acoss

TAX TALKS 3

Re-think, Re-engage, Re-design

Response to the Federal Government Tax Discussion Paper 2015

Who we are

ACOSS is the peak body of the community services and welfare sector and the national voice for the needs of people affected by poverty and inequality.

Our vision is for a fair, inclusive and sustainable Australia where all individuals and communities can participate in and benefit from social and economic life.

What we do

ACOSS leads and supports initiatives within the community services and welfare sector and acts as an independent non-party political voice.

By drawing on the direct experiences of people affected by poverty and inequality and the expertise of its diverse member base, ACOSS develops and promotes socially and economically responsible public policy and action by government, community and business.

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Executive summary

Tax reform can no longer be avoided. Tax reform is essential to help resolve the serious Budget pressures facing federal and state governments which threaten essential benefits and services. We need it to underpin growth - in investment, living standards and jobs - at a time of major structural and technological change in Australia and internationally. It is a key part of the solution to our chronic housing affordability problems. The tax treatment of superannuation is the weakest link in our retirement income system. Finally, tax reform is needed to restore fairness and integrity to a system has for too long allowed individuals and organisations to manipulate the system to avoid contributing their fair share. This means that everyone else has to pay tax at higher rates than would otherwise be required.

The recent history of tax reform is not encouraging. The most comprehensive expert review of tax and social security, the 'Henry Review' still provides the best policy foundation for tax reform. Unfortunately, it was implemented in a partial and one sided way that stalled the momentum for further change. A key problem was the lack of a consensus-building process to explain why reform was needed and involve stakeholders in the search for solutions. The previous Federal Government instead announced a partial response as soon as the report was released, at the same time ruling out key reforms.

There are signs that this unfortunate history is being repeated. Three months after announcing the start of a 'conversation' with the public about tax reform in which 'everything is on the table', the present Federal Government has sent signals that major areas of reform, such as to negative gearing arrangements and superannuation, will not be considered. Already, the door to serious reform of the tax system is closing. This cannot be allowed to happen. The same budgetary problems that make tax reform more difficult also make it essential. In the absence of comprehensive tax and budget reform, social and political conflict over scarce public resources will only intensify. Governments will be trapped in a vicious cycle of austerity and recrimination.

Tax and budget reform can and must be achieved. Experience shows that this is more likely to happen when governments clearly define the problems, take the community into their confidence, engage stakeholders in a search for solutions, and crucially, listen to the diversity of community voices. A degree of political bi-partisanship is also needed, even where major differences remain over the direction of reform.

A degree of consensus for reform is also needed outside government. Last year ACOSS together with peak national business organisations held a conference on directions for comprehensive tax reform. Three years ago, the previous government held a Tax Reform Forum. The experience from both events was that people representing a diversity of interests are willing to work together in a spirit of openness and compromise to achieve common goals.

The previous Government's Forum and the invitation to open dialogue at the start of the present Government's tax review demonstrate that both sides of politics can work constructively with the community on tax reform, and that if given the opportunity, the community will embrace it. ACOSS remains committed to playing our part, particularly in the interests of people experiencing poverty and inequality, to advance the common good.

This submission proposes a pathway for securing broad consensus on tax reform in Australia. It identifies seven key challenges which require reform of the tax system. ACOSS proposes a set of high level goals for tax reform and a framework to achieve them. The submission scopes out potential packages for reform to achieve common goals, whilst avoiding detailed proposals at this stage. This is best way to begin an open and inclusive conversation about tax, rather than starting from a set of preferred solutions and working backwards to 'justify' them. The submission aims to build on important work already done, including the Henry Review, and ACOSS' more recent collaboration across sectors, including the business community. .

An effective tax reform process is one in which the government identifies its broad goals, then opens up a dialogue with the community over the problems which tax reform should resolve, the broad direction of reform, and later a set of policy options informed by the previous discussion which will clearly address problems identified.

It is crucial at this early stage that the government, and stakeholders, avoid ruling out options before we have identified the problems and directions for reform. The government should encourage and make room for dialogue on tax reform among community stakeholders, though at a later stage it should signal its preferred direction for reform to avoid a gap opening up between stakeholder views and consensus and government policy.

Problems to be solved

As with any major reform agenda, tax reform should begin with a clear understanding of the problems to be solved. This submission identifies seven key economic, social and environmental problems which require reform of the tax system. They touch on issues of concern to the community which extend beyond taxation:

1. The sustainability of the Federal Budget, and the services, benefits and infrastructure it funds, are jeopardised by inadequate and unstable public revenue bases.
2. Sustainable economic and jobs growth is jeopardised by biases in the tax system that distort or discourage investment and workforce participation.
3. The tax system is unfair: people are not called upon to contribute in a consistent way according their ability to pay.
4. The retirement income system lacks coherence, fails to deliver income security in an equitable way, and cannot be sustained in its present form.
5. Housing is unaffordable, especially for people on low and modest incomes.
6. State governments lack efficient and reliable revenue bases to fund essential

community services, and invest in essential sustainable infrastructure.

7. The tax treatment of the charitable sector is inequitable, complex and inconsistent.

A framework for reform

We propose a framework for tax reform broadly corresponding to the challenges for reform discussed above. These reforms are not mutually exclusive, nor do they have to be pursued simultaneously in 'one big package'. We present them in this way so that the line of sight between problems and policy solutions is clear.

By way of example, tax reform is more difficult to pursue when the Budget is under pressure, as it is now. This makes it harder to ensure that there are more short term 'winners' than 'losers' from reform. At the same time, pressures are emerging to cut personal income taxes to offset the impact of tax 'bracket creep'. One way to deal with this constraint is to link reform of the personal tax system with personal income cuts, to 'broaden the base to lower the rates'. This is a fairer option, and one that would probably do more to improve economic efficiency, than raising the Goods and Services Tax (GST) to pay for income tax cuts. It would also attract support from many people who believe their taxes are subsidising tax shelters for people who can afford to pay more.

In this report we identify a 'Bermuda Triangle' of personal income tax avoidance comprising the three main mass-marketed tax shelters: capital gains and negative gearing, superannuation, and private trusts and companies. While lower tax rates for long term saving and investment are a necessary feature of any tax system, these concessions are being exploited well beyond their original purpose – to support productive investment and retirement incomes. If personal tax cuts were largely paid for by curbing tax avoidance opportunities, equity and efficiency would be improved at the same time without loss of scarce public revenue.

Another example of framing the case for tax reform in an era of Budget pressures is to draw the connections between taxation and expenditure reform. There is no doubt that governments will need more public revenue to restore their budgets, repair gaps in essential services and the social safety net, and provide services for an ageing population. Tax reform should be linked to these goals, for example by 'earmarking' revenue gains to expenditure priorities. At the same time, wasteful and poorly targeted expenditure should be reduced.

A good example of the link between tax and expenditure reform is the retirement income system. The pension should be better targeted to people who need it, especially by tightening the assets test, but that reform on its own would be one sided if the government fails to confront the inequity and inefficiency of superannuation tax breaks. Another key goal for retirement income and tax reform is to staunch the erosion of the income tax base so that future governments can finance decent universal health and aged care services which are as vital to security in retirement as an adequate income. These issues should be dealt with together in a properly constituted *retirement incomes review*. The starting point should be to seek consensus on the purpose of public support for retirement incomes.

Below ACOSS sets out a proposed framework for tax reform which clearly articulates the purposes and goals to be achieved. These goals are interrelated and complementary.

1. Restore and strengthen Australian government revenue

In the medium-term, restore Australian government revenue to at least its pre-GFC level as a percentage of GDP (25%) by restructuring the key Commonwealth tax bases rather than relying solely on 'bracket creep':

A. Any personal income tax cuts to be funded mainly by broadening the personal income tax base (closing tax shelters), not by increasing regressive taxes (including the GST).

B. Stem the decline in petroleum excise revenues through appropriate indexation.

C. Stem erosion of the personal income tax base, including among people over 60 years, in order to help finance future pensions, health and aged care services (discussed below).

2. Fair and efficient personal income tax

Tax personal income more consistently and strengthen public revenues by closing personal income tax shelters, possibly linked to adjustments to income tax scales to offset the effects of tax 'bracket creep':

A. Tax investment income more consistently including removal of the present bias towards geared investments yielding capital gains.

B. Improve paid work incentives and simplify taxes on labour incomes, with an emphasis on reducing effective tax rates for women on low incomes, and inequitable deductions.

C. Remove personal income tax avoidance opportunities through the use of business and investment entities such as private trusts and companies.

3. Efficient, growth-friendly business taxes

Business income taxes would be redesigned to raise the same revenue in a more investment and growth-friendly way:

A. Any reductions in company income tax to maintain the same tax rates for small and larger companies, and be financed by a combination of taxes on 'location-specific economic rents' (e.g. mining, monopoly rents), clamps on multinational tax avoidance, and business tax base-broadening (removing unwarranted exemptions and concessions).

B. Reduce reliance on business 'input' taxes, including Stamp Duties and insurance taxes.

C. Review tax concessions that privilege some industries or economic activities over others (for example the capital gains tax discount) to ensure that they bring clear economy-wide benefits.

4. Better retirement incomes and services

The system of public support for retirement incomes should be redesigned, based on agreement on its core objective. The objective of our retirement income system should be to alleviate poverty and facilitate people saving enough to enable them to have a decent standard of living in their post-working age life. This approach would improve the equity, sustainability and security of retirement incomes, as well as strengthening the income tax base for health and aged care services:

A. Redirect tax concessions for superannuation contributions towards low and middle income earners in a revenue-neutral fashion, so that tax concessions per dollar invested are as close as possible to equal for people on different incomes.

B. Stem erosion of the personal income tax base for people over 60 years through poorly designed superannuation and other tax concessions, and improve the targeting of pensions, in order to help finance health and aged care services and pensions for an ageing population.

C. Reform the post-retirement phase of superannuation to refocus the system on its main objective and away from other goals such as tax avoidance and estate planning.

5. Improving the affordability of housing

The tax system at both federal and state levels should be redesigned to reduce incentives to speculate in housing prices and to encourage institutional investment in rental housing, especially affordable housing:

A. Redirect revenue saved though reform of Capital Gains Tax and negative gearing arrangements to a more efficient tax incentive for investment in (preferably low cost) housing construction.

B. Broaden State land taxes and use the revenue to replace housing stamp duties, or integrate these two tax bases.

C. Improve rental subsidies for low income households, by increasing them for those with the highest housing costs without leaving people at risk of poverty worse off.

D. Strengthen public investment in social housing and incentives for community and private investment in affordable housing

These reforms would be undertaken in conjunction with broader housing policy initiatives to:

- Improve access to land for housing and encourage urban consolidation.
- Improve planning, transport and community infrastructure.

6. More sustainable and efficient revenue bases for State governments

Tax and expenditure reform should ensure that State governments have the robust and efficient revenue bases they need to provide essential community services and infrastructure, without increasing overall reliance on regressive taxes.

Reform of State and Territory taxes and intergovernmental transfers should be underpinned by assurances to the community that universal essential services will be available to people where they are needed, through an intergovernmental agreement on taxation and expenditure that extends beyond the distribution of GST revenues to clarify the division of responsibilities and their funding between federal and state/Territory governments, and ensures viable revenue streams for States and Territories to carry out their functions:

B. Consolidate State and Territory taxes towards the most efficient (including abolition of the least efficient), without increasing their overall regressivity.

C. Better integrate State/Territory and Commonwealth tax bases while improving incentives for States to make effective use of their most efficient taxes.

D. Maintain GST exemptions for fresh food and human services.

While the current horizontal fiscal equalisation arrangements are not optimal, we support the goal that people should have equitable access to services and supports regardless of where they live, and despite differences in States' own revenue bases.

7. More equitable and sustainable tax treatment for the charitable sector

Improve the equity, consistency and sustainability of tax treatment of different charities, including gift deductibility and Fringe Benefit Tax (FBT) exemptions.

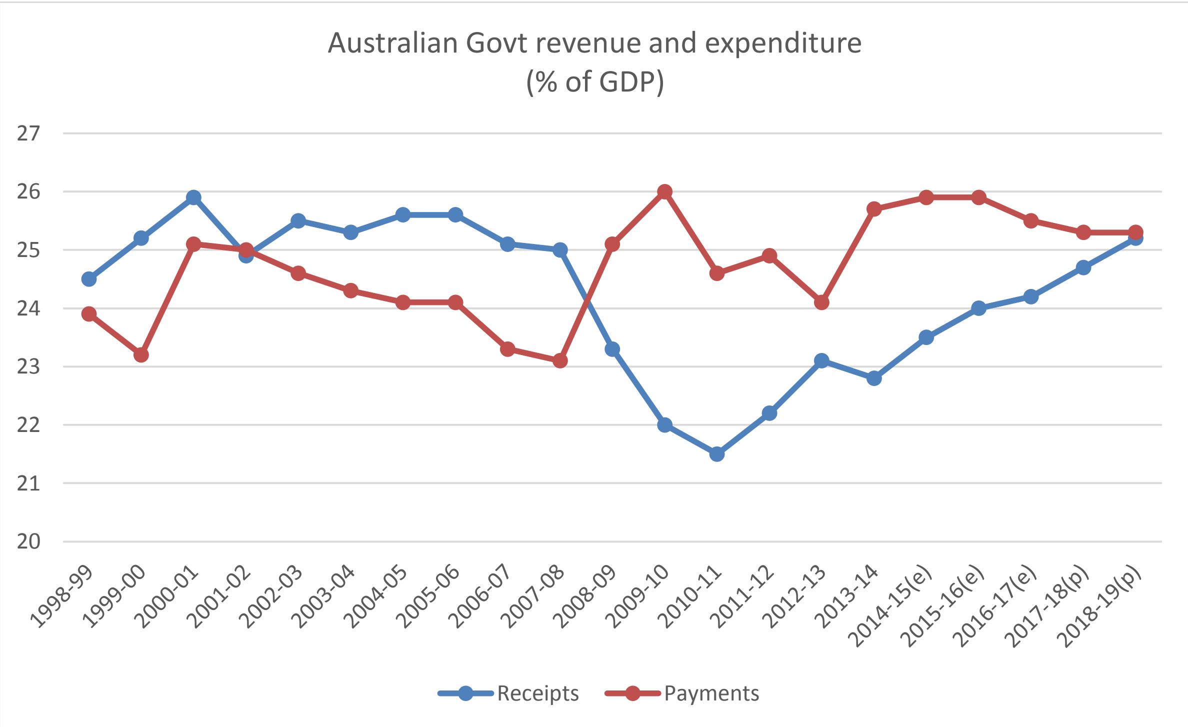
As is appropriate for this stage of the tax review, the remainder of this submission elaborates on the seven key challenges for tax reform we have identified rather than detailing specific reforms. Policy makers and the community need to understand the problems before we turn to solutions.

1. The sustainability of the Federal Budget, and the services, benefits and infrastructure it funds, are jeopardised by inadequate and unstable public revenue bases.

PROBLEMS:

Australian governments face Budget pressures from the winding back of the mining boom, and the unusually high company income tax revenues that came with it, eight successive years of personal income tax cuts, and a lack of attention to repairing the personal income tax base. Those personal tax cuts were largely paid for by temporary windfall revenues from company taxes. When the revenue windfall ended after the Global Financial Crisis, the resulting drop in tax revenues was responsible for the majority of the drift from surplus to deficit.

Figure 1



Source: Australian Treasury (2015): *Budget 2015-16, Budget Strategy and Outlook, Budget Paper No 1* Commonwealth of Australia

On the expenditure side, the revenue windfall was also used to finance poorly targeted direct payments and subsidies to households, especially older people with substantial assets, families with high incomes, and private health subsidies. Action to close long standing gaps in community service provision (including mental and dental health, disability services and schools), income support for the poorest households (especially inadequate Allowance payments and family payments), and to improve housing affordability, was either delayed or not taken at all.[4]

Some poorly targeted expenditures from the boom years remain, including the extension of pensions to people with substantial assets apart from their homes and private health rebates that have had little impact on the cost of public health care. Tax expenditures (such as those for superannuation) are a bigger problem because their cost is poorly controlled in the Budget process.

Australia has one of the most tightly targeted social security systems in the OECD and most public expenditures on human services also go to households on low to modest incomes. This means that scope to reduce overall expenditure as a proportion of GDP – as distinct from re-prioritising it - is very limited without harming people on low and modest incomes.

This is the key lesson from the 2014 and 2015 Budgets, which have attempted to restore a surplus through expenditure reductions alone. These Budgets reveal the grim future for social security and community services if a more balanced Budget strategy is not adopted: by restoring and strengthening public revenue as well as cutting wasteful and poorly targeted expenditure. ACOSS has identified $15 billion in expenditure cuts over the forward estimates 'carried over' from the 2014 Budget which mainly fall on households with low and modest incomes.[5] Many of these measures have stalled in the Senate for good reason: they would disproportionately impact on low and modest income households. In addition, the 2014 Budget reduced grants to the States for health and schools by over $80 billion over the next decade, by indexing these programs to the Consumer Price Index (CPI only). As State governments have argued, this is not sustainable. The 2015 Budget has proposed further harsh spending cuts, for example, $800 million over four years to health services (mainly community-based health care), at a time when the nation is debating how to reduce violence in our communities, mental illness, drug and alcohol abuse.

Expenditures and revenues will need to rise over the next two decades to deal with Budget pressures from population ageing, especially in health, aged care and pensions.

Higher income tax *rates* are not the only way, or the best way, to restore public revenue. Indeed, the current Budget strategy relies too much on income tax 'bracket creep' and too little on structural reform of the tax base.

If governments are to raise more revenue to fund essential services, payments and infrastructure, the tax system must be redesigned so that it is raised in a fairer and more economically efficient way, and to stem the erosion of key tax bases. A major tax re-design is needed regardless of whether we agree as a nation that more public revenue is needed in future.

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[4] ACOSS 2013, *Submission to the Commission of Audit: Balancing the Budget* http://acoss.org.au/papers/acoss_submission_to_the_commission_of_audit_balancing_the_budget

[5] ACOSS 2015, *Budget analysis 2015-16* http://acoss.org.au/images/uploads/ACOSS_Budget_Analysis_2015-16.pdf

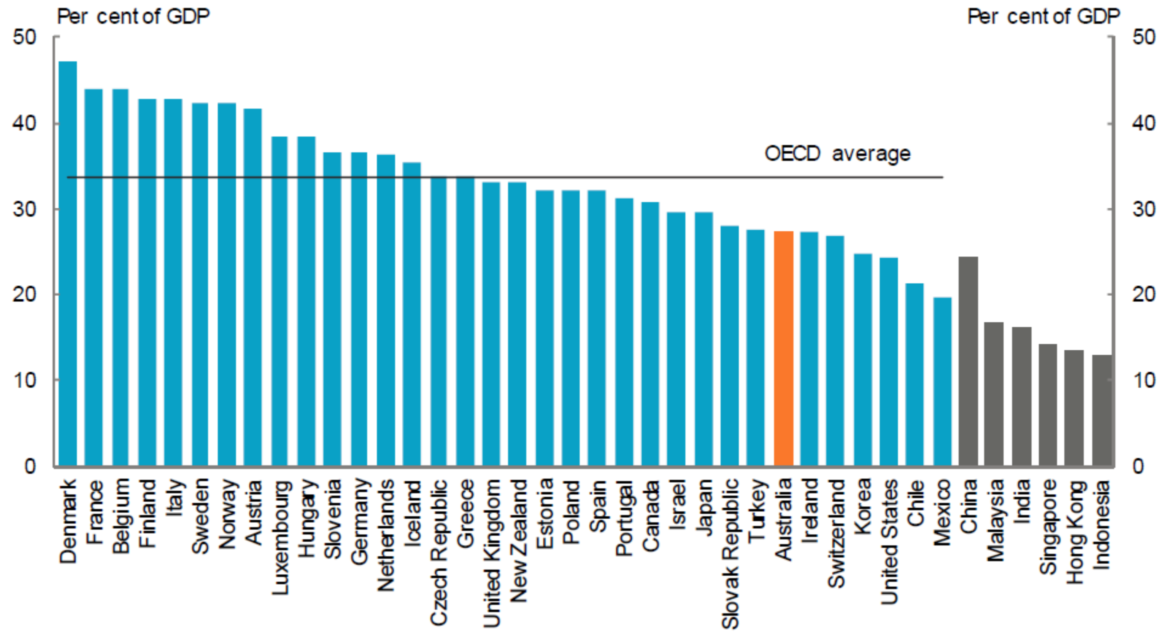
MYTHS:

Myth 1: Taxes, especially personal income taxes, are high in Australia.

Facts:

(1) Australia is the seventh-lowest taxing OECD country.

Figure 2: Tax revenue as a proportion of GDP (2012)



Source: Australian government (2015) Rethink, tax discussion paper, p17.

(2) Australia's average tax rate on labour income is at the OECD average level of 22% (including personal income tax, employee social security contributions, and family payments). If employer social security contributions are included, Australia's average tax rate on wages is 27%, well below the OECD average of 36%.[6]

GOALS:

1. In the short term, restore Federal Budget revenue to at least pre-GFC levels: 25% of GDP.
2. Over time, strengthen fair and efficient public revenue bases to meet the ageing population needs and close major gaps in essential services and the social safety net.

[66] Source: OECD 2013 *Taxing wages: country note for Australia*: http://www.oecd.org/australia/taxingwages-australia.htm

3. Ensure that State governments have robust own-source revenue bases and incentives to use them effectively (discussed further below).

Further reading:

ACOSS 2013, 'Balancing the budget: Submission to the Commission of Audit.'

ACOSS 2015, 'Budget analysis, 2015-16.'

2. Economic and jobs growth is jeopardised by biases in the tax system that distort or discourage investment and workforce participation.

PROBLEMS:

The Australian economy has slowed as it adjusts to the end of the construction phase of the mining boom and lower mineral prices, in the absence of more broadly based sources of growth. Despite a housing price boom in some cities and very low interest rates, business investment has slumped, wages growth is sluggish, and unemployment is rising.

Looking beyond these short term problems of macro-economic management, the economy will need to adjust to structural changes under way internationally, including a new (less resources-intensive) phase of growth in East Asian economies, technological change, and the opening up of markets for the provision of services. This will require new investment in tomorrow's flexible, innovative enterprises and in public and social infrastructure to help the workforce to adjust and improve the efficiency and sustainability of our cities, transport and communication systems.

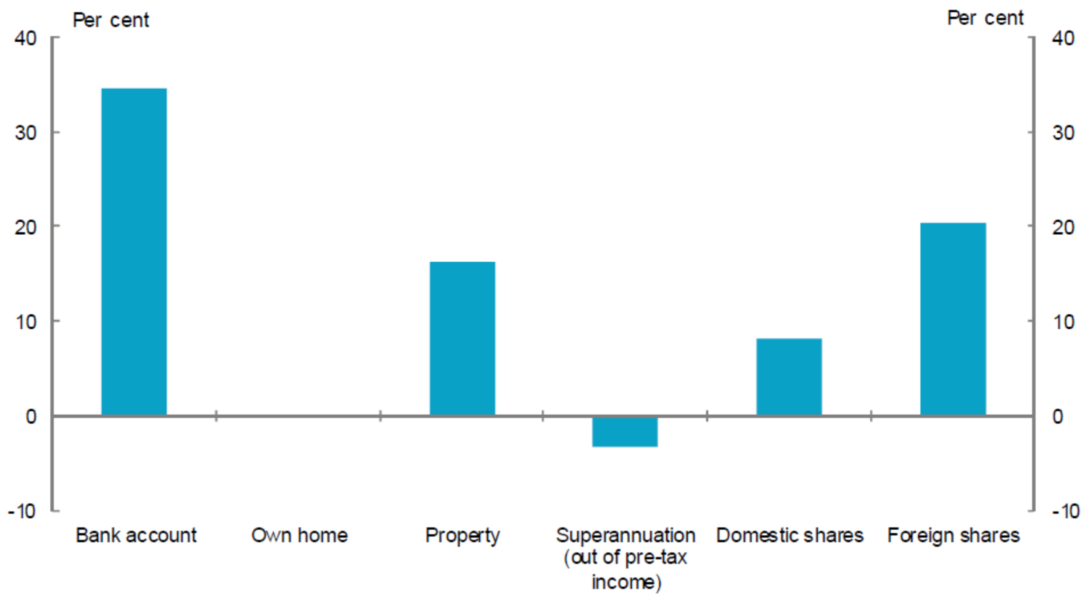
Tax reform is no quick fix for these problems, but an efficient tax system can aid economic growth and adjustment, and tax impediments to growth can be removed.

What matters most for economic and jobs growth is not the overall level of taxes, which is low in Australia in any event, but the degree to which they distort or discourage investment and workforce participation decisions in harmful ways.

Investment income is taxed inconsistently and this distorts investment decisions. A good example of this is the way in which the combination of the 50% Capital Gains Tax discount and negative gearing arrangements encourages over-investment in housing with a view to speculative capital gains, and exaggerates housing price booms without adding substantially to housing supply where it is most needed. These arrangements also have an opportunity cost, by shifting investment in the long run away from activities that would strengthen the economy as a whole.

The tax treatment of superannuation is a stark example of the distorting effect on investment decisions. As Figure 3 shows, the present superannuation tax concessions are compelling for an investor looking for optimal tax minimisation, yet they do little to strengthen retirement saving. As discussed later this is mainly because concessions are skewed towards high income earners who will still save in the absence of tax breaks, and the most expensive tax breaks are not visible to taxpayers.

Figure 3: Effective tax rates on different investments held for 25 years



Source: Source: Australian government (2015) Rethink, tax discussion paper, p60.

The inconsistent tax treatment of different business and investment structures biases decisions on the legal form in which business and investment assets are held (sole traders, trusts or private companies) and diverts the efforts of business owners and investors and their advisers from more productive activity.

Taxes on labour incomes, together with social security income tests, affect decisions to participate in paid work, and working hours. Parents, usually mothers, in low income households are particularly sensitive to these financial disincentives because they also do most of the caring work and must take account of child care costs. Social security and family payment income tests also impact disproportionately upon them.

While unemployment payments for single adults are less than half the after-tax minimum wage, unemployed people face strong financial disincentives to undertake casual part time jobs due to the timing of reductions in their income support payments if they do so, the complexity of the system, and uncertainty surrounding their future working hours.

The impact of taxes and income tests on workers approaching retirement is less clear.[7] This

[7] Headey, Freebairn & Warren (2010), 'Dynamics of Mature Age Workforce Participation: Policy Effects and Continuing Trends' Melbourne Institute, at: http://www.melbourneinstitute.com/downloads/labour/5-10FinalReport.pdf

depends on whether they give more priority to reaching a retirement income target (in which case taxes and income tests may encourage them to retire later) or maximising their current disposable income (in which case they are more likely to reduce their working hours).

Raising the preservation age for superannuation (above 60 years) is more likely to strengthen workforce participation that further increasing the pension age (above 67 years). The reason for this is that those most affected by a higher preservation age (people with substantial superannuation assets) are more likely to be in a position to choose the timing of their retirement than those most affected by a higher pension age (who are likely to have lower skills and have disabilities or caring responsibilities).

Broadly speaking, primary earners, usually male, are less sensitive to financial disincentives in the tax and social security systems, and high income earners less sensitive than low income earners. This means that lower marginal tax rates at the top end are less likely to strengthen workforce participation than adjustments to tax rates and thresholds further down the scale, or social security income tests.[8]

Our *business income tax* system relies too much on taxes on international investors (including corporate income tax) and too little on taxes on 'immobile factors' such as land and resources, and economic 'rents'.

Company income tax mainly affects investment from overseas, since the dividend imputation system compensates domestic investors for any company tax paid. Foreign investment is sensitive to tax to the extent that capital is internationally mobile. For this reason, Australian governments have generally kept our company income tax rate towards the lower end of tax rates levied in comparable (medium to large) wealthy countries. However, investment decisions are affected by many factors other than tax including the quality of public infrastructure, political and economic stability, and the skills of the workforce.

To the extent that investment is location-specific – for example, in minerals – capital is less sensitive to tax levels. If these and other 'economic rents' can be captured elsewhere in the tax system, for example through resource rent taxes or taxes on monopoly rents, it should be possible for governments to lower company income tax rates without loss of public revenue, and to raise the same amount of revenue overall while improving the attractiveness of Australia's attractiveness as an investment destination.

Similarly, if business tax concessions distort investment decisions between different industries or activities in economically harmful ways, their removal should make room for lower company tax rates and an improvement in economic efficiency, without loss of public revenue. Reforms along those lines have been pursued in the past, including the business tax reform of the late 1980s and the 'Ralph Review' reforms in the late 1990s.

Some *indirect taxes* (mainly taxes on consumption or business inputs) are economically inefficient. Broadly speaking, it is desirable to tax different industries, goods and services

[8] Dandie & Mercante 2007, 'Australian labour supply elasticities,' Treasury Working Paper 2007-4

consistently, unless there are good economic or social policy reasons not to do so (some of which are discussed later). Otherwise there is a risk that capital or labour will not be used in the most efficient way. Taxes on business inputs (as distinct from income or consumption) can throw 'sand in the wheels of commerce'. For example, Stamp Duties on housing can discourage workers and businesses from moving, while Payroll Tax exemptions for small and medium sized businesses can discourage businesses from growing. From this standpoint, many State taxes are economically inefficient.

MYTHS:

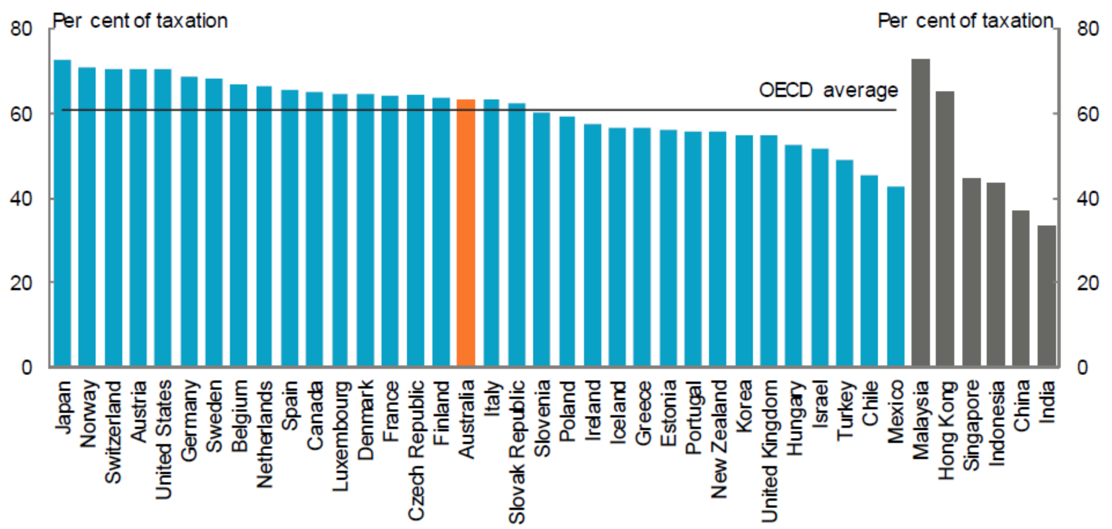
Myth 2:

'Our overall tax mix is much more skewed towards income and away from consumption than in other OECD countries.'

Fact:

When social security taxes levied by other countries are taken into account, the share of public revenue raised from income taxes in Australia is close to the OECD average.

Figure 4: Direct taxes on income as a share of overall taxation (2012)



Source: Australian government (2015) Rethink, tax discussion paper, p19.

Myth 3:

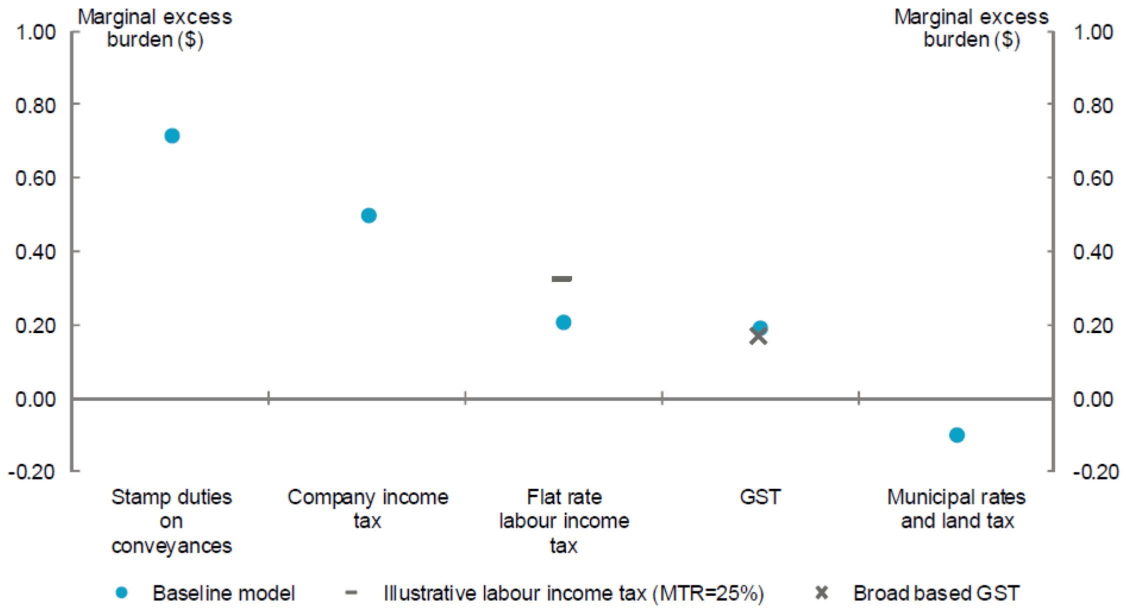
'If we relied less on personal income taxes and more on consumption taxes the economy would grow faster.'

Fact:

In the short term, higher consumption taxes would slow the economy more than higher income taxes, since they impact directly on household spending.

In the long run, the economic impact of personal income taxes is similar to that of that of the GST. Both are efficient taxes, and both mainly fall on labour incomes. Modelling by the Treasury included in the ReThink discussion paper illustrates this. Their estimate of the 'marginal excess burden' (a measure of the adverse impact of a tax on the economy) of the GST is almost identical to that of a 'flat rate' tax on labour incomes.

Figure 5: The economic 'cost' of different taxes (marginal excess burdens)



Source: Source: Australian government (2015) Rethink, tax discussion paper, p25.

This modelling also suggests that a progressive income tax (with a marginal tax rate of 25% above a tax free threshold) is less efficient than a 'flat income tax'. This is based on the doubtful assumption that workers on higher marginal tax rates are more sensitive to tax than those on lower tax rates.[9] As discussed above, mothers on low or modest incomes are more likely to be discouraged from increasing their paid working hours than high income males.[10]

GOALS:

4. The tax system should minimise distortion of decisions to invest, save and undertake paid work, unless there are sound economic or social policy reasons to do so.
5. Tax personal income more consistently.

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[9] The model has only one household, so neither work incentives in dual income households nor the impact of social security income tests is explicitly modelled.

[10] Apps & Rees 2013, 'Raise top tax rates not the GST', Australian National University Centre for Economic Policy Research Discussion Paper 684. https://www.rse.anu.edu.au/media/43012%5C684.pdf

6. Encourage efficient investment through revenue-neutral reform of business taxation.
7. Tax mobile factors less and immobile factors (e.g. land), and 'location-specific economic rents' (e.g. in mining) more.

1.1 The tax system is unfair:

PROBLEMS:

Fairness is a key yardstick by which the public judges our tax system and public programs. Reform will not be supported if the overall result is not fair. People will be more reluctant to pay their taxes if they perceive that the system does not treat them in the same way as others, taking account of their ability to pay.

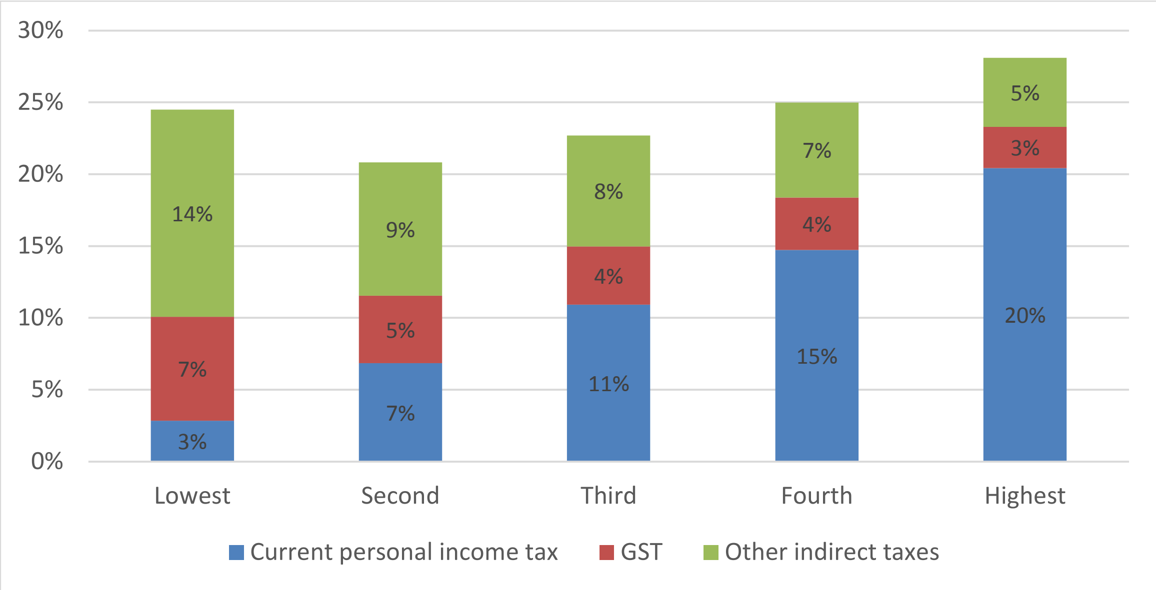
While *personal income tax* is not the only tax base on which governments should rely, it is the foundation stone for overall fairness in the tax system.

This is because the personal income tax system takes account of individual circumstances (it is a 'direct' tax), it taxes investment income as well as income from paid work (and opportunities to save and invest and very unevenly distributed), and it taxes incomes progressively (at higher marginal rates for those with more resources).

Yet when 'indirect' taxes (mainly taxes on consumption and business inputs) are included, the overall tax system is close to a 'proportional' or 'flat-rate' system. People at different income levels pay almost the same overall rate of tax on their income. For example, the bottom 20% of households by income pay an average of 24% of their income in tax while the top 20% pays 28%.[11]

[11] These issues are discussed in more depth in ACOSS 2014: Tax Talk No. 1: Are we paying our fair share? http://acoss.org.au/images/uploads/Tax_Talks_1_Are_we_paying_our_Fair_Share_2015_FINAL.pdf

Figure 7: “Almost flat” The combined effect of personal income tax and consumption and indirect taxes



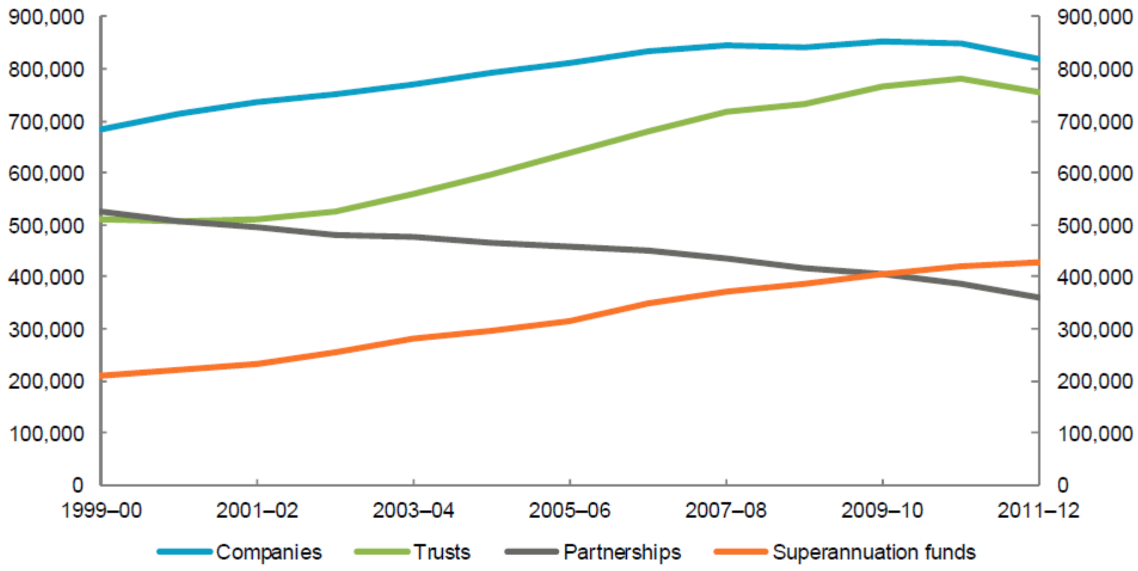
Sources: ACOSS 2015, 'Taxes – are we paying our fair share?' Derived from ABS, 'Government Benefits, Taxes and Household Income, Australia, 2009-10'; ABS, 'Household Expenditure Survey 2009-10.'
Note: Households are divided into five equal groups according to their disposable incomes, adjusted for household size. Average tax rates calculated as a proportion of gross household incomes.

There is a strong case on equity grounds for keeping a progressive income tax scale, as this ensures that people pay according to financial capacity. We also favour keeping individuals, rather than couples or families, as the basic unit for personal taxation, on the grounds that this better recognises the unpaid work undertaken mainly by women in the home and encourages participation in the paid workforce by women.

But progressive income tax rates have less force if people who are 'well advised' can avoid actually paying tax at their marginal rate. Tax avoidance opportunities mainly arise from three cleavages in the personal income tax base, between:

- the tax treatment of current income and capital gains (together with expenses claimed in relation to negatively geared investments),
- the tax treatment of superannuation and other income (to the extent that salaries are 'sacrificed' into superannuation to take advantage of the 15% tax rate, and income and assets are 'churned' through superannuation funds to take advantage of the non-taxation of fund earnings after retirement), and
- the treatment of income received directly and income that is redirected through private trusts and companies.

Figure 8: Entities lodging tax returns



Source: Source: Australian government (2015) Rethink, tax discussion paper, p108.

Inconsistencies in the personal income tax may be unavoidable (for example, the deferral of tax on capital gains until an asset is sold) or a deliberate and desirable feature of the tax system designed to achieve a public purpose (for example, well-designed and well-targeted tax concessions for long term saving through superannuation). Yet in their present form, these 'tax shelters' are open to exploitation and this undermines and distorts their original purpose.

Taken together, these tax shelters form the three sides of a 'Bermuda Triangle' of income tax avoidance that erodes public revenue and confidence in the system. As a result of these avoidance opportunities, income tax rates are higher than they need to be to raise the same amount of revenue. Those who take advantage of these shelters are subsidised by the higher taxes paid by those who do not. This is about equity, consistency and fairness, not 'envy'.

In reforming personal income tax, it is vital that the three sides of the problem are dealt with together. If only one of these large-scale tax avoidance opportunities is closed, the others will be more heavily used.

Other inconsistencies in personal income tax include differences in tax levels according to the form in which labour earnings are received (for example, fringe benefits or employee shares both of which are disproportionately used by people with high incomes), poorly designed tax breaks for specific groups (for example, the tax offset for seniors), and inequitable work-related tax deductions (for example, the self-education deduction, which is disproportionately used by people who already hold professional qualifications).

Taxes on consumption are inherently regressive. That is, they impose higher rates of tax on the incomes of low income earners than high income earners. This is due to differences in household incomes and associated saving patterns. The top 20% of households by income are able to save an average of one-quarter of their income each year. At the other end of the scale, the bottom 20% spends on average one-quarter more (125%) than their annual income because they have gone into debt or drawn down savings in order to make ends meet. A consumption tax taxes them on that 'extra' 25%.[12] Unlike an income tax, a consumption tax does not tax people according to their capacity to pay.

In addition, unlike personal income tax, consumption taxes are typically levied at flat rates because it is not possible to take account of the ability to pay of each consumer. They are *indirect* taxes because the retailer pays on behalf of the consumer.

Most consumption taxes are regressive for the above reasons, but some are more regressive than others because they tax goods or services that take up a large and disproportionate share of the household budgets of people on low incomes. Food and housing costs are the most important of these items. Together they comprise an average of almost two-fifths (39%) of the weekly budgets of the bottom 20% of households compared with one-third (32%) of that of the top 20% of households.[13]

This is the main argument for excluding fresh food (excepting meals out and take-aways) from the Goods and Services Tax. Although high income households spend more overall on fresh food than low income households, it is those on the lowest incomes who are disproportionately affected by a tax on food because it takes up a larger share of their household budgets. There is a trade-off here between taxing consumption simply and consistently, and the equity of the tax system. While it increases administrative complexity for retailers, the fresh food exemption in the GST is likely to have a minimal impact on the overall efficiency of the tax system, as illustrated by Treasury modelling discussed previously.[14]

To summarise: how progressive or regressive the overall tax system is depends mainly on four factors:

- the progressivity of personal income tax rates and thresholds;
- the extent to which individuals can shelter their income from tax, especially at the higher marginal rates;
- the extent to which taxes on consumption fall on major expenditures of low income households such as rent and food;

[12] ACOSS, *ibid.*

[13] ACOSS, *ibid.*

[14] The 'GST' column in figure 6 compares the overall efficiency of the current GST and one without exemptions. There is very little difference.

- the relative 'weight' of personal income taxes and taxes on consumption in the overall tax mix. As Figure 7 showed, the greater the reliance on consumption taxes, the less progressive the tax system is overall.

The Goods and Services Tax is a relatively efficient tax that is an important source of public revenue, especially for State governments. Other indirect State taxes including Payroll Tax, insurance taxes and Stamp Duties, fall at least partly on consumption. A rationalisation of these taxes to simplify the system and improve their efficiency would not necessarily make these State taxes more regressive, but an overall increase in our reliance on consumption taxes would. The equity impacts of reform of indirect taxes should be assessed on a case by case basis.[15]

Decisions on which items should be included in the consumption tax base should not only be based on their *immediate* impact on revenue, equity, and economic efficiency. For example, if some human services, especially education, were included in the GST, the impact would mainly be felt by high income households in the short term because they spend a disproportionate amount of their budgets on private school fees.[16] However, there are other factors to be considered which influence their *long term* impact:

- Human services such as health, education and community services are public goods mainly financed by government.
- If private spending on these services is taxed, this would lead to a complex and inefficient 'churn' of revenue between public subsidies (for example private health rebates) and taxes on the same services.
- It is likely that consumers would press governments for higher direct subsidies for these services to offset the new tax.
- More importantly, if private human services spending is taxed, this would encourage State governments (which receive GST revenues) to shift more of the cost of those services to consumers through user charges. This is similar to the perverse incentives State governments currently have to expand access to gaming services because they increasingly rely on gambling taxes. User charges for essential services particularly disadvantage people on low incomes. If they are excluded from the fees on the grounds of income, they may in return be offered second-rate services.

For these reasons, it is doubtful that people on low and modest incomes would benefit in the long run from the extension of consumption taxes to essential human services.

[15] See for example NATSEM 2015, 'The distributional impact of State taxes for South Australian households.'

[16] The story is different for health and other community services, which form a larger part of the budgets of low income households, in part because retired people spend more on health care.

MYTHS:

Myth 4:

'Taxes on consumption are fairer because they are harder to avoid.'

Fact:

Consumption taxes disproportionately affect low income earners and only lightly tax high income earners (apart from a few taxes on 'luxuries'), because that part of their income which they save and invest is not taxed, at least until the proceeds are spent years later. This benefits people who have the greatest capacity to save and invest, who are generally better off throughout their lives than those who have a low capacity to save because their income barely covers their basic expenses.

Myth 5:

'The GST is the only tax on consumption, and the only regressive tax.'

Fact:

Most other indirect taxes, including insurance taxes, stamp duties and excises, fall at least partly on consumption. Their overall impact on the budgets of low income households is at least as great as that of the GST.

Myth 6:

"Tax cuts will overcome the unfairness of income tax 'bracket creep'"

Fact:

The 'Rethink' discussion paper points out that bracket creep falls more heavily on low to middle income earners than high income earners. One reason is that the tax scales are much 'flatter' (they have fewer steps) than in the past, especially at the upper end. However, the effect of the eight income tax cuts over the 2000s was to increase income inequality, not reduce it.[17] One reason for this is that the bottom one-quarter or so of households do not pay income tax, so do not benefit from income tax cuts. Another is that thresholds at the upper end of the tax scale were greatly increased.

Income tax cuts will be needed in future to prevent tax rates from rising through bracket, but tax cuts are rarely progressive.

Myth 8:

"Tax reforms that disproportionately impact on low income households can be made 'fair' by compensating them through the social security and income tax systems."

[17] This is shown in research by Aziparte for the Brotherhood of St Laurence and Melbourne Institute. http://melbourneinstitute.com/downloads/working_paper_series/wp2014n02.pdf

Facts:

If major tax reform needs a large compensation 'package' to protect the living standards of people on low incomes, this is a sign that the reform is not equitable in the first place.

Reliance on compensation is very risky for people on low incomes, especially for people reliant on social security payments. While adjustments to social security payments may be a part of an equitable tax reform, it is not possible to guarantee that 'compensation' in this form will survive, or that the overall levels of social security payments will be maintained in future.

Last year's Australian government Budget shows that the risk of erosion of the safety net is real. Further, the bottom 25% or so of households who do not pay income tax cannot be efficiently compensated through the tax system.

Myth 9:

'Fairness is served by taxing large companies more and small companies less.'

Fact:

In the end, companies do not pay tax: shareholders, workers and consumers do. If company income tax is reduced for large public companies, then dividend imputation credits for Australian shareholders (which mainly go to high income earners) would automatically decline.

If company income tax is reduced for private companies, the owners can shelter their personal income from tax by retaining earnings within the company. The effects on equity depend on the profile of private company owners. On average, they are likely to be better off than those self employed people who do not make use of a private company or trust structure.

GOALS:

8. Tax reform should not shift the incidence of taxation from higher to low and modest income earners in overall terms, or leave groups on low incomes financially worse off.
9. Maintain individual income taxation with progressive rates, though not necessarily the existing ones.
10. Tax different forms of investment more consistently.
11. Tax personal income received through different personal business and investment structures (especially private trusts and companies) more consistently, and remove the personal tax avoidance opportunities associated with these structures.
12. Remove tax concessions that do not fulfil a justifiable economic or social purpose, or which are more effectively met through direct expenditures, and review them regularly through the annual Budget process.

13. Maintain and improve taxes on consumption while avoiding any overall shift in the mix of taxation from income towards consumption, or towards goods and services on which people on low incomes rely disproportionately, including fresh food.
14. The overall impact of tax reform should be to improve the progressivity and consistency of taxation, not reduce it. Compensation and other transitional measures may be needed, but should not be relied upon to inject 'equity' into reforms which are inequitable.

Further reading:

ACOSS (2015), 'Taxes – are we paying our fair share?' ACOSS Tax Talks No 1.

3. The retirement income system lacks coherence, fails to deliver income security in an equitable way, and cannot be sustained in its present form.

PROBLEMS

The retirement income system has three parts:

1. an *Age Pension* to provide a safety net for those who would otherwise be in poverty. The pension is, for the most part, a well-designed and targeted safety net in retirement;
2. *compulsory superannuation* which allows people to achieve a decent living standard significantly above poverty level, though at the expense of lower incomes throughout working life; and
3. *superannuation tax concessions* to help ensure that compulsory retirement saving is financially worthwhile, and to encourage voluntary saving for retirement.

While the overall structure is sound, the third part, superannuation tax concessions, is the weak link in the chain, retaining a structure set at a time when superannuation was mainly a 'perk' for high income earners.

Lack of clear objectives and coherence:

While the retirement income objective of the pension is clear (to prevent poverty), the goal of the superannuation elements of the system, to which substantial public subsidies are attached, is not. In ACOSS's view, superannuation should facilitate people saving enough to enable them to have a decent standard of living in their post-working age life. However, there is no widely accepted retirement income target which compulsory saving and superannuation tax concessions are designed to achieve. This lack of clarity leaves room for other objectives to intrude. As the Financial System Review argued, for many people, superannuation has become a vehicle for tax and estate planning rather than a source of secure retirement income.

The tax treatment of superannuation lacks coherence: benefits are untaxed yet so are fund earnings in the 'retirement phase'; fund earnings are not taxed consistently; and there are six different tax treatments for contributions. Successive governments have tinkered with the system to deal with these problems but in the absence of structural reform, more changes are needed every few years, which erodes confidence in the system. This problem cannot be 'solved' by preserving the status quo, or more tinkering at the margins.

Another incoherent feature of the system is that the preservation age is out of step with the Age Pension access age, which has several perverse outcomes. To keep the economy growing and to fund essential services as the population ages, it is vital that more mature age people retire later and retire gradually (by working on a part time or temporary basis after leaving their fulltime jobs). Yet the preservation age (currently 55, legislated to increase to 60) enables access to superannuation (and therefore retirement) much earlier than the Age Pension age (65 years, rising to 67 and possibly 70).

Whilst some flexibility would be needed to accommodate people who have little choice but to retire early, for example due to a disability or caring role, and the lower average life expectancy of Aboriginal and Torres Strait Islander peoples, a higher preservation age would have a strong impact on the workforce participation decisions of those who have a choice to retire later. By contrast, a higher Age Pension age would mainly affect those who have little control over the timing of retirement, due to disabilities, prolonged unemployment, or caring roles. Many would be forced to rely longer on the inadequate Newstart Allowance, which is $160 per week less than the pension.

Fiscal sustainability:

As the population ages, health and aged care costs (and to a lesser degree Age Pension costs), will rise substantially. This is a desirable outcome in a wealthy country that can afford to offer people security and essential health care in retirement, but it will have to be paid for. The options include:

- a retreat from public provision or greater reliance on user charges (which would especially disadvantage low income earners and breach the social compact in which governments fund or provide essential services such as health care in return for taxes);
- increasing indirect taxes such as the GST (which fall disproportionately on low income households); or
- improving the integrity of the personal income base, including for people of mature age; and
- ensuring that the Age Pension is well-targeted according to people's current financial needs and resources.

At present less than one-fifth of individuals over 65 pays personal income tax, despite steady growth in superannuation fund earnings and benefits, and increasing participation in paid employment. This is due in large part to a combination of superannuation tax concessions and the tax offset for seniors. It is not sustainable if essential services are to be funded in the future.

Current policies place excessive emphasis on subsidising retirement incomes and assets, including for people whose retirement living standards are well above average, and too little emphasis on the other vital building blocks of security in retirement: universal access to affordable health and aged care later in life, and affordable housing.

Superannuation fund earnings are not taxed in the 'pension phase'. Together with the non-taxation of benefits for people over 60 years, this has opened up opportunities to avoid tax by:

- 'churning' earnings from work and other income through superannuation accounts, without increasing overall savings, to reduce effective tax rates to 15% or less;
- avoid taxation of capital gains (especially on small business assets) altogether;
- pass assets from tax-assisted superannuation savings to the next generation tax free.

While the Age Pension is for the most part well targeted to those who need it, changes to the assets test in 2007 extended part-pensions to people with substantial assets (currently including couples with over a million dollars in assets in addition to their home) who can meet their basic living costs without the pension, or with a lower pension.

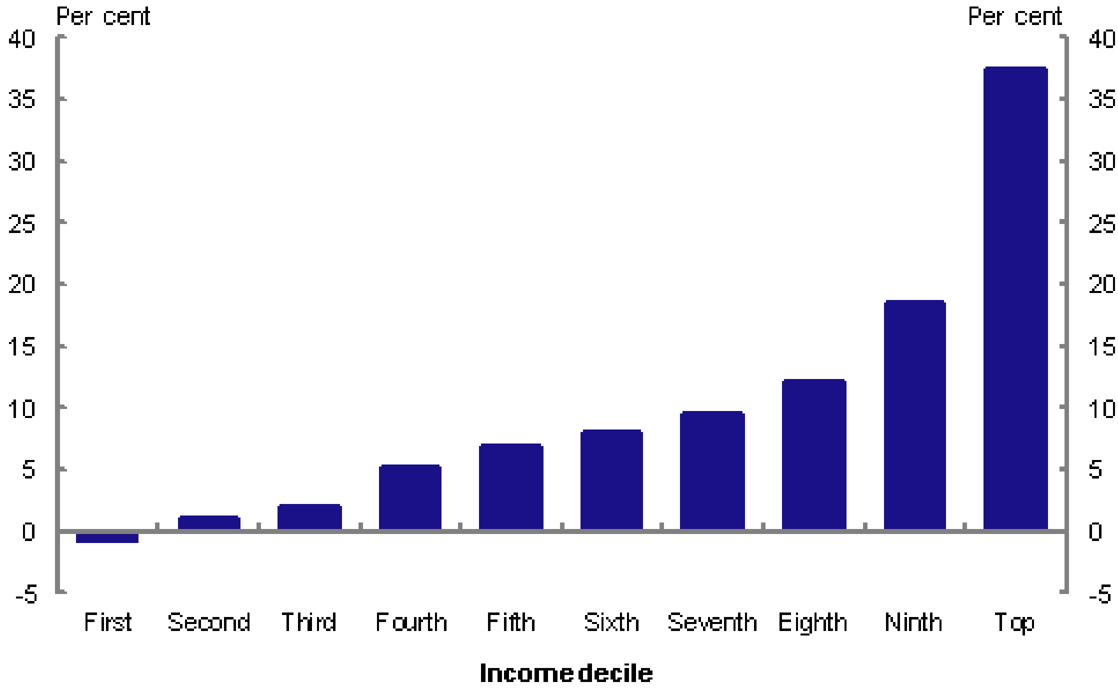
Since health and aged care services have a fiscal cost that is rising as the population ages, it is very likely that future governments will attempt to 'claw back' the costs of these poorly targeted retirement income subsidies through user charges for services. This would disadvantage people on low lifetime incomes or above average health care needs, who would either no longer be able to afford these services, or could be diverted into a 'second class' stream of care. Such a system would not share risks across the community in the way that universal health and aged care services funded mainly from general tax revenue have largely achieved until now.

These are complex and politically challenging issues that require long term planning, a degree of political bi-partisanship, and consensus-building among stakeholders. *For these reasons, we strongly advocate a public review of retirement incomes and services that is part of, or linked to the tax policy review that examines pensions, the purpose and tax treatment of superannuation, and the financing of future health and aged care services for an ageing population.*

Fairness:

The present tax concessions for superannuation are unfair. As the chart below shows, a third of the value of tax concessions accrues to the top 10% of income earners while the bottom 50% receive less than 20% of their total value. This is inefficient as well as unfair, as earners in this group are more likely to save for retirement without tax concessions and are less likely to rely on pensions in any event, yet receive more benefit from tax concessions per dollar contributed to super than low or middle income earners.

Figure 11: Share of total superannuation tax concessions by income decile



Source: Treasury, based on an analysis of 2011–12 Australian Taxation Office data, as reproduced in the Financial Services Review.

This situation arises because employer contributions are taxed at a flat 15% instead of the individual's marginal tax rate. This is unfair because high earners save over 30 cents in tax per dollar contributed by employers, while those on incomes less than approximately $20,000 pay an additional 15 cents for every dollar contributed since they fall below the tax free threshold. The flat 15% tax particularly disadvantages women, many of whom are employed part time on low wages.

The Low Income Superannuation Contribution reduces the tax paid on employer contributions for low income earners to zero by offsetting the 15% tax that would otherwise be paid. Regrettably this is to be abolished next year.

The Financial System Review report noted that around half of the announced policy changes over the past decade have sought to address concerns about the equity of tax concessions, yet major problems remain. Governments have nibbled at the edges of the problem, for example by adding surcharges at the top end or rebates at the bottom without altering the flawed structure of these tax breaks.

Weaknesses in the retirement phase of superannuation:

Too little attention has been paid to the design of the retirement phase of superannuation. The system does not make it easy for people to steer a path between drawing down their assets to fund their retirement (which is the purpose of superannuation, not to leave tax-assisted savings to their children) and leaving themselves open to longevity risk by running down their assets too quickly.

Few people can afford guaranteed or lifetime income stream products, which ensure the holder against both longevity and investment risks. By contrast, alternative account based products which are much more common and affordable allocate the entire longevity risk to retirees.

The idea of distinct 'accumulation' and 'retirement' phases is outmoded, yet the tax treatment of superannuation (especially of fund earnings) is still built upon that foundation, with fund earnings taxed at 15% in the accumulation phase and exempt from tax in the pensions phase. This gives rise to complexity, as well as the tax avoidance opportunities discussed previously.

MYTHS:

Myth 10:

"A retired couple needs almost $60,000 to live 'comfortably'."

Fact:

Most retirees have no dependants, and presently most own their own homes outright. This income level would enable people in these circumstances to eat out weekly in restaurants and travel overseas every few years. Setting retirement income policy to enable people to finance a living standard that is well above average levels across the community is not realistic.

This is not an attainable retirement income for most people, either now over the next decade, unless pensions and superannuation tax concessions are substantially increased.

While it is fine for people to aspire to an above average living standard, it is hard to justify the use of public funds to support this when many people struggle to get by on much lower incomes.

Myth 11:

'Superannuation tax concessions save the government money in the long run by reducing reliance on Age Pensions'

Facts:

The top 10% of male workers receive more from the government over their lifetimes in superannuation tax concessions than they would if they received the full Age Pension in retirement.

Current superannuation tax concessions reward saving by people who would save for their retirement anyway, which is inefficient.

In any event, the overall fiscal cost of superannuation tax concessions will soon exceed that of the pension.

GOALS:

15. Everyone should have a decent income in retirement through an adequate pension safety net targeted to those who need it and compulsory and voluntary saving through superannuation.
    This retirement income goal should be spelt out clearly, taking account of community expectations, budgetary cost and the impact of compulsory saving on living standards during working life.
16. This goal should be supported by a simpler, fairer and more coherent system of tax concessions for superannuation, along with an adequate, well-targeted Age Pension.
17. People on different incomes should as far as possible receive the same tax benefit, per dollar contributed to superannuation.
18. Restore the integrity of the personal income tax system, including through reform of superannuation and other tax concessions for older people, so that everyone contributes to the cost of health and aged care services according to their ability to pay.
19. Simplify the superannuation system in retirement to assist people to draw down their assets progressively to minimise both longevity risk and the transfer of tax-supported savings to the next generation.

4. Housing is unaffordable, especially for people on low and modest incomes.

PROBLEMS

Australia has among the most expensive housing in the OECD, and this basic need is becoming unaffordable for people on low incomes. Recent projections suggest that the median house price in major Australian capital cities will exceed $1 million in the next decade. Nationally, four in five private rental households in the lowest 20% of incomes pay more than 30% of income in rent; along with over 30% of the second lowest quintile.[18]

The high cost of housing is caused by too much demand (especially in recent years from

[18] Kath Hulse, Margaret Reynolds and Judith Yates (2014): Changes in the supply of affordable housing in the private rental sector for lower income households, 2006-2011, AHURI.

rental property investors) chasing too little supply (especially in our major cities). From 2000 to 2013 lending for investment housing rose by 230% compared with a rise of 165% in lending for owner occupied housing. Over 90% of investor borrowing is for existing rental properties, not new ones, so it adds more to demand than to supply. Investors are often chasing capital gains in a rising market rather than stable rental returns.

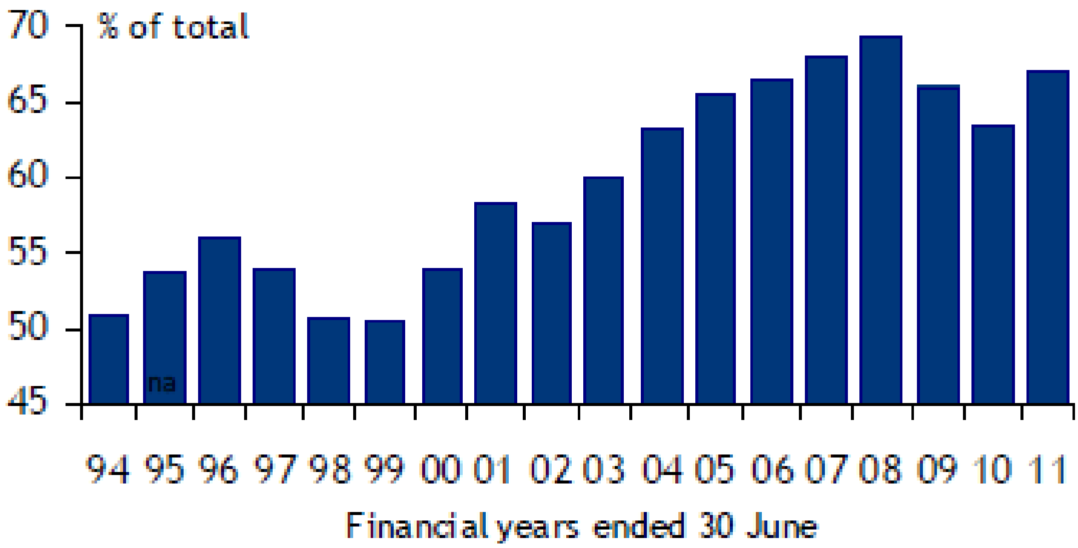
The dominance of individual investors, as distinct from institutions, in the *rental housing market* also means that private tenancies are less secure than in most other wealthy countries.

At the same time, *home owners* have little incentive to use land efficiently or trade down when their children leave home, and the tax system discourages people from moving home when they otherwise would, for example to take advantage of job opportunities.

The tax system is not the main cause of these problems, but it is a key contributing factor.

The 50% tax discount for personal capital gains, and ability of investors to negatively gear their investments, deducting investment losses against income from all sources without limit, contribute to over-investment in rental property during housing booms, and the bias towards individual rather than institutional investors.

Figure 12: Loss-making landlords as percentage of taxpayers claiming rental property expenses



Source: Eslake (2014), Submission to Senate Economics Committee Affordable Housing inquiry.

Stamp duties for home purchases make it harder for people to move house, while land tax is a potentially efficient State tax base that remains underutilised. In particular, it does not apply to owner occupied housing.

Public subsidies for low income tenants are inadequate and inconsistent. As the Henry Report pointed out, private Rent Assistance is well below typical rents for low income households and is insensitive to geographic variations in housing costs.

MYTHS:

Myth 12:

'The solution to housing un-affordability is more tax breaks and subsidies.'

Fact:

Tax concessions for housing, including the 50% capital gains tax discount for investors combined with negative gearing arrangements, have raised housing prices without contributing enough to supply. Over 90% of housing investment lending is for existing housing stock, and does little to stimulate supply. Attracting investment in existing housing stock overheats market prices, and makes the problem worse. This is in contrast to carefully targeted incentive arrangements for new housing development at the lower end of the market, such as the now abolished National Rental Affordability Scheme.

Myth 13:

'Negative gearing strategies mainly benefit low and middle income earners.'

Facts:

Half the value of tax deductions for rental property investment losses accrues to the top 20% of taxpayers earning $80,000 or more in gross income.
Sixty per cent of rental property investor debt comes from the top 20% of households.[19]

GOALS:

20. Ensure everyone has access to decent, affordable housing by strengthening the supply of low cost housing, reducing volatility in housing markets (especially during price 'booms'), and improving rental subsidies for low income earners.
21. Remove biases in the tax system in favour of speculative investment in rental properties by individual investors chasing capital gains and encourage more institutional investment chasing stable rental returns.
22. Shift State taxes relating to housing from inefficient taxes on transfers to more efficient taxes on land.

Further reading:

ACOSS, National Shelter, Community Housing Federation of Australia, Homelessness Australia (2015), 'An affordable housing reform agenda: Goals and recommendations for reform'

ACOSS (2015), 'Fuel on the fire: negative gearing, capital gains tax and housing affordability.' ACOSS Tax Talks No 2.

[19] ATO 2012-13 Taxation Statistics; RBA 2014, Financial stability review September 2014 Box C.

5. State Governments lack efficient and sustainable revenue bases to fund essential community services

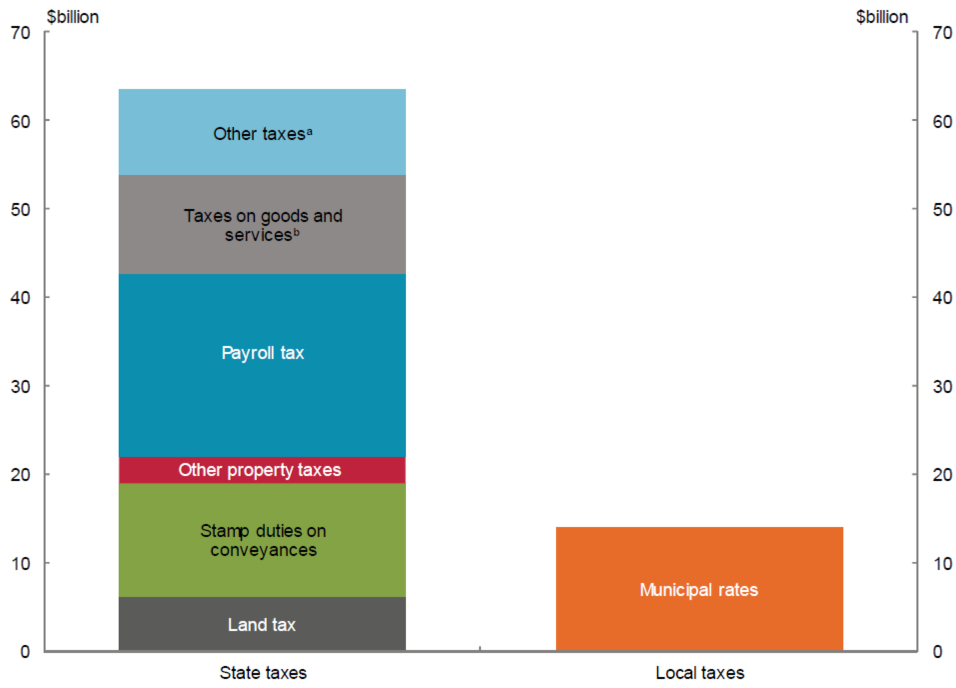
PROBLEMS:

Compared with the Australian government finances, State governments are even more vulnerable to Budget pressures from population ageing and burgeoning health care costs. They also rely more on less robust, economically inefficient tax bases. Those tax bases are also, for the most part, regressive.

State governments have limited incentives to strengthen their own tax bases, and face persistent pressure to narrow them. An example is the pressure of interstate tax competition which has led to higher tax free thresholds for Payroll Tax.

They rely too heavily on the most inefficient taxes (including Stamp Duties and insurance taxes); and on revenues from socially harmful activity (e.g. gambling); and too little on potentially efficient tax bases (including Land Tax and Payroll Tax).

Figure 13: State and Local Government taxes:



(a) Primarily motor vehicle taxes.
(b) Primarily gambling and insurance taxes. This does not include GST revenue.
Note: Figures are for 2012-13, as this is the most recent year local government data is available.
Source: ABS 2014, *Taxation Revenue, Australia, 2012-13*, cat. no. 5506.0, ABS, Canberra.

Source: Source: Australian government (2015) Rethink, tax discussion paper, p142.

Much of the revenue on which State and Territory governments rely comes in the form of Commonwealth grants tied to certain areas of expenditure, especially health, education and community services. So-called 'vertical fiscal imbalance' is not undesirable in principle since the Commonwealth has stronger revenue capacity and macro-economic management responsibilities, and there is a case for a degree of national benchmarking and coordination of essential human services programs.[20]

However, this reliance on federal grants leaves State and Territory governments vulnerable to adverse federal Budget decisions such as the 2014 Budget decision to only index health and schools funding to the CPI plus population growth, starving the states of the funds they will inevitably need in future years to provide decent services.

The objective of the present system of 'horizontal fiscal equalisation' through the redistribution of GST revenues among the States is to ensure that people have equitable access to services and supports regardless of where they live, and despite differences in States' own revenue bases. While this is a desirable goal, there is little consensus among the States over its implementation by the Commonwealth Grants Commission.

GOALS:

23. Ensure that State governments have the revenue they need to provide essential human services and infrastructure.
24. Restructure state taxes to raise revenue more efficiently by abolishing the most inefficient taxes and making better use of the most efficient ones.
25. Better integrate federal and state tax bases and improve incentives for States to raise the revenue they need in the most efficient way.
26. Curb destructive tax competition among the States.
27. Improve incentives, resources and accountabilities for States to provide the services that fall within their area of responsibility, and reduce incentives for cost shifting.
28. Avoid a retreat by the Australian government from its responsibility to share the cost of basic human services with the States.

6. The tax treatment of the charitable sector is inequitable and inconsistent

Charity tax concessions are society's way of showing support for the mission or purpose of charitable organisations. These tax concessions operate in a range of ways to support charitable work, from providing incentives for donations through Deductable Gift Recipient status; to supplementing otherwise inadequate salaries through Fringe Benefit Tax

[20] Jonathan Pincus (2009), 'Much of what we think we know about federalism is wrong or overstated.' CEDA. http://www.ceda.com.au/research-and-policy/research/2009/11/economy/six_myths_federal_state

concessions. The establishment of the independent Australian Charities and Not-for-profits Commission and its role in registering organisations as charities is driving increased transparency and accountability of charities that benefit from tax concessions; and through it, increased public trust and confidence in the sector. The access to, and equity and effectiveness of tax concessions is of interest to ACOSS members and the sector more broadly. We also view these concessions through the lens of our core objectives in tax reform overall: a fair and sustainable tax base that provides adequate revenue to provide the services and supports we need in Australia.

Many of the charitable tax issues raised in the White Paper were explored in detail by the Not-for-profit Sector Tax Working Group (2013). That Working Group built on preceding work, from the Charities Definition Inquiry (2001) through to the Productivity Commission (2010). The Working Group's recommendations incorporated core positions ACOSS has held for years, including the extension of deductibility to all charities; and their analysis reflects views held broadly across the ACOSS Network when we have consulted on these issues. Importantly, the recent Budget reform to cap meals and entertainment allowance to $5000 was also recommended by that Working Group.

PROBLEMS:

The tax treatment of charities and other not for profit organisation is complex and inequitable.

Figure 14: Not simple: the tax treatment of different not for profit organisations

	Charities[1]	Public Benevolent Institutions (PBIs) and health promotion charities	NFP public hospitals and NFP public ambulance services	Deductible gift recipients[2]	Tax exempt clubs and other NFP entities
Income tax exemption	Yes	Yes	Yes	No	Yes
Refundable franking credits	Yes	Yes	Yes	Yes	No
FBT exemption ($17,000 cap)[3]	No	No	Yes	No	No
FBT exemption ($30,000 cap)[3]	No	Yes	No	No	No
FBT rebate	Charitable institutions only	No	No	No	Some non-clubs only
Other FBT concessions	Yes	Yes	Yes	No	No
GST concessions	Yes	Yes	Charities only	Yes	No
Deductible gifts	No	Yes	No	Yes	No

(a) Charities endorsed as deductible gift recipients or specifically listed in the *Income Tax Assessment Act 1997* can receive deductible gifts.
(b) Deductible gift recipients are generally charities that also have income tax exemptions, but income tax and FBT concessions do not automatically flow from an entity having DGR status.
(c) These caps were temporarily increased (to $17,667 and $31,177) as part of the 2014-15 Budget measure to introduce a Temporary Budget Repair levy.

Source: Source: Australian government (2015) Rethink, tax discussion paper, p124.

One of the key issues for charities is the inequity that sees some charities benefit from charitable tax arrangements while others cannot. Deductible Gift Recipient (DGR) status is a good example here, and one in which ACOSS has had a longstanding interest in making more effective for the sector. As the Not for profit (NFP) Sector Tax Concession Working Group noted:

'The deductible gift recipient (DGR) framework is intended to encourage philanthropy. However, the current system for granting DGR status is cumbersome, inequitable and anomalous. Further, the framework is not well placed to handle organisations that carry out a range of purposes that fit within a number of DGR categories. Reforming the framework would increase certainty, reduce red tape for eligible entities and should further increase philanthropy[21]*.*

ACOSS has concerns about the fairness and sustainability of a number of other charitable tax concessions. For example, FBT concessions are another tax arrangement that benefit some charities but not all; and whose benefits are unevenly distributed, even for those who can access it. FBT concessions were intended to provide support to the lowest paid workers in the sector, and to compensate for otherwise inadequate salaries to the charitable workforce. But FBT concessions have come to benefit higher paid workers disproportionately over time; while the value of those concessions overall has been eroding.

While these problems have clear implications for the fairness and sustainability of FBT concessions, they play a central role in how many charitable social services sustain services. Any reform must recognise the impact the loss of such concessions would have on charitable capacity, if it were to occur without alternative remedy.

GOALS:

29. Improve the equity of gift deductibility arrangements and simplify the system by extending DGR status to all charities.
30. Improve the sustainability and effectiveness of other tax concessions for charities, including FBT concessions. Any reform in this area must be undertaken in the context of industry adjustment, for example by incorporating transitional arrangements over time or financial adjustment where reform would otherwise leave community services worse off.

7. Goals for Tax Reform

[21] Not-for-profit Sector Tax Concessions Working Group (2013) *Final Report*, http://www.treasury.gov.au/~/media/Treasury/Access%20to%20Information/Disclosure%20Log/2014/1447/Downloads/PDF/NFP%20Sector%20WG%20Final%20Report.ashx

Budget sustainability

1. In the short term, restore Federal Budget revenue to at least pre-GFC levels: 25% of GDP.
2. Over time, strengthen fair and efficient public revenue bases to meet the needs of an ageing population and close major gaps in essential services and the social safety net.
3. Ensure that State governments have robust own-source revenue bases and incentives to use them effectively (discussed further below).

Sustainable economic and jobs growth

4. The tax system should minimise distortion of decisions to invest, save and undertake paid work, unless there are sound economic or social policy reasons to do so.
5. Tax personal income more consistently.
6. Encourage efficient investment through revenue-neutral reform of business taxation.
7. Tax mobile factors less and immobile factors (e.g. land), and 'location-specific economic rents' (e.g. in mining) more.

A fairer tax system

8. Tax reform should not shift the incidence of taxation from higher to low and modest income earners in overall terms, or leave groups on low incomes financially worse off.
9. Maintain individual income taxation with progressive rates, though not necessarily the existing ones.
10. Tax different forms of investment more consistently.
11. Tax personal income received through different personal business and investment structures (especially private trusts and companies) more consistently, and remove the personal tax avoidance opportunities associated with these structures.
12. Remove tax concessions that do not fulfil a justifiable economic or social purpose, or which are more effectively met through direct expenditures, and review them regularly through the annual Budget process.
13. Maintain and improve taxes on consumption while avoiding any overall shift in the mix of taxation from income towards consumption, or towards goods and services on which people on low incomes rely disproportionately, including fresh food.
14. The overall impact of tax reform should be to improve the progressivity and consistency of taxation, not reduce it. Compensation and other transitional measures may be needed, but should not be relied upon to inject 'equity' into reforms which are inequitable.

A coherent, equitable retirement income system

15. Everyone should have a decent income in retirement through an adequate pension safety net targeted to those who need it and compulsory and voluntary saving through superannuation.
    This retirement income goal should be spelt out clearly, taking account of community expectations, budgetary cost and the impact of compulsory saving on living standards during working life.
16. This should be supported by a simpler, fairer and more coherent system of tax concessions for superannuation, along with an adequate, well-targeted Age Pension.
17. People on different incomes should as far as possible receive the same tax benefit, per dollar contributed to superannuation.
18. Restore the integrity of the personal income tax system, including through reform of superannuation and other tax concessions for older people, so that everyone contributes to the cost of health and aged care services according to their ability to pay.
19. Simplify the superannuation system in retirement to assist people to draw down their assets progressively to minimise both longevity risk and the transfer of tax-supported savings to the next generation.

Affordable housing

20. Ensure everyone has access to decent, affordable housing by strengthening the supply of low cost housing, reducing volatility in housing markets (especially during price 'booms'), and improving rental subsidies for low income earners.
21. Remove biases in the tax system in favour of speculative investment in rental properties by individual investors chasing capital gains and encourage more institutional investment chasing stable rental returns.
22. Shift State taxes relating to housing from inefficient taxes on transfers to more efficient taxes on land.

Efficient and reliable State revenue bases

23. Ensure that State governments have the revenue they need to provide essential human services and infrastructure.
24. Restructure state taxes to raise revenue more efficiently by abolishing the most inefficient taxes and making better use of the most efficient ones.
25. Better integrate federal and state tax bases and improve incentives for States to raise the revenue they need in the most efficient way.
26. Curb destructive tax competition among the States.
27. Improve incentives, resources and accountabilities for States to provide the services

that fall within their area of responsibility, and reduce incentives for cost shifting.

28. Avoid a retreat by the Australian government from its responsibility to share the cost of basic human services with the States.

Simpler, fairer taxation of charities

29. Improve the equity of gift deductibility arrangements and simplify the system by extending DGR status to all charities.
30. Improve the sustainability and effectiveness of other tax concessions for charities, including FBT concessions. Any reform in this area must be undertaken in the context of industry adjustment, for example by incorporating transitional arrangements over time or financial adjustment where reform would otherwise leave community services worse off.

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