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Raising Revenue in Australia

Discussion paper

Matt Grudnoff
David Richardson
Eliza Littleton

REVENUE SUMMIT 22

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Australians want more public services that will require more government revenue. This paper summarises Australia's tax system, its international context, and principles to guide its reform.

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Level 1, Endeavour House, 1 Franklin St
Canberra, ACT 2601
Tel: (02) 61300530
Email: mail@australiainstitute.org.au
Website: www.australiainstitute.org.au
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Raising revenue in Australia

Authors: Matt Grudnoff, David Richardson and Eliza Littleton
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Australians want more public services that will require more government revenue. This paper summarises Australia's tax system, its international context, and principles to guide its reform.

INTRODUCTION

Taxation is often framed as a burden. For decades political debate about tax reform has revolved around lowering taxes, with the resulting revenue shortfalls to be addressed through cuts to public spending. What is lost in this simplistic framing is the important role tax plays in society. Taxation facilitates provision of public services. It is a key policy lever to reduce inequality. It can encourage beneficial activities and discourage others that cause harm.

Tax is the price we pay for living in a civilised society. The question is what kind of society do we want and how can taxation help us achieve it? The pandemic has shown the importance of a well-resourced public sector, and with political leaders of all persuasions wanting to tackle expensive policy challenges such as aged care, the NDIS, childcare, cost-of-living, inequality, climate change and submarines – Australia, we need to talk about revenue!

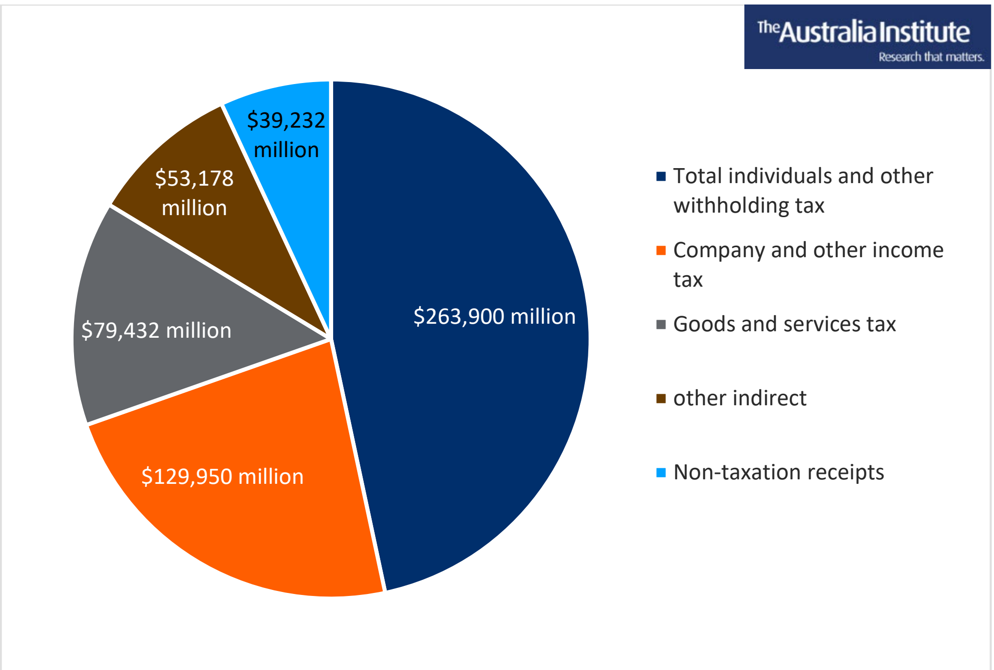
WHAT WE TAX

Most government revenue in Australia is raised through taxes on personal income, company income, superannuation fund income, trusts, partnerships and all the variations on those categories. Income taxes are sometimes referred to as “direct taxation” and are expected to generate revenue of $394 billion in 2022–23, 70% of Australian Government receipts.

Indirect taxes by contrast are those that are levied while producing goods and services. In Australia the prime example is the goods and services tax or GST. The GST system requires most sellers to add 10 per cent to their prices; after netting out GST they pay on their own inputs, the net revenue is forwarded to the Tax Office. Other indirect taxes are similar, although some are levied on a per unit basis. For example, petrol excise is currently 22.1 cents/litre.[1] In total indirect taxes are expected to raise another $132.6 billion in 2022–23, or 23% of revenue.

In addition to taxes, there are various other non-tax revenue items such as dividends from the Reserve Bank of Australia and Australia Post, Future Fund earnings, royalties on minerals and petroleum production, and various user fees. The non-tax receipts are expected to bring in $39.2 billion in 2022–23.

Figure 1: Australian Government revenue by source



Source: Australian Government (2022) *Budget strategy & outlook: Budget Paper No 1, 2022–23*

The pie chart in Figure 1 shows the importance of income taxes on individuals which account for almost half of Commonwealth government revenue. Company tax is almost a quarter of revenue. Indirect taxes (the GST and other) take up almost a quarter of revenue while non-tax revenue accounts for the smallest slice of the pie at 7% of the total.

[1] This is the temporary rate applying from 30 March to 28 September, down from 44.2 cents/litre applying before 30 March. See *Budget 2022-23 - Fuel excise fact sheet*, at https://budget.gov.au/2022-23/content/factsheets/download/factsheet_excise.pdf

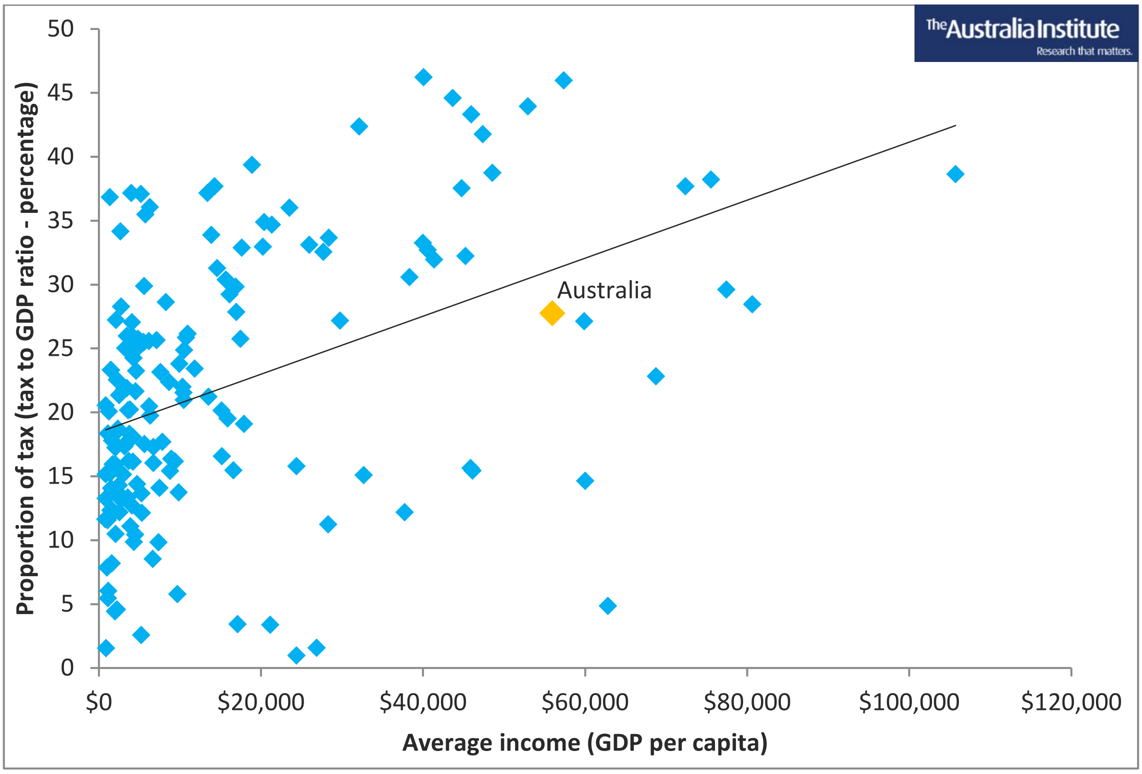
THE EFFECTS OF TAXATION ON THE ECONOMY

Tax and income

Advocates of lower taxation often claim that higher taxation is a drag on the economy and reduces economic activity and income. For example, former Treasurer Josh Frydenberg described policies to raise more revenue as "real wet blanket over the Australian economy."[2] Such claims are not supported by international data. Higher levels of taxation are correlated with higher income per capita and other measures of wellbeing.

Figure 2 below shows average income (GDP per capita) and level of taxation (tax to GDP ratio) for 185 countries. It shows that higher average incomes are correlated with higher levels of taxation.

Figure 2: Tax and income for 185 countries including Australia



Source: Grudnoff (2020) *Tax and Wellbeing: The impact of taxation on economic wellbeing*.

[2] Insiders (2018) *Josh Frydenberg joins Insiders*, ABCTV, 9 December, available at <https://www.abc.net.au/insiders/josh-frydenberg-joins-insiders/10598048>

Figure 2 shows that Australia is one of the highest income countries in the world, while also having average levels of taxation well below the trendline. Few countries have similar levels of income and significantly lower tax to GDP ratios. Those in this category are usually very small and either tax havens, such as Singapore, or petro-states such as Qatar. Countries with higher income and higher levels of tax are mainly Nordic countries such as Norway and Iceland.[3]

Beyond average income, shown in Figure 2 above, a similar correlation is found between level of taxation and other measures of wellbeing including Human Development Index score (the United Nations measure of wellbeing), average life expectancy (which can be seen as a proxy for health outcomes), and happiness.[4]

Correlation does not mean causation. This does not show that higher levels of taxation cause higher levels of wellbeing. But it does provide powerful evidence that higher levels of taxation do not reduce average income or wellbeing. That is, higher levels of taxation are not a drag on economic growth or wellbeing.

Reducing inequality

Tax systems can be a powerful tool to reduce inequality within a society. Laissez faire economies generate wealth and distribute resources, but usually do this in an unequal way. Over time this leads to a widening gap between the rich and poor.

Inequality is problematic both from a social and an economic perspective.[5] More unequal societies are more likely to have social problems such as entrenched poverty, crime and instability. But there is also an economic cost to higher rates of inequality. Research from the International Monetary Fund shows that countries that have a more equal share of income have stronger economic growth.[6] Countries that have less equal distribution of income have slower growth. Decreasing inequality improves the economic growth rate of a country, increasing employment and incomes.

The government can reduce inequality in four important ways:

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[3] Grudnoff (2020) *Tax and Wellbeing: The impact of taxation on economic wellbeing,* https://www.nordicpolicycentre.org.au/tax_and_wellbeing

[4] Ibid

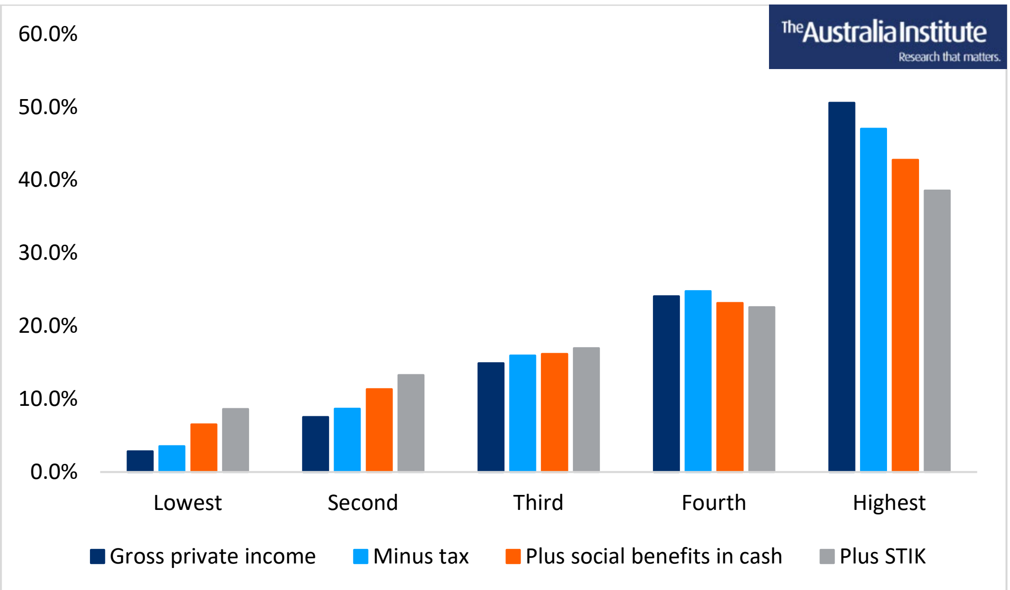
[5] Wilkinson R G, Pickett K (2009) *The Spirit Level: Why More Equal Societies Almost Always Do Better*, Allen Lane.

[6] Dabla-Norris E, Kochhar K, Suphaphiphat N, Ricka F, Tsounta E (2015) *Causes and Consequences of Income Inequality: A Global Perspective*, International Monetary Fund, 15 June, available at https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2016/12/31/Causes-and-Consequences-of-Income-Inequality-A-Global-Perspective-42986

- Through progressive taxation – taxing those on higher incomes at a higher rate than those on lower incomes
- Through the provision of means tested social assistance benefits in cash – these can include pensions, family tax benefits, and unemployment payments
- Through the provision of social transfers in kind (STIK) – these are government services such as education, health, housing, and childcare
- Through regulations, labour market policy, and civil institutions, that alter the pre-distribution of income

Using Australian Bureau of Statistics (ABS) data we can look at how effective the first three of these tools are in reducing inequality. We start with gross income which is income before taxation and without any social assistance benefits in cash or STIKs. We then look at the impact of taxation. Then the impact of social benefits in cash, and finally the impact of STIK. These are shown in Figure 3.

Figure 3: Income inequality before and after tax, benefits and services, 2017–18



Source: Authors' calculations from ABS (2019) *Household Income and Wealth, Australia*, Australian Bureau of Statistics

Figure 3 shows that private income is very unequally distributed with half of all income going to the top 20% of income earners, while the bottom 20% of income earners received just three per cent.

When taxation is included, we see that the income distribution becomes more equal. We can see that the top 20% have seen their income share fall below 50 per cent and the bottom 20%'s share has increased from three to four per cent.

When social assistance benefits in cash are added to the impact of taxation, the income distribution changes again. The top 20% share drops further to 43% and the bottom 20%'s share increases to seven per cent.

When STIK are added, inequality again decreases. The share going to the top 20% falls to 39%. This is 12% less than their share of private income. The share going to the bottom 20% increases to nine per cent, up from a three per cent of private income. This is a tripling of the bottom 20%'s share of income.

PRINCIPLES OF A GOOD TAX

Economists and policymakers have long considered the question of what to tax and how much, and while there is no consensus, the importance of evaluating our tax choices is rarely disputed. To this end, below are five principles to evaluate the strengths and weaknesses of the overall tax system and any new tax reforms.[7]

Principle 1 – Taxes should not change people's behaviour

The idea that taxes should be designed to minimise any impact on how people behave - what they buy, how much they work, etc - is widely accepted but hard to define. An efficient tax is sometimes defined as a tax that limits the change in people's behaviour or the 'distortions' the tax system introduces in individual decision making. While this may sound straight forward, without counterfactuals it is difficult to know whether distortions are occurring.

The exception is, of course, when taxes are used to discourage activities that are undesirable. For example, taxes on cigarettes or greenhouse gas emissions are designed to reduce both of these things by changing the incentives for their consumption and production. When this is the case, the tax should be as effective as possible at changing the behaviour.

Principle 2 – Tax should reduce inequality

Almost all developed countries use the tax system to address inequality and inequity. This is most commonly done by taxing people who earn the same incomes the same amount (horizontal equity) and by taxing those earning higher incomes at a higher rate than those on lower incomes (vertical equity). While these may seem uncontroversial, embedded features of Australia's tax system, the different treatment of wealth and income often undermines both vertical and horizontal tax equity. For example, income

[7] Grudnoff et al (2021) *Principles of a good tax*, https://australiainstitute.org.au/report/principles-of-a-good-tax/

from capital gains is taxed far more lightly than other income, which is advantageous to the rich who benefit more from capital gains.

Besides the moral considerations, reducing inequality through taxation has broader economic benefits. As mentioned earlier, lower levels of inequality are associated with higher economic growth. [8]

Principle 3 – Tax should be levied on those who are best able to pay

Most income tax systems around the world impose progressive taxes so that as income goes up not only does the amount of tax increase, but the proportion of tax paid also increases. This is a beneficial goal for a tax system, firstly because the distribution of goods and services by markets does not necessarily reflect merit, productivity, or the value of contribution and secondly, the marginal utility of an additional dollar is lower for higher income earners. The redistributive effect of a progressive tax system serves to address the concentration of wealth and assist with economic mobility.

While using income as a measure of those best able to pay seems straightforward, it does not account for personal circumstances. For example, some people incur expenses due to having children, others may have health problems that require expensive treatments. For these reasons, a progressive tax system should also consider capacity to pay.

Principle 4 – Tax should be simple to comply with, simple to administer and easy to understand

This principle sounds uncontroversial, but the reality is that over time Australia's tax system, like many around the world, has become extremely complex. The complexity has often come about to encourage certain activities by creating deductions or carve outs. This can have perverse outcomes more broadly for society, particularly when it happens for political reasons. For example, where law makers want to advantage certain groups which undermines fairness in the tax system.

Complexity in the tax system has various consequences including making it easier for some to minimise their tax liability, increasing the cost of compliance, and punishing the lack of financial literacy. A simple taxation system would make it harder to minimise tax and easier for individuals and businesses to understand with their obligations and access their entitlements.

[8] Ostry J, Berg A & Tsangarides C (2014) *Redistribution, Inequality and Growth*, IMF Staff Discussion Note, February, <https://www.imf.org/external/pubs/ft/sdn/2014/sdn1402.pdf>

Principle 5 – Tax should be difficult to avoid

A good tax is difficult to avoid. While a good deal of attention goes into the drafting of tax legislation to ensure taxpayers cannot easily avoid what is owed, it is not always easy to achieve.

Opportunities for tax avoidance are sometimes created by the pursuit of other priorities and principles. For example, using deductions and concessions, opportunities to disingenuously lower taxable income can be created.

Design of a tax and its interaction with other taxes is also important to consider. For example, to pay less tax it used to be common for high income earners to disguise personal income as corporate income, which is taxed at different rates and subject to different exemptions/deductions.

CONCLUSION

The Australian public demand high quality public services from their governments. In particular they are demanding more from aged care, early childhood education and care, disability care and action on climate change. They also expect governments to maintain a stable economy and keep inequality in check. Doing all of these will require a larger role for government in the future. To achieve this, we need to discuss expanding government revenue.

A discussion about how the government should raise revenue has been largely missing in Australian political debate. We need to talk about how much revenue we want our governments to collect and how they will collect that revenue in the most efficient and fair way. Instead, the debate has focused on lowering taxes and running budget surpluses.

The point of government is not to get smaller but to improve the lives of its people. If Australia wants first class services in health, education and the numerous other areas that governments operate in, then it will not achieve this by being a small tax, small government country.

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