A brief history of Australia's tax system

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This paper was presented to the 22nd APEC Finance Ministers' Technical Working Group Meeting in Khanh Hoa, Vietnam, on 15 June 2006. It provides an overview of Australian taxation history, identifying trends and discussing key reforms to Australia's tax system at both federal and state levels of government.

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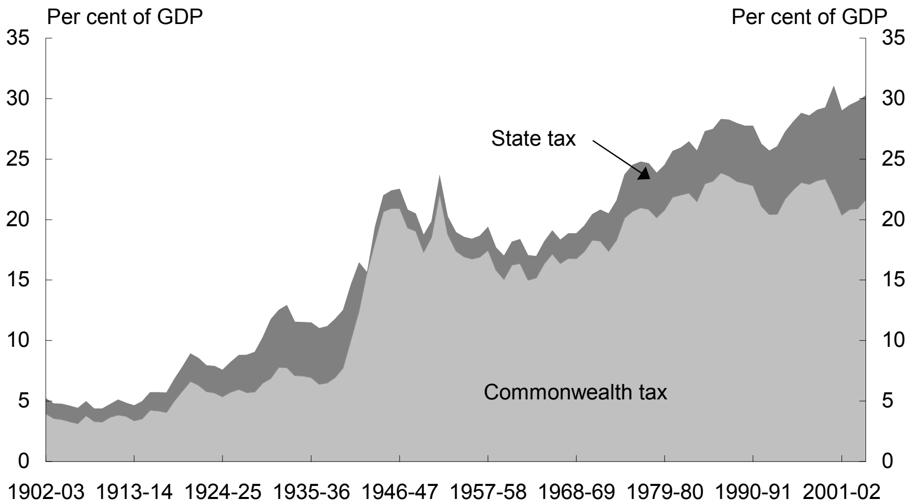
Introduction

At the end of the nineteenth century each of the six Australian colonies had distinct tax systems, which were almost entirely reliant on customs and excise duties. The design of these tax systems was largely driven by administrative concerns, rather than principles of equity or efficiency. Customs duties were also designed to act as trade barriers between the colonies. One of the significant results of Federation in 1901 was the removal of all duties on goods traded between Australian states.

Consistent with most industrialised countries, Australia's tax take (measured as the tax to GDP ratio) grew significantly over the twentieth century, in line with the expanding role of government (see Chart 1). At the time of Federation Australia's tax to GDP ratio was around 5 per cent. This ratio remained reasonably constant until the introduction of the federal income tax in 1915, which was used to fund Australia's war effort. Between the two World Wars, government expenditure and tax revenues grew significantly and by the beginning of the Second World War, Australia's tax take was over 11 per cent of GDP.

Chart 1: Tax to GDP 1902-2005



Source: Budget papers

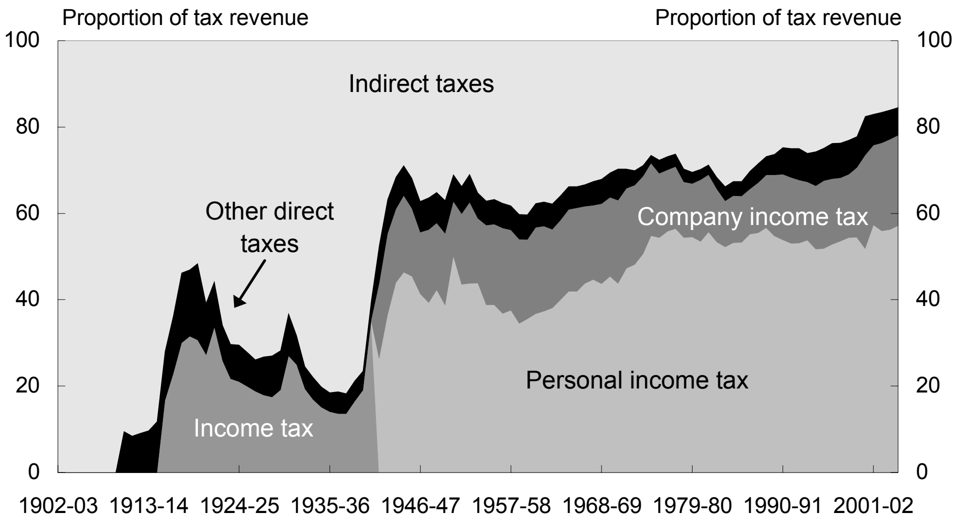
Between 1915 and 1942, income taxes were levied at both the state and federal level, leading to complexity and inequitable taxation of income across states. The Second World War saw fundamental changes to Australia's taxation system. In 1942, income taxation was consolidated by the federal government to increase revenue as a war-time measure. As a result, the states' tax base was reduced (see Chart 1), replaced by federal government grants. The states' tax base was supplemented in 1971, when the then federal government ceded control of payroll taxes to the states.

By the end of the Second World War, taxation revenue had grown to over 22 per cent of GDP. The further increase in taxation largely reflected Australia's involvement in the war and the introduction of government support programmes, such as the widows' pension in 1942 and unemployment relief in 1944.

Tax revenues tended to fall in the middle of the twentieth century and by 1963-64 the tax take was around 18 per cent of GDP. It then increased significantly between 1973 and 1975, largely as a result of increased funding for social programmes. There has since been a modest rise in Australia's tax take, similar to the experience of many other OECD countries. Nevertheless, Australia's tax to GDP ratio is currently the eighth lowest among the 30 OECD countries.

Throughout the twentieth century, federal government reliance on direct taxes as the primary tax base has increased (see Chart 2). The latter part of the twentieth century saw significant base broadening in the income tax system with, for example, changes to the tax treatment of fringe benefits, the introduction of a capital gains tax and the removal of accelerated depreciation. Base broadening in both personal and business taxation has been accompanied by declining rates of taxation.

Chart 2: Federal government taxation revenue — by tax base



Other key areas of tax reform over the past 25 years include the interaction between personal and business taxation and other reforms to business taxation, changes to the taxation of retirement savings and incomes, and the introduction of a broad based goods and services tax in 2000. The goods and services tax replaced a range of less efficient federal and state indirect taxes. Although it was introduced by the federal government, all revenue from the goods and services tax is paid to the states.

Australia's reliance on direct and indirect taxation is broadly consistent with other OECD countries.[2]

Early taxation — excise and customs duties

Established from late in the eighteenth century, Australia's colonies operated as separate economies up until Federation in 1901. Revenue needs were primarily met through an expansion in the range of indirect taxes. Customs and excise duties were the primary sources of taxation, being easy to administer and less likely to attract negative attention than direct forms of taxation. As demand for public expenditure increased, the colonies supplemented this revenue with fees for services and non-tax revenue from land sales. The reliance on these regressive taxes created significant issues in terms of perceived equity and economic prosperity between colonies.

At the end of the eighteenth century, colonial administrators raised small amounts of revenue through wharfage fees and port entry and exit fees (effectively taxing imports), with additional duties on alcohol. From 1813, customs duties were imposed on major export products such as timber, wool, seal and whale oil, and seal skins. The main appeal of customs duties was that they were readily collected at the limited number of wharves where goods entered the colonies. Levying customs duties and excises on necessities also ensured a relatively secure source of revenue. Revenues were generally hypothecated in an attempt to draw support from the public, for example funding an orphanage, gaol, hospital equipment and building works around Sydney.

Early customs and excises duties on goods such as tobacco and alcohol were intended not only to raise revenue, but were also introduced as 'sin taxes', for example in response to concern over the level of alcohol consumption in the colonies. By 1840, customs duties had been extended beyond luxury goods to essential items such as tea, sugar, flour, meal, rice, grain and pulses (see Mills 1925). The narrow base and the high consumption of these goods by poorer households, relative to their income, meant that the poor shouldered a disproportionate share of the burden of early taxation.

Excise duties levied on locally produced goods, equivalent to the customs duties on imports, were also introduced early in the nineteenth century. At this stage in Australia's development, excise duties provided much less revenue than customs duties, partly because of the limited amount of manufactured goods produced in the colonies.

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2 For a detailed comparison of Australia's tax system with other OECD countries, see Warburton and Hendy (2006).

The colonies also introduced a number of taxes on services. These included: liquor retailing fees; auction licence fees; stamp duties; probate fees (service charges for the issue of probates and letters of administration by public legal clerks and judges); and stock taxes. Charges for these services were an additional source of revenue, often exceeding the cost of the services.

The 'gold rush', which began in Australia in 1851, offered a new opportunity for governments to raise revenue, with some small scale alluvial miners making large amounts of money. New South Wales and Victoria introduced a gold licensing fee for the right to mine allotted sections. This was considered the most feasible option for collecting revenue because of the ease of administration. The licence fees were the trigger for a significant uprising by Victorian miners against the colonial authority — the Eureka Stockade. The primary reason for the uprising was the high level at which the licence fees were set, but other contributing reasons included: that the fees had no link to gold discoveries of miners; miners rarely saw any of the benefit of public expenditure; and the inequity of the taxes compared with the light taxation of wealthy land owners. Following the riots and rebellion of the Eureka Stockade, gold licence fees were replaced with a gold export tax and a much reduced miner's right, which were easier to collect and more equitable (see Smith 1993).

Another significant early contributor to colonial revenue was fees on grants of land and leases. New South Wales in particular relied heavily on revenue from land sales and rent, which in 1875 contributed half of the Colony's revenue, and about twice that from all sources of taxation. This revenue source (in particular land sales) was, however, finite, with unallocated lands increasingly less accessible and less fertile.

In the years leading up to Federation, the main political divide in Australia centred on colonial attitudes towards tariffs. Victoria and Western Australia were staunchly protectionist, relying heavily on customs duties and tariffs, whereas New South Wales proudly declared itself a free-trade colony. These differences reflected ideological preferences, each colony's economic development and consumption patterns, and the availability of alternative revenue sources. For example, Victoria approached the limits of land sales as a revenue source much earlier than New South Wales, contributing to its reliance on revenue from tariffs.

Taxation and federalism

By the time of Federation in 1901, Australia had evolved from frontier-style penal and migrant settlements to a modern economy with growing urban and rural populations, rising wealth, and demand for a greater role for government.

Social and demographic changes led to corresponding changes in taxation. Formerly dependent on hidden and regressive indirect taxes such as customs and excise duties, late in the nineteenth century the colonies began to introduce direct, progressive taxes on land and income. The rate of change to the tax bases varied between the colonies according to their stage of development. Although the economic development of the Australian colonies was relatively homogenous compared with other federations, there were sufficiently large differences in the size of the colonial economies, their industrial strength and their policies to provoke some resistance to integration.

One of the challenges accompanying Federation was the creation of a two-tier system of government that centralised control of some functions, while allowing each state sufficient autonomy to meet the social preferences of its constituency. The Australian Constitution allocated the majority of expenditure responsibilities to the states. The expectation of the drafters of the Constitution was that the federal government would carry out functions that the states were not able to conduct efficiently themselves, such as defence and foreign affairs.

The states gave up customs and excise duties to secure interstate free trade and ensuring adequate protection for Australian industry (Groenewegen 1985). Uniform federal tariff and excise duties were introduced in 1901. They largely applied to the goods that had been taxed by the former colonies — tobacco products, beer and spirits and some basic food and clothing. As the federal government's revenue needs were limited, it was expected that revenue from customs and excise duty would be more than sufficient and that only in an emergency would the federal government use its direct taxation powers.

Although the states retained control of land and income taxes, customs and excise duties were by far the greatest source of taxation revenue at the time of Federation. The states were left with a shortfall of funding for their constitutionally allocated expenditure, whereas customs and excise revenue exceeded the needs of the nascent federal government's limited role. To resolve this fiscal imbalance, the Constitution provided for a revenue sharing arrangement for the first ten years following Federation. The federal government retained one quarter of customs and excise duty revenue with the remainder distributed to the states, along with any revenue that was surplus to federal government needs.

Based on views about common citizenship rights, the drafters of the Constitution adopted an 'assumption of "convergence": that Federation would bring about an equalisation of the states' economies and fiscal capacities' (Hancock and Smith 2001 page iv). The federal parliament had power to make laws with respect to 'taxation; but so as not to discriminate between the States or parts of States' (Australian Constitution, Part 5, Section 51(ii)).

It was not long after Federation that fiscal inequality between the states led to federal funding in support of fiscal equalisation. In 1910-11, Western Australia requested fiscal assistance to compensate for the loss of tariffs, which had been its primary revenue source. In 1911-12, Tasmania was also a recipient of federal government grants, and South Australia became a recipient in the 1920s. Over time, horizontal fiscal equalisation was formalised with an independent body recommending distribution of federal government grants based on fiscal need. The ideology of convergence has continued and strengthened over time, so that Australia has a very high level of fiscal equality between the states when compared with other federal systems.

A single income tax

By Federation many of the colonies had introduced income taxes, each with their own definition of assessable income and different rates applying to differing categories of income. Income taxation was further complicated by some jurisdictions taxing according to the taxpayer's residency and others taxing according to where income was earned. This situation became problematic following Federation due to increasing population and capital mobility between states.

A federal government income tax was introduced in 1915, in addition to existing state income taxes, to finance involvement in the First World War. The federal government rates were low and cut in at a high income threshold, minimising double taxation. Following the war, the federal government continued to impose income tax, meaning that two tiers of government were sharing, and competing for revenue from, a common taxation base. The state and federal government taxing systems were kept separate, and administered separately by the different bureaucracies.

As a result of the complexity and inconvenience of paying tax on the same base to two levels of government, there were a number of attempts to harmonise federal and state taxation. In 1919 the federal government offered to withdraw from income tax as an alternative to providing grants to the states, but this option was strongly rejected by some states. Harmonisation of state and federal taxation and ensuring equity in the system of federal grants to the states were the focus of academic and political debate in the period between the World Wars. In 1932, the Ferguson Royal Commission was appointed to suggest ways to harmonise systems. In 1936, similar legislation was enacted in all jurisdictions but over time further changes eroded the uniformity.

The federal government increased its income taxation in the early years of the Second World War to meet the costs of the war effort. Between 1938-39 and 1941-42, federal government income tax revenue grew from 16 per cent to 44 per cent of total federal revenue. With reliance on income taxation rising at both the federal and state levels, differences in state income taxes led to concern about the inequitable tax burdens between taxpayers in different states.

In 1942 the federal government introduced legislation that increased the federal government income tax rates to raise more revenue. The legislation provided for reimbursement grants to the states provided that they ceased to levy their own income taxes. Although a state could legally continue to impose its income tax, doing so would impose an increased burden on its residents and also disqualify that state from receiving federal government grants. In practice, this prevented the states from continuing to levy their own income taxes. The uniform taxation arrangements were initially only meant to apply for the duration of the Second World War and one year thereafter. At the end of the War, the states sought to regain their income taxing powers but were unsuccessful.

Post-war changes to the state tax base

The centralisation of income tax was followed by further changes to the state and federal tax bases during the post-war period.

Land taxes

Land taxes were first introduced by state administrations in the late nineteenth century after a long period of debate and blocking of such taxes by parliaments dominated by wealthy landowners. Land taxes were also introduced at the federal level in 1910 as a form of wealth tax and as a means to break up large tracts of under-utilised land. In most states land was taxed at progressive rates, based on unimproved value, while the federal land tax was introduced as a flat rate tax.

As a form of wealth tax, land taxes became less effective over time as the productivity base of the economy diversified from being mostly agrarian at the beginning of the twentieth century, and wealth was held in more diverse forms. In addition to having no regard to other forms of wealth, land taxes were applied taking no account of net property wealth, such as the value of mortgage debt. By the middle of the twentieth century wealthy primary producers and large landholders had also been largely excluded from land tax requirements through exemptions granted to land used for primary production, restricting the application of land tax to urban property. Land tax revenue became less stable, susceptible to the fluctuations of town property markets. Land taxes were also unpopular as the federal and state taxes were not well integrated with income taxes. In 1952, land taxes were abolished at the federal level, but still operate at the state and local level, accounting for 24 per cent of state and local government revenue in 2003-04 (Australian Bureau of Statistics 2006).

Payroll taxes

The federal government introduced payroll tax in 1941 to finance a national scheme for child endowment. The tax applied as a 2.5 per cent levy on payrolls. With the federal government assuming control of the income tax base, the states lobbied for access to payroll tax and in 1971 the federal government handed over payroll taxes to the states, acknowledging that this tax represented the sole possible growth tax available to the states (Mathews and Grewal 1997). During the following three years the states uniformly increased the rate from 2.5 per cent to 5 per cent.

Over time, the uniformity of state payroll tax rates has been eroded as has the base to which they are applied. State payroll taxes are now levied at rates ranging between 4.75 per cent and 6.85 per cent. Tax competition between states and lobbying by individual employers and employer groups for exemptions has reduced the payroll tax base to less than half of the comprehensive labour income tax base (Freebairn 2005). Nevertheless, payroll taxes are still an important source of tax revenue for the states, accounting for between 24 and 36 per cent of each state's total revenue.

Estate taxes (death duties)

Estate taxes were first introduced in the form of probate duties (a tax on property passing by will) charged by courts in the early part of the nineteenth century in New South Wales. By 1901 estate taxes had been adopted by all of the colonies. The rates were progressive and based on the value of the estate, with reasonably high exemption thresholds, thus limiting the impact on small estates. The duties were an important source of state revenue from the end of the nineteenth century through the first part of the twentieth century. In general, estate duties were relatively low cost to administer and, when introduced, were more readily accepted than a wealth tax, levied throughout a taxpayer's life. Gift duties aimed to ensure that estate duties were not circumvented. In 1914, the federal government also introduced a progressive system of estate taxes to help fund wartime expenses.

By the late 1960s and into the early 1970s, state and federal governments were coming under increasing pressure to amend or remove estate duties. Having not been adjusted since the 1940s, individuals with relatively modest levels of wealth were becoming subject to estate duties. At the same time more wealthy individuals were seen to be avoiding the tax through effective estate planning (Groenewegen 1985). With the increasing impost on smaller estates, estate duties became more costly to administer. Rural producers and small business owners also objected to the taxes on the basis that they impeded business succession.

By the 1970s pressure for estate duty concessions had gradually reduced the tax base. In the end, state tax competition led to the abrupt demise of estate duties. After Queensland dispensed with its tax in 1977, there was concern in other states about emigration of residents and capital and the potential impact of the tax on electoral outcomes (Pedrick 1981). The federal government also abolished its estate and gift duties in 1979. By 1984 all estate duties had been removed, both state and federal. This occurred despite various tax review committees recommending refinements to improve the equity, efficiency and simplicity of the tax.

Other taxes

During the latter part of the twentieth century, the states supplemented their revenues with a range of transaction based taxes. Many of these taxes have since been replaced, or are in the process of being replaced, as part of the reforms to federal financial relations associated with the introduction of the goods and services tax, the revenue from which is paid to the states.

Key developments in federal taxation

Developments in federal taxation can be broadly classified into two periods. Up until the 1970s, the focus of significant changes to the tax system was on expanding the revenue base to fund expenditure programmes. Since the 1980s, increased attention has been paid to reforming the tax system to improve equity and efficiency and, more recently, to reducing tax system complexity.

The catalyst for this reform was a growing concern about the equity of the taxation system, which led to the establishment of the Taxation Review Committee in the early 1970s (Asprey et al 1975). A key theme of the Asprey Report was the need to broaden the tax base to improve equity and efficiency. In 1985, the Draft White Paper recommended a broadening of the tax base through the adoption of a broad based consumption tax, the introduction of a capital gains tax and comprehensive taxation of fringe benefits (Australian Government 1985).

The recommendations relating to capital gains and fringe benefits taxation were adopted following the Draft White Paper but there was insufficient support for the implementation of a broad based consumption tax at that time. In the late 1980s there were also fundamental changes to the taxation of corporate income and the taxation of retirement savings. The end of the 1990s also marked the start of a number of important initiatives, including the introduction of a goods and services tax, reform to the business tax system, a review of Australia's international taxation arrangements and the 2006 Budget proposal to reform the taxation of retirement savings.

Income tax

Tax base

At its inception, the federal income tax was modelled on the income tax systems applying in the Australian states and the United States example of a global income tax system, applying to all forms of income, rather than the British schedular tax system.

There has, however, never been a comprehensive definition of 'income' for the purpose of taxation in Australia. Amounts originally identified by the courts and administrators are now known as 'ordinary income'. The concept of 'ordinary income' was developed both on the form of payment and whether the income could be traced to a source such as labour activities, business activities or use of property. Ordinary income is distinguished from 'capital receipts'. The meaning of these constructs derives largely from English equity. At its inception, income tax was an Australian source-only tax and did not apply to the foreign source income of residents.

From its introduction in 1915, the income tax base had been gradually broadened. In the post-war period, income tax base broadening was limited until the implementation of some of the recommendations included in the 1985 Draft White Paper (Australian Government 1985). In 1985 a capital gains tax was introduced and in 1986 the fringe benefits tax was introduced. The primary motivation behind these base broadening measures was to address gaps in the income tax base, which had led to growth in tax avoidance and evasion activity. In 1999 the removal of accelerated depreciation and a range of other base broadening measures were introduced as part of a broad programme of business tax reform.

Capital gains tax

Prior to 1985, Australia had no general tax on capital gains, with most capital gains excluded from the income tax base. Of the capital gains taxes that were in operation, the most important was that applying to gains from property held for less than one year, which was introduced in the early 1970s.

In 1985, based on equity grounds, it was argued that, 'because real capital gains represent an increase in purchasing power similar to real increases in wages, salaries, interest or dividends, they should be included in any comprehensive definition of income' (Australian Government 1985 page 77).

The Draft White Paper and tax academics also argued for taxing capital gains to improve economic efficiency and reduce tax avoidance. In particular, it was argued that the lack of a capital gains tax distorted investment towards assets providing returns in the form of capital gains, rather than income streams, and provided an incentive to convert income into capital gains. It was also argued that, combined with the classical taxation of dividends (discussed below), the lack of a capital gains tax created incentives for companies to retain profits, potentially resulting in less efficient investment choices from an economy wide perspective.

The capital gains tax arrangements introduced in 1985 applied to realised gains and losses on assets acquired after 19 September 1985. Certain classes of assets are exempt from capital gains tax, such as owner occupied homes. From 1985 to 1999, an indexation system applied, so that only real, and not nominal, gains were taxed. An averaging system was also in place to reduce the impact of the progressive income tax on realised gains accrued over a period of years.

In 1999 a capital gains discount was introduced to promote more efficient asset management and improve capital mobility, by reducing the tax bias towards asset retention, and to make Australia's capital gains tax internationally competitive. The indexation and averaging provisions were removed for assets acquired after 30 September 1999. Under the discount, individuals and the beneficiaries of trusts pay tax at normal rates on only half of any capital gain realised on an asset held for at least twelve months. Superannuation funds receive a one-third discount.

Fringe benefits tax

Fringe benefits (indirect, non-cash benefits provided to employees in addition to wages or salary) have been legally taxable in Australia since the inception of the federal income tax. Because of difficulties in determining the value of fringe benefits and for a range of other administrative and related reasons, in practice there was an almost universal non-inclusion of most fringe benefits in assessable income by employees (Australian Government 1985).

In recognition of the growing trend of remunerating employees with non-cash business benefits (particularly for those employees on higher incomes), the explicit taxation of fringe benefits was proposed in the Draft White Paper (Australian Government 1985). Fringe benefits tax was subsequently introduced in 1986.

Fringe benefits tax is levied on employers, rather than employees, to simplify compliance and administration. Fringe benefits are taxed at the top personal tax rate plus the Medicare levy[3] (currently 46.5 per cent). The fringe benefits tax regime contains a number of specific exemptions and concessions for particular types of benefits such as work-related items and remote area fringe benefits. It also provides for concessional treatment of benefits provided to employees of particular types of organisations, including scientific and public educational institutions, charitable institutions, public and not-for-profit hospitals, trade unions and religious institutions.

Depreciation

Australia has had various forms of accelerated depreciation and investment credits/deductions for much of its tax history. The most radical was the adoption of

3 The Medicare levy is imposed at 1.5 per cent of taxable income, and applies above a threshold that excludes low-income earners.

'5/3' depreciation.[4] This arrangement was gradually wound back in the 1980s, although loadings were reintroduced at times.

In 1999, following the Review of Business Taxation (Ralph et al 1999), the accelerated depreciation arrangements were removed and depreciation rates aligned to an asset's effective life. This change met two broad policy objectives: it removed tax-induced distortions to investment decisions and substantially funded a reduction in the corporate tax rate.

Source and residency based taxation

In 1915, the federal income tax was introduced as a tax on Australian source income, consistent with the state income taxes, other than Tasmania (Harris 2002). In 1930 Australia moved to a residence based taxation system, bringing income of residents from foreign sources into the taxation base. At the request of the United Kingdom, Australia agreed to exempt income derived from the United Kingdom, where it had already been taxed. Following a subsequent request from the United States for similar treatment, in 1947 the government decided that all foreign source income would be exempted where it had already been taxed abroad.

Between 1947 and 1986, Australia operated a bifurcated system, where foreign tax credits were provided for tax paid on dividends from portfolio investments, while income from direct foreign investments of residents was exempt. In 1986 the foreign tax credit arrangements were expanded to cover most foreign income.[5]

Shortly after the Second World War, Australia signed its first tax treaty with the United Kingdom, which limited its taxing rights over income derived by non-residents. A treaty with the United States followed and later one was signed with Canada and another with New Zealand. In the 1970s, Australia began to expand its treaty network and did so with vigour in the 1980s and 1990s. Australia now has close to 50 treaties signed or under negotiation.

Treaties often limit the amount of foreign tax that may be imposed on the income of Australian residents. Under Australian tax treaties, Australia is required to give relief for foreign tax imposed in accordance with the treaty. Although the treaties only provide for relief by credit, double taxation can also be relieved by unilaterally exempting the foreign source income, for example, under domestic law.

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4 Under 5/3 depreciation, eligible plant that could otherwise be depreciated at a rate in excess of 20 per cent using a straight line method, could instead be written off at a rate of 33 1/3 per cent (3 year write-off). Eligible plant otherwise depreciable at a rate of 20 per cent or less, could instead be written off at a rate of 20 per cent (5 year write-off).

5 Some direct income, including foreign source employment income, remained exempt subject to time requirements.

With the 1988 reduction in the Australian company tax rate, it was considered that there was little to be gained in taxing foreign source dividends where the foreign country had a similar tax system to that in Australia. As a result, the foreign tax credit system was scaled back significantly in 1990, with dividends from non-portfolio interests[6] and the profits of branches of Australian companies flowing from comparable tax jurisdictions[7] excluded from the income tax base.

Personal income tax

The 1915 federal income tax was levied on individual taxpayers at progressive rates. A relatively high income threshold exempted most wage and salary earners. The rates of tax imposed ranged from 3 per cent through to 25 per cent. Individuals in the top income quintile accounted for the vast majority of personal income tax paid.

The Pay-As-You-Earn (PAYE) system, where employers deduct tax from employees' pay, was introduced by the South Australian government during the depression and universalised by the federal government in 1942. This system allowed income tax collection from wage earners in lower income groups, which had been impracticable without a system of taxation at source. The PAYE system was more convenient for taxpayers, created a more even flow of revenue for government, and improved compliance as evasion was more difficult with income taxed at source (Groenewegen 1985).

Following the assumption of income tax powers and introduction of the PAYE system by the federal government in 1942, the scope of the personal income tax was progressively broadened such that by the early 1980s the share of personal income tax paid by the top income quintile had fallen to around half, a level that has since been broadly maintained. This expansion in the scope of the income tax base has generally coincided with a reduction in marginal tax rates applying at higher levels of income. Australia's top marginal tax rate has decreased over the past 50 years from over 75 per cent in the 1950s to 46.5 per cent (including the Medicare levy) as of 1 July 2006 (see Chart 3). Notwithstanding the increase in the proportion of personal income tax paid by lower income quintiles, Australia's average effective tax rate on the income of a range of household types is in the lowest eight out of the 30 OECD countries (Warburton and Hendy 2006).

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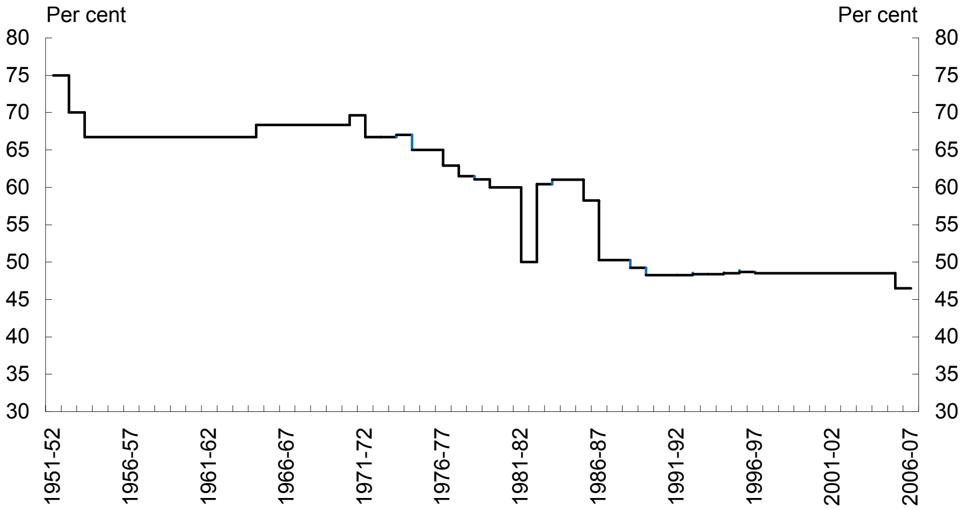
6 That is interests of 10 per cent or greater in a company.

7 Broadly, a comparable tax jurisdiction was a foreign country regarded as having an income tax system comparable to Australia's with roughly comparable tax rates. A list of such countries was included in the law.

Chart 3: Personal income tax top marginal rate



From its origins, the basic tax unit in Australia for income tax purposes has been the individual, although, as is the case today, the early income tax systems did recognise family circumstances with a series of deductions (later replaced by credits) for taxpayers supporting dependants. More recently there has been a greater focus on the overall impact of taxation and benefits on household incomes, particularly those of families.

In 1945 a 'Social Services Contribution' was introduced, which hypothecated a part of income tax revenue for social welfare. The primary motivation for the distinction was to make increases in income tax more palatable, rather than as a means to separate out social security contributions from general taxation (Mathews and Jay 1972). In the early 1950s, income taxes and social services taxes were amalgamated allowing a substantial simplification of the income tax return. The new form allowed taxpayers to assess their tax liability and determine if, after credit for tax instalments, a refund was due or a further amount payable. The public responded well to the simplified form. Since that time, Australia has had no specific tax levied to pay for social security benefits, unlike most other OECD countries.

Company income tax

When income tax was first introduced in 1915, companies were taxed on their profits after deduction of dividends (that is only on retained profits). Where dividends were paid out of accumulated profits, shareholders were entitled to a rebate of tax at the lesser of the company tax rate or their personal rate to compensate for tax already paid. This system was administratively cumbersome, requiring extensive record keeping, particularly as the company tax rates changed over time and rebates depended on the company tax rate at the time profits were accrued (Australian Treasury 1974).

In 1922, a system of taxing all company profits was introduced. The non-refundable rebate system was retained and applied to all dividends, so that individuals with higher marginal tax rates received a full rebate for company tax paid. Individuals on lower marginal tax rates did not receive a rebate for the difference between their marginal tax rate and the company tax rate.

In 1940, with additional revenue needed to fund Australia's involvement in the Second World War, the rebate of tax on dividends received by individual shareholders and non-resident companies was removed. The company tax rate was increased and an undistributed profits tax was imposed on public companies. The removal of the rebate was not intended to remain a permanent feature of the system but remained in place well past the end of the war (Australian Treasury 1974).

From 1940 to 1986, Australia maintained this classical company taxation system, under which profits were taxed at the company rate and at personal rates when distributed. In 1987, Australia introduced an imputation system. Prior to this there had long been calls from business to remove what was seen as double taxation under the two tier classical system. The classical system resulted in both equity and efficiency problems (Australian Government 1985). For example, it provided a disincentive to incorporate, distorted corporate financing decisions by providing a bias towards debt and, combined with the absence of a capital gains tax, provided an incentive for companies to retain profits.

Under Australia's imputation system, resident shareholders receive a credit for tax paid at the company level, thereby eliminating double taxation of dividends. Where the resident shareholder's marginal tax rate is below the company tax rate, the excess credit can be used to offset other taxes (for example, against taxes on wages and salary). Full refundability of excess tax credits for resident shareholders was introduced to the Australian imputation system in 2000.

Under the imputation system, Australia's company income tax system operates as a withholding tax on the income Australian residents earn through Australian resident companies, and as a final tax on (primarily Australian source) income earned by non-residents through an Australian resident company or permanent establishment in Australia.

As shown in Table 1, the company tax rate, like personal income tax rates, has been progressively reduced in recent times, decreasing from a high of 49 per cent in 1986 to the current rate of 30 per cent. The rate reductions have largely corresponded with base broadening measures, such as the removal of accelerated depreciation.

Table 1: Company income tax rates since 1915

Year	Company tax rate (%)	Notes on tax base
1915	7.4	A company was taxed on its undistributed profits (allowing a deduction for income distributed to shareholders).
1922		Tax applied to all profits (not just undistributed profits). Rebate provided to all dividends.
1940		All rebates for distributions of profits to shareholders were removed.
	47.5	*Public company*
	45	*Private company*
1948-72	47.5; 45; 42.5	Lower rate (42.5) applied to initial income (first $10,000 of profits in 1974).
1973-77	45	Private and public company income tax rates aligned.
1979	46	
1986	49	Company tax rate aligned with top individual marginal tax rate. Foreign tax credit system replaced the general exemption for foreign earnings. Credit allowed for foreign tax paid on foreign income up to the amount of Australian tax payable on the foreign income.
1987		The classical system of company taxation replaced by dividend imputation.
1988	39	
1993	33	
1995	36	
1999		Removal of accelerated depreciation.
2000	34	Refundable imputation credits introduced.
2001	30	

Source: Australian Treasury (1974) pp 39-41, Asprey et al (1975), p 225.

Taxation of retirement savings

When the federal government first imposed income tax in 1915, superannuation funds were exempt from paying tax on their earnings provided the fund was set up for the benefit of employees in any business. At that time, unlimited deductions were allowed for employer contributions to a superannuation fund for employees, while a capped concessional deduction was allowed for personal superannuation contributions.

Prior to 1983, the taxation levied on end benefits depended on whether they were paid out as a lump sum or an annuity. Lump sum benefits were taxed very concessionally, with only 5 per cent of the lump sum included in assessable income and taxed at marginal rates. In contrast, annuities were taxed at marginal rates (with an exemption for contributions made from post-tax monies).

Krever (1986) notes that the taxation applied to superannuation prior to 1 July 1983 created a significant incentive for taxpayers to convert employment income to lump sum retirement payments. Reforms to the taxation of superannuation benefits were introduced in 1983 to address concerns that individuals whose remuneration package included superannuation contributions were accessing lower effective marginal tax rates than those individuals who received their remuneration exclusively as salary and wages.

The taxation on lump sum payments was raised to 15 per cent for amounts below a specified threshold, with amounts above this threshold taxed at 30 per cent. Contributions and earnings remained untaxed and the taxation of annuities was largely unchanged. The reforms were applied to service after 1 July 1983, while the pre-1983 arrangements were 'grandfathered'.

Further revisions to the taxation of superannuation benefits were announced in 1988, when the Government imposed a 15 per cent tax rate on both contributions and earnings. To compensate for these changes, the Government reduced the tax rate on the taxed element of lump sum superannuation benefits. The rate was reduced from 15 per cent to zero (provided the benefit was preserved until age 55) for amounts up to the low rate threshold. Amounts above this threshold were taxed at the reduced rate of 15 per cent. While annuities remained taxed at marginal rates, the Government introduced a 15 per cent rebate when benefits were paid to the individual.

Productivity Award Superannuation was created in 1986 under industrial agreements which provided for up to 3 per cent of wage increases to be contributed to approved superannuation funds. While the initiative successfully increased superannuation coverage to approximately two thirds of the population, administration and implementation problems were rife, particularly with respect to the monitoring and enforcement of employer compliance. The Industrial Relations Commission cited these problems as the basis for its refusal of an application to increase the provision by a further 3 per cent in 1991.

The Superannuation Guarantee (SG), introduced in 1992, provides for a percentage of an eligible employee's remuneration to be directed into a superannuation fund by means of a compulsory employer contribution. The motivation for the SG was twofold: to provide a mechanism through which employer contributions could be increased gradually, consistent with the Government's retirement income policy objectives and the economy's capacity to pay; and to extend superannuation coverage to a larger proportion of the population. The SG rate was phased up from 3 per cent to 9 per cent between 1992 and 2002. Superannuation coverage has broadened to about 90 per cent of employees under the Superannuation Guarantee. Although the rate of taxation is higher today than before the first suite of reforms were introduced in 1983, superannuation is still a highly concessional savings vehicle.

In recent years, the Government has introduced a number of policies designed to encourage individuals to make greater voluntary personal superannuation contributions. These include the Government co-contribution for low income workers, superannuation splitting for eligible couples and the introduction of choice of fund.

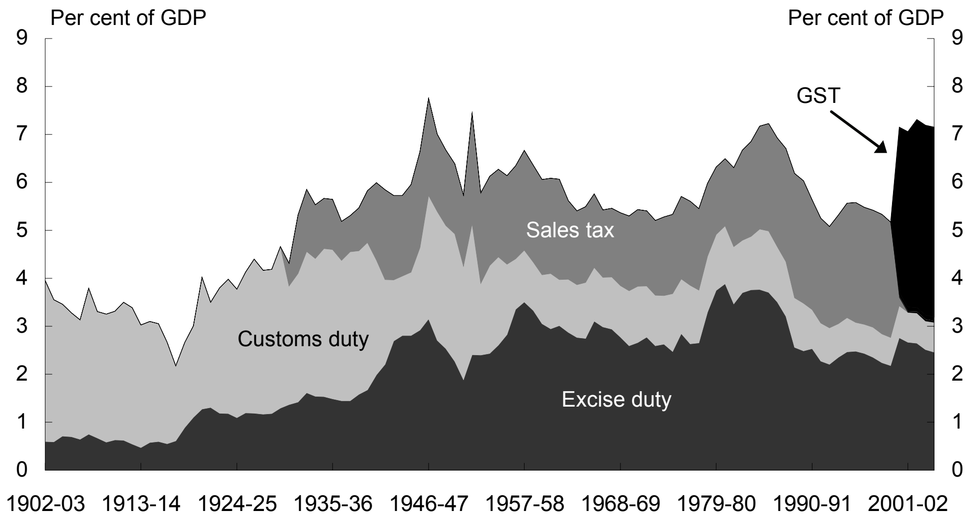
Recent amendments to portability legislation have complemented these initiatives, making it easier for individuals to consolidate their superannuation benefits into a single fund.

The myriad of changes to the superannuation taxation arrangements has led to considerable complexity. In the 2006-07 Budget, the Australian Government announced a proposal to simplify superannuation dramatically and improve retirement incomes. This is to be achieved principally through the removal of taxation on end benefits received by most individuals aged 60 or older. Taxation arrangements are to remain unchanged where an end benefit is taken prior to age 60, but streamlined arrangements would apply. The proposals would improve the incentives to work and save, promoting growth through workforce participation and increased provision for retirement, both of which are an important part of Australia's strategy for addressing the demographic challenges of an ageing population.

Indirect taxes

Indirect taxes have grown relative to economic activity, largely in response to increasing revenue demands brought about by periodic events, such as two world wars and the 1930s Depression, and the increasing role played by the public sector. The composition of indirect taxes has changed considerably over the past 100 years, with Australia's reliance on customs duties declining gradually, while the importance of alternative indirect taxes, particularly excises and more broadly based consumption taxes, has increased (see Chart 4).

Chart 4: Evolution of indirect taxes in Australia since Federation



Wholesale sales tax

The onset of the 1930s Great Depression had a significant impact on the (then) federal government's ability to raise revenue, particularly through customs duties. In addition to falling revenues, the government's debt servicing costs had increased significantly due to a large spending programme in the late 1920s. Faced with a large budget shortfall, the government introduced the wholesale sales tax (WST) in 1930. Raising indirect taxes was favoured because the incidence was disguised, making the tax more politically palatable. It was also argued at the time that such taxes had a smaller impact on labour supply decisions than income taxes (although income taxes were also raised to some degree in the same period).

The WST was levied at the wholesale level to minimise the number of taxing points. It was introduced at a rate of 2.5 per cent, but within a year the rate had been increased to 6 per cent, and by 1940 the rate had been further increased and a multiple rate structure introduced (see Table 2). The WST was levied on many classes of consumables, but provided preferential treatment for food, primary produce and some primary industry inputs (Smith 1999). In its first two years of operation, the WST base averaged 32 per cent of private consumption.

Table 2: Wholesale sales tax rates and schedules

Year	Number of rates schedules	Lower rate(a)	Top rate
1930	1	2.5	2.5
1950	4	10.0	33.3
1970	3	2.5	27.5
1980	5	2.5	27.5
1999	6	12.0	45.0

(a) A rate of zero per cent also applied to excluded items.
Source: Groenewegen (1983), pp 25-26, 1999-2000 Commonwealth Budget Paper 1, Statement 6.

Over time the WST base declined as a proportion of consumption, with an increasing share of consumption expenditure directed towards services. By 1995, the share of private consumption subject to the WST had fallen to 22 per cent. The previously clear lines between wholesalers and retailers became blurred. Where goods were sold directly by manufacturers or importers to retailers, a notional WST value had to be determined. This contributed to complexity, uncertainty and taxpayer disputes. The multiple rate structure also contributed to compliance and administration costs and to the incentives for avoidance, particularly as rates were increased (Groenewegen 1983).

Goods and services tax

The WST was neither an efficient nor simple tax. The narrow base and differential rate structure created distortions to production and consumption decisions in favour of low taxed or untaxed goods or services. Cascading of the WST through the production chain reduced economic efficiency and export competitiveness by increasing the cost of production in Australia. The arbitrary range of WST tax rates and exemptions imposed significant costs in terms of complexity and compliance.

A broad based consumption tax was proposed in the findings of the Asprey Committee (Asprey et al 1975). However, the introduction of a broad based consumption tax in Australia proved difficult, with unsuccessful attempts to introduce such a tax in 1985 and in 1993.

In July 2000, the federal government introduced a goods and services tax (GST), based on the value-added tax (VAT) model, as part of a broader package of taxation reform. The GST replaced the WST and a range of inefficient state taxes, in conjunction with reforms to federal financial relations. Revenue from the GST is paid to the states and territories, providing them with a stable and growing source of revenue and removing their reliance on general assistance grants from the federal government.

The state taxes that were, or are in the process of being, abolished include Financial Institutions Duty; debits tax; stamp duty on marketable securities, conveyancing duties on business property; stamp duties on credit arrangements, instalment purchase arrangements and rental (hiring) agreements; stamp duties on leases; stamp duties on mortgages, bonds, debentures and other loan securities; stamp duties on cheques, bills of exchange and promissory notes; and accommodation taxes. Like the WST, these taxes distort economic decisions and can cascade through the production chain, increasing production costs.

The introduction of the GST was also accompanied by significant changes to personal income taxes and social security payments. This part of the package included significant reductions in personal income taxes and large increases in government payments to families, pensioners and low income earners. Adjustments were also made to excise taxes and some specific indirect taxes to adjust for the removal of the WST and imposition of the GST.

In order to achieve passage through Parliament, several compromises were made to the scope of the GST base. The most notable of these was the removal of basic food and personal products from the GST base.

Effective implementation of the tax was critical to its success. Some of the tools used in Australia were extensive education, information and support programmes for businesses (including visits by field officers, call centre assistance and web sites to provide information and assistance), education programmes for consumers, and monitoring by the Australian Competition and Consumer Commission to ensure the introduction of the tax was not used as an opportunity for profiteering. The Australian Tax Office adopted a flexible administrative approach in the transition period regarding lodgment deadlines, payment arrangements and taxpayer mistakes as well as an ongoing openness to reducing compliance costs for businesses where possible (Australian Treasury 2003).

Modern customs and excise duties

Under current Australian law, excise duty is imposed on the domestic manufacture of petroleum fuels, certain biofuels, alcoholic beverages other than wine, tobacco products, crude oil and oils and lubricants.[8] Equivalent duties on identical imported products are imposed through customs duty, along with tariffs imposed on imported goods for the purpose of protecting domestically produced goods.

Excise and customs duties have remained relatively steady as a revenue source, but have declined in importance as a proportion of tax revenue over the last century (see Chart 4). In 1909 they accounted for three quarters of total tax revenue, while in 2003-04 they accounted for 8.5 per cent of tax revenue. Over this period, customs duties have declined in importance in comparison to excise duties, reflecting both increased domestic production of goods and a decline in the rates of duty applied to imports. Australian tariff levels have been substantially reduced across a wide range of import competing industries since the early 1970s to improve economic efficiency in the Australian economy.

Current Australian excises are typically applied to goods with a relatively inelastic demand and where the number of manufacturers is limited. Inelastic demand means that excise taxes can be applied without creating undue distortions to consumption decisions, the hallmark of an efficient tax. There is, however, an increased incentive to avoid taxation. Monitoring compliance is aided where production of the good is concentrated at a few production points and cannot be readily undertaken by other agents. For example, the number of taxing points is very low for the revenue raised for petroleum, tobacco and alcohol excise, making these administratively efficient taxes to collect.

Excise controls in Australia include licensing of parties that are engaged in the manufacture of excisable goods, issuing permissions that govern dealings with the goods and the classification of those goods (where classification determines the rate of excise liability). These controls provide high levels of compliance. As with excises, a fundamental design element of the administration of customs duties is the control by the revenue authority over dutiable goods until such time that they are dealt with in accordance with the legislation. This is normally at the point of passage into the

8 Wine is taxed under a specific scheme, the wine equalisation tax (WET), on an *ad valorem* basis.

market (known as entry or delivery for home consumption) or export (in which case excise is not payable).

Resource taxation

The federal government's responsibility for the extraction of resources is generally limited to waters between three and two hundred nautical miles seaward of the low water line along the coast. The states own most resources on land and within the coastal boundary and impose taxes and charges on the extraction of those resources using a variety of mechanisms. Where the federal and relevant state governments have a joint interest in a petroleum resource, resource taxation occurs by way of royalty.

In the period up to 1975, petroleum royalties were also the main instrument for accruing a return to society for the extraction of offshore petroleum resources. In 1975, a flat per barrel crude oil excise was introduced. Later, in an effort to encourage exploration and production in new and remote areas, the federal government introduced progressive rates of excise based on total production from a field. It was recognised that even this approach could result in some deposits not being developed because the net return to the investor after the imposition of the excise would not be sufficient to warrant the investment.

In 1987, the petroleum resource rent tax (PRRT) was introduced to generate an equitable return to society from its offshore petroleum resources, while also reducing potential distortions to offshore petroleum exploration and development. The North West Shelf and the Joint Petroleum Development Area in the Timor Sea are the only offshore areas which are not subject to the PRRT regime. In the former case, existing taxation arrangements were grandfathered, while the taxation arrangements in the latter case reflect the joint production agreement between Australia and Timor-Leste.

The PRRT is a tax on 'above normal' profits derived from upstream petroleum production, defined by the point at which a saleable commodity is first produced (for example, crude oil, condensate, natural gas, and methane). Downstream processing or value adding activities, such as liquefaction of natural gas, are not subject to PRRT. A gas transfer pricing formula has been developed to establish the upstream value of gas produced and consumed in an integrated gas to liquids project.

Taxable profits are defined to be net of the recovery of all project related exploration, development and operating expenditures. Where expenditure is carried forward to be offset against future income, its value is compounded at an annual rate intended to broadly reflect the required rate of return for undertaking such expenditure. These compounding rates vary according to the type of expenditure incurred, being highest for exploration and least for general overhead expenditure. In essence, a project will only become PRRT assessable once the owners have earned a 'normal' rate of return.

As a tax on 'above normal' profits, PRRT is levied at a relatively high but constant rate of 40 per cent. Payments of PRRT are deductible for company income tax purposes in the year assessed.

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