growth (Arnold, 2008; Johansson et al, 2008), as they favour saving and investment and have a smaller impact on business costs and profits as well as work incentives compared with other major tax bases, notably corporate-income tax and personal-income tax. Also, taxation of goods and services where there is inelastic consumer demand (or producer supply), provide opportunities to raise revenues with low deadweight losses in economic welfare. Indirect taxes can also "internalise" externalities, in particular those connected with the environment and public health. Of course there are potential downsides: some forms of indirect tax can be a vehicle for protectionism, distort household consumption and saving behaviour and can be regressive.

Indirect taxation is relatively light in Australia, with revenues equivalent to about 7% of GDP compared with an OECD average of a little below 12% (Figure 2, Panel A). Also, the portion of indirect taxation in total government revenues is low (Panel B). The Goods and Services Tax (GST), which is a value-added type tax, accounts for nearly half of all indirect tax with the remainder being dominated by items relating to vehicle use (Commonwealth excise on fuels plus various state-level motor vehicle taxes), customs duties and excise taxes on alcohol and tobacco (Table 2).

Figure 2. **Tax on goods and services**



1. The shaded area is the 25th to 75th percentile range of available OECD countries.

Source: OECD (2014), Revenue Statistics database.

Table 2. **Key items of indirect taxation**

	Revenue (2012-13), AUD billion	As a percentage of total revenue	As a percentage of GDP
Commonwealth government			
Taxes on the provision of goods and services	86.0	20.7	5.6
of which Goods and services tax	50.3	12.1	3.3
Excise on crude oil, petrol and diesel	17.8	4.3	1.2
Taxes on international trade (mainly customs duty)	8.2	2.0	0.5
Other excises (mainly those on tobacco and alcohol)	7.9	1.9	0.5
State and local government			
Taxes on the provision of goods and services	11.1	2.7	0.7
of which taxes on gambling	5.5	1.3	0.4
Taxes on insurance	5.5	1.3	0.4
Taxes on the use of goods and performance of activities	9.7	2.3	0.6
of which motor vehicle taxes	8.5	2.1	0.6
Total	106.7	25.7	7.0

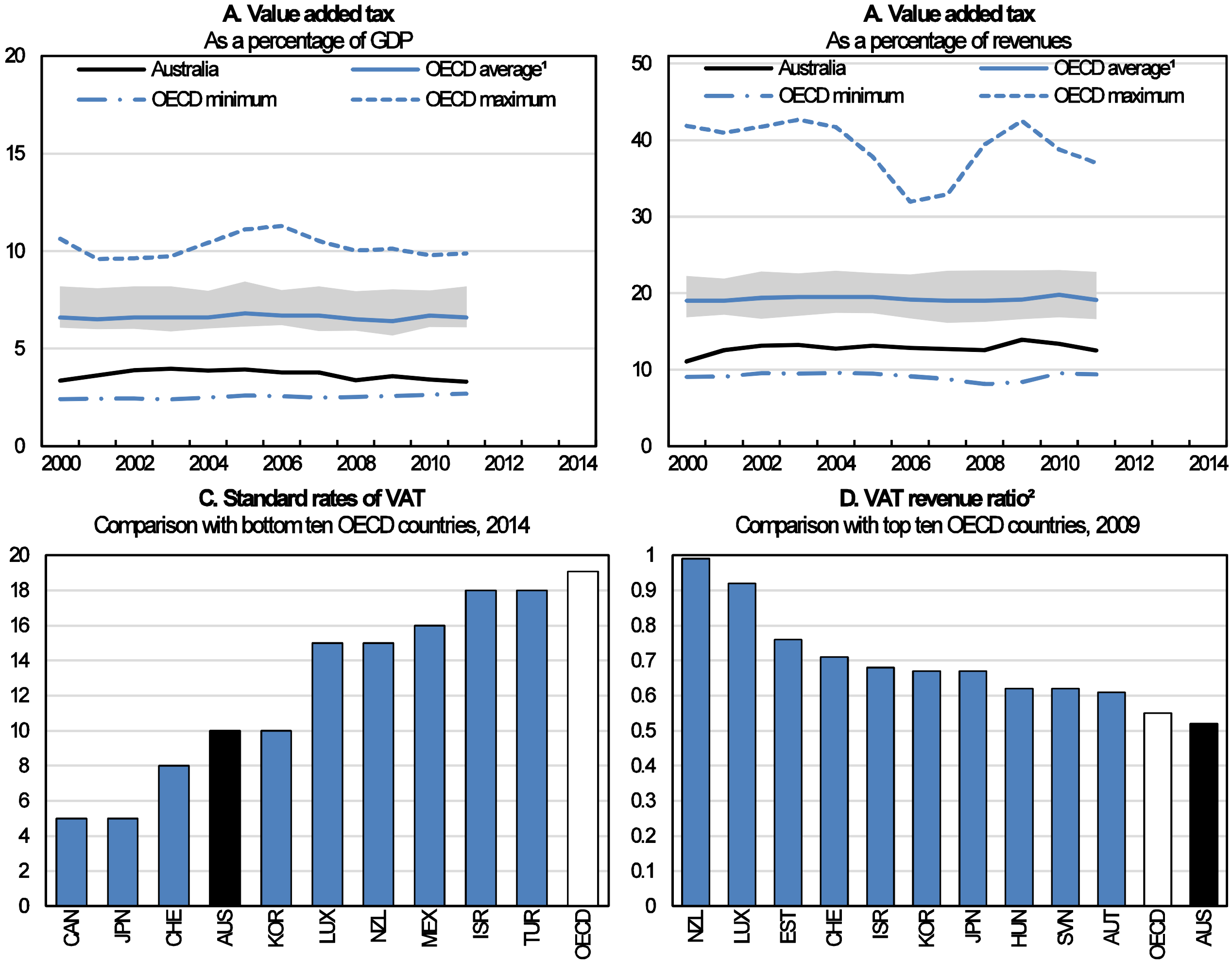
Source. Australian Bureau of Statistics, Taxation Revenue.

The case for raising more revenue from GST

Australia introduced a general tax on goods and services later than many other OECD countries. The Goods and Services Tax (GST) was introduced in 2000 after prolonged political debate. Value added taxes are in principle designed to impose a broad-based tax on final household consumption collected by businesses on the "value added" at each stage of production and distribution. However, Australia’s GST base is narrowed considerably due to extensive preferential treatments (i.e. zero rates and exemptions). Furthermore, the GST rate remains comparatively low, having remained unchanged from the “introductory” level of 10%. The share of revenues, with reference to GDP or to government revenues is correspondingly low in international comparison (Figure 3). Also, the fairly extensive exemptions are reflected in a middle-ranking VAT Revenue Ratio (this ratio is derived by dividing actual revenues by the revenues implied by applying the standard VAT rate to total household consumption).

Broadening the GST base by reducing the number of zero rates and exemptions would make sound economic sense. Most tax expenditures in Australia’s GST are accounted for by zero rates on food, healthcare, education and exemption of financial products. The fiscal cost is sizeable; the total effect of GST zero rates and exemptions for 2013-14 in these categories is estimated at around AUD 20 billion (1.3% of GDP) in foregone revenue (Table 3). Much of the preferential treatment is aimed at various distributional and social concerns, but is ill-suited to this role. A recent OECD study on the distributional effects of consumption taxes (OECD, 2014a) underscores that reduced or zero rates are a very poor tool for targeting support to low-income households. At best, high-income households receive as much benefit from a reduced rate as those on low incomes, and at worst they benefit vastly more than poor households, as their consumption of the tax-favoured goods and services is greater than that of low-income households.

Figure 3. **Value added tax (VAT)**



1. The shaded areas are the 25th to 75th percentile range of available OECD countries.

2. This ratio expresses the revenue collected from the actual VAT/GST in a country as a proportion of the revenue that would be raised if the main standard rate were applied to all consumption. Although the VRR has to be interpreted with care and erosion of the tax base may be caused by a variety of factors (incl. non-compliance), it provides an indicator of the amount of revenue foregone due to the application of preferential treatments such as zero rates and exemptions.

Source: OECD (2014), Revenue Statistics database, OECD (2012), Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administration Issues, OECD Publishing.

Table 3. **Large tax expenditure items for 2013-14**[1]

	Estimate AUD bn	As a % of GDP [2]
Total of items listed below (this does not include all tax expenditures)	**108.7**	**6.8**
Household capital gains and savings	**38.6**	**2.4**
Exemption on main residence--discount component	16.5	
Exemption on main residence	13.5	
Discount for individuals and trusts	4.3	
Concessional taxation on non-superannuation benefits	2.5	
Exemption on interest withholding tax on certain securities	1.8	
Superannuation	**32.1**	**2.0**
Concessional taxation of earnings	16.1	
Concessional taxation of employer contribution	16.0	
GST exemptions	**20.1**	**1.3**
Food	6.2	
Education	3.7	
Health; medical and health services	3.4	
Financial services	4.1	
Child care services	0.9	
Water, sewerage, drainage	0.9	
Other household tax expenditures	**5.7**	**0.4**
Family tax exemptions ("Parts A and B")	2.1	
Exemption of private health insurance rebates	1.5	
Exemption from medicare levy for households below a threshold income	1.3	
Application of statutory formula to value car benefits	0.8	
Business-related expenditures	**8.2**	**0.5**
Non-coverage of agriculture in the carbon-pricing mechanism	2.1	
Caps on the effective life of capital equipment for accounting purposes	1.7	
Simplified depreciation for small business	1.3	
Non-coverage of deforestation in the carbon-pricing mechanism	1.2	
Research and development tax offset	1.0	
Deduction of capital works expenditure	0.9	
"Philanthropic" expenditures	**4.1**	**0.3**
Healthcare providers (notably public and not-for-profit hospitals)	1.5	
Exemptions for "benevolent" institutions (this can include certain types of private school)	1.3	
Exemptions relating to certain types of gift	1.3	

1. These estimates are calculations of ‘revenue forgone’, which do not provide the full impact on revenue of removing a tax exemption (as, for example, they do not take into account behavioural responses by taxpayers). In addition, strictly speaking, such tax expenditures estimates should not be aggregated.

2. Assuming GDP of AUD 1 590 bn in 2013-14

Source: Australian Government (2014b), Tax expenditure Statement 2013, Canberra.

In addition, the "low value threshold exemption" for GST on imported goods requires attention. Such exceptions mean tax is not applied to imported goods below a certain value and are common among OECD countries. They are primarily motivated by the fact that for low-value goods the administrative cost of tax collection can outweigh any tax collected, or if this cost is passed onto consumers then the price would be exorbitant. Australia's low-value threshold is particularly high at AUD 1 000 on any single item and is motivating internet retailers to locate outside the country. The revenue foregone was estimated to be AUD 470 million in 2013-14 (Australian Government, 2014b). Tackling this issue is important, not least because of internet retailing's growth potential. One possibility is to require offshore suppliers of low value parcels to charge, collect and remit the tax, rather than the customs authorities. This could potentially reduce administrative costs and therefore allow for a lower threshold.

In addition to base-widening, international comparison suggests room to raise the rate of GST. In many countries the standard rate of VAT is over 20%; more than twice that of GST. However, this is probably not a good guide for reform as high standard rates often reflect systems riddled with exemptions and concessional rates. Rates in systems with few exemptions (i.e. a high VAT revenue ratio) provide a better model for Australian to adopt. For instance, New Zealand and Israel have wide bases and rates of 15 and 18% respectively.

Under current arrangements, all GST revenues are passed onto state governments, effectively representing an unconditional grant (see Chapter 2 of the 2014 OECD *Economic Survey* of Australia). Given this, any substantial GST reform has ramifications for state financing and, as such, would most likely only make progress as part of a package of reforms to state financing and other aspects of the federation. For instance, increased GST revenues (with corresponding cutbacks in conditional grants) could be one element in a federation reform that aims to give states some more autonomy (but also responsibility) in financing, as is suggested in Chapter 2 of the 2014 *Survey*.

There is room for better balance in vehicle taxation

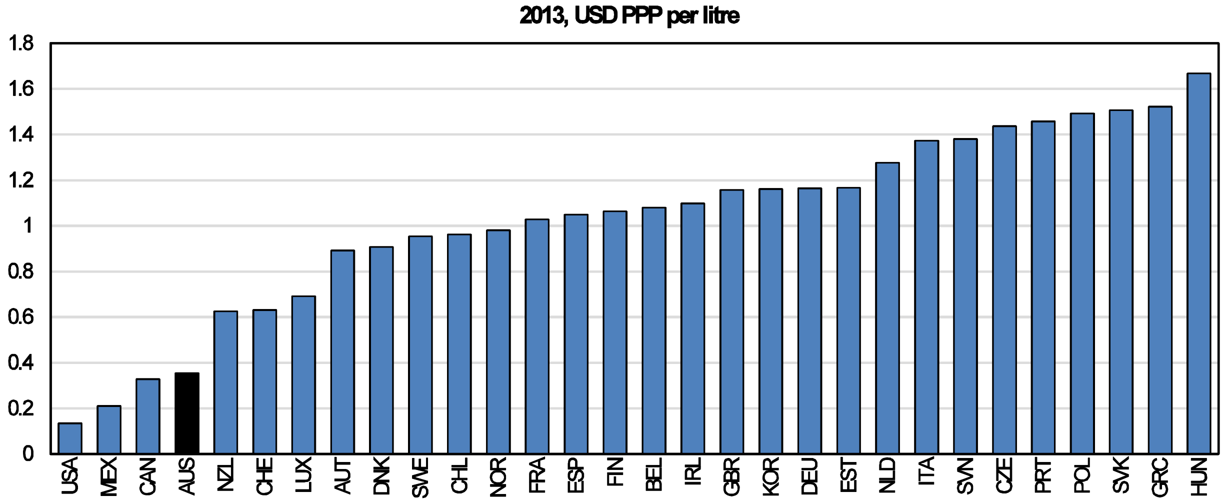
Australia's vehicle taxation comprises various state-based overhead taxes, excise tax on fuel and tolls (Table 4). Retail-fuel taxation in Australia has long been low in international comparison and increasingly so since 2001 when automatic indexing of the excise duty to the consumer price index was stopped. The indexation provided a useful "default" way of ensuring revenue increases for the treasury and preserved the positive influence of the excise environmentally. Therefore, the government's intention to reinstate indexation on the excise represents a sound move. There are also plans to establish a fund that will channel the increased excise revenue towards road infrastructure investment. Such ties between specific revenue and spending areas can compromise efficient resource allocation (as there is no reason why the revenues should match the optimal level of spending). However this is not a risk in this instance as the fund will not be used to fund specific road building projects and will only contribute a small proportion of overall spending on road infrastructure (the fund is expected to raise about AUD 2.2 billion over the four-year "forward estimate" period, while the current road-infrastructure programme over same period will cost over AUD 25 billion).

Table 4. **Key taxes and charges relating to the ownership and use of vehicles**

Area of taxation	Detail
Purchase of a vehicle	• Goods and services tax (10%). • Stamp duty (5%). • Luxury Vehicle Tax (LVT); 33% of the value of the car above a threshold amount. • Registration fee calculated on the value of the vehicle.
Regular overhead charges	Annual state-based fees that vary according to vehicle's value and/or other characteristics ("Motor Vehicle Duty" or colloquially, "Rego").
Vehicle use	• Excise and GST on fuel. Excise has remained unchanged since 2001, and is, for instance, AUD 0.38143 per litre on unleaded fuel, fuel and automotive diesel. Liquid Petroleum Gas (LPG) is much less taxed with a rate of AUD 0.10 per litre, but is undergoing a schedule of increases. • Cashless toll systems on most stretches of motorway but few charges on other sections of road.

Even if the government's planned reintroduction of indexing on the excise goes ahead, Australian fuel taxation will likely remain comparatively low (as other countries typically increase excise over time either through indexation or periodic adjustment), see Figure 4. *Prima facie* this implies headroom for pushing excise higher. However, as in other countries with low population density, such as Canada and the United States, Australia has many rural communities in which long-distance road travel, either for work, leisure or shopping is practically unavoidable. Thus, raising the fuel excise rate could have distributional consequences. Furthermore, as is generally the case, any environment justification of high fuel excise has to assume that the excise is offsetting additional externalities over and above those relating to greenhouse-gases such as congestion, noise pollution and local-air pollution because the price of carbon implied by the excise is typically way above even high-end estimates of its appropriate value. While it can be convenient to give credence to high fuel excise by considering it covers a range of externalities, in fact it may not be the first-best tool to tackle these problems.

Figure 4. **Tax on gasoline**[1]



1. Unleaded premium 95 RON. Tax refers to excise tax and general sales tax.

Source: OECD (2014), Energy database.

In sum, the Australian context favours road charging rather than fuel taxation as the most feasible economic instrument for dealing with transport-related externalities. To date most road pricing comprises tolls on sections of motorway that have been built under build-operate-transfer (BOT) contracts with the private sector. Time-varying charges operate in some cases (for instance the Sydney Harbour Bridge and Tunnel), reflecting good practice. Also, parking levies are being used to discouraging car use; for instance Victoria imposes an annual "congestion levy" on parking spaces in certain urban areas. However, comprehensive schemes that directly target car use, for instance along the lines of London’s “area charging” model or GPS-based charging have not yet been introduced in any of Australia’s states. As stressed in previous OECD *Economic Survey* discussion (OECD, 2012a), getting public acceptance for congestion charging can be a major hurdle.

As in many other countries a substantial share of vehicles are company cars; for instance it is estimated these accounted for one third of new car registrations in Australia between 2001 and 2011 (Harding, 2014). Company-car taxation is inherently tricky because the vehicles are invariably used for both personal and business travel, resulting in complex tax rules. As a result the provision of company cars often features in employee (and employer) tax optimisation strategies, undermining efforts on other fronts to discourage car use. In Australia, company cars are taxed as a fringe benefit. There has been some improvement in the rules recent years. Previously, there was a stepped schedule with four tax rates that declined with distance travelled. This created incentives to purposefully add mileage to enter a lower-rate distance band. Transition to a single-rate began in 2011 and was completed in 2014. Avenues for further improvement should be sought.

Alterations to vehicle taxation and further development of road charging need to be part of a wider transport strategy in the context of a co-ordinated federal and state government policy that strives to make the best allocations of infrastructure development between road infrastructure and options in public transport. Reforms to vehicle taxation should also broadly align with efforts to shift taxation from inefficient tax bases towards those that have favourable characteristics both as in terms of revenue but also economic incentives (as advocated in Chapter 2 of the 2014 OECD *Economic Survey* of Australia) in relation to state-level taxation.

Carbon taxation has been cancelled under a new approach to greenhouse gas emission reduction

The present government has dramatically changed the policy approach to mechanisms for reducing emissions. In July 2014, it delivered on its election commitment to repeal a carbon credit and purchasing system (dubbed the “carbon tax”, as its initial phase involved companies buying carbon credits from government as a first step towards a cap and trade system). By way of replacement, the government has proposed a suite of new measures called the Direct Action Plan.

The Direct Action Plan centres on the Emissions Reduction Fund which is a mechanism for crediting emissions reductions. Emission-reduction projects will be selected via a sealed bid auction and the government will then enter into contracts with successful bidders which specify that it will purchase a specific quantity of emission reductions on delivery. To sell emissions reductions to the government or into the secondary market, participants must first have the reductions verified and be issued with tradable carbon credits. In principle, such a scheme can have the appropriate incentive effects- indeed it can have the same effects as a carbon tax at the margin, providing difficulties in establishing baseline emissions and checking the achievement of emissions reductions are overcome. Unlike a carbon tax or cap and trade system, the Direct Action Plan will involve a net fiscal cost to the government.

However, there are avenues for enhancing the Emission Reduction Fund. Encouraging the development of a secondary market for the credits would help deepen efficient allocation through market forces. Also, in a sound move to address the risk of offsetting increases the government intends to implement a safeguard mechanism in which large industrial facilities will be encouraged not to exceed an established historical baseline. As of October 2014, legislation establishing the fund was in the final stages of parliamentary process while the safeguard mechanism was still at the consultation stage.

Household income tax and benefits

Encouraging employment and combating poverty

Household income taxes and benefits account for a significant portion of fiscal revenues and expenditures, and are an important tool of social policy. Income tax, particularly those aspects applying to people with low earnings capacity, in combination with the generosity, accessibility and qualifying conditions of welfare benefits, govern households' disposable incomes and influence their incentives for engaging in the labour market. Ensuring this aspect of the system of taxes and transfers is well designed is therefore extremely important. As discussed above the present administration has signalled intention for substantial change in this area.

The architecture of Australia's tax-benefit system shares some characteristics to those of other OECD countries with a progressive personal-income tax (PIT) schedule with various credits incorporating social policy objectives coupled with a range of further support through cash benefits. Welfare is financed largely out of taxes rather than social insurance charges (Table 5) and benefits are predominantly means tested (see Table 6) rather than universal. There are two core benefits for the unemployed (Newstart, and the Youth Allowance and Parenting Payment), three for families (Family Tax Benefits A and B and the means-tested Parenting Payment) and one main form of cash support for the disabled (the Disability Support Pension) (Table 6).

Table 5. **Personal income tax and related social security contributions**

Dimension	Notable features
Scope of the tax base	Levied on an individual basis.
Rates and thresholds	There are four rates of taxation, the lowest at 19% and the highest at 45%. Thresholds are not automatically indexed. There was a substantial hike in the universal tax-free threshold from AUD 6 000 in 2011-12 to AUD 18 200 in 2012-13 (offset by the reduction in the Low Income Tax Offset from AUD 1 500 in 2011-12 to AUD 445 in 2012-13).
Tax deductions (*i.e.* deductions from taxable income)	Individuals pay tax on their total income less the costs to incur this income (allowable expenses).Tax deductions are allowed for certain work-related expenses and expenses incurred from earning interest, dividend or other investment income. The latter can result in a "negative geared" asset.
Social charges and other mandated payments	Employers are mandated to transfer 9.5% of gross salary to employee's second-pillar pension fund (superannuation fund), See Table 1.7. A standard charge of 2.0% applies to taxable income (the Medicare Levy). This is reduced (or eliminated) for those on low incomes. There is an additional charge (the Medicare Levy Surcharge) of 1-1.5% of income applying to those on high incomes who do not have complying private hospital cover.
Fringe benefits tax	Levied on employers for spending on non-cash benefits provided to employees. The standard rate is 47%, increasing to 49% for two years from April 2015. Exempt items include, for instance, superannuation and relocation expenses. Special rules apply for motor vehicles.

Table 6. **Key features of unemployment, welfare benefits and activation**[1]

Type of benefit	Details
General features	**Means testing** is common and, linked to this; benefits are usually "tapered" to reduce discontinuities in the tax-benefit schedule. The rate of benefit withdrawal when income is above means-test limits is typically 50%.
Unemployment benefit	**Newstart Allowance**: a means and asset tested benefit targeting the unemployed (and low-income earners) of unlimited duration with fixed pay-outs. Recipients are subject to ongoing activity requirements that are administered by private-sector job centres operating under contract with government.
	Youth Allowance: equivalent scheme for young unemployed.
Family benefits: one-off and short-duration support	**Parental Leave Pay** (introduced in 2011): means-tested payment (individuals with income of AUD 150,000 or more ineligible) to 18 weeks' publically-funded benefit set a level equal to the minimum wage.
	Note. In addition, all employees are entitled to 12 months unpaid leave and some wage agreements contain provisions for employer-funded paid leave.
	Dad and Partner Pay (introduced 2013): means-tested payment to dads or partners, equivalent to two weeks full-time minimum wage.
	Newborn Upfront Payment and Newborn Supplement One-off supplements to the Family Tax Benefit (see below) at the birth of a child (the (eligibility notably excludes those receiving payments under Parental Leave Leave).
Family benefits: long duration support	**Family Tax Benefits Parts A and B**. A two-component means-tested family tax benefit that is effectively a welfare benefit; "Part A" is paid per child while "Part B" provides additional support for families with one income if earning below AUD 150 000 i.e. is also means tested.
	Parenting Payment: means-tested support for when children are under 6 (for those with partners) and 8 years (for single parents).
	Child Care Benefit and Child Care Rebate and the **Jobs, Education and Training Child Care Fee Assistance** subsidies paid to parents for expenditure on childcare services (proof of expenditure on care services is generally required)
Financial support for the disabled	**Disability Support Pension (DSP)**
	Recipients automatically also receive the **Pension Supplement (**which is also available to other benefit categories, notable the Age Pension)
Other Support	**Rent Deduction Scheme:** Rent subsidies in which the benefit administrator (Centrelink) pays rent on behalf of the beneficiary, benefit pay outs are reduced but by less than the cost of rent.
	Pension Supplement automatically paid to certain benefit recipients, notably those receiving the Parenting Payment, Disability Support Pension and the Age Pension. Several supplements have been rolled into it (the Pharmaceutical Allowance, GST Supplement, Utilities Allowance and the Telephone Allowance).
	Pension Education Supplement: fortnightly payments to a range of groups on approved study courses including those on the Newstart Allowance
	Income Support Bonus: automatic biannual payment to certain recipients of other benefits (nominally designated as helping prepare for unexpected living costs)
	Mobility allowance: a two-level cash benefit designated to help with transport costs.
	Energy Supplement. Cash benefit designated to help eligible households with everyday expenses. There is a fairly wide range of eligible groups (includes those who receive Family Tax benefit).
	Education Entry Payment. Small annual payment for low-income groups enrolled in education courses.
	Health Care Card and Pensioner Card: Entitlements include: larger subsidies for prescription medicines, cheaper medical services (at provide discretion) and bigger benefits for medical expenses through safety net arrangements. State and Territory Governments also grant cardholders various concessions on energy costs, public transport and rates.

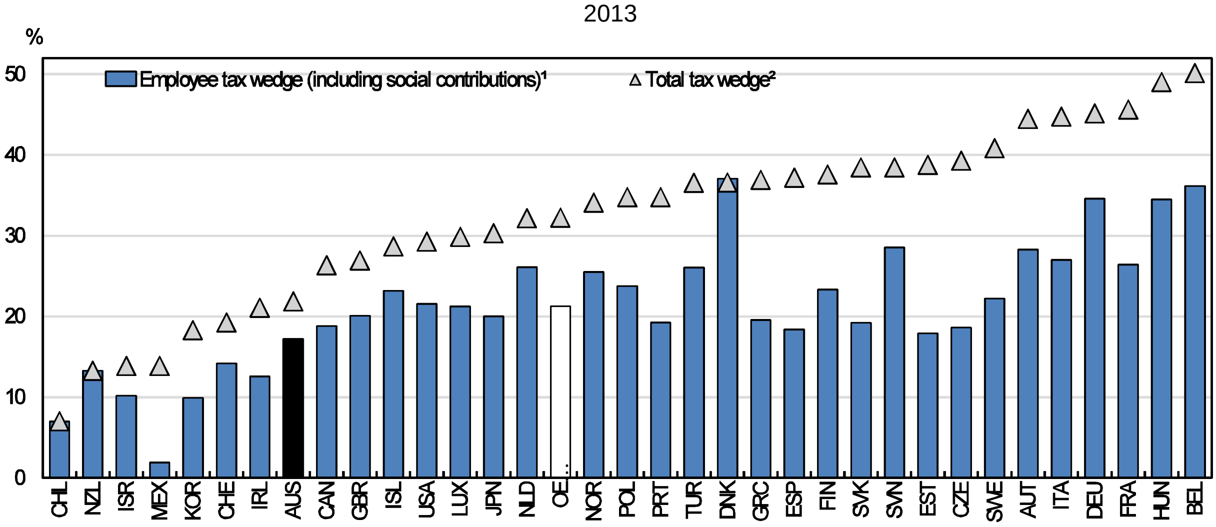
1. Operational details as of September 2014, unless explicitly stated intended reforms, including those in the legislative pipeline are not covered.

2. Typically automatic assessment and provision as part of assessment for the main benefits

Partly thanks to light overall revenue demands, the tax wedge on labour in Australia is comparatively low. This is helpful for employment and competitiveness and particularly important at the low-end of the earnings distribution where workers are most vulnerable to unemployment. As of 2011-12 the compulsory payment wedge for a single person on two-thirds the average wage (including the employers' superannuation payment) was a little under 30% which is well within the bottom half of the OECD distribution (Figure 5). Furthermore, following an increase in the tax thresholds in 2012-13, the wedge will now be lower than this. Given benefits from shifting the tax mix away from income tax, cuts in personal-income tax rates and/or increases in the thresholds are certainly desirable in principle. Current fiscal challenges will probably preclude pressing ahead on this front in the near term, but such reforms should nevertheless remain an aspirational goal.

Figure 5. **Tax and compulsory payment wedges for a single person at two-thirds average wage, no children**

2013



1. The sum of income tax and employee social contributions as a share of gross earnings.

2. The sum of income tax, employee social contributions, employer social contributions, payroll tax, net of cash transfers as a percentage of gross labour costs.

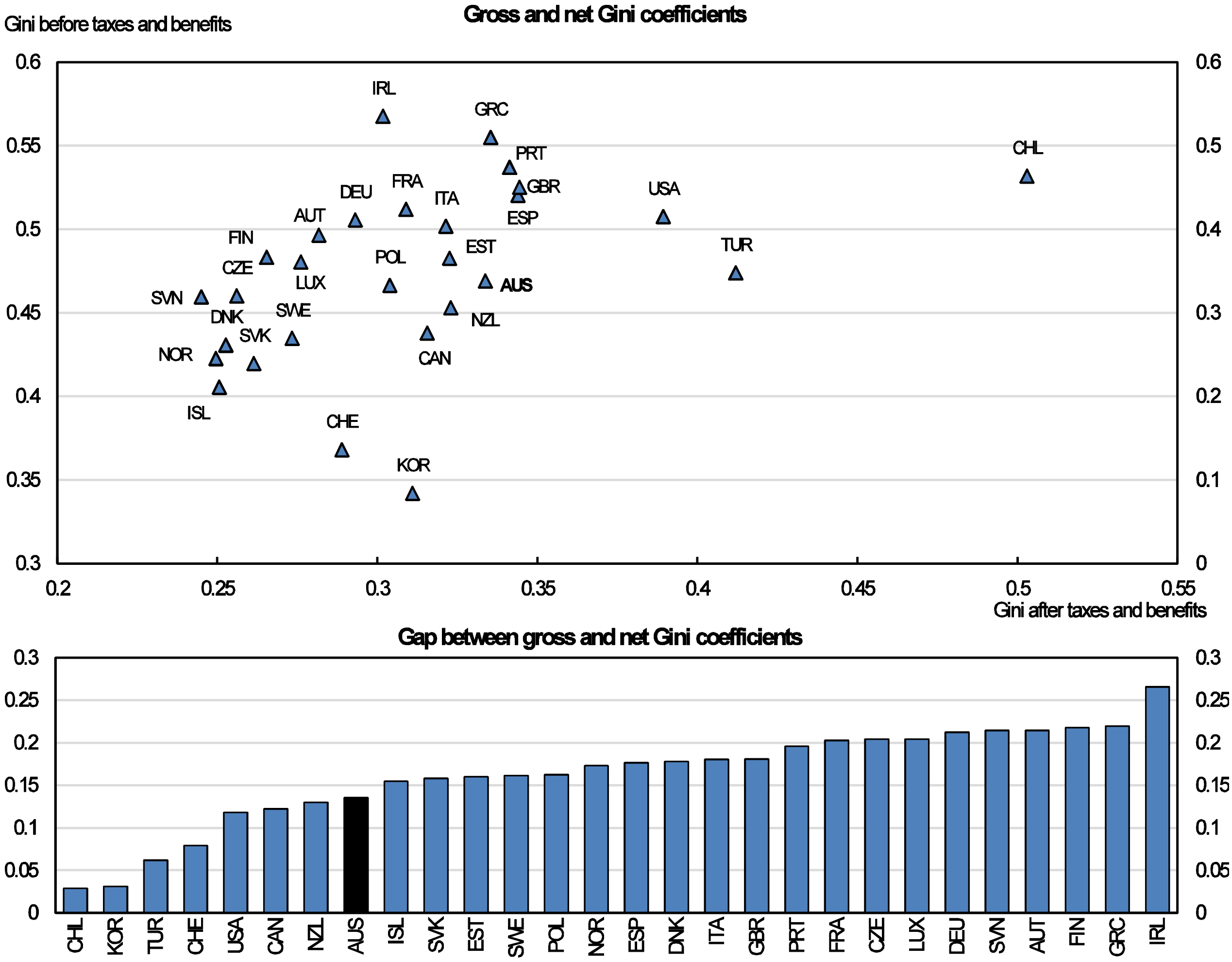
3. OECD is a simple average of member countries' data.

Source: OECD (2014), Taxing wages database.

International comparison of pre- and post- tax (and benefit) Gini coefficients and poverty rates (Figures 6 and 7) indicate that, overall, Australia's tax-benefit system, at least as of 2011, was reducing overall inequality and poverty by rather less than systems elsewhere. For instance, Australia's Gini coefficient was 16th highest in terms of gross incomes but was 8th highest once taxes and benefits are taken into account. These rankings partly reflect the wide differences in the economic positions of OECD countries in recent years. High and persistent unemployment in some countries has pushed up pre-tax inequality and poverty and their benefit systems are doing a lot of work to ameliorate this. Some of the differences between Australia and other countries in Figures 6 and 7 may also reflect certain elements of Australia's tax and benefit system. For instance, the income tax schedule loses progressivity fairly early in the income distribution; the top marginal tax rate threshold is reached at only about two and a half times the average wage. Also, as for other countries with flat-rate means-tested unemployment-benefit, replacement rates are low in the initial phase of unemployment. However, these are not the only factors influencing the progressivity and generosity of tax-benefit systems. In particular, the wide use of means tested benefit and the small role played by social-security contributions in Australia implies a more progressive tax-benefit system compared with counties where universal benefits and contributions feature heavily in the system. Overall, evidence suggests that for Australia the factors that increase progressivity tend to be outweighing those that reduce it. Indeed, indicators based upon micro-simulations for various types of household suggest progressivity in the country's tax-wedge is typically among the highest in the OECD (examples of these calculations are shown in Figure 8).

Figure 6. **Gross and net income inequalities**[1]

Total population, 2011 or latest available

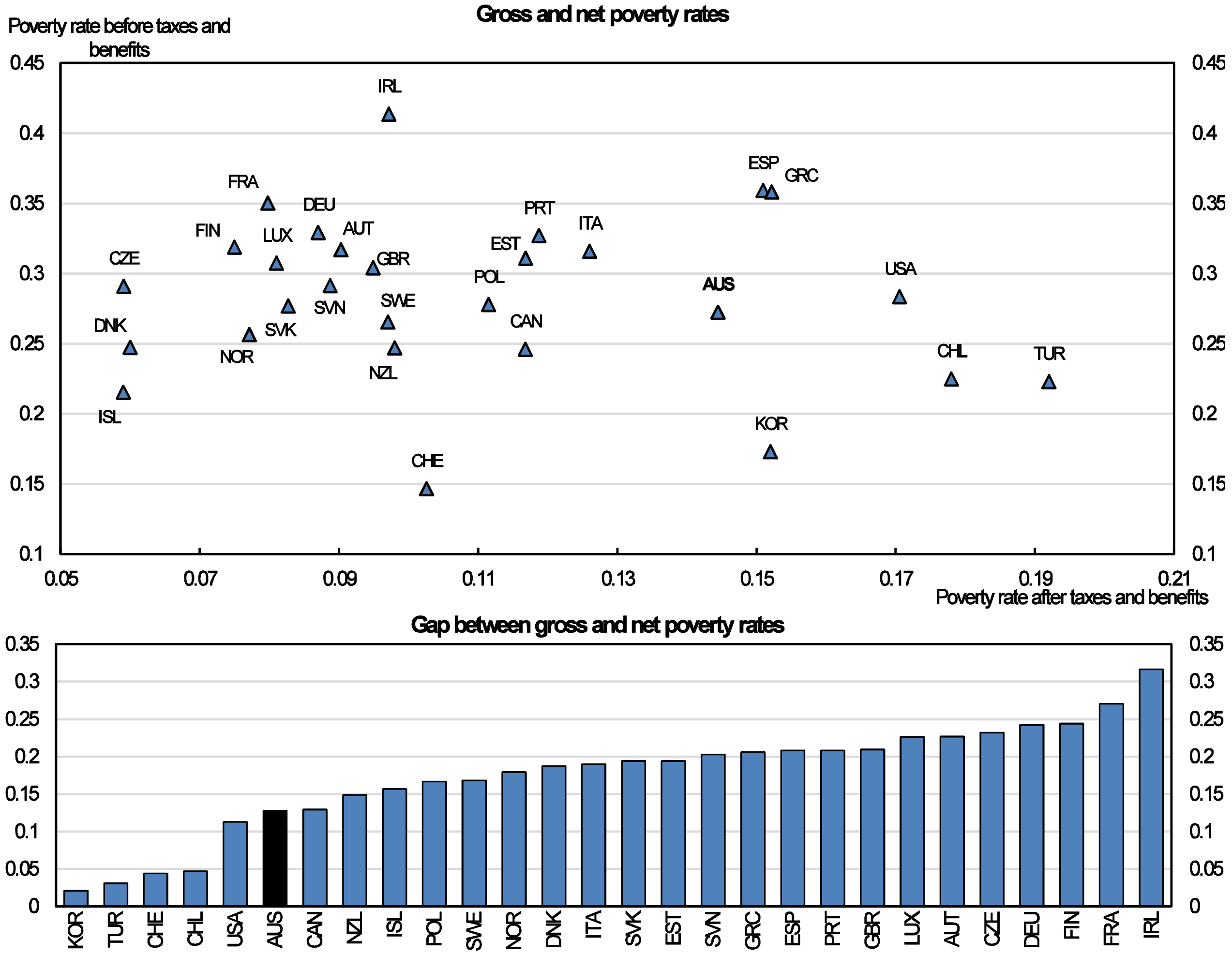


1. The Gini coefficient takes values between 0 for maximum equity (all households receive the same income) to 1 for maximum inequality (one household receives all income).

Source: OECD (2014), Income and Poverty Distribution Database.

Figure 7. **The incidence of relative poverty based on gross and net income**[1]

Total population, 2011 or latest available

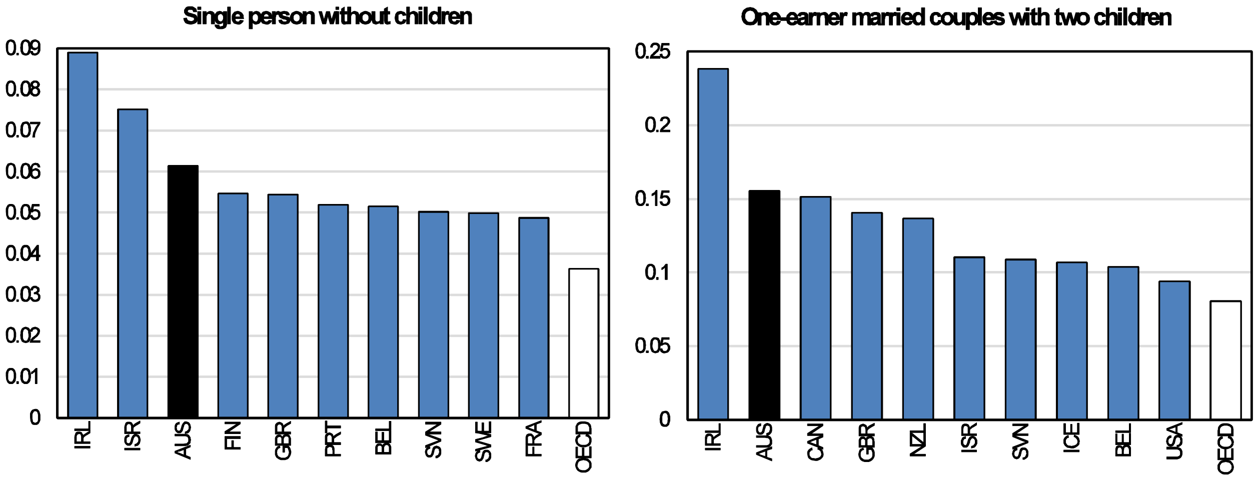


1. The incidence of relative poverty measures the share of households whose equivalised income is less than 50% of the median income.

Source: OECD (2014), Income and Poverty Distribution Database.

Figure 8. **Average tax wedge progression - comparison with top ten OECD countries**[1]

Across income intervals ranging from 50% to 500% of AW, in 2012



1. The average tax wedge progression takes into account the effect of employee and employer social security contributions, payroll taxes and cash benefits on progressivity. The indicator measures the percentage point increase of the average tax wedge per percentage point increase of the average wage over the 50%-500% of the average wage income interval.

Source: OECD (2014), Taxing Wages 2012-13.

There is room for further simplification

If unchecked, tax and benefit systems typically grow in complexity over time. Political "credit" is often greater from bringing in new schemes and mechanisms than it is from identifying and removing obsolescent or ineffective ones. Furthermore, visibility often matters in the politics of making reform happen. For instance, new benefit allowances (with attendant labels) are sometimes added as separate entities even when they effectively represent an increase in an existing payment. In Australia, the core tax and transfer benefits are accompanied by a host of auxiliary benefits; some of which, at least *prima facie*, seems somewhat surplus to requirements.

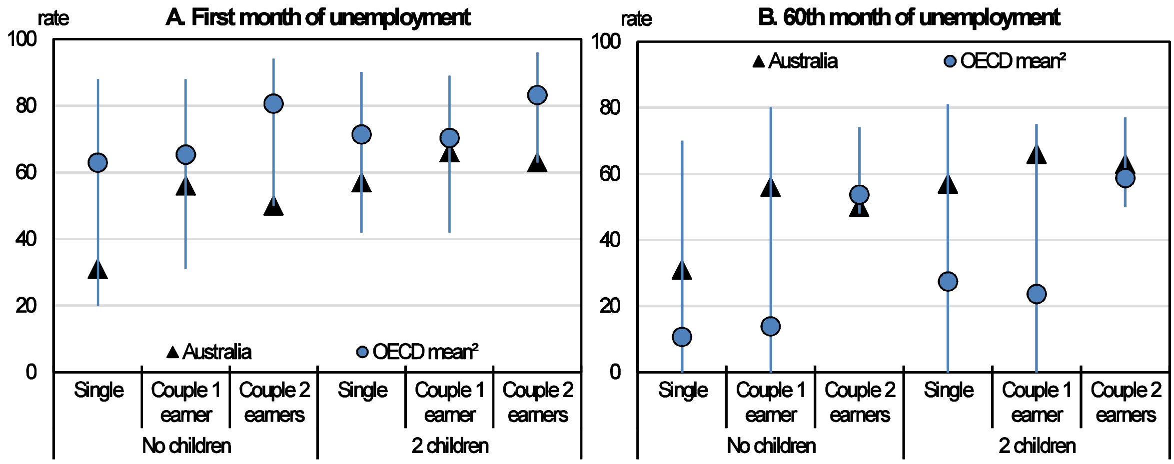
There has been some concrete progress in simplification. For instance a number of designated supplements (including a GST Supplement) are now rolled into a single auxiliary payment, the Pension Supplement (to which beneficiaries from several main benefit schemes are entitled). However there is room for further reform. For instance, the Henry Review advocated replacing Parts A and B of the Family Tax Benefit with one benefit and suggested combining the Child Care Benefit and the Child Care Rebate. Encouragingly, the present government appears committed to simplification. For instance, there are plans to concentrate support for indigenous Australians. There are currently 150 programmes operating under the Department of Prime Minister and Cabinet; these will be compressed into a new strategy (the Indigenous Advancement Strategy) comprising five core themes. Similarly, programmes operating under the Health portfolio will be rationalised (into the Indigenous Australians' Health programme). The sheer number of programmes currently in operation certainly suggests that consolidation makes sense. However, sorting out which elements of the system are worth preserving and which should be scrapped in the interests of improving efficiency will be challenging.

Reform proposals targeting youth unemployment will require close surveillance

Australia's system of unemployment benefit and activation has some admirable qualities. The value of the fixed-rate, means-tested unemployment benefits (Newstart and the Youth Allowance) are modest (Figure 9). Indeed, past OECD *Economic Surveys* have proposed more generous benefit in the initial months of unemployment (OECD, 2010). Furthermore, the system of private-sector placement services operating under contracts with government that contain financial incentives for getting the unemployment-benefit claimants into work has attracted much international attention and has been the subject of a comprehensive OECD review (OECD, 2012b).

Figure 9. **The unemployment benefit replacement rate at two-thirds average wage[1]**

2012



1. The microsimulations normally cover only benefits for which there is a general entitlement. For many OECD countries, where no broad social-assistance programmes exist, the simulations indicate that benefits are zero for some types of household at the 60th month of unemployment. Hence, the minimum OECD replacement rates are zero in some cases. However, in many countries, local authorities or sub-national governments may provide some form of cash support on a case-by-case discretionary basis.

2. OECD mean is depicted on a line connecting the minimum and maximum values within OECD.

Source: OECD (2014), OECD Tax-benefit Models; see http://www.oecd.org/social/workincentives.

The present government aims to improve the pathways to education and the labour market, while making unemployment less attractive, especially for young people, by reducing financial support. Proposals outlined by the government (Australian Government, 2014b) include:

- Tougher rules for unemployment-benefit claimants aged under 30, including demonstration of up to six months job search before becoming eligible for payment (i.e. longer "waited periods" for benefit).
- Increase in the minimum age of eligibility to the Newstart Allowance (and Sickness Allowance) from 22 to 24 years.
- Extending the range of qualifications covered by government-subsidised student loans available to help students pay their contribution to tuition fees (though proposals also include less favourable conditions in these loans and reduction in the government's direct contribution to tuition fees).
- Provision of employment services for jobseekers during the benefit waiting period. The level of services will depend on individual circumstances. At a minimum the aim is for job centres to assist claimants in preparing a resume, and to offer advice on employment opportunities and information about training.
- Expansion of a pilot programme, Work for the Dole, which provides mandatory work experience for certain jobseekers in selected areas of high unemployment.

Under these reforms, particularly the longer waiting periods for benefit, the system will move into unchartered territory and therefore the overall behavioural response is uncertain. The aim is for many unemployed youth to either return to education and training or to intensify job search and compromise more on what jobs they will take. However, the scale of such responses to this type of reform is uncertain and other, less desirable, reactions might be significant. For instance, the changes may prompt some to "drop out", considering that the effort to apply for Newstart or the Youth Allowance and engage in activation programmes is no longer worthwhile. In addition, the changes may elicit intensified application for other benefits (such as disability benefit). Given these possibilities, the government's proposals require close monitoring.

A large increase in public spending on parental leave pay may not be optimal

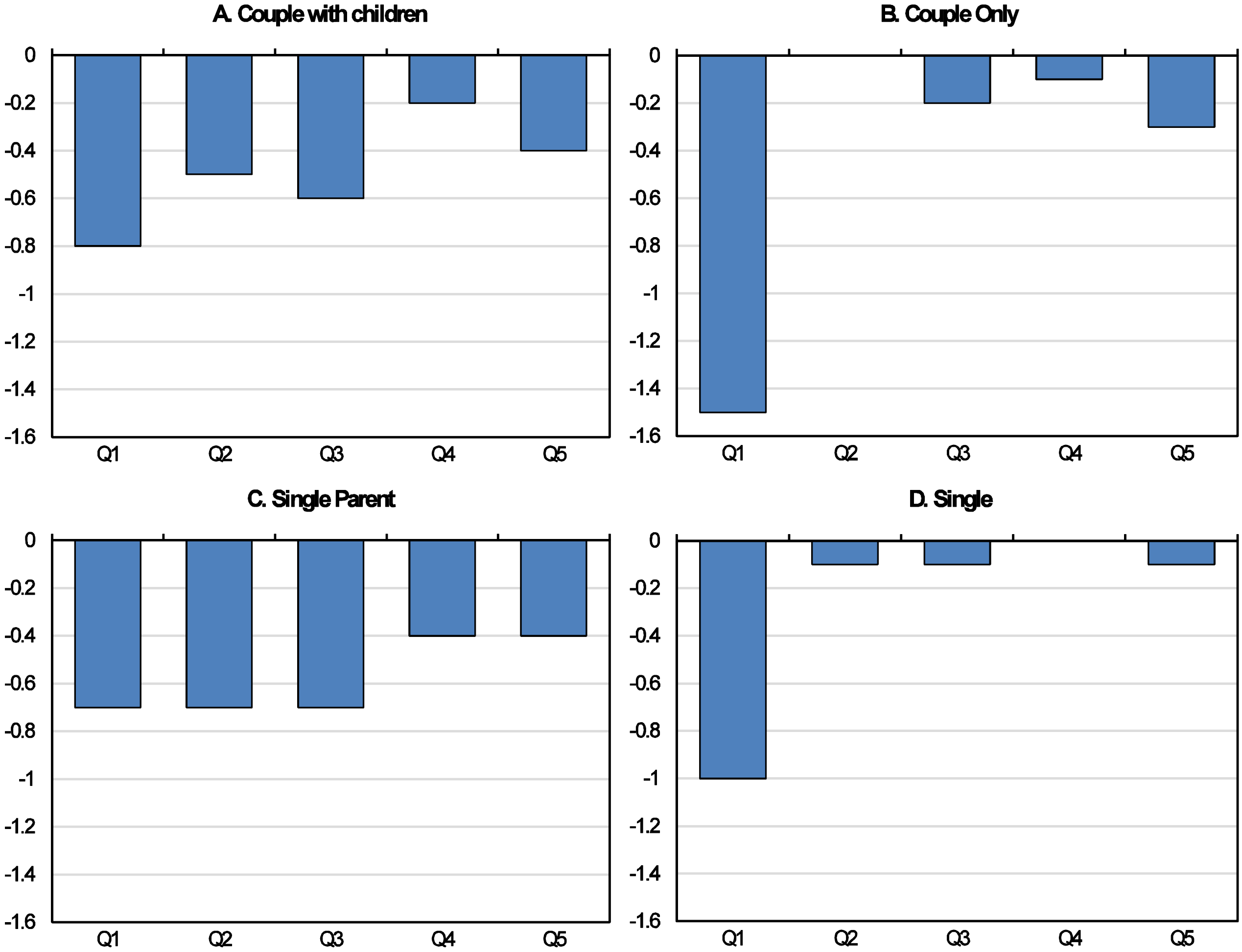
Reforms proposing substantial increase in the generosity of paid parental leave mentioned in earlier sections have been given high priority by the current government. The introduction of publically funded paid parental leave in 2011 established common minimal provision to the various sectoral and employer-specific arrangements for paid parental leave already in place. The scheme provides a flat rate of 18-weeks benefit at the same level as the full-time minimum wage. In many other countries paid parental leave is linked to previous earnings (with caps) and the present government intends to introduce a similar system. The proposal envisages payment over 26 weeks equal to previous earnings or the full-time minimum wage (whichever is the greater) and superannuation contributions will also be paid. Under current proposals the pay-out will be capped at AUD 50 000 in total which is equivalent to a little over six months benefit at the average wage. Such a scheme would broadly encourage labour supply, making the pursuit of careers more attractive (particularly for women), support improved maternal and child wellbeing and increase the retirement savings of women by providing superannuation contributions. However, as for any substantial increase in funding on a specific mechanism, there should be careful cross-checking to ensure that the move stacks up favourably against a more diversified strategy given there may be diminishing marginal returns. Indeed, a recent review of child-care issues (Productivity Commission, 2014) questions whether such substantial additional funding on this form of parental support is the best allocation of resources for boosting female labour supply or for more generally facilitating and encouraging parents to combine work and family life. Indeed, the report suggests diverting some funding for the proposed scheme to other aspects of family policy, for instance to supporting early childhood education and care.

Other welfare-reform proposals will reduce payments to families

In other respects the government's proposals reduce payments to families, for instance with plans narrowing the scope of some family tax benefit, threshold freezes and new indexing restrictions. This is illustrated by simulations of budget-measure impacts using a tax-benefit model based on details from 44 000 families (the "Stinmod" model) by the *National Centre for Social and Economic Modelling.* This modelling suggests that the budget measures will have very little impact in 2014-15 among most of those without children, but may result in a small fall in income, on average, among lower quintiles of those with and without children (Figure 10). Low-income families and individuals will continue to receive public assistance, which the government judges to be substantial. Some calculations of the value of assistance following implementation of the proposed welfare reforms are included in the government's budget documents. For instance, it is estimated that as of 2016-17 a lone parent with two children with income of AUD 30 000 will receive AUD 18 454 in government payments (Australian Government, 2014c). In addition, as in the current system, the household may also be eligible for a range of other government benefits and services.

Figure 10. **Mean impact in 2014-15 on disposable income of households in each quintile from the 2014-15 Budget measures** [1]

Percentage impact



1. The analysis is based on the STINMOD14 model of NATSEM (at the University of Canberra), measuring the impact of tax and benefit changes under the Coalition Government. The calculations do not include proposals to expand paid parental leave. Q1 refers to the lowest quintile (i.e. the bottom 20% of households in terms of mean disposable income) and Q5 refers to the top quintile. The impact refers to the difference between a baseline scenario of disposable income and a scenario including budget measures.

Source: NATSEM (2014), National and Regional Analysis of the 2014-15 Federal Budget, September 2014.

High marginal tax rates from benefit tapering remains a challenge

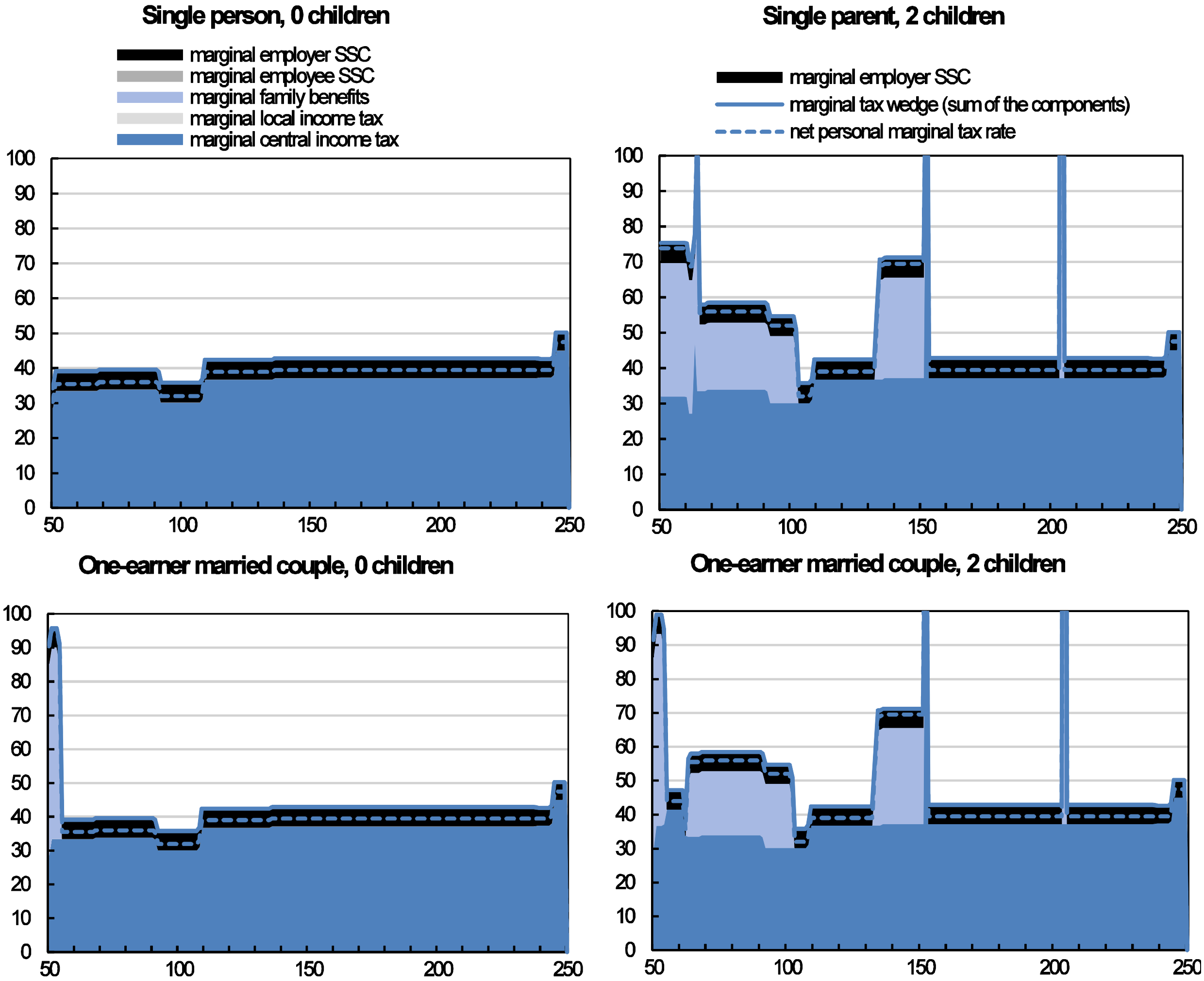
In Australia, policy challenges arising from benefit tapering (or "benefit withdrawal") are greatest in tax-benefit configurations for families. Means-tested benefits are not entirely cut off if a recipient's income rises above a certain threshold; instead they are typically reduced by a fixed proportion, hiking up the effective marginal rate of tax. The lower the rate of withdrawal, the lower the marginal-tax effect and attendant risk to incentives, but the greater the fiscal cost with respect to pay-outs and the weaker the benefit's targeting. Furthermore, schemes cannot be viewed in isolation, as it is the net effect of all benefits and taxes that matters most for incentives. Therefore, tax-benefit systems with multiple means-tested benefits require careful engineering to avoid large numbers of households facing very high (possibly greater than 100%) effective tax rates on additional income, while also bearing in mind the deadweight loss of handing out benefit to households who are outside the intended target range.

These challenges are illustrated in Figure 11 which shows marginal-net-tax-rate calculations (i.e. including income tax and benefits) for earnings in cases of a single-person household with and without children and, similar for a couple with one earner. OECD tax-benefit simulations assume children are quite young, which for Australia means parents are potentially eligible for the Parenting Payment as well as Family Tax Benefit. As shown in Figure 11, the family-related benefits are pushing up marginal taxes from additional income for those earning up to the average wage, mainly from Parenting Payment withdrawal (at a rate of 40%). The benefits also create a "bump" in marginal taxes further up the earnings distribution (between about 1.3 and 1.5 times the average wage) due to withdrawal of the Family Tax Benefit.

These tapering issues reinforce the case for further simplification of the tax-benefit system. Reducing instances of overlapping tapering schedules would allow for some smoothing the marginal tax "bumps", thus improving the returns to households from increases in earned income.

Figure 11. **Marginal tax wedge decomposition**

By level of gross earnings expressed as a % of average wage



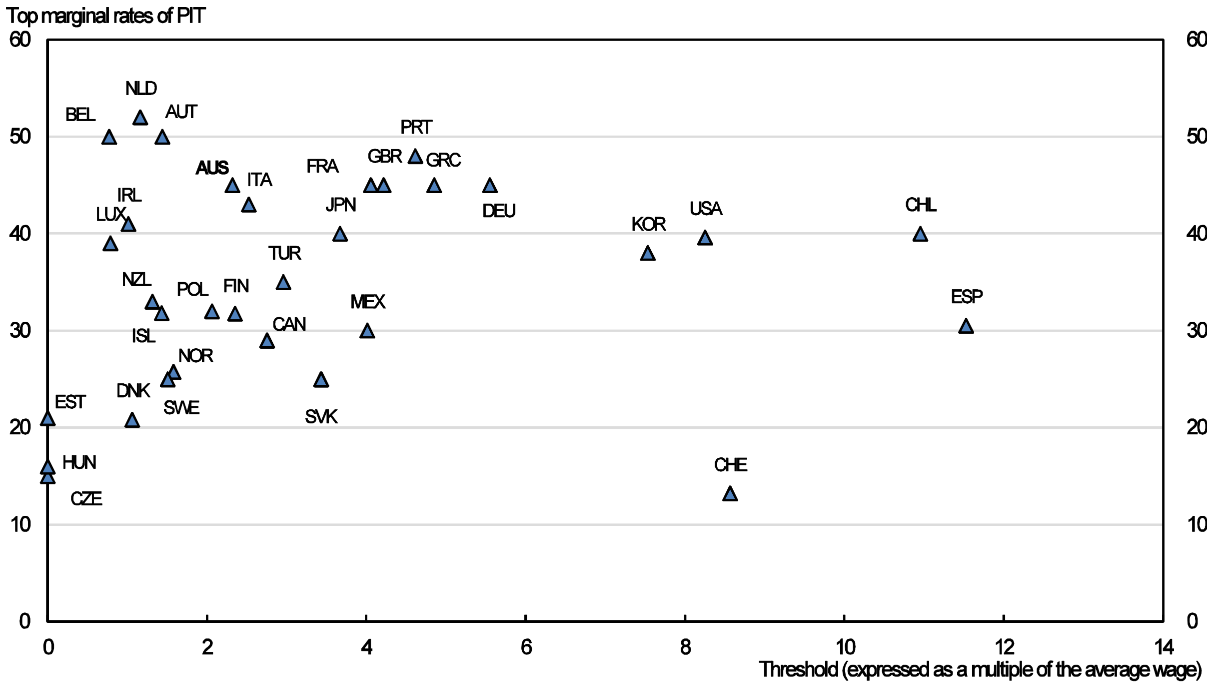
Source: OECD (2013), Taxing Wages 2011-12, OECD Publishing.

Issues for middle and upper-income households

In Australia, the top marginal rate of tax, at 47% (including the Medicare Levy but excluding the recently introduced Temporary Budget Repair Levy), starts at a relatively low threshold of around 2.5 times the average wage. These settings are not too distant from those in many European countries (Figure 12), and broadly are a consequence of heavy reliance on income tax (or, the failure to fully utilise the potential for indirect taxation). This reinforces the case for tax-mix reform that envisages an increase in in PIT thresholds, and possibly rate reductions too.

Figure 12. **Top marginal rates of personal income tax (PIT) and corresponding thresholds[1]**

Per cent, 2013



1. Data comprise the top statutory personal rate plus additional deductions (such as social security contributions) that apply at the threshold where the top statutory PIT rate first applies.

Source: OECD (2014), Tax database.

Much time, effort and money is expended by Australian households on understanding the tax system and filing their tax return. The comparatively low PIT thresholds mean many households have incentives to minimise the taxable component of income. One avenue is through deductible expenses, which are relatively generous compared to other OECD countries. There are also opportunities for employers to provide some remuneration in the form of fringe benefits (such as a car). Employers pay tax on the latter under fringe-benefits tax, but there are a number of concessions available for certain types of expenses, which can make this an attractive avenue to pursue and further complicates tax planning. Reforms underway by the Australian Taxation Office reducing tax compliance costs will certainly help, such as increased pre-population of tax returns (see below). However, avenues for simplifying PIT deductions and fringe benefit taxation should be sought too. Increasing PIT thresholds and/or reducing the rates would lower incentives for sophisticated avoidance strategies, though this should be regarded as a beneficial side-effect rather than a primary driver of such a move.

The government's Temporary Budget Repair Levy, a 2% extra tax on taxable income above AUD 180 000 (i.e. about twice the average wage) for three years, was legislated in June 2014. According to government calculations (Australian Government, 2014c) about 400 000 taxpayers will pay the levy, raising AUD 3.1 billion in revenues over the three years (i.e. about 0.2% of current annual GDP). While these revenues certainly help, the levy probably also reflects a desire by government to signal "burden sharing", especially as the budget includes economies in welfare spending. Given the levy comprises a small and temporary increase in top-end tax, undesirable behavioural responses by employees and firms (for instance, relocation outside Australia) will probably be negligible. However, the levy has no doubt sparked a search for avoidance strategies. For instance, some speculate that a delay in the increase of fringe benefit tax to match the new effective top rate of personal-income tax of 49% will be exploited. However at this stage, there is no evidence whether this or other avoidance strategies, are being extensively exploited.

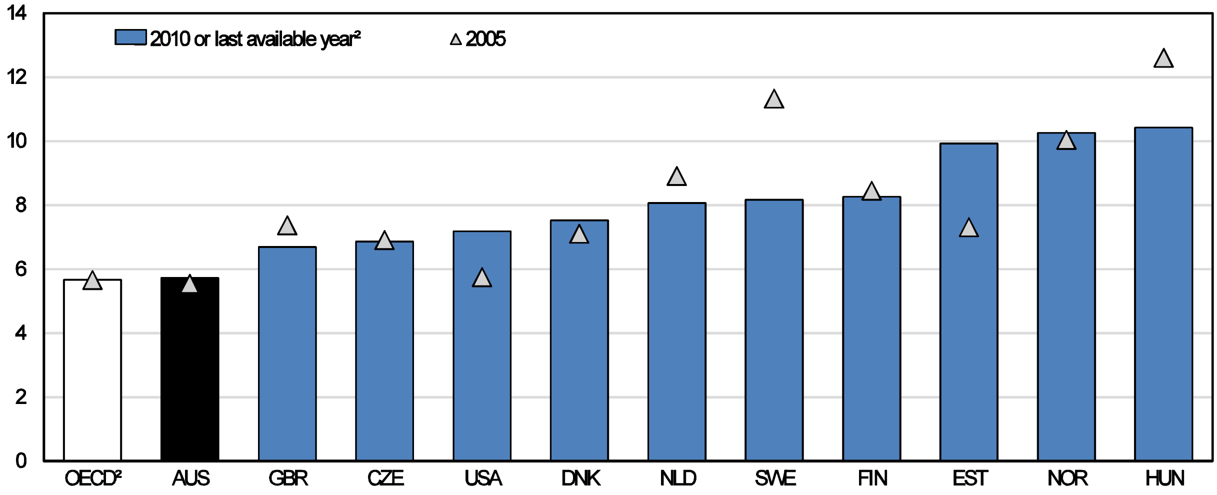
Further reform of the disability system remains important

While the portion of the working-age population receiving disability benefit stopped increasing in the early 2000s, it is nevertheless quite high at a little over 5% (Figure 13). Furthermore, as elsewhere, comparatively few exit the system and become re-employed. Preventing "leakage" of claimants into disability benefits arising from the somewhat greater generosity and, in some respects, the lower conditionalities compared with unemployment benefit remains a challenge as does supporting and encouraging rehabilitation and employment among the existing stock of beneficiaries.

Disability pension systems cannot typically be reformed quickly or easily and therefore typically require a continuous campaign of measures. Adjustments to the Disability Support Pension proposed by the present government comprise a five-year plan to increase activation among recipients aged under 35. These proposals include compulsory activities (with sanctions for non-compliance) for those with an assessed work capacity of 8 or more hours and, for the same age group a review of individuals' eligibility for the Pension. In addition, the authorities plan on imposing tighter rules on overseas travel for disability pension recipients to counter a perceived problem that individuals are embarking on extended holidays while on benefits.

Figure 13. **Disability benefit recipients - comparison with highest 10 OECD countries[1]**

As a percentage of working-age population (15-64)



1. Australia has the 13th highest rank.

2. The OECD average excludes Chile, Iceland and Turkey.

Source: OECD (2014), Economic Policy Reforms 2014: Going for Growth Interim Report.

The government is also committed to continuing a major reform of disability support services. The reform, the National Disability Insurance Scheme, endeavours to resolve uneven service quality, underfunding and fragmentation by introducing a more centralised and better-resourced system run by a new body, the National Disability Insurance Agency. The reform essentially aims to provide a much greater range of universally available support services for the disabled. It entails roughly a doubling of expenditure on disability support services to about AUD 14 billion - i.e. an increase in spending from about 0.5% of GDP to 1% of GDP. About one third of those receiving the disability support pension receive some form of disability service, and therefore improving the latter will mark a substantial rise in living conditions for many of those receiving the pension.

A broadly sound pension system but requiring some specific fixes

Australia's pension system centres on a means-tested benefit (the Age Pension) in combination with a defined-contribution pension ("superannuation") (Table 7). The age of access to the Age Pension is currently 65 but scheduled to increase to 67 by 2023 under reforms of the previous government and the current government intends to programme increases to 70 by 2035. Superannuation comprises a compulsory minimum contribution from the employer (the "superannuation guarantee") to which voluntary contributions can be added. The latter (up to certain limits) can be channelled as an employer contribution (called a "salary sacrifice" as the employee's salary is reduced correspondingly) or otherwise taken out of post-tax income. Under “preservation rules” superannuation can be first accessed at age 55 (due to increase to 60 years). In addition to the Age Pension and superannuation schemes, there are some "sunset" pay-as-you-go pension funds that are closed to new members but which will continue to run for some decades to come.

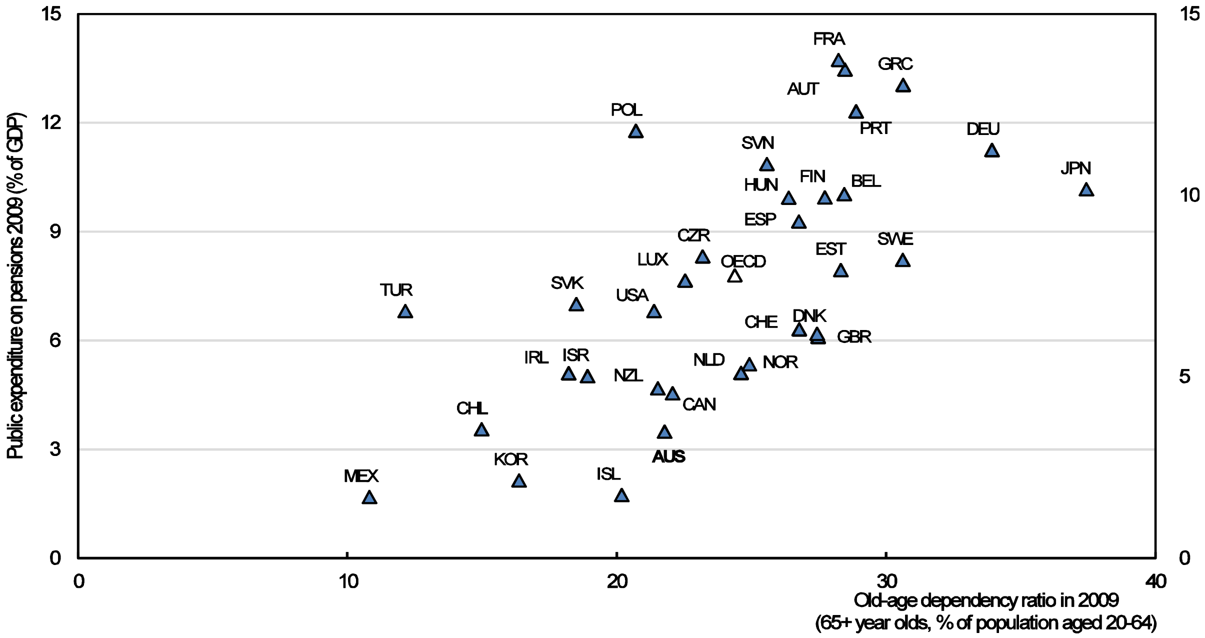
Pay-out from the Age Pension ranks as one of the most modest first-pillar pensions in the OECD despite an increase in provision as part of reforms in 2009. This, combined with comparatively favourable demographics, contributes to a comparatively low level of government spending on pensions (Figure 14) and augers well for future fiscal sustainability. This implies heavy reliance on superannuation in ensuring adequate incomes in retirement. For example, OECD pension simulations show that for an individual with lifetime earnings at half the average wage, the pension system will provide a respectable 91% of previous earnings-well above the OECD average of 70% (Figure 15). However, about 40 percentage points of this total comes from superannuation under assumptions that the individual makes an undisrupted stream of contributions throughout their working life. In the real world there may be sizeable numbers of current (and future) pensioners whose superannuation pay-out falls (or will fall) well short of that assumed in such calculation. Compulsory pension saving for employees via the superannuation system has only been in place since the early 1990s, and in any case there will always be some who, for instance due to low earnings capacity and few contributions due to intermittent employment, will only accumulate a modest superannuation pay-out.

At present the Age Pension's position relative to incomes in the wider population is protected by a floor condition linked to average wages in addition to a favourable indexing rule based on using whichever increase is greatest between consumer-price index and a cost-of-living index for pensioners (Table 7). The present government plans to abolish the floor condition and index the Age Pension only to CPI as part of a general strategy for more homogenous indexing across the welfare system and to help with fiscal savings. However, this reform will mean the pension's value will drift down in relation to average incomes, and at some point may cross socially acceptable limits of adequacy. The government's Intergenerational Reports which are published every five years and examine demographic challenges, provide a mechanism for parametric adjustment of the Age Pension, including indexation. However, constant change to pension indexing is not optimal, given the importance of stability in pension-system parameter settings to help households plan for the future. Narrowing the focus of the Age Pension or increased superannuation contributions (which implies lower pay outs on the Age Pension) may provide alternative avenues for managing the fiscal pressure from the Age Pension.

Table 7**. Key features of the pension system (excluding tax treatment and "grandfathered" schemes)**

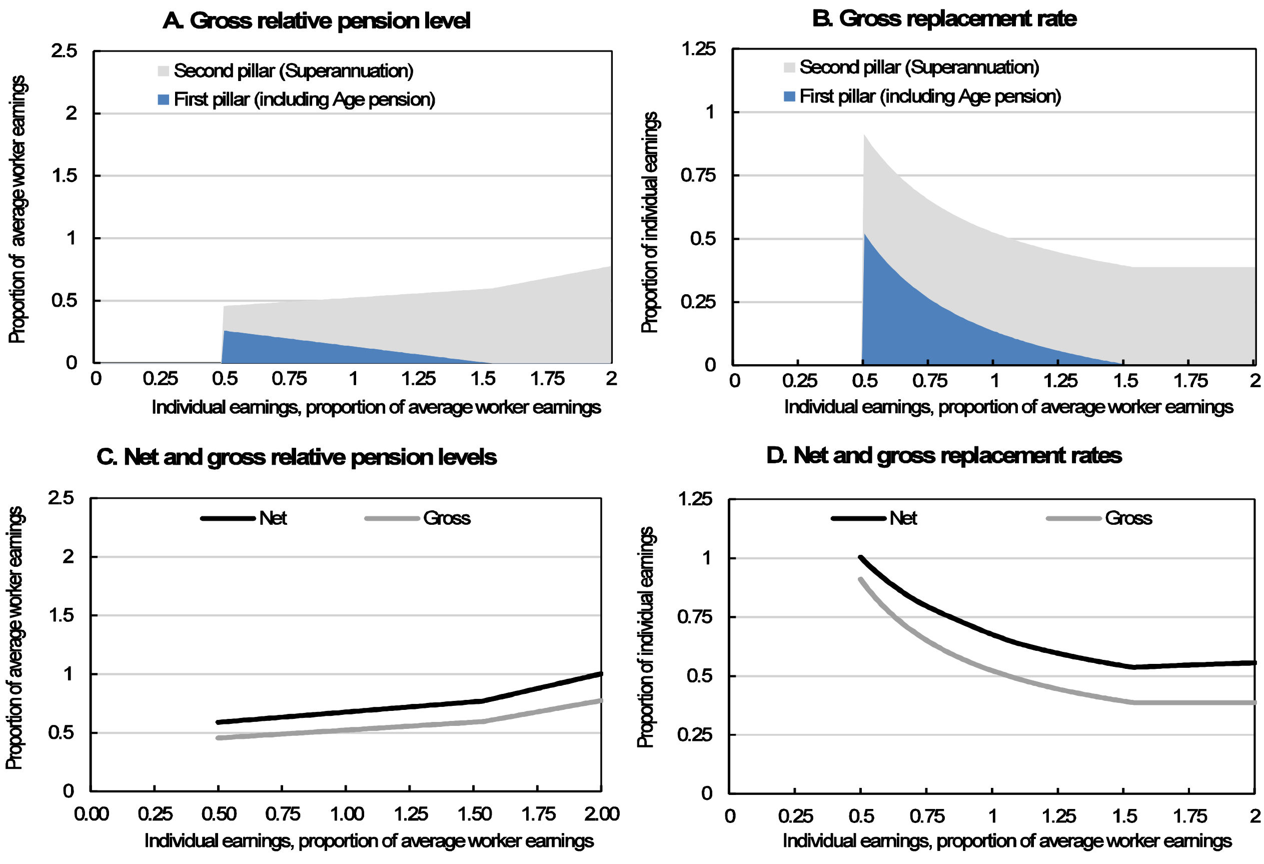
First pillar (the Age Pension and related benefits)	
Age of access and coverage	Currently 65 years and scheduled to increase gradually to 67 years by 2023. Legislation is in the pipeline for further increase. Coverage is practically universal.
Means tests and tapering rules	Both income and asset tests apply. The taper rate is either 40 or 50% in the case of earned income (depending on circumstance) and a reduction of AUD 1.50 is made for every AUD 1000 of assets exceeding thresholds. Due to tapering, around 40% of Age-Pension recipients' have income and assets above the means-test thresholds. There is an additional income-test concession (the Work Bonus) in which earnings from work (up to a certain value) are not counted in the income test.
Pay-outs	Basic rates vary according to circumstance. For instance the maximum basic rate for a single person is AUD 751.70 per fortnight and that for a couple is AUD 1 133.20. The effective pay-out exceeds the basic rates because eligibility to the Age Pension automatically means eligibility to some additional benefits: notably the Pension Supplement (a payment that was created to replace a variety of designated payments supposed to cover certain living expenses) and the Clean Energy Supplement. With these two supplements the single-person pay-out is AUD 827.10 and that for couples is AUD 1246.80 per fortnight.
Indexing	There is biannual indexing based on the greater of the CPI or a special index (the Pensioner and Beneficiary Living Cost Index).They are then "benchmarked" against a percentage of Male Total Average Weekly Earnings (MTAWE). The combined couple rate is benchmarked to 41.76 per cent of MTAWE; the single rate of pension is set at 66.3 per cent of the combined couple rate (which is equal to around 27.7 per cent of MTAWE. Benchmarking means that the pension cannot fall below these values.
Other aspects	Access to the Age Pension can mean access to a range of other benefits (though, possibly conditional on additional eligibility requirements), such as rent assistance.
Second pillar (compulsory and voluntary contributions to "superannuation" funds or similar)	
Types of fund	The superannuation funds are run by individual employers, industry associations, financial service companies; these are supervised by the Australian Prudential Regulation Authority. "Self-managed" funds, which have at most four members, are increasingly popular, and are supervised by the Australian Taxation Office.
Contributions	There is a mandatory employer contribution (the "superannuation guarantee") that remained at 9% for many years but is now being increased in stages. For 2014-15 the contribution rate is 9.5% and is scheduled to reach 12% by 2019-20. Contributions are not compulsory for employees earning small amounts and there is a contribution cap at roughly 2.5 times the average wage. Employers can make additional contributions on employees' behalf (the "salary sacrifice") up to certain limits, and employees can make additional voluntary contributions out of their post-tax income. There is a co-contribution scheme for those on low earnings in which the government makes an additional pension contribution. There are no special provisions for contributions when unemployed or when caring for children.
Rules on investment	Rules on the composition of portfolios are light.
Minimum age for access	Superannuation can currently be accessed from age 55 years (the "preservation age"), though as of 2015 increases are scheduled that will see the preservation age reach 60 years by 2025. The tax treatment favours retirement at 60 or above.
Pay-out conditions	There are no annuity requirements; the pay-out can be taken out as a lump sum on retirement.

Figure 14. **Demographic pressures and public pension expenditure**



Source: OECD (2014), Social Expenditures Database (SOCX); United Nations, World Population Prospects – The 2012 Revision.

Figure 15. **Pension simulations for Australia**



Source: OECD (2013), Pensions at a Glance 2013: OECD and G20 Indicators.

Box.1 **An important caveat on measures of pensioner poverty in Australia**

Some statistics on poverty among pensioners in Australia ring loud alarm bells. For instance, based on income distribution databases, *Pensions at a Glance* (OECD, 2013a) shows a relative poverty rate of 40% among Australian pensioners. This contrasts sharply with the OECD average of 15% (this poverty measure is the share of the pensioner population estimated to have incomes less than half of median income for the population as a whole). However, there are a number of reasons why this type of poverty measure is not necessarily a good indicator of the living standards of older people (OECD, 2013a). These include: the non-consideration of non-cash benefits, such as the value of health and other publicly-provided services; the non-consideration of wealth, including lump-sum superannuation payouts and home-ownership (and the costs associated with different housing tenures); and the sensitivity of a "headcount" poverty measure where there is a flat-rate basic pension. In the Australian case, these issues significantly reduce the accuracy of a simple headcount measure of income poverty. For these reasons, pension poverty and adequacy in Australia is better gauged through other approaches, for instance the simulation results shown in Figure 14 address some of these issues.

The current tax treatment of pensions is unusual and raises questions of focus and efficiency. As is commonly the case elsewhere, contributions up to certain limits are not taxed (unless voluntary and coming out of post-tax income). But unlike most other systems there is some tax in the accumulation phase, and, most strikingly, following a government decision taken about a decade ago, annuity income is not taxed at all (see Table 8). This latter move was primarily motivated by a desire to simplify what had become an overly complex tax treatment of superannuation pay-outs. A number of reforms “grandfathered” existing settings (i.e. reforms only applied to new retirees), generating multiple tax treatments. However making superannuation income tax-free has meant that sizeable sums of public money are implicitly being spent in a way that largely benefits middle and upper income earners; for 2013-14 the spend is estimated at around AUD 32 billion, i.e. equivalent to about 2% of GDP (Table 3).

Table 8. **Tax treatment of pensions**

Contribution phase	Accumulation Phase	Pay-out phase
First pillar (the Age Pension and related benefits)		
Not applicable	Not applicable	Included in taxable income (but the effective tax rate is typically very low).
“Concessional contributions” (compulsory and “salary sacrifice” contributions)		
Not taxed in that the contributions are made by employers and therefore do not figure in the employees tax returns.	An initial tax of 15% applies to incoming contributions. Subsequent dividends and capital gains are also taxed. For many households the rate is “concessional” in that the tax is lighter than on other forms of saving.	For those aged over 60 pay-outs in the form of annuities are tax-free. Lump-sum pay-outs are tax free up to certain thresholds.
“Non-concessional” contributions		
Taxed in that these are contributions made out of post-tax personal income	No initial tax on contributions, but there is tax on dividends and capital gains.	Neither annuity pay-outs nor lump-sum withdrawals are subject to tax.

There are a number of other issues regarding the pension system, some of which are being addressed in the Financial System Inquiry, which is scheduled to report to the government in November 2014. One question is whether there should be rules on how individuals access their superannuation. At present there are no restrictions; the pay-out can be taken as a lump sum or as an income stream product (such as an annuity) or as a combination of both. There are tax incentives to take up an income-stream product; in particular investment earnings on assets supporting an income stream are tax free. Nevertheless, the take-up of lifetime annuities in Australia is relatively low. While this accords with the notion of giving retirees complete freedom in how to deploy their superannuation benefits it is somewhat inconsistent with the core motivation for compulsory-contribution pensions; that of combatting myopia in households' financial planning. On this basis one might expect, for instance, rules stipulating that individuals must take out an annuity (even if only for part of their superannuation) to ensure all retirees have a regular cash income stream from superannuation. This said, such rules are only worthwhile if superannuation pay outs are typically of a size that can generate a non-trivial income stream (net of costs). This may be a relevant factor in Australia given that the compulsory superannuation system has only been in place since 1992 and so pay outs for those currently retiring are only based (at most) on 22 years of contribution.

Questions have also been raised about superannuation funds' high equity content and related to this the absence of default-track provisions in which risk is reduced as the individual heads to retirement. Concerns have been raised about superannuation-fund fees too (for instance, Minife, 2014). Partly in reaction to this, provisions allowing self-managed funds have proved very popular. Evaluation of the superannuation system will be a core theme of the *Financial System Inquiry*'s report mentioned previously.

Property and capital gains taxation

Taxation relating to housing takes a fairly standard approach

Capital gains and income tax treatment of owner-occupied housing is similar to that in many other countries (see Table 9). Following a seemingly ubiquitous practice, capital gains from the sale of owner-occupied dwellings are not taxed. Furthermore as in quite a number of OECD countries, owner-occupiers are not taxed on imputed rental income (tax theory suggests otherwise). Equally however, owners are not allowed to deduct mortgage interest payments, which represents a reasonable compromise.

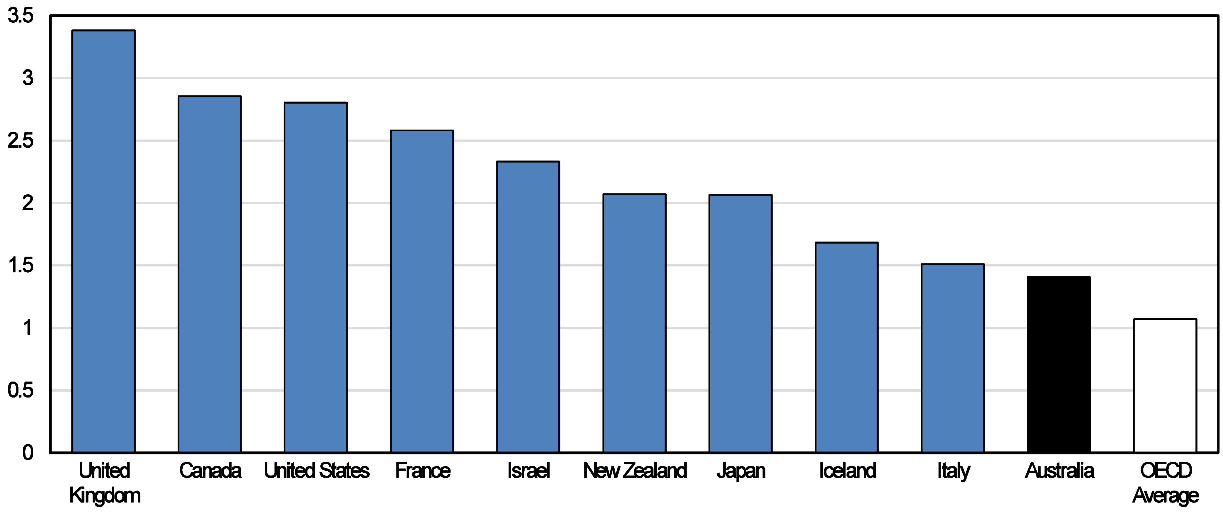
In Australia, income from housing that is purely an investment is subject to personal income tax following the tax-system's principle of inclusiveness; *i.e.* that of applying PIT to all forms of income (net of costs incurred to derive it). Therefore, taxpayers are allowed to claim deductions for the costs of running such properties (for instance accounting expenses, interest payments, and maintenance and management costs). When these expenses exceed the rental income, the taxpayer is able to deduct this "loss" against their other income, such as salary and wages. This is known as negative gearing, and in principle, the same situation can arise for other forms of investment. Those investing in housing anticipate that the capital gain when they sell the property will more than offset the initial loss of disposable income. This is assisted by only half of the net capital gain being liable to income tax (the same applies for equity investments). While the inclusive approach is theoretically neat, the incentives to negatively gear could be reduced. For instance, the Henry tax review recommended a discounting mechanism that would lower the reduction in taxable income from net investment losses (Australian Government, 2010).

Transactions costs on purchasing residential property and businesses most notably include a state-based "stamp duty" (i.e. a tax levied on documents). The cost can be sizeable; for instance the duty in New South Wales for an AUD 750 000 property is about AUD 29 500, or nearly 4% of property value. These add to already sizeable transactions costs; an OECD study estimates the total housing transactions costs in Australia at close to 14%, which is among the highest in international comparison (Andrews et al, 2011). Given the potential for transactions costs to reduce household mobility (again, see Andrews et al, 2011) the state stamp duties should be pruned or eliminated, and efforts made to reduce the other transactions costs.

Recurrent tax on property (that is, immobile property) comprises state-based land taxes and municipal rates charged by local governments. In international comparison the revenues collected as a portion of GDP are somewhat above the OECD average (Figure 16). Broadly speaking this is good, given the attractive economic properties of such a tax (immobile base, little distortion of economic decisions). Indeed, as frequently recommended for other countries, this form of tax should, in principle be exploited more. An exemption of owner-occupiers from land tax could be abolished, and greater use of municipal rates could also be considered, as discussed in Chapter 2 of the 2014 *Economic Survey* of Australia.

Figure 16. **Recurrent taxes on immovable property**[1]

2012 or latest year data, as a percentage of GDP



1. This sub-heading covers taxes levied regularly in respect of the use of ownership of immovable property. These taxes are levied on land and buildings. OECD refers to the simple average of OECD member countries.

Source: OECD (2014), Revenue statistics database.

Table 9. **Key features of the tax treatment of housing in Australia**

Tax or charge	Further detail
Taxes and charges relating to property transactions	
State-based stamp duty	*Example.* New South Wales imposes a progressive seven-rate stamp duty on purchase price of the property with marginal rates ranging from 1.25% to 7%.
Capital-gain treatment	Principle residences are exempt and various deductions apply. As for other capital gains, the tax is computed as part of personal-income tax. For individuals and trusts, only 50% of the net capital gain is subject to personal-income tax if the asset is held longer than 12 months.
VAT treatment	GST levied on new housing construction and housing improvements.
Taxes and charges during ownership	
Treatment in personal income tax	• Principle residence: imputed rent not included but also there is no deduction for mortgage interest. • Investment residence: the net balance of rental income against claimable costs (including interest payments) can often be made negative, thus reducing taxable income.
State-based Land Tax	*Example*. Victoria imposes a progressive schedule comprising five rates ranging from 0.2 to 2.25% with land values supplied by municipal councils. Principle residences are exempt.

Source: Based on Andrews et al (2011)

Is there a case for more wealth transfer taxation?

Australia no longer imposes any form of wealth transfer tax, such as estate tax or gift tax. In the past, death duties were imposed at both the state and Commonwealth levels but by the late 1970s all had been abolished.

Despite this, as proposed by the Henry Tax review (Australian Government, 2010), the case for specific tax on bequests warrants further investigation. Evidence that definitively teases out and quantifies the relative importance of the various motivations for bequests is unlikely to emerge. However, it is reasonable to assume that bequests are to some extent "accidental" *i.e.* a residual from precautionary saving, rather than the result of a plan to leave inheritors a specific sum of money (Cremer et al, 2012). In these circumstances taxes on bequests are non-distorting in that the tax does not affect the amount saved. Furthermore, some argue that the motivational impact of reducing wealth transfers on recipients (or potential recipients) is also a positive. Similarly, some see merit in the implications for equity arising from the reduction in wealth transfer from bequest tax.

However, bequest taxes raise questions and pose practical difficulties. Such taxes are likely to prompt criticism that they represent unfair double taxation, an issue which is not a concern economically (as taxes are anyway imposed at many points in the economic system), but a point which probably needs defending. More problematic economically, bequest taxes require auxiliary provisions to limit losses from avoidance, for instance rules on gifts need attention. Indeed, such complications contributed to the demise of death duties (along with inter-state tax "competition"), and require close evaluation against the potential revenue.

Clearly, any feasibility study of bequest taxation needs to look closely at a wide range of issues. In particular, research on behavioural reactions, compliance and avoidance needs to focus closely on wealthy households. This is where most of the tax base for bequests will lie given that similar to systems elsewhere, any bequest tax proposal for Australia is likely to have a fairly substantial tax-free threshold that implies only large inheritances are subject to tax.

Company taxes and business subsidies

A number of issues drive policy on corporate tax and business subsidies, including revenue and tax-mix concerns, competitiveness issues, and efforts to encourage high-value-adding activity (such as scientific research and development). In addition, Australia is one of several OECD countries where royalties or special taxes on natural resources are of particular importance.

There is a case for lowering the headline rate of corporate taxation

As in other open economies, exposure to capital mobility means there are tensions between keeping business tax light in the interests of investment while accommodating revenue needs and tax-fairness considerations. Tax expenditures in corporate taxation and business subsidies (Table 10) are, in effect, often differentiating between different degrees of mobility, thus helping ease this tension.

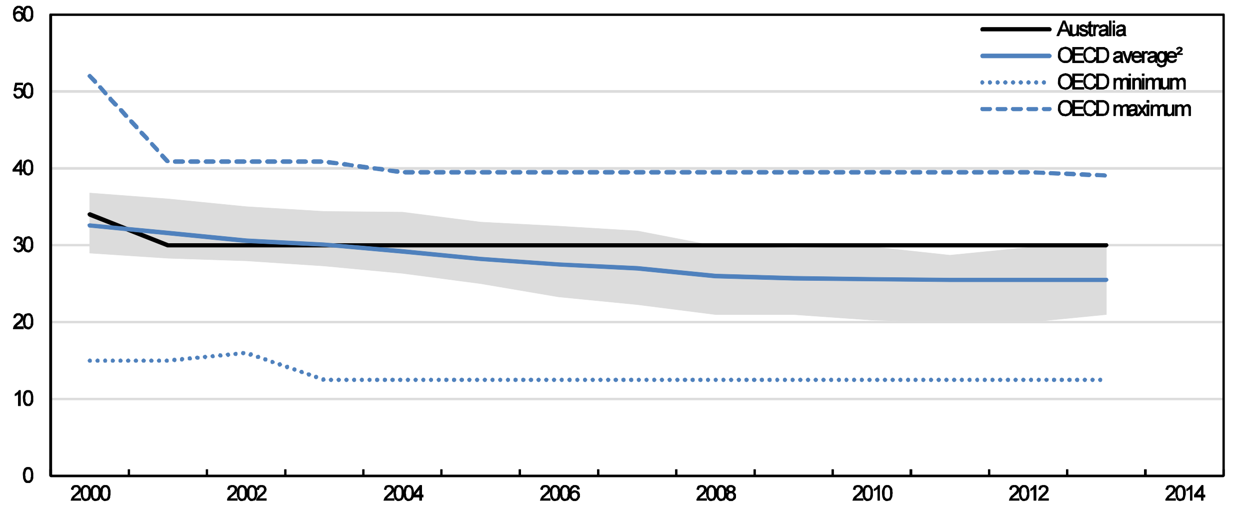
Despite headline rates of corporate tax being only one of several influences on the effective rates of business tax, they feature prominently in international comparisons of tax systems. Therefore, Australia’s relatively high rate of corporate taxation, at 30%, does not help the country’s “profile” in the eyes of investors (Figure 17). To its credit, the current government intends to cut the corporate-tax rate by 1.5 percentage points to 28.5% from July 2015. Further reductions should be envisaged, perhaps in the form of commitment to a schedule of cuts over several years, to enhance certainty for businesses and maximise positive near-term expectation effects on business decisions.

Table 10. **Key features of corporate taxation and business support**

Corporate taxation	
Corporate income tax	• 30% rate on taxable income, deductions notably including R&D spending. • Dividend imputation system through "franking credits". • Absence of concessionary rates or similar, for instance to attract large greenfield investors. • Favourable rules for small- and medium- enterprise.
Tax/royalty for natural resource exploration and extraction	• Separate state-based royalty systems (technically, the states are the owners of land-based mineral resources). • A Commonwealth super-normal profit tax on offshore petroleum resources has been in place since the mid-1980s (the Petroleum Resource Rent Tax). • Before end of September 2014, a federal-level tax aiming to capture super-normal profits in the iron ore and coal sectors (the Mineral Resource Rent Tax) operated.
Business support	
Federal tariffs on imported goods	• Although less substantial than in the past customs tariffs still apply to many imported goods the rate is typically 5%.
Federal direct support	• Sector-specific support offering a mixture of grants and support services, most substantial grants are for available for the automotive industry (but expenditure is due to decline following announced closure of plants).
State-level support	• Packages of support to "mobile" capital, such as manufacturing. • Agreements with mining companies on auxiliary building of infrastructure and services.

Figure 17. **Statutory rates of corporate income tax[1]**

Per cent



1. The proposed rate for Australia of 28.5% from July 2015 is not shown.
2. The shaded area is the 25th to 75th percentile range of available OECD countries.

Source: OECD (2014), Tax database.

However, the government's 1.5 percentage-point cut in the corporate tax rate is to be offset by a levy of 1.5% on taxable corporate income above a threshold of AUD 5 million. The revenues have been nominally linked to funding the expansion of paid parental leave (see above). One side-effect of the levy is that broadly speaking the effective rate of corporate tax will be lower for small and medium sized enterprises; thus representing an implicit form of support for that sector. However, it is moot whether there is an economic case for support of this nature. Assistance for small-and-medium enterprise is perhaps better delivered through existing programs that address shortfalls in expertise and specialisation for handling regulation and administrative processes and in conducting marketing campaigns for exports.

Australia commendably avoids double taxation of dividends by accompanying pay outs with a "franking credit", a tax credit equal to the value of corporate tax paid on the dividend. However, the approach amplifies home-country bias in investment for (as yet) there are no mutual tax agreements with other countries on this issue. For instance, one paper estimates that the franking-credit effect accounts for between 20 and 30 percentage points of domestic content of Australian portfolios out of a total domestic content averaging about 75% (Klement et al, 2013).

Ensuring the fruits of natural resource wealth are appropriately distributed

In principle, resource taxation should ensure that the public (as owners of the resources) receive the value of the resource itself (the resource rent), which implies that companies extracting the resources should not make supernormal profits. In practice, optimising royalty/tax regimes to this end is complicated by variations in extraction costs; connection between mining-company return, exploration effort and (therefore) known reserves; uncertainties and risks, especially in exploration; and, information asymmetries between resource companies and revenue authorities. Furthermore, the nature of revenue streams differ, some regimes deliver regular and reasonably certain income stream (such as fixed volume-based royalties for which demand and production are reasonably predictable), while in other regimes revenues can be lumpy and unpredictable.

Taxation of Australia's land-based mineral resources has traditionally relied on state-based royalties (the states, not the Commonwealth, own land-based resources). These royalty regimes have complex structures. For example in Western Australia there are fairly straightforward royalty "ground rules" but for many resources (including important ones) these are over-ridden by product-specific royalties (Table 11). Furthermore, royalties for economically important specific mineral deposits are typically negotiated alongside a range of other issues in deals between the Western Australian government and the relevant mining companies ("State Agreements").

Table 11. **Key features of Western Australia's royalty regime**

Dimension of regime	Detail
Legislative framework	Mining Act (1978), Mining Regulations (1981)
"Baseline" royalty regime	1. Specific royalty applied to low-value non-metallic products. 2. *Ad valorem* royalty with three (decreasing) rates applied at different points in the production process (designed to encourage investment in downstream processing).
Product-specific royalties	*Examples:* Iron ore "fines" 7.5% of *ad valorem* base (as of 2013), Gold, 2.5% spot market price at time of sale.
Royalties specified in State Agreements	*Example.* Royalties on iron ore operations run by the two main players, BHP Billion Iron Ore and Rio Tinto Iron Ore, are incorporated in State Agreements. In 2010, new agreements were signed that *inter alia* ended long-standing preferential royalty rates.

Source Western Australia Government website

A country-wide tax on supernormal profit, the Mineral Resource Rent Tax (MRRT) was introduced in 2012 for the key mineral resources of coal and iron ore, operating in tandem with state royalties (OECD, 2012a). Ideally it was meant to tax only the supernormal rent from natural resources, allowing "normal" profits and not distorting investment and extraction decisions. A broadly similar tax treatment on offshore petroleum resources (the Petroleum Resource Rent Tax, PRRT) has been running since the mid-1980s.

However, the Mineral Resource Rent Tax's legislation had a bumpy ride to the statute books. Like the "Carbon Tax", the Tax has been a leading issue in political debate. For instance, opponents promoted the notion (through extensive ad campaigns) that the tax was very damaging for competitiveness, household incomes and jobs. The views of more impartial experts indicate that the final version of the legislation was less than ideal (though with perhaps different criticisms to those of the business community). Dilution and compromise in the legislation's passage through parliament seems partly to blame and some argue the design was overly complicated. Very little revenue has been raised by the MRRT so far, in part due to many deductions and exemptions. The present government has followed through on an election promise abolish the tax; legislation repealing the tax was passed in September 2014.

A tax on supernormal profit (as previously recommended) would be less dissuasive to investment and exploration compared with royalties as it is only imposed if profits surpass a level compatible with that of a competitive market. However, royalties can fulfil a useful role as they deliver a more regular and predictable revenue stream, as mentioned above.

Encouraging innovation includes plans for a medical research fund

As elsewhere, R&D activity and innovation in general are encouraged through favourable tax treatment and a range of targeted programmes providing grants and other forms of support. Economic justification for favouring innovative activity lies in externalities arising from gaps between public and private returns to innovation and knowledge spillovers. However, while there is little doubt as to the existence of such phenomena, their scale is uncertain, and the processes generating them are complex. Therefore, developing sound support programmes (either in the form of tax exemptions or grants) requires good systems for monitoring and assessing programme impact and low policymaking inertia when it comes to dropping poorly performing schemes or ramping up those that prove successful.

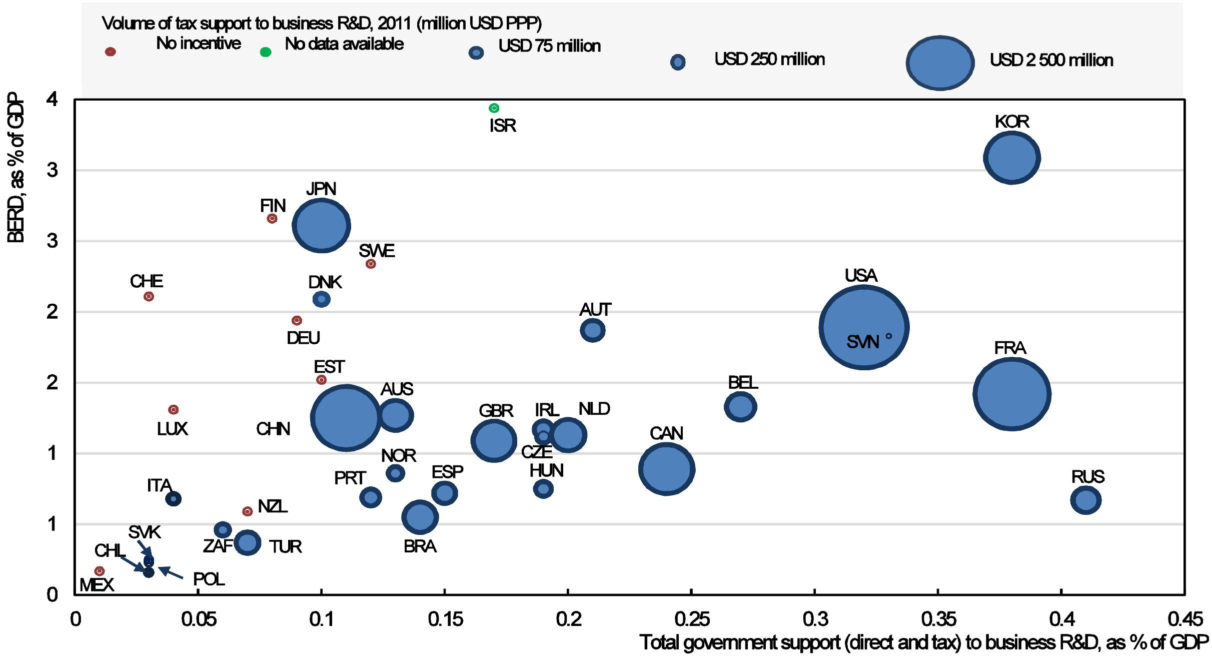
Australian business spends comparatively little on scientific research and development on a per capita basis (Figure 18). Distance from major consumer markets and global centres of research act as key constraints and therefore trying to match the R&D spending levels of top-ranking countries is therefore probably not an appropriate goal. However, policy nevertheless needs to give appropriate weight to the potential economic and social gains from pure research, facilitate interaction between public and private research and ensure taxes and business subsidies reflect the beneficial externalities of scientific innovation.

In accommodating these issues, Australian policy relies on instruments that are widely used in other countries, notably favourable treatment of R&D expenditures in corporate income tax and direct public support to research. A review of policy settings in the 2012 OECD *Economic Survey* of Australia (OECD, 2012a) for instance underscored a need for more simple and flexible schemes encouraging collaboration between university and business research.

To raise broad-based productivity, innovation policy ought to take a wide perspective, recognising the important role that non-scientific innovation can play in improving productive capacity, such as improvements in supply-chain management and service-sector innovations. Helping business innovate in this broad sense requires ensuring sound general conditions for business; stable macroeconomic conditions, flexible labour markets, exposure to competition and minimal red tape. Broadly speaking, the Australian authorities appear to recognise the importance such non-discriminatory framework conditions in encouraging broad-based innovation. However, somewhat in contrast to this principle, the current government plans a highly targeted scheme to accumulate a medical research fund worth AUD 20 billion (about 1.3% of GDP) by utilising the savings from various health related measures in the 2014-15 Budget.

Figure 18 **Business R&D intensity and government support to business R&D, 2011**

As a percentage of GDP



Source: OECD, based on OECD R&D tax incentives questionnaire, publicly available sources, and OECD, Main Science and Technology Indicators Database, www.oecd.org/sti/msti.htm, June 2013.

Similar to other countries, Australia offers wide ranging support to SMEs. As regards financing, the current government is re-examining tax rules on employee share schemes following complaints from businesses that stricter conditions introduced in the 2009-10 Budget have considerably reduced the attractiveness of share schemes for employees, thereby closing off this form of financing to SMEs. On other fronts the government plans on discontinuing co-financing the Innovation Investment Fund, which is a form of venture-capital fund. However, it aims to continue with concessional tax treatment of such funds via the Venture Capital Limited Partnerships scheme. A number of countries, for instance Canada, have established secondary trading platforms for high-risk investment (these for instance typically entail lighter reporting requirements than those in the primary stock exchange) and such a platform may be worth considering for Australia.

Admirable resistance to additional industry subsidy but new drought support for farmers

The closure of Australia’s three remaining automobile assembly plants has been announced by the relevant companies, marking the end of an era and reflecting healthy resistance to appeals for additional support. Australia’s generally high cost and small volume operations (Productivity Commission, 2013) have long struggled to find a viable place in increasingly globalised vehicle supply chains, despite government support via direct financial assistance and tariffs on imported vehicles. It is estimated that closure of the plants will result in savings of around AUD 620 million over the coming years, which is equivalent to little a under 0.5% of current annual GDP (Australian Government, 2014c).

In agriculture, standard measures of producer support continue to confirm that, broadly, Australian subsidy is among the lowest in the OECD area. For instance, the latest OECD calculations indicate producer support is now equivalent to only 2% of farm receipts (OECD, 2014b). In 2013 a new intergovernmental agreement heralded the end of drought-focused programmes (so-called Exceptional Circumstances programmes) and the establishment of more general support for hardship. This has been a good move in that some drought support, such as the Exceptional Circumstances Interest Subsidy, created undesirable incentives, making farmers less inclined to plan and invest appropriately for drought risk. Somewhat counter to the 2013 agreement, in February 2014 the government announced new drought assistance programme worth AUD 320 million, the lions share (AUD 270 million) as concessional loans. There is a risk that similar incentive problems will emerge and the authorities should closely monitor the impact and act decisively if difficulties emerge.

Evasion, avoidance and administration issues

Enhanced tax compliance, for instance through reduced red-tape for filing tax returns, ramping up campaigns against tax evasion and aggressive avoidance, can raise additional revenues, creating room for manoeuvre in tax strategy and helping fiscal balances in general. The increased attention, both domestically and world-wide, to tax evasion and avoidance is providing a political opportunity for renewed policy vigour on this front.

A campaign to cut red tape is underway

As part of the present government’s drive to cut red tape, the Australian Tax Office aims to bring savings for government, business and households worth AUD 250 million each year through changes in regulation and processing. As of mid-2014 a scheme offering a streamlined tax return to businesses with relatively straightforward accounts (*MyTax*) was underway and regulations had been changed allowing many small businesses to make pay-as-you-go instalments less frequently. Many other measures are planned, for instance, more "pre-population" of tax returns, further development of the government’s internet portal, *MyGov*, reduced transfer-pricing documentation, greater use of digital correspondence and implementation of OECD’s standard for the exchange of information on foreign residents. These further efforts will likely enhance the Tax Office’s already good reputation.

The authorities are actively campaigning against base-erosion and profit shifting

As in other countries the attention of policymakers, the press and the public has focussed on the seemingly low levels of tax paid by some well-known business operations. Indeed, strategies that erode the corporate tax base by shifting profits between tax jurisdictions (base erosion and profit shifting, or BEPS) has become a focus of OECD analysis (for instance, OECD, 2013b). BEPS not only implies revenue losses but also put multinational enterprises in an advantageous position over domestic firms and distort investment. In addition, the perceived unfairness of BEPS risks damaging trust and compliance elsewhere in the tax system. However, making progress in addressing these issues is tough; proposed measures invariably run counter multinational companies’ vested interests and some tax jurisdictions benefit from tax-avoidance strategies. As G20 President, Australia has been actively assisting the international campaign to tackle BEPS through representation by Treasury and the Australian Taxation Office officials at working-level meetings, participation in fora to help developing countries address BEPS and co-hosting a G20 tax meeting in Japan in May 2014.

Several alterations to Australian tax law that aim to reduce BEPS have already been made and more are underway:

- Tighter "thin capitalisation" rules have been introduced to further dissuade multinational enterprises from claiming debt-interest deductions in Australia (thin capitalisation means an entity operating with comparatively little equity capital in relation to debt, the presence of which may reflect efforts to exploit differences in the tax treatment of debt-interest deductions across tax jurisdictions).
- A loophole has been closed that permitted multinational taxpayers to claim a tax exemption for interest income from loans to offshore subsidiaries and ramp up the debt allocated to Australia.
- The Australian Tax Office has stepped up scrutiny of international businesses. For instance, under the four-year International Structuring and Profit Shifting initiative, the Office is reviewing companies that have undertaken an international business restructure or have significant related-party cross-border arrangements. An initial 86 cases have been identified and are currently under review. Furthermore, the Office is also collaborating with tax authorities elsewhere to develop a better understanding of multinationals’ activities and their compliance with tax laws.

Recommendations on taxes and transfers

Key recommendations

- **Rebalance the tax mix**; shift away from income and transaction taxes and make greater use of efficient tax bases. Reform could, for instance: *i*) make greater use of ***GST*** by reducing preferential treatment and by raising the rate; ii) look toward increasing ***personal-income tax*** thresholds and reducing rates in the medium term; *iii*) in ***taxation relating to housing*****,** reduce transactions taxes and consider greater use of recurrent tax on property; *iv*) lower the ***rate of corporate tax***, perhaps via a series of rate cuts over several years as a means of signalling a firm commitment to a sustained rate reduction; and, *v*) as regards ***taxation of natural resources sectors*****,** envisage taxation of supernormal profit for mineral-resource sectors, starting with considering the design of State royalties.

- **Concentrate on broad support for business;** prioritise corporate-tax rate cuts and reduce regulatory burdens but meanwhile be tough on corporate welfare and tax avoidance. In ***support for specific sectors*** maintain a stiff resistance to prolonged subsidies for specific industries and plants; beware of undesirable incentives in the new drought support for farmers. Ensure a co-ordinated and common front in negotiation with resource companies. Campaigning against unwarranted ***base erosion and profit shifting (BEPS)*** strategies should continue through further international co-operation and the closure of loopholes domestic corporate tax settings.

- **Monitor the proposed welfare reforms** to ensure they raise work-force participation cost effectively without adverse social outcomes. In particular monitor the tougher ***benefit-eligibility rules for unemployed persons*** aged under 30 to ensure they meet their objectives Consider on the long-term implications of the change to ***Age-Pension indexing*** through the forthcoming Inter-Generational Report. Better target ***superannuation*** (pension) tax concessions.

- **Achieve greenhouse-gas emission targets.** Ensure the proposed Emission Reduction Fund is efficient through: i) robust measurement and verification methods; and ii) implementation of a safeguard mechanism that prevents offsetting emissions elsewhere in the economy.

- **Make transport policy greener**; enact the proposal to index ***excise duty on retail fuel***, expand other use-based vehicle charges and extend public transport.

Other recommendations

- Simplify ***household taxes and benefits*** aim, *inter alia*, to reduce recourse to professional accounting services by households and aim to reduce "bumps" in the marginal tax schedule arising from benefit tapering.

- Re-examine the balance between ***paid parental leave*** and other aspects of family policy following the release of the Productivity Commission's review of child care.

- Continue to reform the ***disability pension system*****;** by improving assessment processes for new claimants, and re-evaluating the stock of existing claimants; this is a "long game" requiring ongoing policy attention.

- As regards ***old-age pensions***, pursue proposals to gradually increase the age at which first and second pillar pensions can be accessed.

- Re-examine the case for bringing back ***bequest tax***; given past experience only a tax the federal level should be considered.

- Pursue vigorously the Australian Tax Authority's campaign to cut ***red tape and compliance costs*** for taxpayers.

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