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## The political economy of taxation

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**Lucas Rutherford**

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Tax and Transfer Policy Institute

Crawford School of Public Policy

The Australian National University

### Abstract

This paper makes the case for a more deliberate and expansive consideration of political economy issues in the context of Australian tax policy. Although there is a rich international literature analysing how political factors and institutions shape tax policy outcomes, with a few notable exceptions it is a relatively under-explored field in Australia. A deeper understanding of the forces influencing tax policy outcomes in the Australian context has the potential not only to provide insights into why we have the system we have today and the trajectory of the system, but more importantly, insights on the factors relevant to achieving successful reform. The paper proposes a number of areas of analysis to further develop an understanding of Australia's tax policy landscape.

Keywords: political economy, tax reform, tax policy, public finance

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Tax and Transfer Policy Institute  
Crawford School of Public Policy  
College of **Asia and the Pacific**  
+61 2 6125 9318  
[tax.policy@anu.edu.au](mailto:tax.policy@anu.edu.au)

The Australian National University  
Canberra ACT 0200 Australia  
[www.anu.edu.au](http://www.anu.edu.au)

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## Introduction

Tax reform is hard. Australia's last completed comprehensive tax review, *Australia's Future Tax System (AFTS) Review*, released in 2010, arose from a 2008 summit the goal of which was to develop a vision for an Australia in 2020. The passing of 2020 has seen few of the substantive changes recommended in AFTS implemented. The decade that has followed the release of AFTS has seen the promise of a further four broad-based tax reviews commissioned at the commonwealth or state level<sup>1</sup> largely unrealised. Moreover, the remnants of a number of high-profile attempts to substantively change the tax system can now be found today in un-enacted Bills or repealed legislation.

Why is tax reform difficult? Arguably it is not because there is no sense of the structural problems facing the existing system or the direction that reform might take. For example, the National Tax Summit convened by the Tax and Transfer Policy Institute (TTPI) in 2020 noted a consensus around the need to address 'an over-reliance on personal income taxes for revenue raising, unsustainable corporate tax settings, ineffective Goods and Services Tax...(and) underutilised state taxes,' amongst other issues.

The answer to the question of why reform is hard lies beyond the areas of academic enquiry that have traditionally been applied towards understanding Australia's tax system. Drawing on their own intellectual traditions, legal and economic scholarship can tell us much about how our system operates today and can give us insights into the type of system we might like tomorrow. Yet understanding the forces at play that explain *why* we have the system we have, *how* it may evolve going forward and the likelihood of substantive changes being implemented is a broader undertaking. It requires an understanding of a complex combination of fiscal, political, historical and cultural factors, as well as legal and economic factors.

Political economy, an academic field that seeks to apply such a broad-based approach to understand policy processes and outcomes, provides some insights. Although there is rich international literature on the political economy of taxation, with a few notable exceptions it is a relatively under-explored field in Australia. This paper does not purport to be a comprehensive political economy analysis of the Australian tax policy landscape. Instead, in drawing together this literature and, where relevant, drawing parallels to Australia's tax policy experience, this paper seeks to demonstrate that this is a valuable area of further enquiry in the Australian context.

The first section of this paper describes what is, and what is not, political economy analysis as well as the value it can bring in understanding policy processes and outcomes. The second section of the paper considers the contextual, institutional and agential factors that can influence tax policy outcomes. The final substantive section is focussed on reform, identifying those factors that have been associated with successful reform efforts and discussing some of the proposals for changing the institutional environment to make such efforts more likely to succeed in the future. Finally, the paper concludes with suggestions of areas for further analysis and enquiry.

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<sup>1</sup> The Commonwealth's *Re: Think* (2015), Tasmania's State Tax Review (2010), South Australia's State Tax Review (2015) and the Northern Territory's Revenue Discussion Paper (2017).

## 1 What is political economy analysis?

*Political Economy* looks at the relationship between politics and economics (Corduneanu-Huci et al. 2013).

The first in this partnership, *politics*, is best summed up by the title of a 1936 book by US political scientist Harold Lasswell *Who Gets What, When and How*. The answer to these questions is a complex one, informed by the myriad of factors that together influence collective decision-making processes. This includes history, formal institutions such as the overall political regime or the electoral laws, and informal factors such as the access of interest groups to decision makers and their capacity to influence outcomes (Corduneanu-Huci et al. 2013).

The other dance partner, *economics*, was described by British economist Alfred Marshall in 1890 as ‘the study of mankind in the ordinary business of life’. Today the traditional textbook definition of economics is that it is the study of how society manages its scarce resources (Mankiw, 2011). Public finance, an arm of economics, is an area that considers the role of Government in intervening in the economy (including through taxation) and in understanding the economic impacts of those interventions.

For the purposes of this paper, we can think about political economy as seeking to answer the question, *how do political factors and institutions shape tax policy outcomes?* Importantly, though containing the word ‘political’ it is not a discipline that seeks to endorse, or otherwise, a specific political institution or arrangement. It is simply about applying an analytical framework in seeking to understand how decisions are made.

The emergence of political economy as a distinct academic discipline is a relatively recent development. However, it is a longstanding area of intellectual enquiry. Before the trend of separating academic disciplines along methodological lines took hold in the late 19<sup>th</sup> Century (Balaam & Veseth 2020), those concerned with the ‘study of mankind in the ordinary business of life’ took a more holistic view to the issues that they were seeking to understand – effectively drawing on ideas and approaches that would form the basis of various academic streams of the social sciences that would follow – including economics and political economy.

For example, the ideas contained in Adam Smith’s *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), built upon in later work, such as David Ricardo’s *On the Principles of Political Economy and Taxation* (1817) certainly laid the groundwork for modern economics. Yet they were also a direct intellectual challenge to the prevailing British mercantilist views at the time – an attempt to challenge the central role of the state and promote the role of the individual as the key institutional driver in delivering optimal economic outcomes.

There remain important linkages between the disciplines of *economics* and *political economy* as we know them today. Welfare economics, for example, has been described as ‘the subfield in economics to which the practical-political concerns of classical political economy have been delegated’ (Vanberg 2018). More specifically on taxation, a reader of any introductory public finance material on taxation, and indeed any Australian tax review since Asprey (1975), will quickly be introduced to the criteria of efficiency, equity and simplicity as a means of assessing ‘good tax policy’. However, applying these principles falls short of an exact science. Their application almost always requires a trade-off between the criteria that is ultimately a matter to be determined through the political process.

## 1.1 Strengths and weaknesses of political economy analysis

Political economy analysis is a widely accepted and important part of the toolkit in many fields of work. This is particularly true in the area of development policy. Australia's own Department of Foreign Affairs and Trade (DFAT) actively promotes the use of political economy analysis as part of the implementation of Australia's aid program. Understanding the broader political context and the extent to which policy interventions are politically feasible are important in helping to improve the effectiveness of aid interventions (DFAT 2016).

The literature on the political economy of taxation outlines the value of such analysis in the context of tax policy. In their 2017 paper *The Political Economy of Taxation in Europe*, Profeta and Scabrosetti make the point that an appreciation of the broader political, as well as economic, factors can help us to understand the forces and mechanisms that have created existing systems and to suggest avenues for future reforms. Pure economic analysis focussed on the equity-efficiency trade off, they argue, does not exhaust the theory of taxation and tax reforms (Profeta & Scabrosetti 2017).

Similarly, in the chapter on political economy in the Mirrlees review, the UK's last comprehensive review of its tax system, the authors noted that taxes and tax systems, while ideally arriving at a balance of the traditional tax axioms<sup>2</sup>, also need to be politically sustainable. In doing so they cited the 1980s example in the UK of the replacement of domestic rates with a nation-wide flat rate charge for each adult in a household. Known officially as the 'community charge' the tax became known colloquially as the poll tax. The imposition of the tax led to fierce opposition, including riots in London, and was a major contributing factor to Margaret Thatcher's subsequent downfall (Alt et al. 2010). Needless to say the tax was ultimately repealed.

Political economy analysis is arguably *particularly* relevant in the study of tax systems. In their historical analysis on the political economy of taxation going back to pre-industrial civilisations, Kiser and Karceski (2017) noted that taxation has always been a core feature of political economy as it is the starting point for everything else a state does. Eccleston (2007) suggests that taxes are more than the lifeblood of the modern state – they are inherently coercive and must necessarily balance a range of political, as well as economic, priorities. Indeed, the compromises embodied in existing tax systems can provide much insight into the underlying power dynamics in a state.

Political economy analysis has its limitations and detractors. Critics highlight that it is overly pessimistic in its focus on large-scale institutions and processes that rarely change but neglects marginal improvements that can occur even in bleak environments. Another criticism is that it is not sensitive enough to context because of the necessary simplifications it makes in relation to incentives, payoffs and the nature of information flows between actors (Corduneanu-Huci et al. 2013). Yet there are limitations in all academic disciplines and the methodologies around which they have developed. For instance, writing in the context of the global financial crisis, Paul Krugman remarked that the 'economics profession went astray because economists, as a group, mistook beauty, clad in impressive-looking mathematics for truth' (Krugman 2009). The inevitable limitations of applying any single methodology to understand something as complex as tax policy highlights the value of a cross-disciplinary approach.

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<sup>2</sup> Equity, efficiency and simplicity to which is often added revenue adequacy

## 2 A political economy perspective on tax system design

Whilst there are a wide range of tools and approaches to political economy analysis, it traditionally involves considering the interaction between context, institutions and agents to understand how decisions are made (DFAT 2016).

**Context**, commonly referred to as ‘structures’ in the literature – this is the exogenous environment within which the other elements (institutions and actors) come together in the making of decisions. It is usually taken ‘as given’ – the contextual environment can and does change, but usually slowly.

**Institutions**, not to be confused with organisations, are the rules of the game. Both formal and informal, they are the laws, conventions and traditions that shape a decision-making process.

**Agents** are the individuals, organisations or groups involved in the decision-making process. If the institutions represent the ‘rules of the game’, then the agents can be thought of as ‘the games within the rules’ (DFAT 2016).

### 2.1 Context

There are a range of factors that can help to define the national context in which relevant policy decisions are made. These can be domestic factors such as demographics. It can also include international factors that exist beyond the experience of any particular country. One example that is *particularly* relevant to taxation is globalisation.

#### 2.1.1 Globalisation

Globalisation is consistently identified as a key force influencing domestic tax system design. Whilst arguments may be made that Australia is a ‘middle power’ that ‘punches above its weight’, in reality this means we can at best hope to shape rather than drive global forces. As the Board of Taxation noted in its comprehensive *Review of International Tax Arrangements*, ‘Australia’s tax system must respond to globalisation’ (Board of Taxation 2003).

The role of globalisation on domestic tax system design can most clearly be seen in the impact that international competition has had on capital taxation (Kiser & Karceski 2017). The (unweighted) average headline company tax rate across the OECD, for example, has declined from over 28 per cent in 2005 to around 24 per cent in 2020. This places pressure on other countries, such as Australia, to respond. Similarly, recent indications that countries such as the UK and the USA may be looking to increase corporate taxes may relieve this pressure, at least in the short term.

The fact that there has not been a complete ‘race to the bottom’ in company tax rates, as feared by many, also highlights the role of other political economy factors at play. Australia, which has maintained a headline rate of 30 per cent during this time despite attempts at reducing it for all companies, is a good example of this. As discussed further below, this reflects Australia’s mix of democratic processes and institutions, as well as the strength of societal fairness norms.

Another potential impact of globalisation is the limitation it imposes on simplicity (Brys 2011). In particular, domestic tax systems need to sit within and interact with a range of other domestic tax systems around the globe. The ability of companies to tax plan across borders creates a necessity for Governments to implement complex integrity rules in their domestic laws. This includes thin capitalisation, transfer pricing, controlled foreign company (CFC) rules and, more recently in Australia, the Diverted Profits Tax and Multinational Anti-Avoidance Law.

Ideas, developed and improved on over time, may become a part of an evolving global economic orthodoxy that can ultimately have a significant impact on the domestic institutional environment.

In his book *Taxing Reforms*, which considers the GST/VAT reform experience of Australia, Canada, Japan and the United States, Australian political scientist Richard Eccleston notes that the ‘international ascendancy of a new neo-liberal public finance orthodoxy that promoted broad based consumption taxes,’ provided the context to the eventual adoption of such a tax in three of the four countries that were the subject of his study.

## 2.2 Institutions

The literature on the political economy of taxation has a particular focus on the formal and informal institutions that govern and define policy processes. This may be because they are more readily identified and analysed than the broad swathe of agents involved in decision-making processes, and it may also be because they can explain much about the different tax policy experiences in different countries. They also tend to be the focus of practical political economy analysis, such as in development policy, as they are often the target of interventions (DFAT 2016).

### 2.2.1 Systems of Government

A cursory study of history clearly shows that systems of government can have a significant bearing on the level and design of taxation in society. This is illustrated in Kiser and Karceski’s 2017 paper which examined the evolution of tax systems in Western countries from pre-modern to modern times. They note that societies pre-dating the industrial revolution, and as far back as the Greek city states, had tax systems characterised by low amounts of revenue and a heavy reliance on easy to collect and regressive taxes. Whilst administrative limitations (discussed below) clearly played a role, the power relationships embedded in the form of government were a key factor. The general population in feudal societies, for example, had limited expectations of what their rulers would provide and there was little incentive for rulers to provide much. However, there were incentives for rulers to appease other powerful forces, such as the nobility and the churches, that could threaten their rule. This meant that direct taxes, where they were levied, ‘were mainly paid by conquered subjects, religious minorities, and peasants’. One exception were the Greek city states where there was some progressive taxation of wealthy people, partly a result of early democracy, stability and trade.

Economic developments in the industrial revolution and corresponding political developments in the Enlightenment, led to increased levels of democratisation and a transition of tax systems throughout the 19<sup>th</sup> Century. This transition was characterised by increasing levels of tax revenue, partly as a result of the demands of war and partly because citizens in a democracy demand more of government. Democracy also ‘dramatically lowers the transaction costs of creating and enforcing fiscal contracts between taxpayers and rulers’. As the voting franchise expanded and the median wealth of the voter declined, the preference for progressive taxation also increased.

The specific features of modern democracies may also have implications for tax system design. The number of veto rights, which include bicameral parliaments, coalition governments or presidential systems where the president has a veto, have been found in a number of studies to lead to lower overall tax revenues (Kiser and Karceski 2017). The United States, whose tax to GDP ratio of 24.4 per cent ranks it 32<sup>nd</sup> of 37 OECD countries is a clear example of this. The US Constitution was specifically framed to limit the power of any one arm of Government. There is a presidential veto, but the Executive otherwise has limited control over the Legislature. Eccleston (2007) suggests that this political structure, in part, accounts for the strong partisan opposition to consumption tax reform in the US. As discussed further below, the fact that the US is a relatively low taxing country also likely reflects societal norms in the US around the size of Government.



Comparing tax data and a database on political institutions, Profeta and Scabrosetti (2017) analysed the correlation between the particular political features and experiences of a country with tax system design across the OECD. They found that when the ruling party becomes more left wing, income taxes tend to become more prevalent. They also found that when a ruling party was more powerful (for example, they did not have to rule in coalition) property taxes became more significant.

In his analysis of Australia's experience with the GST, Eccleston (2007) considers that there are a number of aspects to Australia's formal system of Government that influences tax policy outcomes. This includes the fact that the Executive Government is constrained by a relatively short electoral cycle, the existence of a potentially powerful and hostile Senate and a majoritarian electoral system in the Lower House of Parliament which has ensured the institutionalisation of a competitive two party system. Combined with Constitutional limitations and the experience of Federation (discussed in the next section), these features present significant barriers to the successful implementation of particularly sensitive or complex policy proposals.

### 2.2.2 Constitutional constraints and federation

When considering the 'rules of the game' the basic rules and laws of a nation or state, embodied in its constitution, can play a significant role. In Australia's context, as in other countries operating a federal system, the Australian Constitution and its subsequent interpretation in the Courts, has played an integral role in defining the federal fiscal relationship between the Commonwealth and the States. Although the Constitution does include a number of articles specifically relating to taxation which are reasonably unambiguous, such as providing that only the Commonwealth can impose customs duties and excises,<sup>3</sup> it has been the interpretation of the Constitution and the evolving power dynamics between the two levels of Government that has done much to define the federal fiscal relationship that we have today.

A full history of how this relationship has evolved is beyond this paper but is being explored in Paul Tilley's series on the history of taxation in Australia (see Tilley 2020a, 2020b and 2021). In brief, probably the most notable example of this federation dynamic is the history of Australia's income tax. Originally imposed only by the States, forced by the exigencies of war the Commonwealth introduced its own income tax in 1915. Whilst the two systems co-existed for many years, again forced by the financial pressures of war, this time WWII, the Commonwealth sought to assume full control of the income tax base through imposing it at a level where both could not, economically, co-exist, and tying the abolition of State income tax to Commonwealth grants. The Constitutional validity of this was challenged on a number of occasions but was upheld by the High Court (Twomey 2014) resulting in the largest tax base in the Federation being the sole domain of the Commonwealth.

Other tax bases have also been shared and swapped over the years. Land tax, now the sole domain of the States, was levied by the Commonwealth between 1910 and 1952. Payroll tax, today the largest own-source of revenue for the States, was levied by the Commonwealth between 1941 and 1971 and was passed over to the States to provide them with a growth tax (NSW Government 2020).

The payroll tax story since 1971 provides another insight into the influence that the federation has on tax policy. Whilst the Commonwealth transferred to the States a uniform payroll tax system with uniform rates (2.5 per cent), the various payroll tax systems began to diverge and be hollowed out in part as a consequence of inter-state competition for business – somewhat akin to the competition

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<sup>3</sup> Section 55. This was introduced to remove barriers to inter-state trade and commerce.

on corporate tax rates at the international level. This has limited the role of a potentially efficient tax base and increased the complexity facing businesses operating across state borders (NSW Government 2020).

### 2.2.3 Regional and international rules and institutions

As well as helping to define the contextual environment, globalisation has also led to the emergence of regional and international institutions that can more directly influence tax policy design and processes. Alt et al. (2010), for example, noted that in contrast to the experience of some countries that faced real challenges in introducing a broad based consumption tax (such as Australia), in the UK it was relatively uncontroversial as the introduction of their Value Added Tax was a requirement of EU membership.

Although Australia is not bound by a similar regional institutional architecture (and neither, for that matter, is the UK anymore<sup>4</sup>), our formal international legal commitments do limit domestic tax changes. The World Trade Organisation's rules, for example, limit the capacity of member states to use taxation, both direct and indirect, as instruments of domestic trade and industrial policy. Indeed the WTO's Dispute Settlement Body (DSB) has heard a number of cases relating to taxation, ruling against the use of taxes as effective tariffs or as subsidies for local manufacturers (Daley 2016). Australia has not been the subject of any of these high profile tax related rulings of the DSB. However, the potential for such an action being taken at the DSB in the future cannot be discounted. The most recent Trade Policy Review of Australia by the WTO noted concerns raised by other members of 'advantages accorded to certain producers through the Wine Equalization Tax' and the 'Luxury Car Tax, together with the proliferation of similar taxes at the state level [which] presented a distinct disadvantage to the exports of some trading partners' (WTO 2020).

Despite the fact that the international tax system lacks the comprehensive formal architecture of the global trading system, it can nonetheless limit scope to enact domestic tax change. Bilateral tax treaties,<sup>5</sup> of which Australia has over 40 and which seek to delineate the taxing rights between the two signatory states, can impose very real limitations on the capacity to meaningfully enact domestic reforms, particularly where they relate to cross-border investment. This is because, by design, where there is any inconsistency tax treaties will override domestic law.<sup>6</sup> Where existing treaties stand in the way of meaningful domestic reforms there are few options. Renegotiation is one, albeit a long and drawn out process and subject to the willingness of the other signatory state. This was the option recently taken by India with respect to its agreement with Mauritius, the generous capital gains provisions of which saw the small Indian Ocean island becoming, on paper, the largest investor in India. Another option is the unilateral cancellation of a treaty. This is seldom used because of the implications for foreign relations.<sup>7</sup>

The international tax system also imposes less formal boundaries on tax system design. An example of this is the promulgation of international taxation standards through the G20 over the last two decades. These standards have included tax transparency, being the agreed rules of exchanging

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<sup>4</sup> Though there is no indication that the UK, as a consequence of leaving the UK, is contemplating a return to imputation and the abolition of its value added tax

<sup>5</sup> The majority of which are modified by the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* [2019] ATS 1.

<sup>6</sup> So long as it is in respect of its field of operation and according to its provisions (*GE Capital Finance Pty Ltd v Federal Commissioner of Taxation* (2007) 159 FCA 473 at [44]). One notable exception is Part IVA.

<sup>7</sup> A notable exception was Mongolia which, in late 2012, cancelled its treaties with Netherlands, Luxemburg, Kuwait and the United Arab Emirates due to their concerns about the use of these treaties to facilitate tax avoidance by extractive companies operating in Mongolia.

information between tax authorities, and various other standards most recently promoted through the G20/OECD Base Erosion and Profit Shifting (BEPS) project. The latter has included a rejuvenation of the OECD's longstanding *Harmful Tax Practices Initiative* which has sought to deter countries implementing domestic tax policies considered to be 'harmful' to other jurisdictions. Enforcement of these standards is achieved through peer review processes to identify compliance with these standards together with a public 'naming and shaming' of jurisdictions that fail to meet the standard.

As a member of the G20 and the OECD, Australia's commitment to the development of international tax standards has seen it enact a number of changes to its domestic law to promote international tax transparency, as well as to meet the BEPS 'minimum standards'.<sup>8</sup> Most recently this has included a commitment to remove the preferential tax treatment provided by Australia's *Offshore Banking Unit* regime, to address the concerns of the Forum on Harmful Tax Practices that the regime was harmful (Frydenberg 2021).

#### 2.2.4 Administrative capacity

The capacity of a bureaucracy to effectively enforce and collect taxes is clearly a binding constraint on tax policy design and outcomes. As outlined by Kiser and Karceski, this has been true throughout history. The challenges for the Roman Empire to govern such a broad swathe of territory, and its limited ability to guard against the corruption of officials in far flung territories, led to the privatisation of tax collection (so called 'tax farming') to ensure the alignment of incentives between the tax collector and government.

Even when societies actively sought to apply more deliberate tax policies, for example taxing based on wealth, administrative limitations meant that readily identifiable proxies for wealth, such as windows and chimneys, were used. It also meant that applying taxation at bottlenecks, such as ports or town gates, had the consequence of making excises and customs duties particularly attractive.

The bureaucratisation of European civil administrations in the 19<sup>th</sup> Century facilitated changes in tax system design not the least of which was the ability to effectively implement income taxes. Today, tax administrations using sophisticated data matching technology are increasingly effective tax collectors. Further exploration of the use of emerging technologies, such as artificial intelligence and blockchain, is likely to continue to push the boundaries of what, from a tax policy perspective, is possible.<sup>9</sup>

However, there remain limitations. Kiser and Karceski, for example, note that whilst income tax is readily applied to salaried workers, it is far more difficult to apply to those not earning their money through wages, and those who are able to take advantage of the planning opportunities offered in moving assets and offshore income. The authors argue that the challenges of effectively enforcing a progressive tax system, in a globalised world, may be contributing to its gradual decline. Relatedly, the TTPI's recent research paper on the *Taxation of Savings* (2020) suggests that Australia's current

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<sup>8</sup> Countries signing up to the OECD/G20 BEPS inclusive framework must commit to implement standards with respect to combatting harmful tax practices, the spontaneous exchange of information on advance tax rulings, the inclusion of anti-abuse clauses in double tax agreements, country-by-country reporting and a dispute resolution mechanism.

<sup>9</sup> The Institute for Austrian and International Tax Law, within the University of Vienna, for example, has developed a stream of work which is exploring the potential use of emerging technologies in tax administration. See <https://www.wu.ac.at/en/taxlaw/institute/gtpc/current-projects/tax-and-technology>

taxation settings relating to savings are in fact regressive (Varela et al. 2020). This necessarily limits the ability of Australian Governments to deliver an overall progressive personal income tax system.

### 2.2.5 Information asymmetry

As well as the role that the formal architecture of the state has in helping to define the policy development process, there are less formal aspects of the process that help to determine outcomes. The fact that some actors in a policy making process have more or better information, often called information asymmetry, is consistently identified as a key factor in shaping policy outcomes. In the political economy chapter of the UK's *Mirrlees Review*, the authors noted that 'a lack of understanding of the tax system and its elements may play a significant role in the shape the system takes' (Alt et al. 2010). Tax systems are complex and many of the tools and principles used by economists and policy experts to guide thinking on tax policy are not readily accessible or understood by the general public. This disconnect leaves tax systems often falling far short of what an ideal system (measured by an economist or policy specialist) would be.

One feature of this information asymmetry is that people tend not to associate taxes with the public services that they fund (Eccleston 2007). This can engender a general public aversion to taxation. On the other hand, it also makes certain forms of taxation more attractive than others to policy-makers. In the context of the UK, for example, Alt et al. noted the high level of support for National Insurance Contributions relative to income tax more generally, given that people mistakenly believe that the contributions are used to fund the National Health Service. A similar story could be told around Australia's Medicare Levy. Whilst a 'levy' brings with it connotations of impermanency, Australia's Medicare Levy has been an enduring feature of Australia's tax system since its introduction in 1984, albeit with numerous changes. This is despite the fact that at no time has the revenue from the levy ever been directed specifically ("hypothecated") to fund Australian health care costs, nor have the amounts raised come close to funding those costs (Sammut 2017). As illustrated in Table 1, temporary levies, acting effectively as a surcharge on the existing personal income tax system, have been a popular means of boosting general revenue by Governments at particular times.

**Table 1: Temporary levies imposed on top of the Commonwealth Personal Income Tax System**

| Levy  | Description  |
|---|--|
| Gun buyback levy  | The Government increased the Medicare levy from 1.5% to 1.7% of income for one year to finance the 1996 buyback program.   |
| Defence East Timor Levy (announced but later withdrawn) | In November 1999, the Government announced its intention to impose a levy of 0.5% on income between \$50,000 and \$100,000 and 1% on incomes above \$100,000 per annum. This was to help meet the cost of Australia's deployment to East Timor. The levy was later withdrawn on the basis that the costs were not as great as expected and that the budget situation had improved. |
| Temporary Flood and Reconstruction Levy                 | The Flood Levy was imposed on income earners over \$50,000 per annum to rebuild infrastructure in flood affected regions during the 2011/2012 financial year.  |
| Temporary Budget Repair Levy                            | Announced in the 2014–15 Budget the levy required individuals with a taxable income of more than \$180,000 to pay 2 per cent of each dollar of a taxpayer's income over that threshold. The levy applied to the 2014–15, 2015–16 and 2016–17 income years.   |

Another feature of Australia's tax system that is reflective of a general aversion to taxation has been the historical reliance on *fiscal drag* to raise additional revenue. This is where the average tax rate facing an individual in a progressive tax system increases as a result of inflation. The most commonly understood aspect of this is 'bracket creep' - where an individual finds themselves being pushed into a higher tax bracket, even though they have not received a real wage increase.<sup>10</sup> As a means of raising additional revenue, fiscal drag is a far less sensitive option compared to an active and scrutinised decision of Government to raise existing taxes or create new taxes. This may explain why, although indexation of personal income tax thresholds in Australia has been implemented in the past, it has not been an enduring feature of Australia's personal income tax system.<sup>11</sup> In this respect, Australia is not alone.

In the UK, Alt et al. see fiscal drag as one of a range of symptoms that reveal a preference of successive UK Governments for what they term 'stealth taxation'. This includes a preference for indirect taxes that are concealed in final prices and income taxes where amounts are deducted from payslips before being received by workers.

Again, parallels can be drawn to Australia's tax policy experience. The Australian states, for example, maintain some of the least efficient tax bases in the Federation. This includes stamp duties on conveyances and insurance products (Cao et al. 2015). In a country in which natural disasters are a common occurrence, the continued imposition of insurance taxes which can lead to under insurance or households not taking up insurance at all (Australian Government 2015) appears to be particularly puzzling. However, seen through the political economy lens of a preference for less visible taxes, the continued reliance on a tax that is hidden in the final price of insurance products facing consumers is more readily understood.

Similarly, despite the overwhelming evidence of the significant economic benefits that would result if stamp duty on conveyances were replaced with a broad based land tax (Productivity Commission 2017), the prevalence of such duties may reflect not only a status-quo bias (discussed further below) but the fact that a one off cost incurred in the context of a much larger outlay of funds, is preferable to a regular (and visible) annual charge. The political economy challenges with such a significant reform may help to explain why, to date, such a change has only been implemented in Australia in the relatively politically benign jurisdiction of the Australian Capital Territory. It may also help to explain the voluntary (opt-in) model currently being explored by the NSW Government as a means of overcoming some of the political economy challenges with such a significant reform (NSW Government 2020).

Another consequence of information asymmetry identified in the literature is the incentive it creates to generate tax expenditures – a concession to a particular group of taxpayers or to a particular activity. Whilst the benefit it provides to the recipients is visible and invariably welcomed, the broad implications for the system and other taxpayers – increased complexity and an implicit increase in the tax burden on other groups – is not readily understood or visible (Brys 2011).

In recognition of this incentive, most countries, including Australia, produce some form of public statement providing a description of the various expenditures and their estimated value. In Australia these have been produced by the Treasury since the enactment of the *Charter of Budget Honesty Act 1998*. These statements include both 'positive' expenditures – those where there is some

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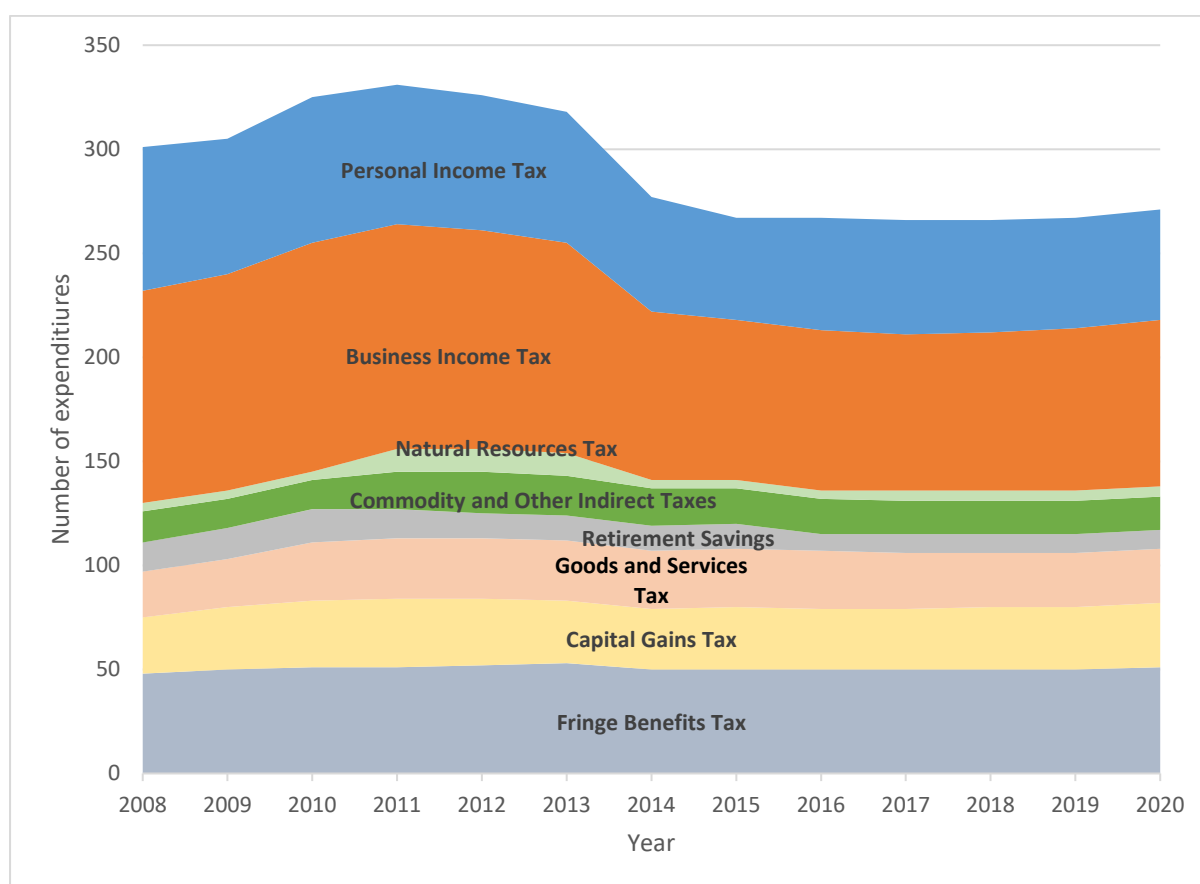
<sup>10</sup> *Fiscal drag* also occurs without individuals moving into higher brackets as, under a progressive system, the average tax rate increases with wage increases as a greater proportion of income is taxed at higher rates.

<sup>11</sup> Indexation of personal income tax was introduced in 1976-77 by the Fraser Government but it only lasted a few years, ceasing in 1979-80 (Tilley 2020b)

concession relative to a benchmark treatment – and ‘negative’ expenditures – those where additional revenue is raised relative to the benchmark.

Figure 1 illustrates the *number* of tax expenditures excluding negative expenditures<sup>12</sup> in the Commonwealth tax system since 2008, the year in which expenditures relating to the GST began to be reported. It highlights that tax expenditures are an enduring feature of Australia’s tax system with those in the business and personal tax systems being the key focus. This is unsurprising given this is where the majority of tax is raised. Interestingly, the trend over the last decade sees an increased number of expenditures in the years following the global financial crisis, again driven by changes in the personal and business tax systems. This may reflect the inclination to use the tax system to assist certain groups impacted by the economic downturn. Also of note is the relative stability for certain tax bases. The number of expenditures for the GST, for example, has remained relatively stable since reporting began, likely reflecting the challenge in amending a tax base where such amendments require the agreement of all states and territories.

**Figure 1: Number of tax expenditures/variations excluding ‘negative’ expenditures (2008-2020)**



Source: Tax Expenditure Statements, Treasury (renamed Tax Benchmarks and Variations Statement in 2018)

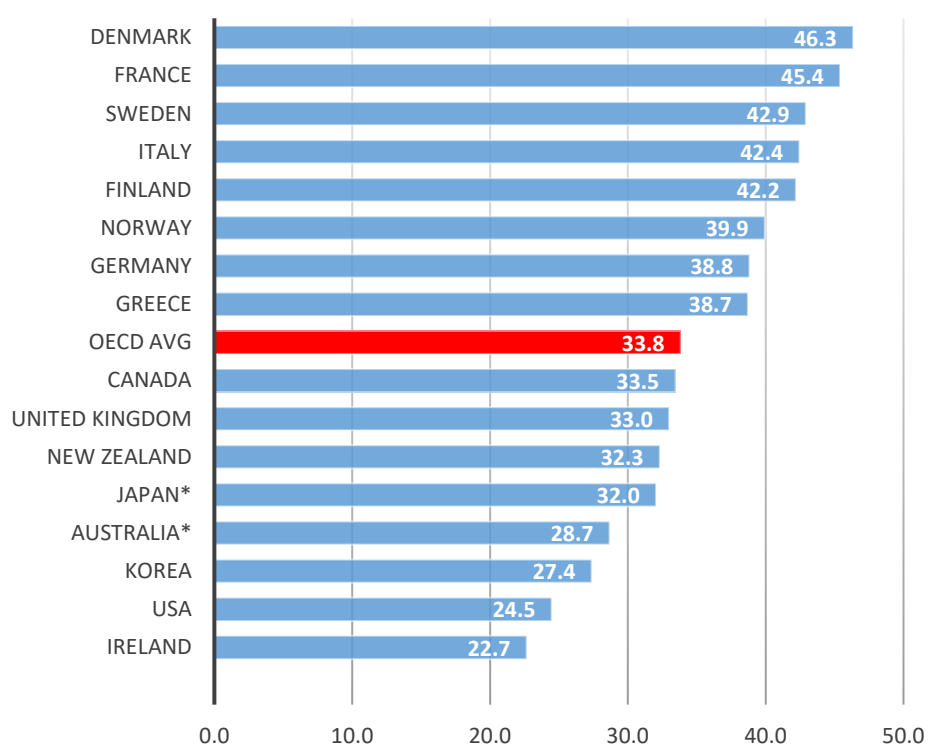
<sup>12</sup> We omit those clearly identified as consistently negative. Due to the methodology of producing the Statement, some expenditures may alternate between ‘positive’ and ‘negative’ over the period reported in each Statement.

### 2.2.6 Public sentiments

Public perspectives and attitudes towards taxation create the normative background that underpin the legitimacy of policy proposals in the eyes of the general public (Eccleston 2007). As Kiser and Karceski (2017) argue, an aversion to ‘big Government’, informed by the historical experiences of countries, helps to explain the significant differences in overall taxation revenues between social democracies in Europe and liberal democracies such as the United States and Australia.<sup>13</sup>

This view is supported by Eccleston in *Taxing Reforms*, noting that the historical experience of each of the countries he analysed, being the US, Canada, Australia and Japan, suggests that there was a traditional scepticism in the public of ‘big government’. As illustrated in Figure 2 this stands in contrast to the social democracies of continental Europe.

**Figure 2: Tax to GDP ratio (per cent) of selected OECD countries (2019)**



Source: OECD – see <https://data.oecd.org/tax/tax-revenue.htm>

\* Data for Australia and Japan is for 2018

Eccleston (2007) further argues that the public in the countries he analysed also strongly supported the use of tax systems as a means of redistribution. The latter view underpinned a strong belief in progressive taxation and entrenched opposition to regressive taxes; something that informed the views on proposals to introduce a proportional flat consumption tax.

These sentiments can, and are, shaped by significant events. The mass conscription of World War I and World War II in some countries produced a demand for progressive taxation by ‘activating fairness norms’. This was a reaction to working class voters being called off to war and seeing older, wealthier people as being less likely to fight and more likely to profit economically from war (Kiser & Karceski 2017).

<sup>13</sup> As well as other factors identified above, such as the number of veto rights in the system

More recently, as Governments slowly begin to turn their minds to balancing budgets after the COVID-19 stimulus, early surveys are already suggesting that the experience with the pandemic will shape attitudes to taxation policy. In a recent International Monetary Fund (IMF) working paper *Pandemic and Progressivity*, the authors report the results of a survey of over 2000 US citizens over how the pandemic related fiscal challenges could best be met. The findings are consistent with previous research that suggests that people's personal experiences with economic upheavals can shape their views on tax policy. The survey finds, amongst other things, a strong support for further progressive taxation amongst those who have been significantly impacted by the pandemic from either a health or economic perspective. Whether a similar survey undertaken in Australia would return similar results would be a valuable avenue of enquiry, given the different experience Australia has had with the pandemic compared with the US.

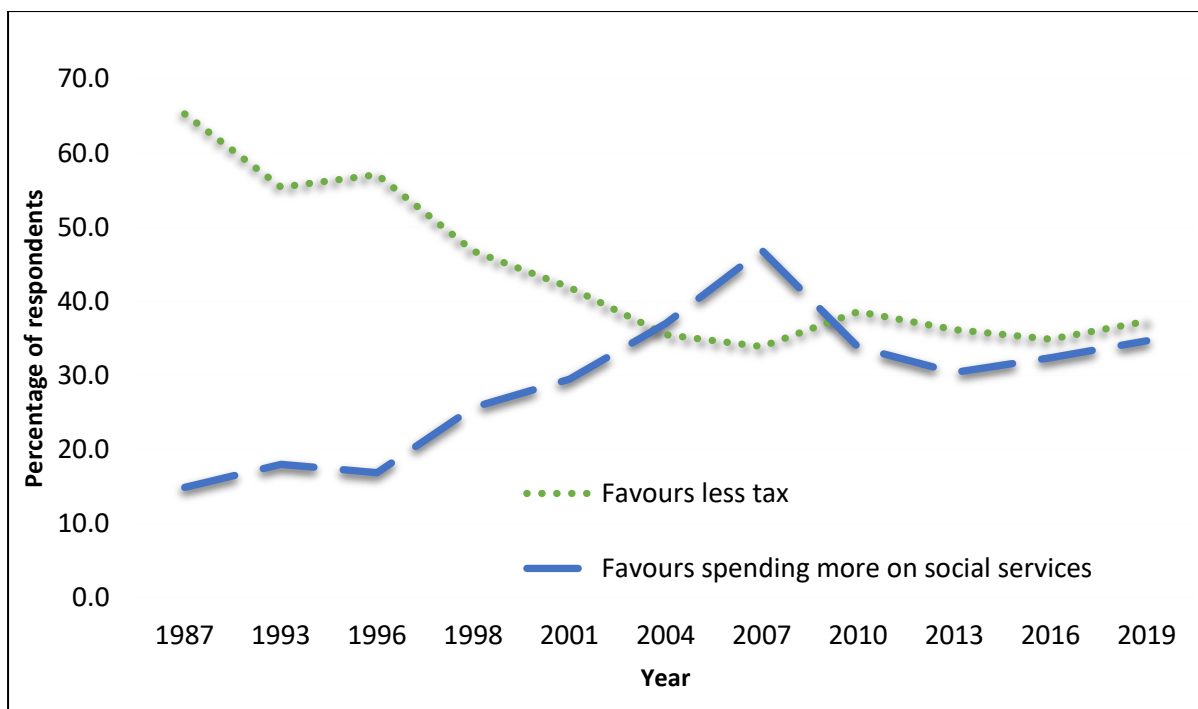
What is clear though is that concepts of fairness are important in the Australian context. In the inaugural Alf Rattigan lecture in 2016, journalist Paul Kelly argues that reform in Australia invariably needs a strong equity profile (Kelly 2016). In the case of Rattigan, the Chair of the Tariff Board and later Industries Assistance Commission, who pushed for tariff reductions in the face of significant opposition, Kelly noted that he (Rattigan) was alert to the need for structural adjustment to assist workers impacted by the reform. Rattigan played a surprisingly prominent role (for a bureaucrat) in the move to reduce Australia's tariffs in the face of significant industry resistance.

Public sentiments can and do change. In his analysis on Australia's experience with the GST, Eccleston notes that an important factor contributing to the ultimate adoption of the GST was the emerging dissatisfaction with Australia's personal income tax system through the 1970's and 1980's. The period saw high levels of inflation result in real income tax increases through fiscal drag, and a growing public awareness of tax avoidance and evasion engaged in by the self-employed and by professionals. The combination led to a view, particularly amongst the wage earners being asked to shoulder an increasing tax burden, that 'Australia's income tax system was no longer an effective instrument of redistribution' (Eccleston 2007).

Another area where there is some evidence of evolving public sentiment is in relation to the level of public spending. In its regular survey of Australian political attitudes since 1987, the Australian Election Study has been asking respondents the following question - *If the government had a choice between reducing taxes or spending more on social services, which do you think it should do?* The trends depicted in Figure 3 below suggest an increasing openness to 'bigger government'. The next iteration, coming as it does after an unprecedented level of Government spending in the context of the economic response to the COVID-19 pandemic, might reasonably be expected to show a continuation of this recent trend.

**Figure 3: Survey results of choice between reduced taxes or spending more on social services (1987 – 2019)**





Source: The Australian Election Study available at <https://australianelectionstudy.org/>

## 2.3 Agents

Having discussed the exogenous environment which provides the context to policy decisions, as well as the formal and informal institutional factors that define the decision-making process, we now consider the individuals and groups that play a role in that decision-making process.

In thinking about the agents involved in tax policy, it is easy to focus on those with formal decision-making powers – with respect to the Australian tax system at the Commonwealth level, this would be the Treasurer, the Prime Minister, other members of the Expenditure Review Committee of Cabinet and, ultimately, the Cabinet. Yet in reality, these formal decision makers are operating in a complex environment – not just institutionally as described above, but with a range of actors all with an interest in and, to varying degrees, the capacity to influence, policy outcomes.

A full analysis of all these groups is beyond the scope of this paper. Drawing on the literature, this section provides a way of thinking about the relative influence that various groups have on tax policy outcomes. It also includes a discussion on the role of key Government advisors.

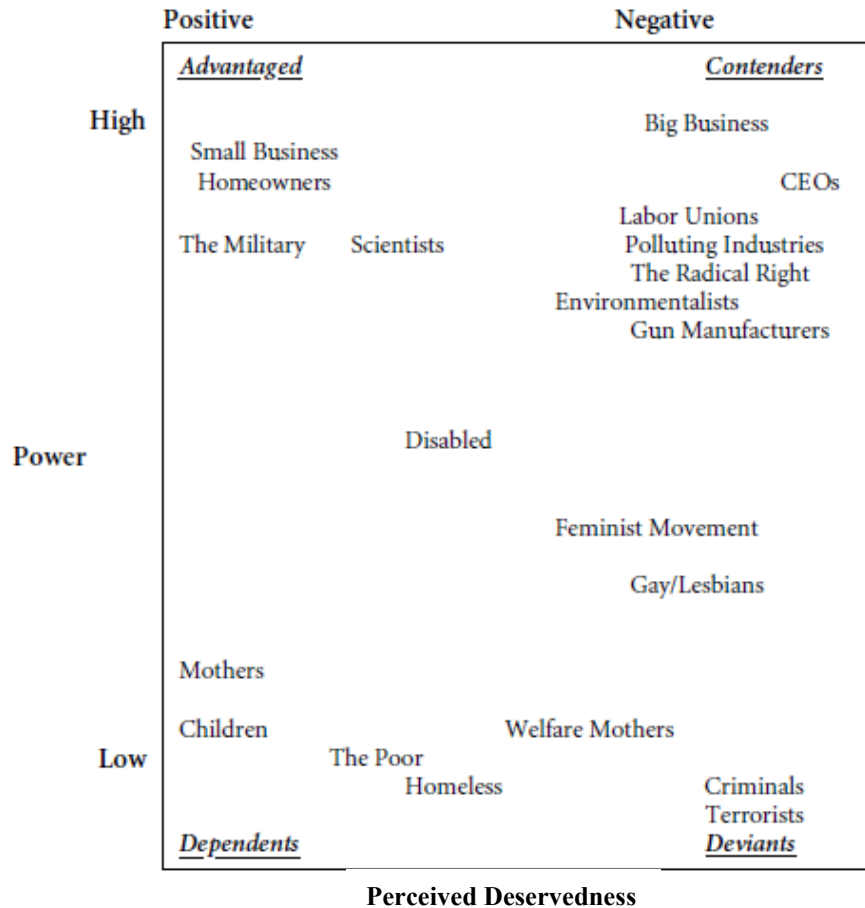
### 2.3.1 Interest groups

‘Interest groups’ is a very broad term. One way to think about the influence that various groups can exert on the policy process is offered by social construction theory (Ingram, Schneider & deLeon, 2007). This theory suggests that the allocation of benefits and burdens to target groups depends on two factors - their political power and whether they are seen to be ‘deserving’. The political power of a group depends on its resources, whether they are large, united and easy to mobilise around key issues of concern and how they navigate the informal channels of policy development.

‘Deservedness’, linked closely to the public sentiments described above, refers to whether or not the particular group is seen to be more-or-less deserving and as contributing more-or-less to general welfare.

In their 2007 paper, Ingram, Schneider & deLeon developed a matrix depicting various groups in the US context with the x-axis representing the group's level of deservedness and the y-axis representing their level of political power. This is extracted in Figure 4 below.

**Figure 4: Social construction of US target groups**



Source: (Ingram, Schneider & deLeon, 2007)

The *Advantaged* group, found in the top left, represents those with both political power and those that are perceived to be deserving. Such groups are likely to get a greater share of benefits. This is in part because the provision of benefits to these groups bestows considerable political capital on policymakers, as they are welcomed by the groups themselves and ‘others will tend to acquiesce because the rationales often connect the policy to broad-based national interests, even though the policy actually favors [sic] specific target populations’.

*Contenders*, in the upper right hand quadrant are those groups with significant influence that are not seen as deserving. Such groups are likely to receive benefits because of their political power but the benefits are more likely to be ‘buried in the details of legislation and difficult to identify’.

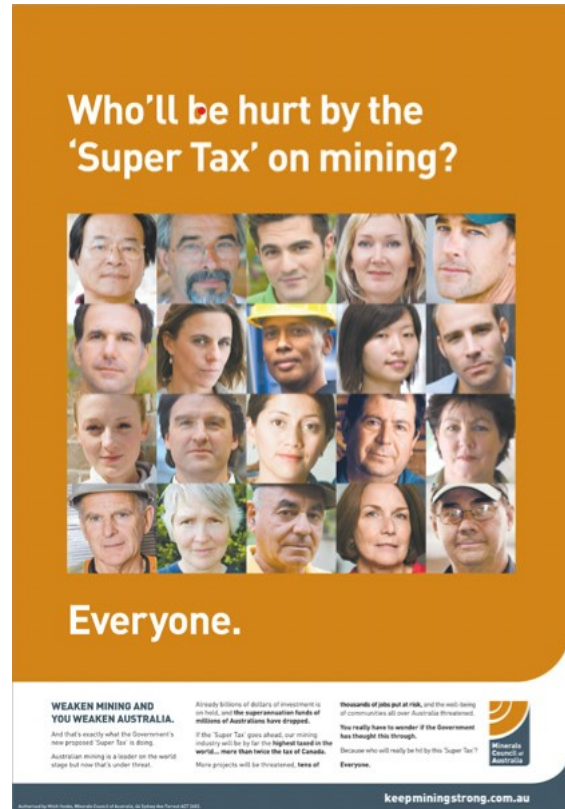
*Dependents*, in the bottom-left quadrant, are seen as deserving but lack political power. Their receipt of benefits is likely to be curtailed by their limited power.

Finally *Deviants*, in the bottom-right hand quadrant, are neither seen as deserving nor have any political power. These groups ‘tend to receive a disproportionate share of burdens and sanctions’.

A matrix constructed for the Australian context may look somewhat different to that depicted in Figure 4, but there are likely to be a number of parallels. Small businesses, for example, are almost

certainly to be amongst the *Advantaged*. Small businesses, variously defined, are consistently identified in public discourse as the ‘engine room of the economy’ (ASBFEO 2020), and this is reflected in policy development. Tax policy remains a preferred policy instrument for delivering support to small businesses, with various tax concessions valued at over \$6 billion in foregone revenue being provided to small businesses in the 2020-21 year alone (Treasury 2021).

This social constructionist way of thinking about interest groups can also provide insights in the manner in which certain groups seek to influence policy. A contemporary example is the ill-fated mining tax announced by Prime Minister Kevin Rudd in 2010. The announcement led to fierce opposition from the mining sector, with a comprehensive advertising campaign commissioned by the Minerals Council of Australia (MCA) and developed by the advertising and communications agency Lawrence Creative. The advert depicted here was one of 20 different print advertisements, eight radio ads and 11 television commercials. It is consistent with the brief provided to the agency to illustrate ‘the important role the minerals industry plays in the lives of all Australians,’ and to send the message that ‘if you hurt mining...you hurt Australia’ (Padula 2013). Using the social constructionist terminology, it was a successful attempt to move the focus from an ‘undeserving’ group to a ‘deserving’ group.



### 2.3.2 The role of central finance ministries

Central finance ministries have been identified in the literature as specific entities which have important roles in the policy making process. These ministries are the part of the public service with responsibility for advising Government on tax policy.

In the UK context, Alt et al. (2010) noted the predominant role of the UK Treasury in policy development, relative to the UK Parliament, in the following way:

‘It is hard to over-play the dominance of the executive over tax policy, the Treasury in particular. This is because as well as enormous agenda-setting powers, the resources available to the Treasury are vast when compared with those of most MPs. The Treasury can draw on much policy and practical expertise, as well as analysis conducted by HM Revenue and Customs (HMRC). MPs have many fewer resources at their command throughout the year.’

The authors contrast the policy development process in the UK – undertaken predominantly within Treasury and the Executive more generally – with the process in the US. The US Congress, through its various Committees, plays an important role in the development, analysis, negotiation and, ultimately, marketing of tax policy proposals, resulting in tax policy development being a far more public process.

Having inherited much of the UK's system of Westminster Government, the Australian landscape shares many similarities with the UK. Australian Parliamentary Committees, such as the House Standing Committee on Tax and Revenue and the Senate Standing Committee on Economics do consider tax policy issues and, in the case of the latter Committee, can play an important role in articulating the case against proposed changes contained in draft legislation. However, as in the UK, they have a far more benign role in driving policy discussions relative to the US system.

In his analysis of Australia's experience with the GST, Eccleston makes similar reflections on the role of the Australian Treasury that Alt et al. make with respect to the UK Treasury. Eccleston suggests that 'for most of the 20<sup>th</sup> century the Treasury exerted an almost doctrinaire influence over macroeconomic policy making in Australia and exhibited a fierce determination to protect this institutional influence'. On tax policy in particular, Eccleston suggests that this dominant position of the Federal Treasury meant that, whilst there was a clear economic policy agenda focussed around the need for a broad based consumption tax, there were challenges in building broader coalitions in an otherwise fragmented policy environment.

The potentially influential role played by a bureaucracy has also been noted by commentators with respect to experiences across the Tasman. Johan Christenson (2012) suggests that the neo-liberal tax reforms<sup>14</sup> in New Zealand in the 1980s and again later in 2010, is 'best understood as the product of autonomous bureaucratic action'. That is, the New Zealand bureaucracy (predominantly the Inland Revenue Department and the Treasury) developed the goals and ideals for reform, took an active role in policy making and took on a concerted, and ultimately, successful role in influencing the policy preferences of ministers.

A number of commentators have, however, suggested that the influential role of the bureaucracy within Westminster systems is waning. Alt et al., for example, noted in 2010 that ministerial offices had become far more important in the tax policy development process in the UK. Similarly, in his recent book *Changing Fortunes*, long serving Australian Treasury official, Paul Tilley, suggests that the Department's influence has waned significantly since the reformist era of the 1980s and the 1990s. This is in part a result of the far more contestable environment in which policy advice is provided and, in particular, the shifting of policy advising responsibilities away from the public service to ministerial offices. It is also a consequence, Tilley argues, of the declining policy advising capability within the Department (Tilley 2019).

### 3 Political economy of reform

So far we have discussed some of the contextual, institutional and agential factors that may help to explain tax policy outcomes, drawing on examples in the Australian context. This final substantive section of the paper examines the factors most commonly associated with structural changes in tax systems (i.e. reform).

#### 3.1 The challenge of reform

On any empirical measure, changing the tax system is not difficult at all. Indeed, change is a constant feature of tax systems, unsurprising given their importance and complexity. Australia is no exception. In the course of the 45<sup>th</sup> Commonwealth Parliament (August 2016 to April 2019), for example, over 40 separate pieces of legislation containing over 100 separate measures amending Australia's tax laws were enacted.

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<sup>14</sup> Low rate, broad based and neutral taxation

What is more challenging is *reform* – substantive changes to the tax system that go beyond the tinkering of rates or existing tax bases. Why is reform so hard? The literature emphasises that there is a strong resistance to substantive change and, when it does happen, change tends to follow the path set down by the existing system. Put another way, there is a ‘status-quo’ bias in the system and, relatedly, a ‘path dependence’.

This status-quo bias is intuitive. If the various forces described above – structural, institutional or agential – have helped to shape the system that we have, then those same forces will be working towards the system’s preservation.

Much has also been written in political science literature about ‘path dependence’. As Pierson (2000) notes, this is the idea that once a country starts down a particular path, then this will mean both that the costs of reversal are high and that any future movement is more likely than not to be on that same path. He cites Levi’s (1997) use of the tree metaphor – ‘from the same trunk, there are many different branches and smaller branches. Although it is possible to turn around or to clamber from one to the other – and essential if the chosen branch dies – the branch on which a climber begins is the one she tends to follow’.

Path dependency can be applied in a range of different contexts. It explains, for example, why if you were driving in the United States you would find yourself bound by speed limits delineated in *miles* and refuelling your car with petrol by the *gallon*. With respect to tax policy, the UK’s experience of its Research and Development Tax Incentive, noted by Alt et al. (2010) in the Mirrlees Review, is a case in point. Although no group was advocating for it prior to its creation, once established, a strong coalition campaigned fiercely not only for its retention but also for its expansion. An example, the authors suggest, of ‘policy drift’ as the regime moved further and further away from its original policy intent. Or, using Levi’s metaphor, further down the chosen branch of the tax policy tree.

The asymmetry that has informed the development of the existing system, both in terms of information and the interests and power of the various agents involved, may also help to explain the challenge of reform.

Profeta & Scabrosetti (2017) suggest that the challenge of individuals to meaningfully engage with such a complex system acts as the biggest impediment to change. Substantive changes often involve immediate, clearly visible costs whilst the benefits are likely to be realised over a longer time and be far more abstract.

In its *Tax Policy Reform and Economic Growth* paper written in the context of the Global Financial Crisis, the OECD (2010) attributes the underlying reason tax reform is not always effective to be the heterogeneity of agents. The paper argues that ‘the different endowments and/or preferences of different groups mean that tax reforms will have a differential impact on them, and even socially beneficial reforms may contradict the interests of many’.

In the Australian context, the debate in recent years around the proposed cut to the company tax rate provides a useful case study. A key economic policy of the Turnbull Government, the proposal to cut the company tax rate for all companies to 25 per cent, in time, was first introduced into Parliament in 2016. Despite a number of attempts to pass the legislation through the Senate, the broader cut was eventually abandoned with a narrower tax cut, focussed on smaller businesses, ultimately enacted by Parliament.

With Australia now with a corporate tax rate that is equal second highest in the OECD<sup>15</sup> and the company income tax consistently being identified as one of the least efficient tax bases in the Federation (Cao et al. 2015), the case for lowering the company tax rate may be one of the closest thing Australia has had to prevailing economic orthodoxy when it comes to tax policy. Supported in *AFTS*, a (albeit modest) part of the subsequent 2010 proposed tax reforms that included the original mining tax, the Turnbull Government's proposed changes built on the case again being made in the *Re:Think* discussion paper.

Despite this policy pedigree, prosecuting a case for change which relies on articulating the difference between the economic and legal incidence of taxation and one in which the promise of benefits (such as higher wages) will flow *eventually* over the medium to longer term, proved too challenging in the face of perceptions that it is a tax cut for 'the big end of town'. The presence of dividend imputation, which makes changes in corporate tax rates much less relevant to domestic shareholders, likely also explains why changes in Australia have proven far more challenging relative to countries (such as the UK) which abandoned their imputation system some years ago.

### 3.2 Overcoming challenges

Status quo bias and path dependence may explain much about why many of the more substantive recommendations in the various Commonwealth and State tax reviews referred to in the Introduction remain unimplemented. Yet substantive changes can and do occur. Overlooked in the introduction of this paper are the significant changes being implemented in the Australian Capital Territory following its review in 2012<sup>16</sup>, as well as the current consideration by the NSW Government of substantial property tax reforms consistent with the recommendations of the Thodey Review (NSW Government 2020).

So what factors are most associated with successful reform?

#### 3.2.1 A dramatic change in context - the role of crises

Although many of the contextual/exogenous factors influencing tax policy processes evolve only slowly, a dramatic change in the exogenous environment can radically transform the policy dynamic enabling significant changes to be made.

In his book, Eccleston (2007) notes the significant literature linking tax reform to key moments of crisis that enable or demand a Government to make significant changes. He argues that, 'given the weight of such evidence, any study of tax policy changes must be attuned to the impact of political and economic crises on the institutional structure of the tax policy arena' (Eccleston 2007). In an OECD Taxation Working Paper written in the immediate aftermath of the Global Financial Crisis (GFC), Brys supports this, noting that the political obstacles to reform might be easier to overcome during a crisis, 'especially because of the increased pressure to raise more tax revenue in order to restore public finances' (Brys 2011).

The history of income taxation provides a good case study for the role of crises. Britain first experimented with an income tax to fund the Napoleonic wars in the late 18<sup>th</sup> Century, a precursor to its permanent introduction in the mid-19<sup>th</sup> Century. Similarly, in Australia the increased fiscal demands brought about by the two World Wars led to significant increases in income tax and, ultimately, the take-over of that tax base by the Commonwealth.

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<sup>15</sup> For 2020, data obtained from OECD stats available at [https://stats.oecd.org/Index.aspx?DataSetCode=TABLE\\_I11](https://stats.oecd.org/Index.aspx?DataSetCode=TABLE_I11)

<sup>16</sup> For more information see <https://apps.treasury.act.gov.au/taxreform>

Whilst falling short of a war-level crisis, Eccleston suggests that growing economic pressures in the 1970s and the 1980s in Australia, and the implications this had for the tax system, provided the structural context for a number of subsequent attempts to reform Australia's tax system. The end of the post-war boom saw Australia from the 1970s facing very high levels of inflation, with the consequence that salary and wage earners faced real increases in income tax burdens. Eccleston estimates that the marginal income tax rate on average weekly earnings doubled from 15 per cent to 30 per cent between 1955 and the 1970s. Combined with the fact that Australia had a relatively high reliance on income taxes together with the increasing public evidence of large numbers of self-employed and professionals engaged in tax evasion and avoidance through 'Bottom of the Harbour'<sup>17</sup> and similar schemes, this provided the 'political backlash' that helped make difficult reforms possible.

### 3.2.2 Overcoming the collective action problem

Collective action is the engine of change (Corduneanu-Huci 2013). In many areas of public policy, building a sufficiently broad coalition of actors necessary to challenge and displace the groups that have an interest in the preservation in the existing system is difficult. It is arguably *particularly* difficult in tax policy given the complexity of the system and the fact that reform proposals, as noted above, often offer benefits that are diffuse and long term. It took decades after the public finance literature had articulated the case for broad based consumption taxes for sufficient support for such a tax to materialise in Australia.

In development policy, there is often a focus on the role that civil society can play in both articulating the case for change and in developing the breadth of support necessary to overcome collective action challenges. Whilst often less of a focus in the context of tax policy in developed countries, particularly in Australia, the role that civil society has played in the last two decades on international tax issues presents a worthwhile case study.

The emergence of civil society groups focussed on taxation has seen a growing focus on concepts of 'tax fairness' that has engaged the public and helped to shift public sentiments and has led to tangible changes in domestic tax systems. Since its foundation in 2003, the UK based Tax Justice Network (TJN) has emerged as somewhat of a leader of such civil society groups (Seabrooke & Wigan, 2016). The founder of this organisation was John Christenson, a trained economist and former chief economic adviser to the Crown Dependency of Jersey. The TJN developed as a network of like-minded professionals from various backgrounds that together sought to promote greater public scrutiny of the tax practices of both multinationals and wealthy individuals using 'tax havens'. Amongst other interventions, this increased scrutiny and advocacy within the EU, G7 and, ultimately G20 has seen the adoption of proposals originated by the network. Notably this includes standards for 'Country by Country Reporting' - a reporting standard requiring multinational enterprises to report on global allocation of profits, income and taxes to improve the risk assessments of tax administrators.<sup>18</sup>

Journalists and the media have also played a role in promoting broader public engagement in tax issues. The international tax landscape, including the ongoing focus on tax transparency issues at

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<sup>17</sup> Involving the stripping of assets and accumulated profits before tax fell due – metaphorically sending it to 'the bottom of the harbour'.

<sup>18</sup> The original template for an international standard was originally published in May 2003 by Richard Murphy, one of the professionals linked to the TJN (Seabrooke & Wigan). As of 21 March 2021 there are now over 2700 active bilateral exchange relationships implementing the agreed standard (which differs from its original design).

forums like the G20, has been shaped by Governments needing to respond to well publicised exposure of tax and financial data, such as ‘Lux Leaks’ (2014), the ‘Panama Papers’ (2016) and the ‘Paradise Papers’ (2017). The public scrutiny that followed these well publicised leaks has had implications for domestic policy settings. The exposure of the ‘Panama Papers,’ as part of broader tax planning practices, led New Zealand for example to make a number of amendments to its foreign trust regime (Littlewood 2017).

### 3.2.3 Policy entrepreneurs

Crises and a growing public awareness of the need for change may provide a contextual and institutional environment conducive to reform, but capitalising on such an opportunity may ultimately require an individual prepared to commit their own personal capital in the pursuit of such a goal (OECD, 2010). Such a *policy entrepreneur* may play a role in translating growing public awareness of the need for change into an active coalition, or may seek to articulate the case directly for change, helping to translate the diffuse and long term benefits from reform into something real for voters.

Given their formal role, it is politicians that might ordinarily take on such a role. In his keynote address to the TTPI’s National Tax Summit in 2020, long serving Chief of Staff to the US Congress’ Joint Committee on Taxation, Thomas Barthold, noted that a key feature of all major US tax reforms in the last 35 years was the active role, and leadership of, the US President. Specifically, a key to success was for the Presidency to build a consensus around clearly articulated goals that underpinned reforms. This included the 1986 Reagan reforms focussed on lower rates and simplicity, the 1997 Clinton reforms aimed at ending welfare ‘as we know it’, the 2001 Bush (W.) reforms to return the surplus to the US taxpayer and the 2017 Trump ‘pro-growth’ reforms (Barthold, 2020).

Policy entrepreneurs need not necessarily be those with formal decision-making authority. With respect to Australia’s GST experience, Eccleston identifies Graeme Samuel, then President of the Australian Chamber of Commerce and Industry, as such a policy entrepreneur. Shortly after the Coalition’s election victory in 1996, Samuel reached out to the President of the Australian Council of Social Service. The two organisations, representing business and social welfare groups, hosted a community summit on tax reform. As a consequence of the summit, welfare groups agreed that a low rate, broad based consumption tax needed to be a part of Australia’s overall tax mix.

### 3.2.4 Other factors associated with successful reform

In *Tax Policy Reform and Economic Growth*, drawing on the experience of its member states, the OECD identifies a range of strategies that can contribute to successful reform efforts. These are summarised in Table 2 below.

**Table 2: Strategies for successfully implementing growth-oriented reforms (OECD 2010)**

| Strategy/Factor                    | Discussion   |
|------------------------------------|--|
| Appropriate framing of tax debates | Ensuring the debate goes beyond a focus on the immediate ‘losers’ from a particular change and the change is placed in the broader context of the tax (and transfer) system can help bolster chances for success. In the Australian context, Smith (2013) suggests that strengthening the inter-generational and sustainability narratives may help to build the case for longer term structural challenges. <sup>19</sup> |

<sup>19</sup> Writing in 2013, Smith notes although the intergenerational reports have made some progress in changing community expectations, they have continued to be narrowly focused with gaps in areas



|  |   |
|--|---|
| 'Bundling' reforms   | The report notes a strong body of literature supporting the case for 'bundling' reforms, rather than pursuing changes to individual tax bases. As well as ensuring a whole of system debate, the bundling of changes can make it easier to address distributional issues particularly where fairness is a concern.  |
| Articulating a clear strategic vision supported by strong analysis | A deliberate and considered communications strategy is crucial to ensure that the particular set of reforms is placed into a broader context (as in the US cases noted above). The aspirations of tax reform are ideally announced ahead of any specific proposals. Once the broad goals have been stated, individual proposals need to be rigorously assessed against this benchmark with respect to behavioural impacts, revenue implications, distributional impacts and compliance implications.  |
| Accepting some constraints up front may be essential               | Accepting that some constraints may be binding (e.g. revenue or redistribution neutral) may be necessary, though too many constraints may limit the potential benefit of any reform.  |
| Appropriate transitional rules                                     | Appropriate transitional rules can be crucial in helping to defray the opposition to reforms from those most immediately impacted. Too many or overly generous transitional rules can, however, undermine the policy goals of the reforms and introduce new challenges.   |
| Timing is crucial and it helps to be able to pay for reform        | <p>If mistimed, reform efforts may be blocked and such reform directions may be taken off the agenda for many years. Experience suggests that countries can more readily enact fundamental reforms when running Budget surpluses and are able to 'pay' for reform. On the other hand, economic downturns can make change easier if they create a crisis or the perception of one.</p> <p>Timing is also a question of when Government is ready to answer the difficult questions associated with a challenging reform path.</p>   |
| Investing in quality institutions                                  | <p>Good institutional planning of fundamental tax reform is a precondition for its successful implementation and comprehensive analysis is the 'bedrock' of change.</p> <p>This suggests that Governments with tax reform ambitions need to provide adequate resources for the development and maintenance of tax models that can provide good quality analyses of the impact of tax reform on agents' behaviour and tax revenues and by investing in the human capital of its staff.</p> <p>The development of specific institutional arrangements to pursue reform can be useful. The Reports noted, for example, the establishment of the Tax Commission of Denmark in the context of their 2010 reforms. The Commission brought together academics, experienced politicians and senior officials.</p> |

like state spending, the future costs of superannuation etc. and have not been adequately linked to policy variables like the NDIS and education reform.

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| Coordination of reform across levels of government is important                           | This suggests that channelling the demand for greater revenue from sub-national Government could provide an avenue to build the case for reform. However there are substantial challenges with coordination.  |
| Post-reform evaluation and international dialogue may help strengthen the case for change | A commitment to review existing policies and incorporating explicit triggers (e.g. sunset clauses) into regimes, supports continuous improvement and can build the case for change.<br><br>International coordination may in some cases be critical in successful reform if a particular reform only makes sense if undertaken in concert with other countries. |

The OECD paper, as other papers such as Profeta and Scabrosetti (2017), also discusses the relative merits of ‘big-bang’ reform relative to incrementalism. As well as providing an opportunity to ‘bundle’ various reforms as noted above, pursuing a comprehensive package of reforms quickly might prevent the formation of lobby groups powerful enough to prevent the reform. A gradual approach may also result in ‘partial reform equilibrium’ if a reform process is stopped or loses momentum part way, or degenerates into a series of ad hoc measures with little overall impact.

The inclusion of a table such as the one above could give the impression that there is a checklist that ensures that major reforms are successful. Of course this is not the case. Approaches to reform efforts need to be tailored to the particular circumstances of the time. Australia’s 1985 tax reforms are a good example of this. Reflecting the style and approach of Prime Minister Hawke, there was initially a strong emphasis on consensus building in the lead up to the reforms. This culminated in the holding of a *National Tax Summit* at Old Parliament House in July 1985, which almost immediately went off track when the first speaker representing the Business Council of Australia rejected all reform options on the table. Following the summit, Treasurer Keating worked with Treasury to develop a package which was simply announced through a Ministerial Statement some months later and which Keating and other Ministers then set about selling. Whilst the final package did not include a broad based consumption tax, which had initially been in the mix, it did include the introduction of a capital gains tax, fringe benefits tax and dividend imputation and still represents one of the most significant reforms in Australian tax policy history (Tilley, 2021).

### 3.3 Changing the ‘rules of the game’

The institutional environment may help to explain a strong status quo bias and path dependence for existing systems. Accordingly, changes to that institutional environment may make certain reform paths possible or more likely. Indeed, as noted above, interventions to change the ‘rules of the game’ are often the focus of development policy.

The same can be applied to taxation. Writing in the Mirrlees Review, Alt et al. (2010) suggests that, whilst there is a limit as to the extent voters can be aware of and hold government to account for ‘good tax policy’, institutional reforms that improve transparency and public understanding could help avoid situations where government makes increasing use of tax policy instruments that are ill-understood by voters or less visible or transparent to voters.

There are a number of examples of such institutional changes in the Australian context.

As noted above, the annual publication of the Tax Benchmarks and Variations Statement (previously known as the Tax Expenditures Statement) is required by the *Charter of Budget Honesty Act 1998*, and seeks to provide transparency around, and promote dialogue on, the use of the tax system to

accomplish particular policy objectives. Australia is not alone in publishing such a document – it is common place in most developed countries and, increasingly, in developing countries (Mansour 2019).

A more recent example was the decision of the then Government to require the ATO to publicly disclose the tax payable by large corporations. Published since the 2013-14 income year, this change was based on the desire to ‘enable the public to better understand the corporate tax system and engage in policy debates’ (Bradbury 2013).

Notwithstanding that the opening of this paper emphasised the unrealised promise of a number of reviews over the last decade, another example is the direct product of the implementation of an AFTS recommendation. The AFTS final report included a discussion on the need for ongoing monitoring and reporting on the tax and transfer system to promote transparency and accountability and ultimately support the long-term performance of the system. Amongst other recommendations, AFTS proposed that the government ‘support one or more institutions to undertake independent policy research relevant to the Australian tax and transfer system’.<sup>20</sup> The result was the Tax and Transfer Policy Institute which is providing the platform for this paper to be published.

Similarly AFTS also recommended the regular publication of a ‘Tax and Transfer Policy Statement that analyses and reports on the overall performance and impact of the system,’<sup>21</sup> and for the better collection and dissemination of data to support analysis and research.<sup>22</sup> With respect to data, Australia has made major advances with the production and publication of the Australian Taxation Office’s Longitudinal Information Files (Alife) which provides longitudinal data on taxpayers from 1991 to 2018. The Australian Bureau of Statistics has also made more business data available, including data that allows for the analysis of the effect of business taxation and subsidies, through the Business Longitudinal Analysis Data Environment (BLADE).

There are also a range of other ideas and proposals for institutional change. In the UK context, for example, the key recommendation by Alt et al. in the Mirrlees review was the increased resourcing of the UK Parliament to assist MP’s to more meaningfully engage in tax policy as a counterbalance to the dominance of the Executive. In Australia, arguably a step towards that was the creation of the Parliamentary Budget Office (PBO) in 2012, which plays a role in costing tax and other policy proposals for non-Government members of Parliament, as well as providing a report on the cost of election promises. The PBO does not, however, provide advice on the merits or feasibility of particular proposals.

More substantive proposals that have been proposed at various times include the creation of an independent and permanent Tax Commission designed to be ‘beyond politics’ (Hewson 2014). Such a Commission could be structured to serve a role similar to that of the Productivity Commission – an independent institution that could seek broader public input to an issue, commission research and ultimately provide a report to Government. At the other extreme, such a Commission could take the place of Government in setting tax policy, akin to the role of the Reserve Bank in relation to monetary policy. However, this latter proposal seems unrealistic given the inherently political nature of tax policy setting.

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<sup>20</sup> Recommendation 134

<sup>21</sup> Recommendation 132

<sup>22</sup> Recommendation 133

## 4 Conclusion

This paper makes the case for a more deliberate and expansive focus on political economy issues in Australia by those with an interest in Australia's tax policy settings. The analytical frameworks and extensive international literature in this discipline offer insights that complement the more traditional areas of legal and economic analysis. Whilst the paper has drawn parallels to Australia's tax policy experience in making this case, these have necessarily been brief and there are numerous potential avenues of further enquiry.

First, developing a deeper understanding of the contextual and institutional environment has the potential to tell us much, not only about why we have the system we have today, but also the factors influencing the trajectory of the system.

The BEPS project generally, and the recent changes to Australia's Offshore Banking Unit regime in particular, highlight the continuing role that globalisation and the international institutional environment will play in shaping Australia's domestic policy settings. A broader geopolitical assessment of national interests and perspectives – one that goes beyond those countries with which we share cultural and linguistic similarities – could support Australia in effectively navigating an increasingly dynamic international institutional environment in which emerging and developing economies are increasingly playing a role.

Administrative capacity has and will continue to help to define what is possible from a policy perspective. With one of the world's most capable tax administrations, Australia through the Australian Taxation Office has the potential to be – if not already – at the forefront of applying emerging technologies. Understanding the possibilities, limitations and risks of these technologies could better position policy-makers to responsibly capitalise on this potential.

Norms around 'fairness' are likely to remain a – if not *the* – key factor in defining public sentiment towards tax policy in Australia. However, as evidenced by the Australian Election Study, public sentiments can and do evolve, both in terms of what we think is 'fair' and what we expect from our tax system. In the context of the pandemic, the response to which continues to include significant increases in social spending, understanding how public sentiments are shifting will be of critical interest to policy makers going forward. As the IMF survey suggested, 'policymakers...would be well advised to devote even more attention than usual to political economy factors and to gauge the support for the policy choices.' A survey, such as the one undertaken by the IMF in the US, would be a worthy area of further work in the Australian context.

Given it has been published for around two decades, it would be timely for a detailed analysis of Australia's annual Tax Benchmark and Variations Statement. This analysis could include trends, both in terms of number and value of expenditures, to identify any correlation with economic conditions or, more specifically, the status of the overall Budget. This analysis could also be extended to the tax expenditure reporting of the states and territories, often produced as part of their annual Budgets. International comparisons, looking at the value of tax expenditures relative to a country's overall tax base, would also be useful in identifying whether Australia has a *particular* reliance on tax expenditures relative to comparable countries.

Secondly, the many voices that have called on Governments to seize the reform opportunity offered by the health and economic crisis caused by the pandemic, would do well to understand the lessons from international experience, distilled through the political economy literature. No crisis and no reform is the same, but these experiences and lessons could at the very least provide a starting point and structure in thinking about how the case for reform might be built in the Australian context.

Understanding Australia's own unique context will be of critical importance as well. As the GST experience attests, achieving reform in a country with a vibrant two-party system, relatively short election cycle, a powerful Senate, and one in which the major tax bases are split across different levels of Government, is likely to be hard won. Yet, as the GST also shows, it is possible.

Importantly, reform will require sufficiently broad community support. Given the number of submissions made to various reviews over the years, it should be possible from publicly available material to undertake a detailed stakeholder analysis of the type that is commonplace in informing development interventions. Although this could be expected to confirm the sectoral focus of particular groups, it might also provide insights into the potential to develop the sufficiently broad coalitions necessary to challenge the status-quo bias, through identifying those groups that have taken a broader tax system perspective to issues in the past, or in identifying common ground amongst key groups across the social and economic spectrum.

Clearly and simply articulating complex ideas in an environment in which narratives must be built through a 24 hour news cycle remains a challenge. Although this is an enduring challenge for policy makers, academia and members of civil society who seek to inform public debate on tax policy issues should continue to explore ways to maximise the impact and reach of their empirical work. Collaboration with schools of journalism, communication and media could, for example, help to inform communication strategies of organisations like the TTPI that have an important role to play in Australia's tax policy debates.

Finally, taking a longer term perspective, further work could be undertaken to understand the impact of the institutional interventions over the last decade. This could form the basis of analysing the value of further institutional changes aimed at increasing tax system transparency and encouraging broader public understanding and informed engagement in tax policy issues. Although the creation of a Reserve Bank-type organisation that sets tax policy independent of Government is unlikely, this could include the annual report cards suggested in the AFTS Review or mechanisms to bolster the role of Parliament in tax policy issues such as through an expanded role in tax policy analysis by the Parliamentary Budget Office.

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