

RETHINKING FISCAL SUSTAINABILITY IN A CHANGING AUSTRALIA: TWELVE FISCAL ISSUES FACING AUSTRALIA IN 2025

e61 Institute

Summary

To provide practical guidance of the fiscal challenges faced, and their relationship with varying policy levers, we have investigated twelve key revenue, expenditure, and state level issues that arguably require reform.

These twelve fiscal issues provide an opportunity to highlight the nature of the aggregate fiscal challenges described in this document, and provide examples about how to interpret and operationalise the policy reform principles. These twelve issues have been written in a stand-alone manner to allow a reader to focus on the specific policy issues. However, they have been grouped into three overarching categories based on the economic pressures and the nature of the policy solutions.

Federal revenue issues reflect economic and policy trends that are reducing the ability for the Federal Government to efficiently and equitably raise revenue. When faced with fiscal sustainability pressures, the efficiency of the tax system is a key factor for determining the ability to credibly meet these pressures, and the economic cost of doing so.

Federal spending issues instead reflect areas where current and future spending pressures may exacerbate Budget concerns or force an inequitable generational allocation of net receipts from government.

Finally, **State government** faces issues related to both revenue and expenses. As government fiscal risk reflects general government – combining Federal, State, and Local government pressures – risks across all levels of government are important and often under-considered in the fiscal sustainability debate.

The policies highlighted in this document reflect the policy levers that are relevant for the related fiscal issue, and where further work understanding the trade-offs associated with these policies would be valuable. They are not recommendations.

Twelve issues

Issues	Risks	Remedies
① Gaps in income tax base	High economic and social cost of budget repair	Broaden tax base
② Threats to fuel and tobacco excise revenue	Lower revenue	Evaluate other sources of user pay
③ Technological change and relative taxation of labour and capital	More untaxed revenue	Equalise treatment of capital
④ Investment distortions due to tax	Make uneconomical decisions due to tax	Corporate tax reform
⑤ High cost of capital for foreign investors	Disincentive world's best firms from entering Australia	
⑥ The shift from income transfers to in-kind services	Higher expenditure	Means testing
⑦ The growing importance of housing in capital income	Higher intergenerational inequality	Reduce concessionary treatment of housing
⑧ A fiscal burden poorly distributed across the life-cycle	Liquidity constraints on young limit their ability to invest	Potential adjustments to superannuation and HECS
⑨ State fiscal pressures	Growing state expenditures risks fiscal balance	Tie transfers to States to broad fiscal rules
⑩ Inefficient state taxes	Inefficient state tax base increases cost of budget repair	Stamp duty land tax switch
⑪ Misallocation of Federal and State service responsibilities	Misalignment in revenue raising and expenditure raise inefficiencies	Devolve responsibilities for service provision
⑫ The WA GST deal	Vertical fiscal equalisation creates perverse incentives	Equalisation of receipts

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1. Federal Revenue Issues

Over-reliance on an increasingly narrow income tax base

Falling revenue from indirect taxes has made Australia increasingly reliant on its income tax base. However, a growing capital share of income and increasing tax expenditures have conspired to narrow the income tax base, making revenue raising more difficult.

Although the Australian tax-to-GDP ratio is low by global standards, the capacity to raise additional revenue efficiently from the income base is limited – due to the ability to tax plan using trusts, concessionary treatment of superannuation savings vehicles, and a high top tax rate that is imposed at a relatively low-income level.

Future-proofing the tax system ensures that revenue raising is done in the most efficient manner – irrespective of the shocks Australia faces.

Suggested directions for reform that warrant further investigation are:

1. An increase in the rate of GST and base-broadening of the tax (to include all final good and service purchases).
2. Consistent treatment of capital income – including capital gains and superannuation contributions and accumulation.
3. Harmonisation of the taxation of trust income with the rest of the tax system.
4. Replacement of the imputation system to reduce the disincentive for foreign direct investment into Australia.

1.1 Gaps in the Comprehensive Income Tax Base

Summary

Technological and policy change is both shrinking and narrowing the income tax base in Australia. This increases the efficiency cost of funding government and leads to inequity in the tax system. Reform to broaden the Australian tax base – both through equalising the treatment of capital income and increasing the size and scale of GST – is necessary to future proof government finances.

With core spending pressures rising at the Federal and State levels there will be need to raise an increasing amount of government revenue or cut real government spending on some groups. When it comes to revenue raising there are questions around Australia's ability to increase revenue from its primary tax base – income tax. A comprehensive income tax base reflects a flow of revenue received that is generated from the use of labour or capital subtracting expenses required to generate this income. On this basis wages and salary, dividends, interest, business earnings, and realised capital gains all reflect forms of income.¹

Broad taxation of a comprehensive tax base allows the government to raise an amount of revenue with the lowest tax rate. As the efficiency cost of taxation (deadweight loss) rises disproportionately with the tax rate, a broad-based low-rate (BBLR) tax system is often seen as relatively efficient. Furthermore, treating a dollar as a dollar for tax purposes is seen as **horizontally equitable**. However, over time significant holes have appeared in the Australian income tax base.

- **Exclusion of some forms of capital income:**

- For assets held for over a year, a 50% capital gains tax discount is applied – essentially halving the income that is taxed. However, full tax allowances are still given to capital expenses which can be claimed against tax liabilities on other income sources.
- Favourable tax treatment of superannuation contributions and returns on super balances (accumulation) at concessionary rates.
- Small business tax concessions and a variety of arbitrary tax credits.

- **Gaps in the consumption tax base:**

- A clean and efficient Goods and Services Tax (GST) equally taxes all forms of final consumption within a jurisdiction. For example, the New Zealand GST only exempts or zero-rates financial transactions, the transfer of a going concern, most residential property transactions, and expenditure overseas – as these either do not reflect final consumption or do not occur within New Zealand.
- Exemptions are more common in other countries – including Australia – which leads to reclassification to avoid tax (i.e. Jaffa Cakes in the UK) and inefficient changes in consumer behaviour.

- **Personal deductions:**

- As a matter of principle individuals should be able to subtract expenses used to generate income from their taxable income. However, there are circumstances where expenses may practically be claimed when there isn't a fully taxed income source (i.e. negative gearing, personal car use).

- **Trusts and income smoothing:**

- Trusts provide an important vehicle for managing estate affairs and contractually determining the legal allocation of assets among complex groups. However, their differential tax-treatment also allows high income earners to tax plan, reducing their overall tax liabilities.

- **Mixed income and the transition to self-employment:**

- Technological change has increasingly blurred the line between labour and capital income for individuals, with major ramifications for labour market regulation and taxation.

¹ A **comprehensive** income base is distinguished from a **Haig-Simons (economic)** income base in terms of the nature of revenue. A comprehensive base generally treats the income as generated when a liquidity event occurs (i.e. the realisation of a capital gain) while Haig-Simons income include non-market transactions that generate consumption and denote that income reflects potential consumption through consumption or a net wealth change (i.e. an accrued capital gain).

- The nature of platform income (e.g. earnings from Uber, sales through Amazon, or revenue from YouTube videos) and the inconsistent treatment of both deductions and tax residency for sellers on these platforms poses a risk for traditional income tax systems as outlined in OECD, 2019.
- Importantly, by removing these individuals from the withholding system there is a risk of generally lower tax compliance.

Tax expenditures and the income tax base

The magnitude of **tax expenditures** (reflecting tax amounts that are hypothetically surrendered if the income item is treated as part of the tax base) are assessed in the annual Treasury Tax Expenditure Insights Statement (TEIS) (Australian Treasury, 2024). These expenditures reflect only the tax revenue surrendered on revenue that isn't deemed to be income given current fixed revenue and expenses – it does not assume any behavioural changes. As a result, the forgone revenue will most likely be **significantly lower than these estimates suggest**.

In the 2025 Statement, the estimate of gross tax expenditures totalled \$259bn in FY2024/25 – approximately 38% the size of total Federal Revenue. Many of these are legitimate deductions for revenue producing expenses (i.e. rental deductions) or relief for other tax expenses (i.e. local government bodies income tax exemption). These types of tax expenses should be deducted in a comprehensive tax base. Looking at the rationale above, implied tax expenditures that should be in scope reflect the following \$159.4bn of revenue:

	Tax expenditure	Share of revenue	Note
CGT	\$51.5bn – exclusion of the principal place of residence \$24.0bn – CGT discount	10.5% of current total revenue. 14.8% of current income tax revenue.	* Inclusion of main property would require allowance for expenses – depending on the size of any tax on imputed rents this will reduce net revenue.
GST	\$26.8bn	3.7% of current total revenue. 5.3% of current GST revenue.	* Financial transactions continue to be excluded from this base.
Superannuation	\$57.1bn	8.0% of current total revenue. 11.2% of current income tax revenue.	

The size of the potential **gap around deductions and trusts is more complex**. Neither are directly concessionary in nature – with deductions reflecting legitimate expenses for generating income, while trusts apply a flat rate of tax to a complex legal entity whose income doesn't easily translate to an individual taxpayer.

However, both deductions and trusts can be used by high information-high income taxpayers to manage their tax affairs and reduce tax payments (Breunig et al., 2024; Zaresani et al., 2025). If the deductions are legitimate, then the tax advantage is solely from being able to smooth income through time and avoid what may be perceived as unfair high taxation of volatile income.

But if the deductions reflect personal consumption, and if the trust income would have been taxed at a rate higher than the trust rate in the absence of the use of the trust, then this is purely a form of avoidance behaviour that is allowed by the current system.

Internationalisation of the income tax base

Tax expenditures are not the only future risk to the Australian tax base. The **growing importance of platforms** highlights an important future risk. Cross-border agreements have helped Australian tax authorities keep Australian-based revenue associated with platform activity in the tax base.

However, depending on the platform and the way individuals treat platform income, the tax base is likely to shrink. This issue is exacerbated by the fact that platforms can avoid **substantive presence** rules in the corporate tax system – even when the platform clearly does have significant presence in a jurisdiction. The OECD reforms to mitigate these trends by changing the tax treatment of multinational enterprises help somewhat, but will also increase administrative and compliance costs of the income tax system.

A broader risk to the international component of the comprehensive income tax base comes from the growing prevalence of tariffs. Outside of the direct economic disruptions associated with tariffs, and the reduced return for Australian exporters in the short-term, there is a rising risk that international tax rules will switch from an origin to a **destination basis**. Hebous et al. (2019) estimates of the winners and losers from a switch to destination based taxed noted that Australia was a large revenue loser from such a reform. Applying these estimates to the current tax base suggests that \$62bn of tax revenue is at risk from such a change (Nolan, 2025).

Position of the current income tax base

Given rising spending pressures and the growing holes in the income tax base, government revenue would need to rise from 25.5% of GDP to 26.8% of GDP in order to restore fiscal budget balance. If defence, interest, and health care expenditure risks materialise, the required tax burden would rise to 29%.

These gaps don't just directly lead to less income being raised from an increase in tax rates – they also increase the ability for individuals to adjust behaviour to avoid paying tax, further reducing tax capacity.

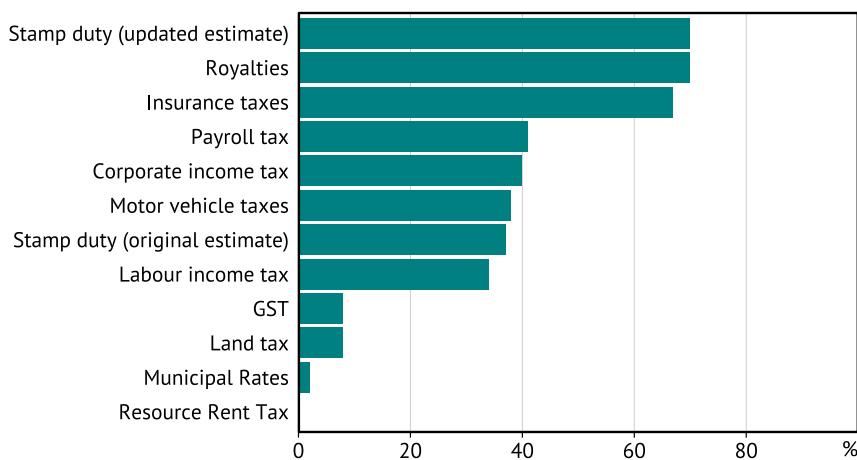
The concept that reflects this is termed the *elasticity of taxable income*. Estimates of the elasticity of taxable income in Australia in Johnson et al. (2024) find substantial shifting of income for self-employed individuals, while Breunig et al. (2024) finds that individuals also use deductions to adjust income below tax thresholds.

Such elasticities are a product of both real changes in economic behaviour and tax planning behaviour. However, irrespective of the cause, an elasticity of -0.21 (as estimated in Johnson et al. (2024) for high income earners) implies that a one percentage point increase in the tax rate would reduce the income tax base by 0.21% – leading to revenue rising by less than the one percentage point increase in rates.

Furthermore, with other tax bases shrinking the 2023 Intergenerational Report (Australian Treasury, 2023) indicates that personal income taxes will become an increasingly dominant part of the revenue base over the next 40 years. Given the higher marginal excess burden of these taxes relative to GST, fuel, and land taxes (Cao et al., 2015; KPMG Econtech, 2010; Tran & Wende, 2017) these pressures will force inefficient revenue raising from a stretched base.

Figure 1: Relative efficiency of varying tax bases

Marginal Excess Burden (cents per dollar raised)



* Estimates from KPMG (2010) report for the Australia's Future Tax System Review.

** Updated Stamp Duty Estimates used by PBO come from Cao et al (2015)

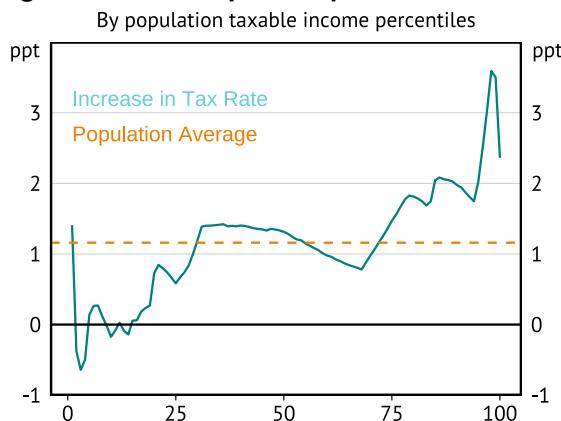
Sources: KPMG Econtech; PBO

This mix of facts speaks to the limits of higher income tax rates in raising the revenue needed to fund government spending – due to both rising deadweight loss of taxation and increasing administrative burdens.

With the income base narrowing and successive governments unwilling to look at other tax instruments there is an increasing risk that bracket creep will be used to finance future cost pressures.

Bracket creep reflects a situation where individuals average tax rates rise due to inflation – not because of higher real earnings. This means that even if your job gave you a pay rise to compensate for rising prices, government taxation would push your real take-home pay down. The relatively ad hoc consequences of bracket creep on average tax rates were documented in (Dwyer, 2025).

Figure 2: Inflation pulled up tax rates for most



* Blue line show the percentage point difference between the tax rate on taxable income for a percentile in 2022 relative to 2012.
Orange line is the average change.
Sources: ATO; e61

Average tax rates have increased across the income distribution, with the average tax rate of the median individual rising approximately 1.4ppt between 2012 and 2022. Furthermore, **current government projections rely on tax rates rising a further 2.3ppts for the average full-time worker through bracket creep.**

Stage Three tax cuts since 2022 have focused on reducing average tax rates, especially lower in the income distribution. However, this focus on reducing tax rates low in the income scale is expensive and also means that between 2012 and today average and marginal tax rates for high-income earners have risen.

Given this **we are at our limit in terms of relying on bracket creep and the taxation of high taxable income earners in order to repair the government budget.** Prior estimates from Creedy and Héault (2012) indicate that the progressive structure of the Australian tax transfer system was largely balanced in FY08/09. With the top tax bracket unchanged in nominal terms until FY24/25 (when it increased by \$10,000), it is **likely that the income bracket for the top tax rate is now at too low a level** given reasonable estimates of Australians' preference for reducing inequality and the accepted relative economic cost of such taxes.

Options for tax base repair

Bracket creep is not an efficient or equitable means for meeting the cost of rising government spending. As a result, tax brackets should be adjusted (either automatically or through principled discretionary policy making) and other forms of tax reform should be used to repair the tax base.

A common suggestion is to undertake a tax-mix switch – increasing the GST rate and reducing income tax rates.

Although income tax provides a broader base than consumption, it has three primary flaws:

1. Greater compliance and administrative costs.
2. Higher taxation of consumption in the future.
3. It embeds a distribution of the tax-burden between generations that may be seen as inequitable in a weak growth environment.

Given this there may be a **case for an increase and broadening of GST alongside lower income taxes.** Such a shift is estimated to have significant efficiency benefits due to the aforementioned lower excess burden of GST. A tax-mix switch – that is a

flat rate reduction in income taxes and increase in GST – that provides government funding of 2% of GDP would reduce the marginal excess burden of taxes by approximately \$11.9bn.

Furthermore, if we view older high wealth individuals as having contributed too little historically towards the tax take, there are distributional benefits from raising the rate of GST instead of personal income tax – as an increase in the GST rate acts as a one-off tax on existing wealth.²

However, there are two primary concerns with such a change:

1. This would change the tax treatment of the normal return on capital (by implicitly not taxing this capital return).
2. By increasing prices for illiquid consumers and given gaps in the consumption items taxed, GST can be slightly regressive in a lifetime sense.³

As a result, if the intention is to continue taxing currently taxed capital income in the same way and to achieve certain distributional outcomes, it may make sense to focus on broadening the income tax base. This could be done through:

1. reductions in the capital gains tax discount and alignment of trust and personal income taxation;
2. taxing superannuation contributions and accumulation as normal income;
3. the introduction of a dual income tax system; and/or
4. the replacement of capital income taxation with a low-rate wealth tax.

The first two options would be consistent with the principle of taxing income items consistently (comprehensive income tax), while the last two would allow for differential rates of taxation on labour and capital on a consistent base. These topics are discussed further below.

² This result can be complicated by the practical implementation of consumption taxes – where purchases made while overseas by domestic residents are excluded from the tax base, with the taxing rights allocated to the jurisdiction where the spending occurs.

³ A common view is that GST is very regressive given that – at a point in time – low-income individuals tend to borrow, and high-income individuals tend to save. However, saving is a mechanism to shift consumption through time, consumption that a GST will largely tax. As a result, a fully comprehensive GST that captured all possible consumption and did not impose liquidity constraints on people would be distributionally neutral over a person's lifecycle.

1.2 Threats to fuel and tobacco excise revenue

Summary

Technological and behavioural changes threaten revenue raised from fuel and tobacco excises. While these taxes are small relative to income and consumption taxes, they still support government revenue raising. Applying these taxes poorly risks inefficiently raising revenue – however, these taxes are not just about revenue raising and may target other social ends. Being clear on the policy intent of these taxes is crucial to inform how best to reform them, including whether, and if so how, to replace them with other taxes.

Tax revenue directly impacts the fiscal position and the sustainable level of goods and services the governments can fund. Income (personal, corporate and superannuation) and consumption taxes are by far the dominant contributors to revenue raised at the federal level. However, the next largest contributors to federal revenue are fuel and tobacco excises.

Fuel excises raised \$14.9bn in FY23/24⁴ while the tobacco excise raised \$9.7bn, though these are relatively small compared to the \$332bn raised from individuals taxation and \$141bn from company taxes.⁵ Even though their contribution to federal revenue is relatively small, it is still consequential. Without the revenue from these excises, the recent Budget surplus would have been a deficit.

The revenue raised from these taxes is expected to decline due to technological and behavioural changes. The 2023 Intergenerational Report (IGR) (Australian Treasury, 2023) highlights this, projecting that indirect taxes (which fuel and tobacco excise are the major components of)⁶ will decrease from 2.2% of GDP in FY22/23 to 1.4% in 2062–63. It's likely that such changes are accelerating quicker than projected in the IGR, as evidenced by the recent downgrade of tobacco excise forecasts by 18.5% in the 2025–26 Budget.⁷

Beyond these downward trends in revenue, there are two key considerations for excise tax design:

- 1. Variability in revenue:** Excise taxes tend to be more variable than more stable tax bases, such as income and consumption taxes. This variability may increase over time due to the drivers of some of these trends. Combined, this makes it harder for governments to plan and spend on the basis of this revenue.
- 2. Corrective nature:** Excise taxes are often there to implement a user pays system or correct for spillovers on other individuals (externalities). For these objectives, the revenue raised is not the main concern of the policy.

Fuel excise threats

Fuel excise raises revenue through an excise and custom duty on petroleum fuel (including diesel), with a rebate provided to some businesses. Excise on petrol was initially hypothecated to fund road spending in 1929, with the link changing over time, and eventually ceasing in 1992.⁸ However, the link between fuel excise and road funding is often raised in the policy debate surrounding the fuel excise. The policy goal of fuel excise has historically been to raise revenue, in part to fund road expenditures.

The fuel excise raised \$14.9bn in FY23/24, and is expected to grow by 16% over the coming four years. However, there are several underlying trends that threaten to substantially decrease the size of this excise base in future.

In simple terms, the excise base is determined by the combination of how much petrol engine vehicles are driven, and how fuel efficient those vehicles are (both household vehicles, and to a lesser extent commercial vehicles⁹).

⁴ This is in net terms. Fuel excises raised around \$25bn, however the Fuel Tax Credits Scheme provided as a rebate to certain industries to offset fuel excises cost over \$10bn.

⁵ Note, these are statutory reported figures. Due to Australia's imputation system, individuals tax receipts would be larger in the absence of company tax.

⁶ Note, the IGR analysis excludes the Goods and Services Tax, a consumption tax fully passed onto State and Territory Governments.

⁷ Budget 2025-26, BP1, Table 4.6.

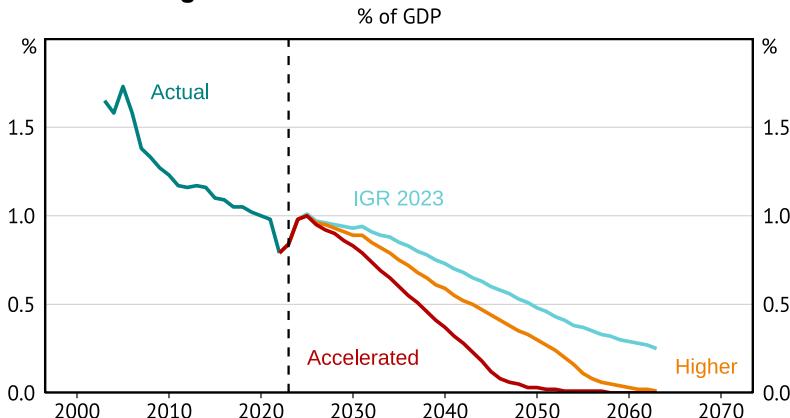
⁸ <https://www.pbo.gov.au/about-budgets/budget-insights/budget-explainers/fuel-taxation-australia>

⁹ Households and business on-road light vehicles pay the full excise amount. Off-road business vehicles receive Fuel Tax Credits that fully offset the excise. On-road business heavy vehicles receive partial Fuel Tax Credits to pay a lower effective excise rate.

In the near term, improvements to fuel efficiency of petrol vehicles will reduce per-kilometre fuel consumption.¹⁰ This improved efficiency will combine with the decreasing trend in distances driven, which may be further exacerbated by the switch to hybrid work.¹¹

In the longer term, the replacement of petrol engine vehicles with electric engine vehicles represents a threat to fuel consumption, and thus fuel excise revenue. If the speed of electric vehicle uptake is quicker than anticipated, with uptake still modest in Australia compared to other developed nations, there will be downward pressure on fuel excise revenue. This is highlighted in Figure 3. Under current forecasts, fuel excise revenue will decrease from 1.01% of GDP in FY24/25 to 0.25% in FY62/63. However, under an accelerated take-up of electric vehicles, fuel excise revenues will be effectively 0% by the early 2050s.

Figure 3: Forecast fuel excise revenue



Source: Treasury

Tobacco excise threats

Tobacco has been subject to excise and customs duty in Australia since Federation. It rose to particular prominence in the 2010s when it was increased significantly as a deterrence to smoking rates (alongside a range of other policy tools), increasing the cost of a packet of cigarettes by around \$10 over an eight-year period.¹² In FY23/24, the tobacco excise raised \$9.7bn.

Increases in tobacco excise have historically had the primary goal of drastically reducing, and eventually eliminating, smoking rates.¹³ This was partially motivated by negative spillover impacts from passive smoking and (publicly funded) healthcare costs, as well as concerns about the smoker's own welfare from an addictive substance.¹⁴

Revenue raised was not historically a key goal of the excise, rather a secondary benefit. However, as excise rates increased over time the revenue raised increased, with the increase in excise rates more than offsetting the decreased consumption of tobacco products (Figure 4). Daily smoking rates declined from around 20% in 2001 to 8% in 2023.¹⁵ This is a **deliberate decrease in the size of the potential revenue base through achievement of the primary policy goal**.

10 The implementation of the New Vehicle Efficiency Standard will likely lead to further decreases in expected fuel consumption, however this will depend on imported fleet changes and the relative prices of different vehicles.

11 <https://www.abs.gov.au/statistics/industry/tourism-and-transport/survey-motor-vehicle-use-australia/12-months-ended-30-june-2020>

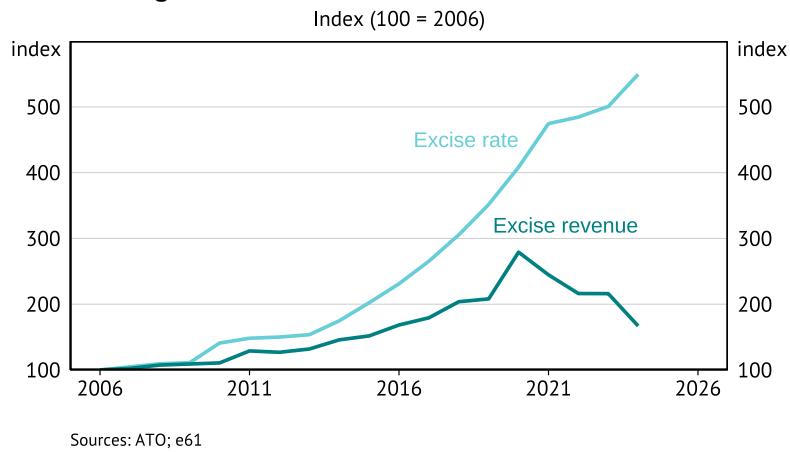
12 <https://treasury.gov.au/publication/p2019-T392185>

13 <https://www.abc.net.au/news/2010-06-15/cigarette-tax-hike-laws-passed/867710>

14 <https://oia.pmc.gov.au/published-impact-analyses-and-reports/25-cent-tobacco-excise-increase-post-implementation-review>

15 <https://www.aihw.gov.au/reports/smoking/tobacco-smoking-ndshs>

Figure 4: Tobacco excise rate and revenue



Recent Budgets have seen significant downgrades in forecast tobacco excise revenue. In the 2025–26 Budget, forecast revenue was downgraded by \$6.9 billion over four years. This continues a downward trend in revenue, from \$16.3 billion in FY19/20 to \$12.6 billion in FY22/23, to an expected \$7.0 billion in FY25/26.

The downward revisions are not from unexpected decreases in smoking rates and volumes. Rather they are from the increased use of illicit tobacco. This is **a decrease in the size of the revenue base, without achievement of the primary policy goal**.

The uptake of illicit tobacco has predominantly been driven by differential prices for licit and illicit tobacco. Initial reductions in smoking rates from higher prices (through increased excise) affected those with more price-sensitive (elastic) demand. As smoking rates have declined, we would expect the remaining group to be less price-sensitive and thus require higher excise rates to disincentivise smoking.

However, the illicit price of tobacco acts as an effective price ceiling on licit tobacco for individuals, where this price ceiling varies based on the cost for that person from breaking the law. As the licit price rises, more people will be willing to switch to the illicit substitute as the licit price crosses their individual price ceiling. Concerningly, as the size of the illicit market grows, the scale this brings allows them to reduce their prices, further allowing the tobacco black market to grow through time.

To help mitigate this impact the Government is spending additional money on compliance activities, increasing the effective price of illicit tobacco. However, it's unclear how effective this will be, relative to the cost of compliance activity. There may also be a fixed cost of first using illicit tobacco (e.g. from identifying a supplier, assuring quality, and engaging with unknown risk), which some have now incurred thus reducing the effective price of illicit tobacco and how those consumers view the price differential with licit tobacco.

Options related to the future of excise tax

The best policy response to the threats identified above will depend on the goal that policymakers are aiming to achieve. This will likely differ across fuel and tobacco excises.

Fuel excise: If the goal of replacing future declines in the fuel excise is to mitigate the revenue impacts, then the best option will be to increase tax revenue from the best available source. This is not necessarily transport-based, rather the marginally least inefficient revenue source, such as a land tax.

However, if the policy aim of replacing fuel excise is to introduce a policy that efficiently addresses externalities, then there are three key negative externalities related to fuel excise that policy should consider:

1. **Road degradation and maintenance:** When vehicles use the road, they add to its wear and tear and degradation, which incurs maintenance costs. While the benefit of the road use is accrued by those driving on it, with more benefit accruing to those who drive more, the cost of maintenance is spread across taxpayers.
2. **Emissions and pollution:** When vehicles use petrol, it creates carbon emissions and other pollutants in the atmosphere. This has a negative spillover to those affected by those pollutants, both in the immediate area as well as more broadly (e.g. over time through climate change).

3. Congestion: When vehicles use roads they take up space, potentially causing congestion if other vehicles are travelling on the same road at the same time. The cost on other travellers from own road use (congestion) is not accounted for by individuals, leading to negative spillovers onto other road users.

The best-placed policy response will depend on the externality policymakers are aiming to address.

To account for the externality of road use, degradation and maintenance, and align the costs with those who benefit, a key option to explore is a broad-based road user charge (RUC).

A RUC is a fee charged to vehicle owners or drivers based on their actual use of road infrastructure, typically calculated by distance travelled. Australia currently applies a quasi-RUC implicitly on households and small businesses through the fuel excise, and explicitly on heavy vehicles through fuel excise and tax credits (at a lower rate than households). However, this is a petrol consumption-based charge.

A RUC that replaces the fuel excise could be distance-based to better reflect the cost incurred to transport infrastructure. It would be charged at a rate per kilometre travelled, with rates able to be varied by vehicle weight to reflect increased road impacts from larger vehicles. Such charges have been implemented internationally, for example in New Zealand.¹⁶ It is likely that the Federal Government would need to implement any RUC, given recent High Court rulings against implementation by a State Government.¹⁷

To address the negative externality of emissions and pollution from petrol engines, policy would focus on a comprehensive and consistent approach to pricing the negative impact of these. An option often recommended by experts to efficiently achieve this is a broad-based carbon price mechanism, which implements a tax on carbon emissions that reflects the size of their negative externality. This approach would also ensure consistency in taxation between different activities that produce emissions and pollution, rather than just on vehicle users.

To account for the negative externalities of congestion from road use in peak periods (through key transport corridors), policy should focus on a separate user pays system of congestion charging. Congestion charging is a form of road pricing that charges drivers a fee for entering or traveling within designated areas during peak traffic periods, with the goal of reducing traffic congestion by making drivers pay for the social costs of their travel during busy times. Congestion charging can be varied by time of travel, and specific location of travel, to best target the negative externality from key congestion points.

Tobacco excise There are two key policy aims policymakers are considering when examining reform of tobacco excise:

1. Reducing smoking rates.
2. Raising revenue.

The primary policy aim will then dictate the best response, noting there may be some overlap in responses.

If the policy goal is reducing smoking rates, then a health evidence-based approach should be followed. Tobacco taxation would be only one policy tool used, with excise rates needing to be calibrated based on other policy settings (it could plausibly be increased or decreased based on what the other settings are).

If the policy goal is raising revenue, then policy should investigate the excise rate that maximises revenue. Given recent switching to the illicit market in the face of higher excise and prices, it's likely a lower excise rate would maximise revenues (noting this could lead to increased smoking rates). Additionally, applying equal regulation and taxation to other similar products and behaviours would improve the efficiency of taxation, decreasing the regulation-created distortions between products and mitigating potential black market activity.

Increased compliance and enforcement activities may also be beneficial, depending on their cost and effectiveness. It would be valuable to evaluate recent programs that have increased funding for such activities against illicit tobacco to better understand their cost effectiveness.

¹⁶ Note, the New Zealand RUC is applied to diesel, hybrid and electric vehicles. Non-diesel petrol vehicles have fuel taxed at source.

¹⁷ <https://www.theguardian.com/environment/2023/oct/18/victoria-electric-vehicle-tax-high-court-ruling-could-impact-nsw-wa-western-australia>

1.3 Technological change and the relative taxation of labour and capital

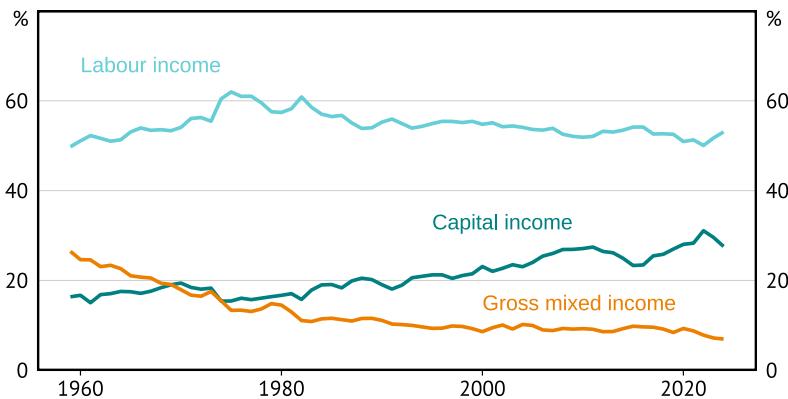
Summary

Over the past 50 years there has been a gradual shift in the way people earn money – with the share of income earned from capital rising considerably. Gaps in the comprehensive income tax system due to policy and technological change imply that this capital income is more lightly taxed than labour income, increasing pressure on wage earners to pay for government expenditure.

Movements away from taxing full comprehensive income has also led to differential treatment of labour and capital income. As well as making the income tax system less efficient at raising revenue for government expenditure, this trend also interplays with ongoing rapid technological change and the accumulation of wealth.

Figure 5: Labour and capital income

Share of total factor income



* Labour income is measured as compensation of employees. Capital income is gross operating surplus of private corporations and excludes government and housing.
Sources: ABS; e61

The economic literature suggests that capital income should be taxed at a lower rate than labour income. The reason for this is that the taxation of the normal rate of return on capital leads to double taxation of future consumption relative to current consumption. In other words, when the return on capital is taxed people choose to spend now rather than save.

At one extreme theoretic studies (Atkinson & Stiglitz, 1976; Chamley, 1986; Judd, 1985) suggest that capital income should be excluded from the income base, or as argued in Kaldor, 1955 that the appropriate tax base should be expenditure.

However, positive capital taxation has remained in place for three reasons:

1. Capital income is more unequally distributed than labour income, allowing the government to target equity goals through its taxation – a result that Straub and Werning (2020) explain is reinforced by the fact the intertemporal elasticity of substitution (savings response to interest rate changes) is below one in most countries.
2. Some individuals can reclassify income from labour to capital, allowing them to avoid taxation of legitimate labour income. Preventing this has administrative and compliance costs.
3. With heterogenous returns to capital associated with varying investment opportunities, optimal capital income tax is greater than zero (Gerritsen et al., 2025).

Taxation of capital

When the timing of an individual earning and using income differs we can think about the system including three potential period to tax: 1) When the initial income is earned, 2) when a rate of return is received from holding that income, and 3) finally when the income is spent. If we taxed at all three of these stages we would term the tax system TTT (taxed-taxed-taxed), while if we exempted all three stages we would term it EEE (exempt-exempt-exempt).

A comprehensive income tax is often termed a TTE tax system – as we tax the income when initially earned and as it accumulates, but not in the withdrawal/consumption phase. The **double taxation** reflects the fact there are two T's in this description.

The accumulation phase is complicated by the nature of the **return to savings**. Part of the return is the **normal rate of return** – the return required to undertake the investment. However, part may reflect a **supernormal return** or rent associated with the investment opportunities that individual has above others.

Although the taxation of the normal rate of return is double taxation of consumption, the taxation of the supernormal return is not.

Artificial intelligence alongside a number of other labour-saving technologies could boost capital income shares in the future. By design the current tax system does tax both labour and capital income – but with the noted gaps in capital income treatment earlier. As a result, a surge in capital income does not immediately threaten the tax base in a comprehensive tax system.

However, as capital income is more unequally distributed than labour income this does generate concerns about **vertical equity** and the nature of the tax and transfer system. Furthermore, as **capital income is more mobile** than labour income or consumption, the shift in the income tax base towards capital income will make it more difficult to raise additional revenue and increase the marginal excess burden of income taxes.

This is not just a tax question. Growing concentration of income and potentially labour substituting technical change can reduce opportunities for individuals who are not endowed with capital to start with. Although a self-perpetuating cycle of rising inequality as stated in Piketty (2013) is not currently a feature of the Australian economy, significant technological change could make this a reality.

Increasing concentrations of wealth and more limited opportunities for mobility may require the structure of government tax and spending policies to change.

Options for a growing capital share

A rising capital share is a challenging issue, and provides a key counterpoint to policy recommendations to introduce a lower rate of tax on capital income (i.e. dual income tax, tax-mix switch to GST, allowance for corporate equity).

However, the appropriate intervention depends on the particular concern related to a rising capital share. The four concerns raised are that:

1. capital income is more unequally distributed than other forms of income,
2. wealth and associated capital income can be inherited generating intergenerational inequality,
3. the “unearned” income from accumulation will grow more quickly than “earned” income from work and active investment,
4. technology will make the capital income base more mobile.

The first option would be **consistent treatment of capital income sources** in order to reduce avoidance opportunities – these changes are consistent with the recommendations in the narrowing income tax base section.

Alternative options are to tax the stock rather than the flow associated with capital income at varying points in time:

1. **A combination of inheritance/estate/gift taxes:** This would tax the implied market value of large income transfers from one family member to another.
2. **Wealth tax:** This would involve an annual tax on the implied market value of the asset above a de minimis threshold, mirroring the application in Norway and recommended by the UK wealth tax commission (Advani et al., 2020).

- The argument for a wealth–capital income tax switch depends on the prevalence of economic rents, administrative and compliance burden, and whether the investment choices of potential entrepreneurs or the wealth of existing wealth holders is more mobile as highlighted in Guvenen et al. (2023).

However, none of these options are able to mitigate the tax base threshold associated with growing cross-border mobility of capital income and by increasing rates of taxation may exacerbate it.

1.4 Investment distortions due to tax

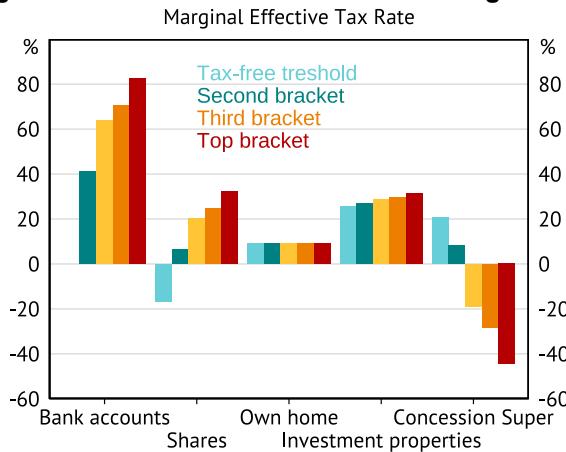
Summary

The differential treatment of household and business savings based on the savings vehicle used significantly distorts investment decisions in Australia. Reducing these differences would improve the equity of the tax system, ensure that the relative cost of capital more closely reflects the relative economic use of an asset, and encourage greater asset diversification among Australian households.

The Australian tax system aims to treat a dollar as a dollar when assessing someone's tax liability. As a result, both labour and capital income are bundled together when assessing a tax liability. However, **the return on saving** is taxed differently depending on where a household decides to save and the amount of other income that they have.

Work by Varela et al. (2020) highlights the wide variety of marginal effective tax rates (METRs) faced when deciding to invest in varying asset classes. An METR tells us about the incentive an individual has to save an extra dollar in a given savings vehicle – with the METR the proportion of the pre-tax rate of return on that asset that is lost to the individual due to taxation.

Figure 6: Tax differences influence saving choices



* Tax rates used across brackets are: 0%, 21%, 34.5%, 39%, and 47%

Source: Varela, Breunig, and Sobeck (2020), Table 3.1

These differences in marginal tax rates provide a wedge between the rates of return necessary for an individual to invest in a certain asset class. If the METR is 20% for one asset and 0% for another, the pre-tax return on the former asset would need to be at least 25% higher for the individual to invest in that asset.

The **wedge on household savings** influences the investment portfolio of households, adjusting the risk profile faced and generating excessive savings in asset classes with lower tax treatment. The clearest distinction is the favourable treatment of superannuation – with negative METRs for long-life concessionary superannuation contributions. Furthermore, even non-concessional superannuation faces a METR of 20% – well below the marginal rate faced by most other asset classes.

Another asset with low METRs is investment in a person's own home. The beneficial treatment of purchasing one's own house is three-fold:

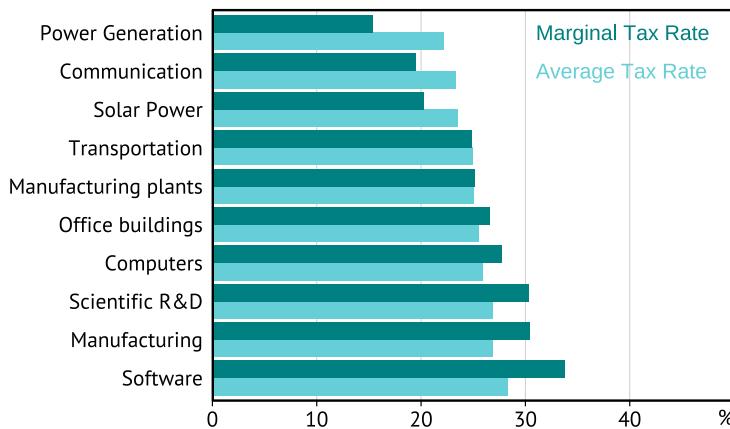
1. the exclusion of capital gains from taxable income,
2. the exclusion of imputed rent from the tax base,
3. the exclusion of the full value of the family home from asset testing for income transfers (e.g. the aged pension).

The lack of deductions for housing costs and the imposition of stamp duty and local body rates does mean there is a small positive tax rate on this asset – but it is much lower than for many other assets.

The clear high-tax savings vehicle is low-risk saving in a bank savings account – which is taxed at full personal rates. This distortion is further exacerbated by mortgage offset accounts – accounts that essentially allow an individual to tie a savings account to housing wealth, with any income generated untaxed. As a result, even if an individual does value liquidity they are incentivised to shift these funds into housing wealth rather than other forms of saving.

Figure 7: Taxes influence type of business investment

Implied effective tax rate for business investment



* Based on 2015 tax system as modelled in Hanappi (2018)
Source: OECD

The **wedge on business investment** influences the productive structure of businesses. The taxation of corporate income involves depreciation allowances that time the tax expense to match the timing of income – not when the expense is undertaken. However, if these allowances differ from the true economic rate they can also create distortions.

These corporate wedges are exacerbated by the gap between the corporate tax rate and the top personal tax rate, alongside the debt bias inherent in the corporate tax system.

As estimated in Hanappi (2018), during 2015 both average and marginal tax rates were highest for software investments, at 28% and 34% respectively. However, the increase in the instant asset write-off since that time, alongside accelerated depreciation during the COVID-19 pandemic, will have reduced these rates for such investments.

Overall, the distribution of business investment rates is relatively narrow compared to other OECD countries. As a result, the distortion in productive practices is limited relative to peer countries. Furthermore, Australian evidence from Win et al. (2025) suggests little short-term response to the user cost of capital on business investment.

These are two separate tax wedges that cumulatively incentivise investment in less productive activities – one in terms of the broad assets that households will finance, and another in terms of the set of inputs businesses will use to produce goods and services.

Across both the household and firm level **current system more heavily taxes more liquid, shorter-duration asset classes**. This incentivises individuals to hold less liquidity than they would otherwise need for lifecycle shocks (e.g. health, job-loss), and make choices that inferior in a pre-tax sense solely due to the tax-advantaged status of the investment.

Options to reduce investment distortions

Under the current income tax system the following set of reforms would lead to equal treatment of varying asset classes:

- Consistent treatment of capital gains between asset classes.
 - Taxation of imputed rent and capital gains on owner-occupied property, alongside allowances for expenses (the Dutch and Swiss model).
 - Taxing superannuation contributions and accumulation consistently with other personal income. This could reflect TTE or EET treatment, and may allow a concessionary allowance due to compulsion.

Furthermore, a reform that would both ensure equal treatment of all asset classes and reduce the effective tax rate on the normal return to business investments would be immediate expensing of capital investments as outlined in Sobeck et al. (2022). However, such a reform would treat the normal rate of return differently relative to financial investments and investments in non-depreciating assets (i.e. bank deposits, land purchases).

1.5 High cost of capital for foreign investors

Summary

The imputation system places a high average tax rate on foreign investment in Australia, dissuading the entry of large foreign investors with unique managerial and organisational practices. Reducing this tax liability could encourage the entry of economically viable foreign enterprises, including valuable spillovers in productive processes in Australia.

Australia is relatively unique in its corporate tax settings, with corporate income taxed at relatively high rates relative to other countries. For a domestic investor this tax burden is relieved through the use of franking credits, reducing the final tax paid to the personal income tax level. However, for a foreign investor franking credits cannot be used to reduce their international tax liabilities – and as a result they face a higher tax burden than they would investing in most other countries.

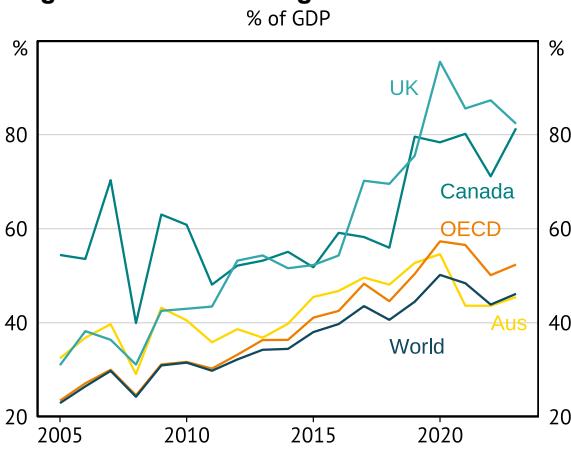
In situations where the foreign investor is the marginal investor (i.e. when domestic savings available are insufficient to fund the domestic investment), the incidence of this corporate tax falls fully on Australians – through lower wages and a higher cost of capital.

However, if a foreign firm is not the marginal investor due to the imputation system (i.e. due to home bias in Australian's investment decisions) there are still potential efficiency costs along two margins – inefficient use of Australian capital and the missed opportunity to bring foreign ideas and managerial practices into Australia.

In both cases, the double taxation of foreign direct investment (FDI) disincentivises the entry of foreign capital that is tied up with ideas and knowledge that are unavailable in Australia. If these ideas and practices have positive spillovers on the productive process of domestic firms, as suggested in Productivity Commission (2020) and Keller (2021), then the efficiency cost of this taxation may be even higher.

Furthermore, the home bias it generates for Australian investors leads to Australians building a portfolio that is more heavily weighted towards Australian assets than it would be in the absence of the system.

Figure 8: Inward Foreign Direct Investment



Sources: e61; OECD

The imputation system provides an elegant solution to concerns about the double taxation of corporate income. However, as described in Sobeck et al. (2022) the investment benefits of this system are limited in practice, and there are other ways that Australia could more broadly support business investment without this system.

More broadly, there are also significant non-tax barriers to FDI that may exacerbate these issues, as highlighted in Productivity Commission (2020).

Options to reduce the cost of capital/home bias

Sobeck et al. (2022) outline multiple potential reforms for the corporate tax system:

- **Comprehensive Business Income Tax (CBIT):** This would mirror the current corporate tax system but disallow interest payments as a tax expense.

- **Allowance for Corporate Equity (ACE):** This would mirror the current corporate tax system, but allow a notional interest expense to be claimed against business equity.
- **Allowance for Corporate Capital (ACC):** This reform would both disallow direct interest expenses, and then allow a notional interest expense on both debt and equity (a capital allowance).
- **Cash Flow Tax (CF):** A more significant reform to the corporate tax system in order to tax it on a cash flow, rather than income, basis.

They recommend the implementation of an ACE system, alongside a dual income tax system (differing personal tax rates on capital and labour income), for their preferred reform for the taxation of savings overall – the introduction of a dual income tax would involve ending the current imputation system.

The introduction of a dual income tax instead of a comprehensive personal income tax system with imputation credits would lower the costs of capital in circumstances where foreign investors are the marginal investor. Furthermore, the reduction in marginal tax rates in the ACE system would also encourage investment.

By lowering the cost of capital such reforms may help boost investment and wages. If the reform is funded through increases in less distortionary taxes (i.e. land and consumption taxes), the long-term increase in economic output will support a more sustainable fiscal position.

However, a key shortcoming of such reform would be surrendering the higher level of taxation of location-specific rents from foreign holders of Australian capital. Conceptually this could be a major issue for Australia given the importance of the mining and finance sectors.

Treasury estimates from Rimmer et al. (2014) indicate that, even with allowances for such rents, the marginal excess burden of corporate tax is still substantially higher than for other personal income taxes and consumption taxes. In this context the benefits of corporate tax reform appear to outweigh the costs.

2. Federal Spending Issues

The lost tradition of supporting those most in need

Rising universalism in government transfers combined with an ageing population is increasing government expenditure. Many of these spending decisions have been made in isolation for political expediency, instead of taking into account a systems view of the type of supports available and who is most in need of support – or which spending would have the greatest benefit.

These spending pressures are in part the product of fiscal habits built up when population and productivity growth was stronger. This weaker growth increasingly places a higher burden on future workers to fund the lifestyles of current Australians – a potentially unfair intergenerational transfer that needs to be faced.

Suggested directions for reform are:

1. A system-wide review into government transfers to understand the full distributional consequences of the combined income support and social transfer in-kind systems.
2. Increased means testing of government transfers, especially in health and aged care.
3. Adjustments to the HECS and compulsory superannuation system to reflect liquidity needs when young.

2.1 The shift from income transfers to in-kind services

Summary

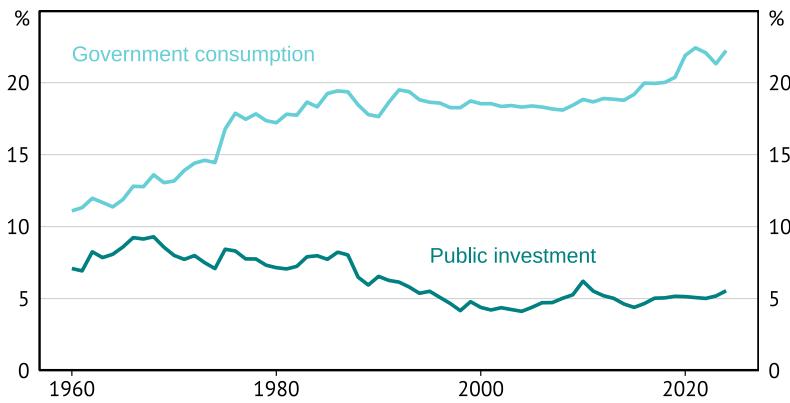
Australia's fiscal system has shifted from tightly targeted cash transfers towards broad-based in-kind social spending, with programs like the NDIS, Medicare, and childcare now outweighing direct payments. While these services are essential, their broad reach and rising costs have made the system less progressive and risk undermining its historical strengths in fairness and efficiency.

Australian fiscal policy has undergone a quiet but significant transformation in recent decades. Once defined by its highly targeted cash transfers aimed at supporting low-income households, **the system has increasingly shifted toward broad-based in-kind social spending**. This change reflects a broader trend in political and policy priorities, and it raises critical questions about the fairness, efficiency, and sustainability of the Australian welfare system.

Historically, Australia was distinguished by a small government footprint coupled with highly effective redistribution through means-tested payments. Programs like age pensions, family payments, and unemployment benefits were tightly focused on need, delivering significantly more assistance to the lowest-income households. This targeting made Australia's fiscal system both fair and cost-effective.

Figure 9: Public demand

Share of GDP

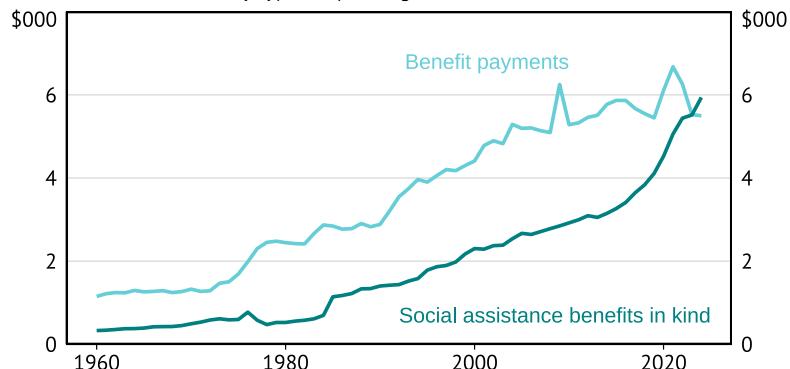


Sources: ABS; e61

However, recent trends show a steady erosion of this model. **Government consumption of goods and services now accounts for close to one-quarter of the economy, with growth over the past decade driven by a strong rise in real spending on in-kind social assistance benefits** such as the NDIS, Medicare, aged care, and childcare. In fact, these in-kind benefits exceeded cash payments for the first time in FY23/24.

Figure 10: Real government spending per capita

By type of spending; 2023/24 dollars



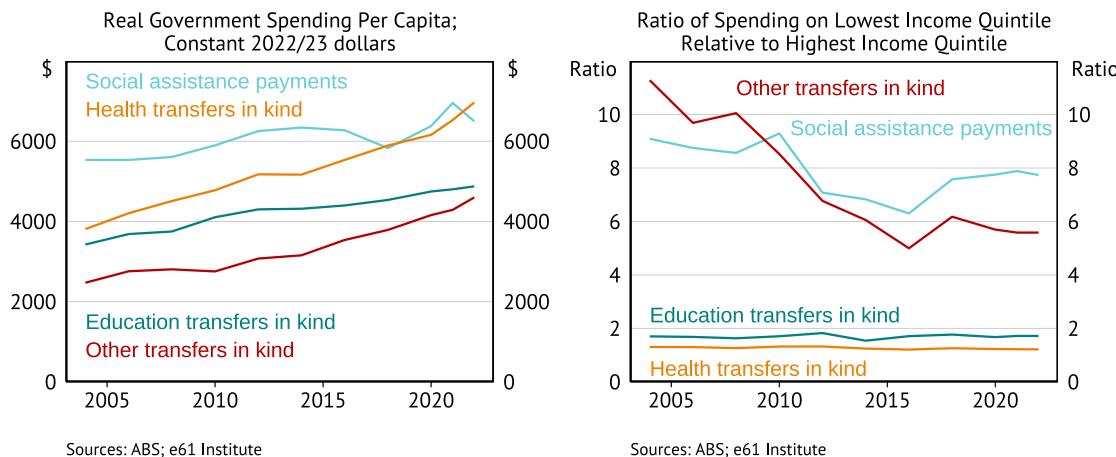
* Social assistance benefits in kind includes services provided by the government that are basically free. These include the reimbursement of pharmaceutical costs under the PBS and pre-paid supports in NDIS plans. Benefit payments are means-tested payments to households, such as the age pension and JobSeeker payment.

Sources: ABS; e61

Universal transfers are more unequally distributed

These services, while essential, are far less targeted. **Their benefits accrue broadly across income levels, often providing substantial subsidies to middle- and higher-income households.** For example, social assistance payments are about 8 times more likely to go towards people in the bottom income quintile compared to the top. In contrast, in-kind transfers of education and health (e.g. public hospitals) are only twice as likely to go towards people in the bottom income quintile relative to the top (Rankin & Nolan, 2025).

Figure 11: In-Kind Transfers have grown and are less targeted



This shift in spending priorities is driven in part by an explicit targeting of need, with the NDIS trying to relieve the income burden associated with a persistent disability.

However, **the broad application of many of these schemes is often more a product of electoral incentives rather than need.** In-kind expansions—such as universal bulk billing or childcare subsidies—tend to be more politically appealing than boosting targeted payments like JobSeeker. Yet the overall result is a less progressive system. In-kind programs are also more complex to administer, involving the creation of publicly subsidised quasi-markets that are prone to inefficiencies, provider capture, and escalating costs.

Together, **these changes suggest a structural reorientation of Australia's welfare state – from one focused on income-based support toward a broader, less progressive model of social provision.** Without deliberate reform, this trajectory risks undermining the very strengths that once made Australia's fiscal system a model of fairness and efficiency.

Options for reforming in-kind transfers

The more limited **targeting efficiency** of social transfers in kind leads to a larger welfare system that does less to reduce poverty. **Means testing** in a manner that recognises that the individual receiving the in-kind transfer may require more income in order to meet a reasonable living standard, would reduce the fiscal cost of these schemes while ensuring that those who can look after themselves do.

The main shortcoming of such means-testing is the high effective marginal tax rates that this creates. In other words, the withdrawal of support makes it unattractive for individuals to work, or disincentivises full-time work.

However, many of these universal payments (e.g. aged care, NDIS) are likely to have smaller labour supply effects. Furthermore, even for those where labour force participation is a major concern, such abatement of support can be, and has been historically, phased in (e.g. child care).

2.2 The growing importance of housing in capital income

Summary

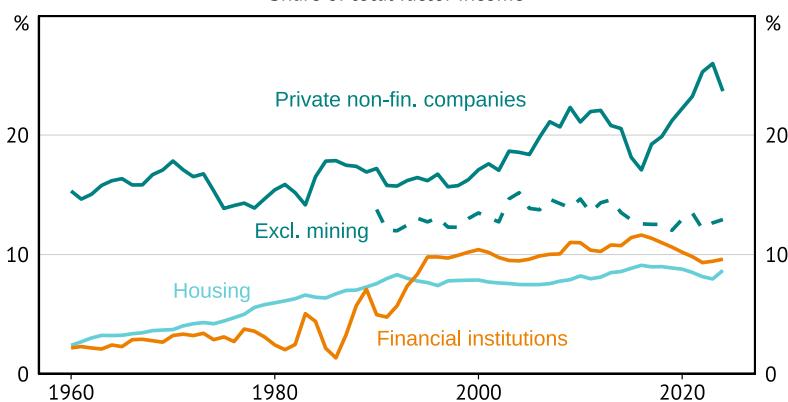
Housing has become a major and increasingly untaxed source of capital income in Australia, largely due to the non-taxation of imputed rent. This disproportionately benefits older households that own their homes outright. This shift has significant implications for intergenerational equity and raises important questions about the fairness and sustainability of the current tax system.

There have been significant changes in the composition of wealth and capital income in Australia over recent decades, with important implications for tax settings and reform.

Alongside the mining and finance sectors, housing now accounts for a large and growing share of capital income in Australia. *Housing capital income* includes both rental income received by landlords and imputed rent – the estimated rental value homeowners effectively receive by living in their own homes. While landlords pay tax on rental income, homeowners do not pay tax on imputed rent, making this a substantial tax concession. Indeed, all the growth in housing capital income in recent decades has come from untaxed imputed rents.

Figure 12: Capital income

Share of total factor income



* Capital income is measured as gross operating surplus. Government sector is excluded.
Sources: ABS; e61

This shift has important implications for the intergenerational compact, as much of the increase in housing capital income has gone to older households. Several forces underpin this trend:

- Older Australians make up a growing share of homeowners, driven by an ageing population and falling rates of home ownership among younger people.
- Among older homeowners, a rising share of income now comes from imputed rent.
- Income has increasingly flowed from younger renters to older landlords through rising rents (relative to total spending).

Taken together, these trends mean that younger Australians are paying more in rent while older Australians benefit from increasing untaxed housing wealth.

It is a historical quirk that Australia taxed imputed rent until 1923. At that time, homeowners were required to include the estimated rental value of their homes in taxable income—just like landlords. This was consistent with the principle of taxing all forms of income, including non-cash (in-kind) benefits. The tax was abolished in 1923 amid broader reforms, partly due to political resistance, administrative challenges, and a desire to promote home ownership.

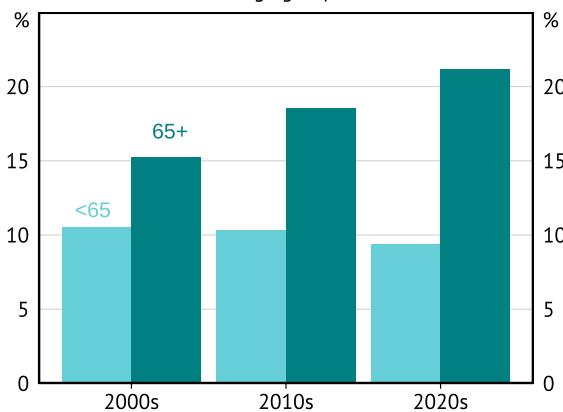
But a century later, with housing now such a large share of national wealth—and a key driver of intergenerational inequality—it may be time to reconsider how we tax housing wealth.

Some potential options for reform include:

1. **Tax owner-occupier housing income:** Introduce a system that taxes both imputed rent and capital gains for owner-occupied housing, while allowing deductions for housing-related expenses, such as mortgage payments. This would bring the tax treatment of homeowners more in line with landlords and better reflect economic resources available to households.

Figure 13: Housing capital income

Share of total household disposable income; by age group

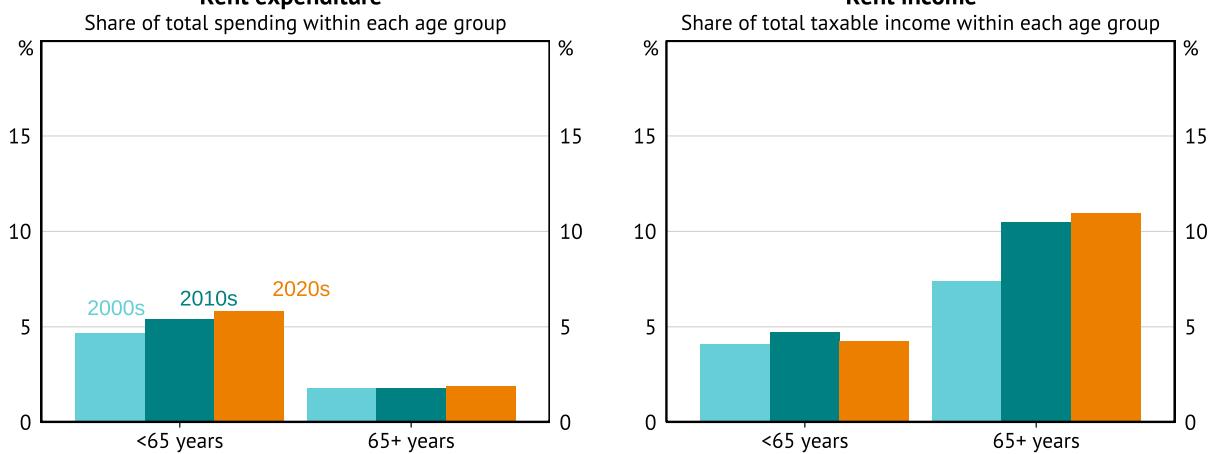


Sources: ABS; e61 Institute

Figure 14: Average rent spending and income by age group

Rent expenditure*

Rent income**



* Equivalised rent spending sourced from the HILDA Survey.

** Personal rental income sourced from ATO sample files.

Sources: ATO; e61; HILDA Survey Release 22.0

2. **Land tax:** Implement a progressive land tax that applies to all landowners, including those occupying their own homes. Unlike property taxes, land taxes do not discourage housing supply and are harder to avoid, while capturing some of the unearned windfall gains from rising land values.
3. **Reform capital gains exemptions:** Phase down or cap the capital gains tax exemption on principal residences above a certain value threshold, to better target tax concessions and reduce distortions in investment.
4. **Means-testing pensions to include owner-occupied dwellings:** Incorporate home equity into eligibility assessments for age pensions to ensure that public support is better targeted and reflects true household resources.

2.3 A fiscal burden increasingly poorly distributed across the life cycle

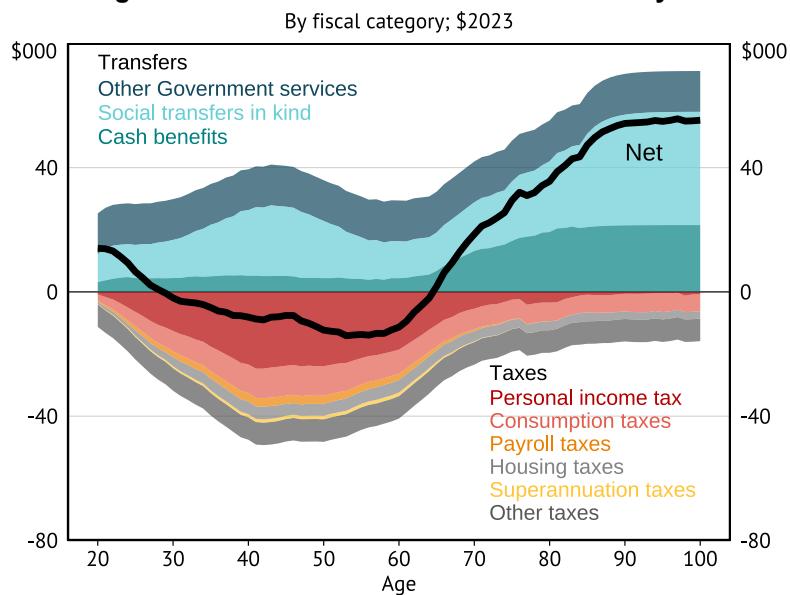
Summary

Over a person's lifetime their capacity to pay tax, and when they pay it, changes. However, these differences have increased due to growing financial pressures on young people and the evolving nature of how people earn income. Including imputed rents, Australians over the age of 60 now have post-tax and transfer incomes that are nearly 80% higher than those aged 18 to 30. Yet policy still requires younger Australians to save 12% of their income for retirement, just when many are trying to buy their first home, pay off their student debt and start a family.

Australia's fiscal system is structured so that the amount people contribute changes over their life cycle. Young Australians generally receive more in public services, such as education, than they pay in taxes. Working age Australians contribute more in taxes than they receive in services. In retirement, people generally again become net recipients of public support, such as through aged care, healthcare and the age pension.

However, there are additional fiscal systems that further restrict the income available for young and working age Australians to use now (i.e. a reduction in liquidity). Superannuation requires an individual to contribute 12% of their earnings to a compulsory savings vehicle that they largely cannot access until retirement, while student loans include income-contingent repayments that take up to 10% of an individual's take-home pay.

Figure 15: Taxes and transfers over the life cycle



Source: Varela, Breunig and Smith (2025)

Such a tax and transfer system imposes a liability when your earnings are high and returns money and services when your earnings are low. This type of system helps individuals smooth their lifetime consumption in the presence of imperfect capital markets.

But due to two long term trends this system may be making it more difficult and/or costly to smooth their lifetime consumption – by taking too much when people are young and leaving some people with too much when they are old.

Changes to how and when Australians earn income

How Australians earn income has changed over the past 30 years. Income from capital gains on housing, imputed rent and superannuation returns has increased from 33.4% of total income between 1993 and 2003, to 37.3% between 2013 and 2023. At the same time, wage and salary income has fallen from 56.6% of income to 52.4% (Varela et al., 2025).

This shift has also changed the distribution of when Australians earn income over their life cycle. Australians over the age of 60 have seen the largest gains, while Australians under the age of 30 have seen the smallest. Australians over the age of 60

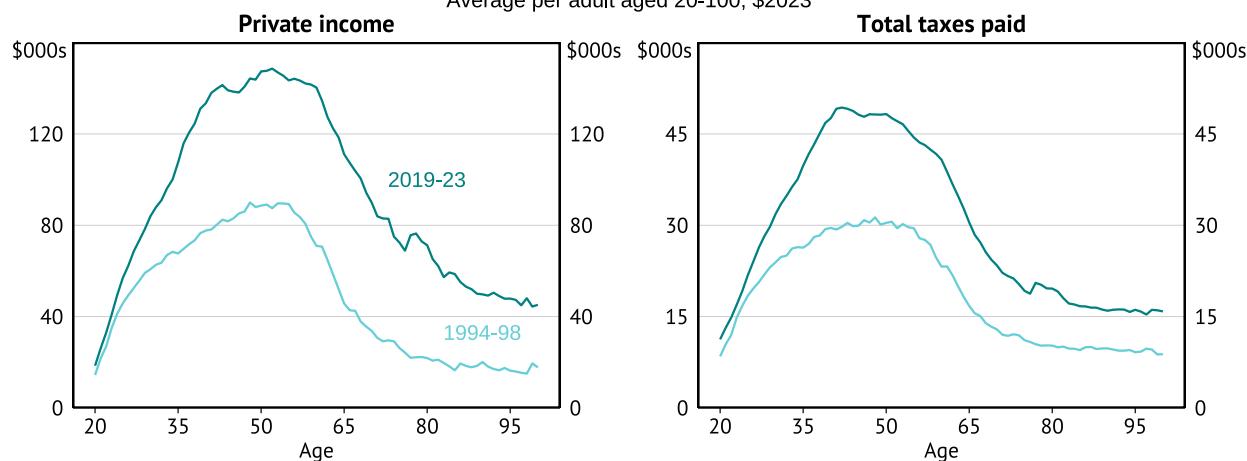
now earn 25% more in private income than Australians aged between 18 and 30, and they have gone from earning 51% of the average private income of 18- to 60-year-old Australians to 82% (Varela et al., 2025).

The distribution of the fiscal tax and transfer burden over the life cycle has not adjusted to match this new distribution of income. This is largely because income from owner-occupied housing and superannuation remain lightly taxed under our current income tax system.

The result is that our tax and transfer system still treats older Australians as if they are poor, despite Australians over the age of 60 now earning 51% more private income than Australians under the age of 30.¹⁸ Australians over the age of 60 pay 5% less in tax and receive 60% more in transfers than Australians aged 18-30. All up, after tax and transfer, their incomes are now 78% higher than Australians under the age of 30 (Varela et al., 2025).

Figure 16: The distribution of income and tax over the life cycle

Average per adult aged 20-100: \$2023



* Taxes include personal income tax, payroll taxes, consumption taxes, housing taxes, superannuation taxes and other taxes such as corporate income tax. Transfers include both cash transfers, such as the aged pension, and in-kind transfers, such as education, aged care and health care. All items are calculated on a per adult basis. Transfers made to children, such as public education, are assigned as a transfer to their parents.

Source: Varela, Breunig and Smith (2025)

Increasing concentration of financial pressures on younger Australians

There are three drivers of these financial pressures. The first is the rapid growth of housing prices relative to incomes. Since the 1990s, housing price-to-income ratios have increased from just over 2 to just under 6 (RBA, 2022). While falling interest rates have helped keep mortgage payment-to-income ratios relatively stable, increases in home prices mean that young people must still either save more of their income each year or save over a longer period to afford the deposit for their first home.¹⁹

The second driver is rising levels of student debt due to increased participation in higher education. Between 2012 and 2022 the number of Australians under 35 with an outstanding HELP debt grew from just over 20% to just over 30%. The average size of these debts also increased by over 30% in real terms to reach \$26,000 in 2022 (Akyol et al., [forthcoming](#)). While higher levels of education may positively shape the future earnings of younger Australians, repaying their HELP debts also means reducing their disposable incomes by up to 10% well into their mid-30s.²⁰

The final driver of increased financial pressures on younger Australians is the introduction of compulsory superannuation and the increase in the size of contributions over time. Since the early 1990s, compulsory superannuation contributions have increased from 3–5% of income to 12% today.

The introduction of compulsory superannuation has helped reduce pressure on Australia's public pension system and eased the tension in the intergenerational compact. However, Australians over the age of 60 now earn post-tax and transfer incomes that are 78% higher than Australians aged 18 to 30. When superannuation was introduced in the 1990s, Australians over the age of 60 had post-tax and transfer incomes that were roughly the same as Australians aged 18 to 30.²¹ This means that

¹⁸ Note the measure private income includes imputed rent and unrealised capital gains.

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¹⁹ While first home buyers also have to pay stamp duty, existing evidence suggests that the economic incidence of stamp duty largely falls on the seller in the form of lower prices (Davidoff & Leigh 2013).

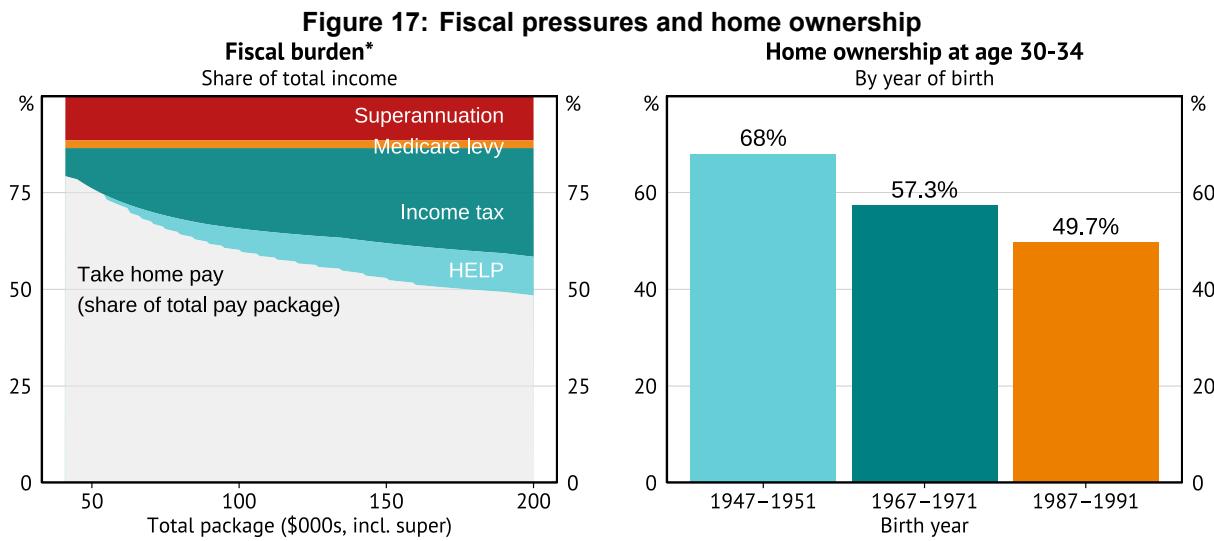
²⁰The average age of individuals making the final payment on their HELP debts hit 34.8 in 2022 (Akvol et al., *forthcoming*).

20 The average age of individuals making the final payment on their HELP debts hit 34.8 in
21 These post tax and transfer incomes include imputed rent and unrealised capital gains.

superannuation now transfers 12% of young Australians' income from a period in their life when they are relatively low income to a period when they are relatively high income. And while it does still help Australians save for retirement, it also reduces their ability to save via other means, such as home ownership, that bring with them other benefits.

The combination of these three pressures has made it harder for younger Australians to buy their first home. Currently, a young Australian with a HELP debt earning the average full-time annual salary of roughly \$100,000 will take home less than 65% of what they earn after paying income tax, making compulsory superannuation contributions and HELP debt repayments (Figure 17). Even if they were to then save a third of their take home income, it would still take them over 6 years to afford a 20% deposit currently required to buy a median-priced apartment in an Australian capital city (CoreLogic, 2025).²²

As these financial pressures have increased, home ownership rates for Australians aged between 30–34 have fallen to record low levels. Almost 70% of Australians born between 1947 and 1951 owned their own home by the age of 35, compared to less than 50% for the generation born between 1987 and 1991 (Figure 17).



* Assuming an individual eligible for JobSeeker but not Rent Assistance, who has \$25,000 of HELP debt. Superannuation rate is 11.5% of work income.

Sources: AIHW; e61

This matters because home ownership is a uniquely tax-advantaged way that Australians accumulate wealth. Our tax and transfer system does not tax capital gains on owner-occupied dwellings or imputed rent, and the family home is not counted in the age pension assets test.

Delayed home ownership and increased financial pressures may also be distorting the behaviour of young people in other ways. For instance, young people are not only taking longer to buy their first home, they are also taking longer to move out of home, move in with a partner for the first time, and start a family (Akyol et al., *forthcoming*). While there are many factors at play here, it seems likely that the decrease in financial security has played a role.

Options to improve the distribution of the fiscal burden

Policy solutions to improve the distribution of the fiscal burden over the life cycle can be grouped into three broad categories of solutions.

The first category of solutions is measures to adjust the age profile of our tax and transfer system so that it better matches the changing age profile of income.

This could be achieved either by reducing current tax concessions for housing and superannuation income, or by introducing more means testing and user costs for services such as aged care and healthcare to older Australians. Of course, it is important to note that older Australians likely still need greater support than younger Australians. Any changes to our tax and transfer system should take this into account while also having those that can afford to contribute more do so.

The second category of solutions is to do more to smooth consumption over the lifecycle by adjusting when HELP debts are repaid and superannuation contributions are made.

22 For an apartment in Sydney it would take the same individual almost 8 years to save for a deposit

For HELP debts, this could be achieved by reducing the rate of compulsory repayment or raising the threshold at which compulsory repayment begins. Any shortfall to the government could be made up by slightly increasing the interest charged on HELP debts.

For superannuation, this could be achieved by reducing compulsory contributions substantially and potentially making the contribution scale progressive.

The third and final category of solutions would be to adjust other policy settings to ease pressures on the finances of younger Australians.

One option would be to reform planning regulations to allow the supply of housing to increase and put downward pressure on home price growth. This would ease one of the most important financial pressures on younger Australians.

3. State Government Issues

Weakening State Budgets generate fiscal concerns

Prior to COVID, State Budgets were roughly in balance with limited State debt burdens. However, **State fiscal discipline loosened during the COVID-19 pandemic** and substantial deficits have persisted since then.

The ageing population, rising wage costs, and increasing infrastructure demands are putting upward pressure on state finances, while the State revenue base remains stagnant.

Suggested directions for reform are:

1. State governments could make better use of user pay systems to support self-financing of capital investment programs.
2. Switching stamp duty for land tax in the state revenue mix.
3. Devolution of some Federal spending initiatives to state governments.
4. Re-evaluation of the GST distribution to more consistently support partial equalisation principles.

3.1 State Fiscal Pressures

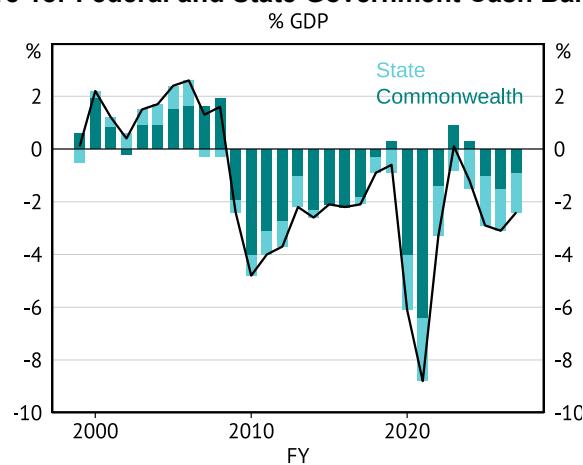
Summary

States and Territories now play a bigger part in Australia's overall fiscal position. Around half of the overall general government sector cash deficit each year is now attributable to the states. This reflects a long trend of high recurrent spending growth, and a recent (and substantial) rise in capital spending. State taxes are small (as a share of the economy) and narrowly based, leaving them with few discretionary options to address their fiscal position.

State and Territory governments are an important contributor to Australia's fiscal settings. Overall, state and territory payments are equivalent to 16.4% of GDP, compared with 27% for the Commonwealth.²³

Despite this size, for the period between the late 1990s and the COVID-19 pandemic, states had only a minor effect on the combined (Commonwealth and State) General Government sector cash balance. Prior to the GFC, states largely ran modest cash surpluses. Between the GFC and the pandemic, they ran minor cash deficits. From the COVID pandemic onwards, states have run larger cash deficits, worth a combined 1.5% of GDP on average.

Figure 18: Federal and State Government Cash Balances



Sources: ABS; e61; Treasury

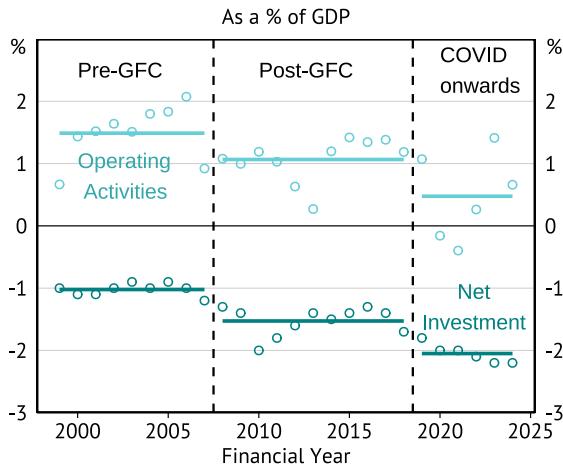
The states' collective fiscal position has thus taken on greater importance, including in the conduct of monetary policy by the Reserve Bank. It also raises questions about the long-term sustainability of state budget settings.

The deterioration in states' underlying cash position can be mechanically attributed to two factors – lower cash flows from operating activities (revenue less recurrent payments) and larger investment programs. Regarding the latter, states collectively invested around 1% of GDP in annual capital works for the first decade of the 2000s. This rose to around 2% during the GFC, driven in part by Federal stimulus programs for schools and social housing, which were delivered by the states.

Following the pandemic, states increased their annual capital spend to more than 2% of GDP. This was led by New South Wales, re-investing the proceeds of its energy privatisation program, and Victoria, largely through borrowings.

²³ State spending is partly financed through grants from the Commonwealth, hence combined payments are around 39% of GDP (The Commonwealth of Australia, 2025).

Figure 19: State Government Cash Flows

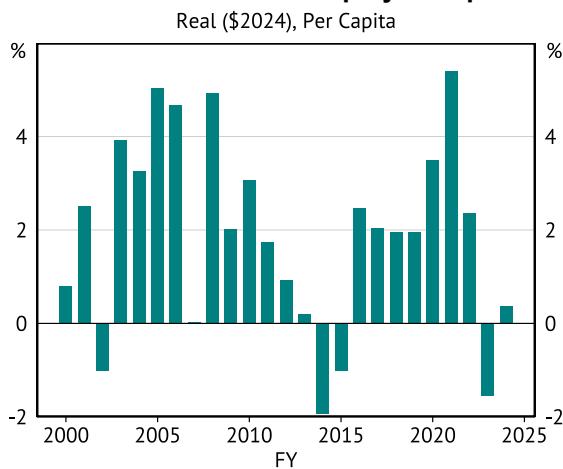


* Dots represent a given year, lines are the average of the period.
Sources: ABS; e61; Treasury

On the recurrent side of the budget, the fiscal deterioration has been driven by **significant real per capita spending growth**. For example, the growth in total employee expenses has, in almost all years, exceeded the growth in population and general wage or price inflation.

In the first decade of this century, revenue growth (fuelled by strong property markets) was sufficient to cover this rise in real spending. This largely ceased to be the case in the years following the GFC, leading to the reduction in states' cash from operating activities as seen in the chart above.

Figure 20: State Government Employee Expense Growth



It is likely that key underlying drivers of spending growth – population ageing and rising wage pressures for the public sector workforce – place greater pressure on state than they do on Federal budgets.

For example, health spending is impacted by volume growth driven by ageing and cost growth driven by new medical technology. Health makes up 16% of federal expenditures, but over 30% of the states'. States generally do not benefit from the same 'growth dividend' on the expenditure side of the Budget as does the Commonwealth. The Federal Budget gains from strong employment or income growth through reductions in means-tested payments. States tend to experience pro-cyclical spending pressures when the labour market is strong. (Noting that states' employee expenses are roughly four times the level of payroll tax revenue.)

Ultimately, the health of state finances depends crucially on productivity growth, in both the private and public sectors. In particular:

- **Economy-wide productivity growth** is the only sustainable way to drive a positive wedge between state revenues (if assumed to grow broadly in line with GDP) and the cost of delivering existing services to an expanding population (WPI or CPI plus population growth).
- **Public sector productivity** is the only sustainable way to deliver the equivalent volume and quality of services with less labour input.

In a world of low productivity growth, the fiscal pressure on states will grow.

The scale of this problem is open to debate. No state faces an immediate fiscal crisis, or an inability to borrow in public debt markets. The only jurisdiction that has come even close to this level of concern is the Northern Territory, which is small and highly dependent on the Commonwealth (who have shown a willingness to support the Territory financially when required in order to equalise service delivery with other states).

The risk is more of a slow burn, with interest costs rising as a share of state budgets and limiting budget flexibility. The ongoing challenge of keeping spending growth within a modest price + population benchmark could mean that states once again revert to cutting back capital works to inadequate levels in order to stabilise their debt to GSP levels.

3.2 Inefficient state taxes

Summary

State taxes are relatively inefficient, led by stamp duties and payroll tax. Large scale reform of stamp duty – and its replacement by a land tax – has stalled. But it remains a strong candidate for inclusion in any broad tax reform package.

State taxes raise between 4 and 6% of Gross State Product – a relatively modest amount compared with overall state expenditure. The gap is largely made up through Federal provision of GST revenue.

However, for revenue states raise directly utilises relatively narrow and inefficient taxes.

In some cases, such as stamp duties on insurance or real property transfers, the tax is inherently inefficient, in that it imposes a significant excess burden for the revenue raised. In other cases, including payroll tax, the inefficiency stems from policy design such as exemptions and the relative administrative and compliance costs.

A variety of sources have found that stamp duty on land transfers has among the highest marginal excess burden at around 70 cents per dollar – implying very significant welfare losses for each dollar raised, due to the distortions created by the tax. This reflects that stamp duty is levied on transfers, hence tends to discourage (or prevent) transactions from taking place. This is in contrast to alternatives like land tax, levied on the unimproved value of land, which had a measured excess burden of less than 8 cents per dollar raised (Cao et al., 2015; KPMG Econtech, 2010).

Research by the e61 Institute has highlighted the impact of stamp duty on transaction volumes. Using a natural experiment in Queensland, when the duty on principal residences was raised relative to the duty on investment properties, e61 found a large response: roughly a 7.2 per cent fall in transaction volume for every percentage point increase in the stamp duty rate (Garvin et al., 2024).

Payroll tax, by contrast, has a potentially broad base and could be levied quite efficiently. However, each state has imposed a high tax-free threshold, and carved out a number of exemptions. Furthermore, unlike a technically equivalent consumption tax like GST, the compliance and administrative costs are higher for a payroll tax. As a result, the Henry Review estimated the marginal excess burden of payroll tax at around 40 cents per dollar raised. Further e61 work has highlighted the perverse effects of a poorly designed tax-free threshold in South Australia, which was found to stymie firm growth and employment (Andrews et al., 2024).

Payroll tax and stamp duty are the two largest revenue raisers for the states as a whole. This means that the overall excess burden of state taxes is high for the dollars raised. It also implies that substantial reform of these taxes is difficult because of the significant fiscal cost involved.

Options to reform State revenue raising

- Over recent decades a number of reform proposals have been floated to replace stamp duty with a broad-based land tax.
- At least two states have removed the stamp duty on commercial transactions.
- One small jurisdiction (the ACT) is in the process of a long-term phase out of stamp duty in favour of a broad land tax.
- Other jurisdictions have found the reform too difficult.
- One model, briefly floated in New South Wales, involves a gradual transition from stamp duty to land tax, giving purchasers the ability to opt-in to a land tax instead of stamp duty.
- One challenge with this model is that it defers revenue and thus involves a substantial fiscal cost during the transition period.

Although data are limited, it is likely that the incidence of stamp duty falls most heavily on working age Australians, who are more likely to engage in multiple transactions as they climb the property ladder. Older incumbent property owners might benefit from stamp duty abolition to the extent it gets capitalised into property prices, but this effect should be offset by the present value of any land tax replacement.

As a result, the possible facilitation of a stamp duty-land tax switch; or the replacement of stamp duty with revenue from another source, is a candidate for inclusion in any broad tax reform package.

3.3 Misallocation of Commonwealth and State service delivery responsibilities

Summary

Australia's vertical fiscal imbalance sees revenue raised at the Federal level and distributed to the states to fund services. It creates political incentives for the Federal Government to impose conditions on funding, and to substitute its own programs for state-delivered services. This is not always the most efficient way to achieve a desired policy outcome, given the states' comparative advantages in direct delivery and market stewardship.

It is unlikely that the vertical fiscal imbalance (VFI) at the heart of Australia's federation is the main reason for the states' deteriorating budget position. However, this institutional structure may be leading to an inefficient configuration of service delivery between the states and the Commonwealth.

It has been argued that VFI creates incentives for states either to increase spending (given that much of the associated revenue is raised by federal taxes) or to advocate for more spending in Commonwealth-State fora (but demanding that the Commonwealth pay). These tendencies are balanced by other considerations:

- For any expansion of state spending, the marginal dollar will be raised from state taxes, leaving the state with full political accountability.
- To the extent states have an incentive to advocate for more spending in Federal-state contexts, the Commonwealth – which will raise the marginal tax dollar – has the opposite incentive. It also has the veto.

But VFI does create incentives for the Commonwealth to maximise its political benefit from the tax dollars it has to raise. This can drive two trends:

1. **Bias towards tied grants:** The Commonwealth might give preference to tied, rather than untied, grants to the states. In practice, this means a higher share of Commonwealth grants will take the form of specific purpose payments (with various conditions attached) rather than general revenue assistance.
2. **Commonwealth provision:** The Commonwealth might, over time, favour its own directly delivered programs over programs delivered through the states. In practice, this takes the form of using Commonwealth Own Purpose Outlays in preference to payments to the states.

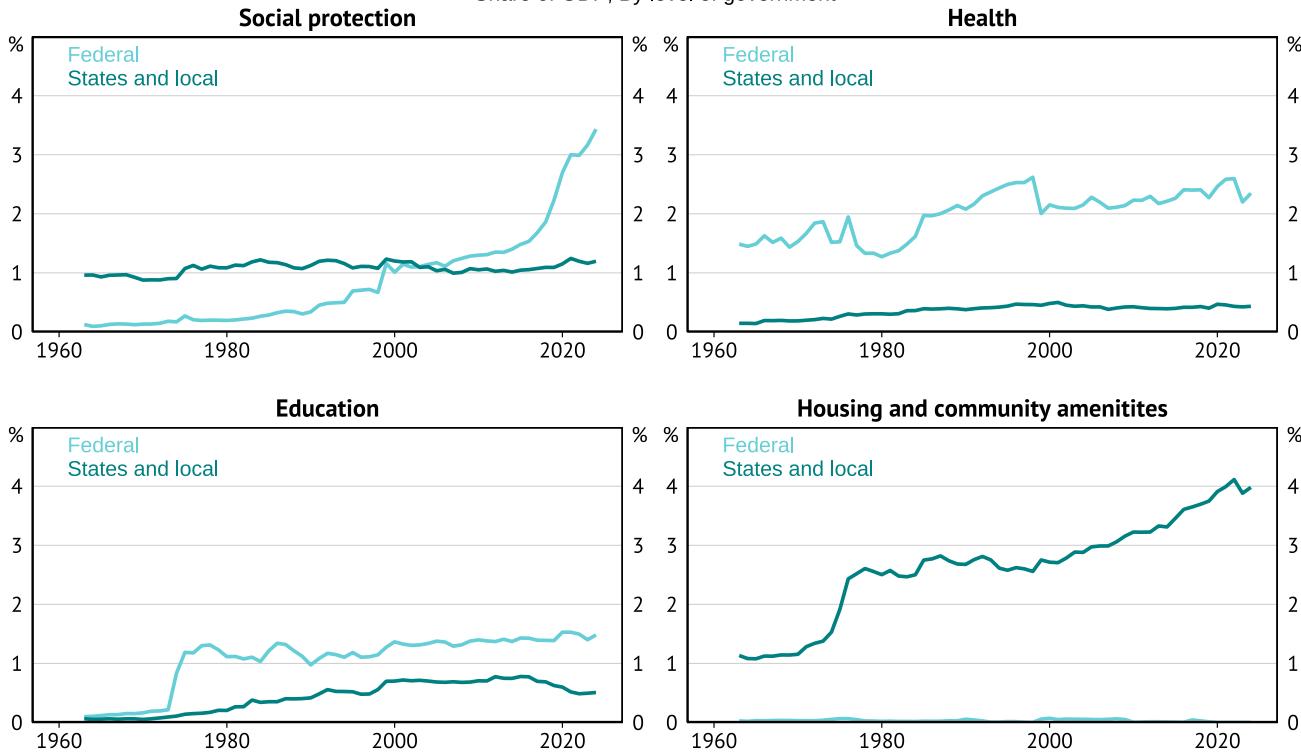
There is some evidence for both tendencies. Growth in specific purpose payments has exceeded general revenue assistance to the states. For example, in 2006–07, untied GST revenue made up 58 per cent of payments to the states. In 2024–25, it was down to 51 per cent (The Commonwealth of Australia, 2025).

Growth in direct Commonwealth program delivery can be seen in the rise of the Federal share of general government consumption expenditure relative to the states in key areas like social protection.

In many cases, the rise in the relative share of Federal spending is driven by the different design of Federal, as against State, programs. Federal funding of service delivery tends to be voucherised and demand-driven – with funding either provided directly to the service user, or to the service provider based on the individual service provided. States, by contrast, tend to deliver services directly, or contract third parties but without the same emphasis on demand-driven or voucher-based funding models.

Figure 21: Government consumption

Share of GDP; By level of government



Sources: ABS; e61

As a result, Federal programs tend to place more emphasis on consumer choice, contestability, and horizontal equity, while States place more emphasis on service oversight and market stewardship. From a fiscal perspective, the cost of Federal programs is heavily parameter-driven and subject to significant 'estimates variations'. State programs tend to have capped funding. Cost overruns are driven more by the challenges of controlling input costs than by unforeseen changes in demand (though there are exceptions).

	Health	Education	Housing
State programs	Public hospitals: Capped funding allocated across the system	Schools: Budgets set by the education department using a formula	Social housing: Directly owned and provided by the state
Federal programs	MBS: Patients receive a rebate on GP and specialist fees	Higher education: Students receive a HELP loan, with a Commonwealth grant paid to the university	Rent assistance: Eligible renters receive income support based on rent paid

The potential for inefficiency as a result of the incentives associated with VFI are twofold:

- Wasteful conditions built into specific purpose payments by the Commonwealth which distort service priorities, or impose a costly reporting burden.
- Instances where a direct delivery model with state control or market stewardship would be superior to a voucher-based quasi-market because of the challenges of getting the market settings right.

Examples of the latter – where devolution of service responsibilities to the states could be preferable – include child care, disability services, aged care, chronic disease management, mental health, or vocational training.

3.4 The WA GST deal

Summary

The 2018 changes to GST distribution fundamentally changed Australia's traditional model of fiscal equalisation. They have left us with an illogical and unsustainable system. However, it is probably infeasible to reverse the changes altogether. To the extent that we decide to move away from the traditional system of full equalisation, the approach could at least be more predictable, fair and conceptually justifiable.

The reality of vertical fiscal imbalance (VFI) in Australia means the Federal Government provides substantial grants to the States in order for the latter to meet their service responsibilities.

Around half of those grants are untied, or general revenue assistance, largely consisting of the GST revenue raised by Commonwealth and passed on to the states. The distribution of untied grants to the states is governed by the principle of horizontal fiscal equalisation (HFE).

The intent of HFE is to provide each state and territory with enough revenue to provide an 'average' level of service to their community. The equalisation formula, overseen by the Commonwealth Grants Commission explicitly compensates states for their innate disadvantages in raising revenue or delivering efficient services.

For example, small jurisdictions like Tasmania and the Northern Territory have less innate capacity to raise payroll tax given the structure of their economies. The Northern Territory, Queensland and Western Australia have significant remote populations which are costly to serve, including a large indigenous population. On the other hand, states with mineral resources have a capacity to raise revenue from this source.

Generally, the formula does not 'reward' policy-induced inefficiency. It adjusts for underlying demographic and structural economic attributes. Except in rare circumstances, states are not penalised for policy choices, including pro-growth reforms.

But the formula is detailed, complex and often unpredictable.

HFE has existed in some form for most of Australia's post-Federation history, but found full form in the 1970s with the advent of the Grants Commission, and was reinforced by the 2000 tax reforms which entrenched the GST revenue as a source of untied grants to the states.

For most of the Federation's history, the outcome of the equalisation process was to provide the two largest states – New South Wales and Victoria – with less than a per capita share of Federal grants, in order to subsidise other states. Despite some tension, this was a largely stable and enduring political equilibrium.

The system traditionally targeted 'full' equalisation – that is, it sought to distribute grants so that all states had their fiscal capacity raised to the level of the strongest state.

In principle, it mimicked the effect of a unitary state (rather than a federation) in distributing money across geographies in accordance with the differential costs of standard service delivery.

The system was fundamentally challenged by the extraordinary rise in mining royalties as a result of the terms of trade boom of the early 2000s and subsequent expansion of output. In 2002-03, the Queensland and Western Australian Governments raised a combined \$1.5 billion from royalties (less than 0.2 per cent of GDP). In 2022-23 they raised a combined \$29.2 billion (more than 1.1 per cent of GDP).

This poses challenges for the formula, because some states have significant scope to raise revenue from mining royalties while others do not. Victoria raises \$19 per person from mining royalties. South Australia raises \$207. Queensland raises \$3,381 per person and WA \$4,398 per person. As a result, the mining component of the formula is the largest source of redistribution, taking over from the demographic and socio-economic factors that traditionally drove the redistribution of revenue across states.

The effect on Western Australia's 'GST relativity' (measuring the percentage of a state's per capita share they would receive under the equalisation formula) was dramatic. In rough terms, WA's share of GST revenue fell from around 100 per cent of a per capita allocation, to less than 30 per cent. This tested the stability of the political equilibrium that had hitherto underpinned HFE.

In 2018, the Federal Government altered aspects of the formula to soften this fall in WA's GST share.

To demonstrate the severity of the change for WA, the table below compares each jurisdiction's assessed relativity (their share relative to an equal per capita distribution) in 2004, compared with what it would look like in 2024 in the absence of the 2018 reforms.

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
2004	87%	87%	106%	103%	120%	156%	113%	427%
2024	95%	115%	86%	18%	148%	193%	126%	528%

The 2018 reforms made a number of changes to prevent WA's relativity from falling to these stark levels. Specifically it:

- Imposed a floor on states' relativities such that they could receive no less than a 70 per cent share of a per capita allocation, rising to 75 per cent.
- No longer equalising states fiscal capacity to that of the strongest state (now WA) but to the stronger of Victoria or NSW – referred to as the 'standard state'.
- Providing a transition period during which these changes were phased in, and
- Providing a time-limited 'no worse off' guarantee to all states, effectively providing them with the equivalent outcome they would have received under the old formula. This guarantee was due to expire in 2026-27 but has been extended to 2029-30.

There are two problems with the current situation.

The less significant issue is that it creates a Commonwealth fiscal exposure due to the 'no worse off' guarantee. This year the Commonwealth will contribute an additional \$5.3 billion to the pool, on top of GST revenue.

This is arguably a minor issue: it is not a net fiscal cost – just a transfer from one level of government to another. To the extent this crowds out money that would otherwise flow to the states in Specific Purpose Payments, its untied nature could have net benefits.

The more significant issue is that the current arrangements leave Australia's Federation in a no-man's land between fiscal equalisation on the one hand, and allowing differences in state fiscal capacity on the other. Specifically, we now have a formula that provides for two fiscal standards: one for WA and one for every other jurisdiction, equalised to the so-called 'standard state'.

There are some economic arguments for equalisation, and some against. But no principled argument for the hybrid we now have.

Options for a new equalisation agreement

The argument for equalisation is as outlined above: it broadly replicates the effect of delivering a standard service across a unitary state (as individual states do in their own jurisdictions: individual locations generally do not receive back their per capita share of tax paid). And because it targets innate characteristics rather than policy-induced ones, it generally leaves intact the incentive to improve efficiency and generate growth.

The argument for allowing disparities in fiscal strength across states is that it can encourage efficient locational decisions. For example, individuals should be attracted to locations where the cost of delivering services to them is lowest.

These two considerations could perhaps justify a partial equalisation system (e.g. a blended formula between equalisation and equal per capita; or a minimum floor as a percentage of the fiscally strongest state).

The current deal, as noted, is neither full equalisation, equal per capita or a blend of the two. It is effectively two systems: with most states fully equalised and one with an arbitrarily higher fiscal capacity.

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4. HILDA data use disclaimer

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