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Committee Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Committee Secretary

Decentralise and simplify the tax system to reduce income tax burden and promote economic competitiveness

The purpose of this letter is to share research and analysis conducted by the Institute of Public Affairs (“the IPA”) with the Economics References Committee (“the committee”) as it conducts its inquiry into Australia’s Taxation System.

Reform of Australia’s tax framework has been stagnant for a considerable period of time, with the last major change being the introduction of the national goods and services tax (“GST”) in 2000. This stagnation means that Australia’s taxation system remains overly centralised, complex, burdensome, and one that fails to promote economic competitiveness.

The analysis below reveals flaws in the tax system and provides solutions which could be adopted to address those flaws. These solutions include:

1. Investigate reducing Vertical Fiscal Imbalance by devolving some income taxing powers back to state governments;
2. Establishing a special economic zone in Northern Australia;
3. Adopting the New Zealand pension tax model;
4. Halving the tax on superannuation savings, and rejecting the Superannuation (Better Targeted Superannuation Concessions) Imposition Bill 2023 currently before parliament, which proposes to increase the rate to 30 per cent for funds with more than \$3 million saved; and
5. Reducing redistributive horizontal fiscal equalisation and returning GST revenue to the states the tax is generated in, or introducing a per capita GST distribution model.

The tax system is too complex, centralised, and is holding back our economic competitiveness

Dr Ken Henry stated in a 2023 speech that the objective of a national tax system is to ensure that it is “capable of generating sufficient revenue to underwrite fiscal sustainability, without

unacceptable consequences for economic efficiency, fairness (including intergenerational equity), risk, and system complexity.”¹

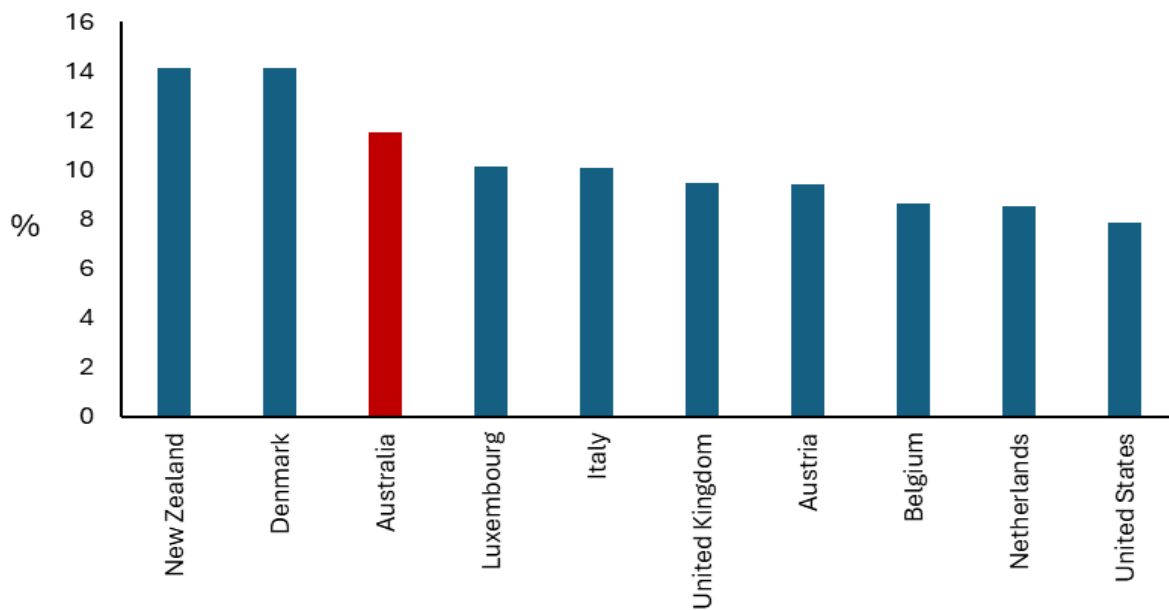
In that same speech he made the striking statement that we as a nation fail on all counts. He cited the specific example that the only revenue base that is growing faster than GDP is personal tax, while all other tax bases are unreliable and only add complexity to the system at large.²

The major pieces of federal legislation regarding tax; the *Income Tax Assessment Act 1936*; *Income Tax Assessment Act 1997*; *A New Tax System (Goods and Services Tax) Act 1999*; *Taxation Administration Act 1953*; and the *Fringe Benefits Tax Assessment Act 1986*, are quite extensive and complex, and combined are 10,316 pages long.

When the *Income Tax Assessment Act 1936* was first introduced, it was 82 pages. Illustrating how complex the income tax system has become over time, income tax legislation is found not only in the *Income Tax Assessment Act 1936*, but also the *Income Tax Assessment Act 1997*, and spans over 7,700 pages.

Australia is one of the most income tax burdened nations in the developed world, with income tax being proportionately higher than the vast majority of other OECD nations.

Chart 1: Income tax revenue as a percentage of GDP in OECD nations (2021)



Source: OECD

Economic analysis by the IPA found that Australia declined from the 4th most economically competitive nation in 2004, to 19th in 2023. Significantly, the tax burden is an area that

¹ Ken Henry, *The need for ambitious tax reform* (Speech given to The Tax Institute, March 2023).

² Ibid.

Australia neglected during that period: In 2004, Australia ranked 52nd and 54th for individual tax burden and company tax burden respectively: in 2023, Australia ranked 57th and 56th. As noted in the IPA's analysis of the findings, "The high taxes that individuals and companies are required to pay amount to lost investment and foregone economic activities."³

Income tax, the only tax revenue outgrowing GDP, highlights how Canberra-centric the tax system is. It also accounts for some states' reluctance to help pay for services provided to the Australian public, for example the NDIS.

The centralisation of the tax system, alongside consistently high government spending, is a significant factor in the excessive size of the federal government, which has rapidly become a barrier to broader economic growth. A working paper by Professor Sinclair Davidson found that the size and growth of the government is having adverse effects on the economic productivity of the nation at large.⁴

As Australians become disproportionately older, and the income tax base becomes smaller and smaller – as predicted in the 2023 Intergenerational Report – the dependence on income tax as a revenue source is going to become more burdensome for working Australians. This reinforces the need for tax reform that promotes workforce participation and removes the costs associated with working.

Reform Direction 1: Give tax back to the states and establish competitive federalism

Following a series of centralising High Court decisions, power over taxation is now disproportionately held by Canberra, and the states are dependent on the federal government to fund their activities. This has produced the phenomenon of severe 'vertical fiscal imbalance' that gives the Commonwealth government immense influence over the states.

The mismatch between revenue raising (mostly by the Commonwealth) and direct spending on public services (mostly by the states) has led to a perennial "blame game" between the different levels of government whenever money is wasted or fails to reach the people who need it. As former Labor finance minister Peter Walsh noted, "a fundamental principle of responsible government in any system is that each government must raise the money that it spends." Addressing the vertical fiscal imbalance by restoring the revenue raising abilities of the states is critical to restoring accountable government.

Transferring income tax responsibilities to the states would promote tax competitiveness across the country, while also giving the states greater capacity to raise the revenue needed to pay for their programs. By replacing one-size-fits-all tax regimes, the states would be empowered to tailor taxation arrangements to meet their needs, and there would be an

³ Kevin You, *Australia's Economic Competitiveness In Continuing Decline* (Institute of Public Affairs Parliamentary Research Brief, November 2023).

⁴ Sinclair Davidson, *The Australian federal government is too big* (Institute of Public Affairs Working Paper, September 2024).

incentive to ensure their tax laws are more attractive than those of other states. This is known as competitive federalism.

An example of how tax competition can operate is the abolition of death duties in Queensland under the premiership of Sir Joh Bjelke-Petersen. This led to a movement of Australians from other states to Queensland, which brought economic investment and development, and led to the other states following suit by abolishing death duties.

This would also allow for greater tax reform, with state governments given the license to trial alternative policies which other states might adopt or slightly alter to achieve desired outcomes. Such innovations could include:

- Reducing the number of separate income tax brackets to incentivise upward mobility and simplify taxation administration.
- Indexation of income tax brackets to address bracket creep, which allows inflation to increase relative marginal tax rates over time.
- Allowing a taxpayer in a single-income household to transfer part of their income to their spouse for tax purposes, to eliminate the systemic bias in favour of dual-income households.

Reform Direction 2: Create a Special Economic Zone in Northern Australia

Special Economic Zones (“SEZs”) are zones within countries with special regulatory arrangements to promote economic development and growth. Successful SEZs attract domestic firms and multinational companies, which contribute to business investment, local employment, and economic growth.

A key component of an SEZ is the granting of tax concessions to entities and individuals operating in the region. These tax concessions incentivise entities to remain in the zone, support the creation of jobs, and help build and maintain critical infrastructure.

The IPA has long championed the implementation of a SEZ in Northern Australia. The IPA, alongside Australians for Northern Development and Economic Vision, made a submission to the 2011 Inquiry into the Development of Northern Australia, proposing a Northern SEZ (encompassing areas of Northern Western Australia, the Northern Territory, and Northern Queensland), which aimed to address key economic challenges in Northern Australia.

The reality is that parts of Northern Australia are uncompetitive internationally because of the high taxes and burdensome red tape imposed by the federal and state or territory governments on the industries that operate there.

An SEZ in Northern Australia should involve the lowering of taxes on individuals and businesses within the zone, with options including: a business rate discount; a decreased flat rate on income tax; a decreased flat rate on all tax activities within the SEZ; exemption from customs duties; corporate tax holidays; or reduced capital gains tax. Tax incentives in any Northern Australia SEZ would not be unfairly advantageous to Australian industries, but

rather, would restore Australian industries to a competitive position in the global market. This is vital, as Australia's most important industries—agriculture, coal, gas, iron ore, and other mining—all occur in Northern Australia.

IPA analysis has also highlighted the fact that Australia's persistent nation-wide worker shortage is being disproportionately felt in Northern Australia. The North is currently underpopulated and under-developed, which is undermining the potential of the region to benefit from its wealth of natural resources. The SEZ would incentivise businesses to invest in Northern Australia, incentivise individuals to remain in the region, and attract people from other regions through a combination of lower taxes, job opportunities, and lower input costs.⁵

Moreover, the establishment of an SEZ in Northern Australia would raise Australia's overall economic competitiveness by incentivising other jurisdictions to lower their tax rates and create a policy environment that promotes business dynamism and higher economic productivity.

Reform Direction 3: Put an end to the tax penalties pushing pensioners and veterans out of the workforce

The unfair tax settings that penalise Australian pensioners who want to work requires urgent reform.

Under current rules, Australian pensioners can receive a maximum of \$523.55 per week on the age pension. This is progressively reduced where a pensioner earns employment income over \$226 per week on average (known as the Work Bonus). If the annual income of a pensioner or veteran is less than \$11,800, no pension received will be reduced.

Any income earned that exceeds the Work Bonus is assessed under the pension rules. If a recipient's remaining assessable income is above \$226 per week, their pension payment is reduced by 50 cents for every additional dollar in income earned. A pensioner or veteran's combined employment income and pension receipts are subject to income tax. Since pension payments accumulate over a year above the income tax free threshold of \$18,200, a pensioner or veteran already sits in a taxable income bracket of 16 per cent, even before earning employment income. The combined effect of these tax and pension rules is that a pensioner or veteran who works is potentially subject to an effective marginal tax rate of 66 per cent.

This is why only three per cent of Australian pensioners work. The most recently available survey data from National Seniors found that 20 per cent of Australian pensioners would enter the workforce if these tax and red tape barriers were removed.

This means that 20 per cent of Australian pensioners are entering early retirement because it is simply not financially viable for them to work, when they might otherwise choose to

⁵ Saxon Davidson, *Unprecedented Nationwide Jobs Crunch: Geographic analysis of worker shortages in Australia* (Institute of Public Affairs Research Report, September 2023).

remain in the workforce. It is in the national interest to allow these Australians to experience the dignity of work by removing these unfair red tape and tax barriers.

These exact same barriers exist for Australian veterans. Similarly, students on the Youth Allowance face an effective marginal tax rate of 76 per cent should they earn \$288 per week.

Australian policymakers should reform the system in line with New Zealand's pension system. Under current rules, pensioners and veterans in New Zealand can earn employment income without reducing or affecting their pension entitlements. If a pensioner or veteran in New Zealand earns income, they only have to pay income tax on their combined income earned and benefits received. Unlike Australia, there is no income free threshold in New Zealand and the marginal tax rate of a worker in New Zealand who earns up to \$14,000 NZD is 10.5 per cent, the next bracket being 17.5 per cent for those earning between \$14,001 NZD and \$48,000 NZD. These rules regarding work and income are the same for those who receive the Veteran's Pension in New Zealand. This is why one in four New Zealand pensioners work compared to only three per cent of pensioners in Australia.

IPA research found that these tax differences and subsequent labour market gaps are the major reason New Zealand avoided a worker shortage, while Australia has been experiencing persistent worker shortages since 2021.⁶

Reform Direction 4: Cut taxes on superannuation savings and empower fund members to choose how to use their super

The purpose of superannuation should be to provide maximum retirement income for the owners of those superannuation funds. This can be achieved by lowering the tax of earnings from superannuation savings. The current standard rate of 15 per cent erodes the fund owner's savings annually and provides no benefit to the fund owner, particularly as the rest of their earned income is subject to income tax.

There is currently legislation before the parliament, the Superannuation (Better Targeted Superannuation Concessions) Imposition Bill 2023, which would increase this rate to 30 per cent for funds that are above \$3 million in value, and wouldn't index that value to remain at its real value.

This is a form of double taxation of the same income, because super contributions are compulsorily claimed from income which is already taxed. Not only that, it is also a form of taxation on unrealised capital gains, as superannuation is inherently an investment.

The IPA has previously proposed cutting the tax on super earnings to 7.5 per cent, as well as increasing the flexibility of savings balances for current use, such as purchasing a first home.

⁶ Saxon Davidson, *How New Zealand Solved It's Worker Shortage Crisis* (Institute of Public Affairs Research Report, February 2024).

These policies would allow Australians to have larger savings for retirement within and outside the superannuation sector.⁷

Reform Direction 5: End redistributive horizontal fiscal equalisation and return GST revenue to the states it is raised in

There are primarily two categories of grants that the federal government pays to the states: specific purpose payments (or tied grants), and general revenue assistance comprised mainly of GST revenue. However, the GST revenue is distributed by the Commonwealth Grants Commission (“CGC”) according to the principle of horizontal fiscal equalisation – a redistributive model that disincentives pro-growth policies – based on obscure calculations and resting on principles that are fundamentally flawed.

Specifically:

- Equity should not be the sole policy objective: The differing fiscal circumstances between the states do not need to be addressed by the federal government: the states should have the autonomy to address their fiscal deficiencies themselves.
- Equalisation calculations are prone to methodological and data problems: The calculations made by the CGC that form the basis of GST redistribution are complex and lack transparency, and the calculation of states’ revenue raising capacity or expenditure requirements are riddled with uncertainty and the CGC frequently resorts to ‘a best guess.’ This is not a reliable method for distributing billions of taxpayer dollars among the states.
- Equalisation negatively distorts incentives: The equalisation process has a perverse impact by incentivising state governments to avoid pro-growth economic reform that would increase their tax base and thereby reduce their GST allocations.⁸

Substantial reform of the GST system is required. As a starting point, it must be accepted that the policy of horizontal fiscal equalisation is deeply flawed, and entrenches existing structural problems in the tax system.

In its place, the Commonwealth could adopt ‘state of origin distribution’. The GST revenues could continue to be collected by the Commonwealth government (consistent with the current High Court interpretation of the Commonwealth’s power to levy excise) but the revenue could be distributed to each state according to where the revenue was generated. This would have the benefit of removing the arbitrariness and complexity of the current system, and negate the perverse incentives: states would be encouraged to promote greater economic growth, as such growth would lead to higher consumption spending and, in turn, GST revenue.

⁷ Henry Ergas and Rebecca Weiser, *Strangling The Goose With The Golden Egg: Why we need to cut superannuation taxes on Middle Australia* (Institute of Public Affairs Research Report, September 2016).

⁸ Morgan Begg, *Time to End GST Redistribution: 2018 Update* (Institute of Public Affairs Research Report, April 2018) 9-14.

In the longer term, the Commonwealth should explore further decentralisation of consumption taxes by allowing the states to set the rates that apply in their borders or to the products the GST will apply to. This would be a significant step towards restoring a competitive federalism and more accountability in the GST system.

Recommendations

Based on the analysis above, the IPA recommends that the government:

1. Investigate reducing Vertical Fiscal Imbalance by devolving some income taxing powers back to state governments.
2. Establish a special economic zone in Northern Australia.
3. Adopt the New Zealand pension tax model.
4. Halve the tax on superannuation savings, and reject the Superannuation (Better Targeted Superannuation Concessions) Imposition Bill 2023, which proposes to increase the rate to 30 per cent for funds with over \$3 million saved.
5. Reduce redistributive horizontal fiscal equalisation and return GST revenue to the states the tax is generated in, or adopt a per capita distribution model.

We wish to thank the committee for the opportunity to provide this submission. Please do not hesitate to contact us at [REDACTED] or [REDACTED] for further consultation or discussion.

Kind regards,

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