Realising Our Full Potential: Tax Directions for a Transitioning Economy

Business Council of Australia

Contents

FOREWORD

The role of business in tax reform

The Business Council of Australia is made up of over 130 of Australia's top companies. Our members play a vital role in Australia's economic development and our success as a country by:

- employing about one in 10 working Australians
- paying more than 40 per cent ($25 billion) of all company tax last year
- paying around $45 billion in dividends to shareholders.

Business Council members are also part of a broader business community that generates a substantial part of Australia's overall wealth. Collectively, more than 10 million Australians work in small, medium and large businesses.

So the business community has a significant understanding of what will drive economic growth and the creation of rewarding jobs. We know the kind of system that will move the country forward and the kind of system that will hold us back.

The Business Council of Australia is seeking to inform the current debate about possible changes to our tax system.

The Business Council wants to steer that debate towards changes that will improve the living standards of all Australians by growing the size of the economy, not increasing taxes to fund ever-growing spending. It is about making changes to the tax system that will encourage investment, create new jobs and be fair. It's about creating a tax system that helps the economy make the transition to a highly competitive, globalised, digital world.

The Business Council also strongly believes that the tax system must be fair. The system overall must be progressive, that is, everyone must pay their fair share, according to their capacity to pay. Any changes must protect low-income earners and the most vulnerable people in the community. But fairness also means that people should not be penalised for effort and hard work. It means giving people the opportunity to work.

We have consulted widely to explore the types of tax change that, through stronger growth, would deliver gains for all Australian households.

About this paper

This paper sets out a path for transforming the tax system to one better suited to Australia's economic situation and future challenges. It sets out:

- Australia's economic situation and the challenges we face as a nation
- why our current tax system needs to change
- the objectives and essential elements of a tax system that will promote growth, job creation and fairness
- some options and possible directions for change
- facts and analysis to help the government and the community navigate the impacts, benefits and risks and trade-offs of different options, including doing nothing.

KEY MESSAGES

The opportunity and the problem

Our economy is not growing as fast as it should or could.

This has serious implications for jobs, wages and living standards.

Because the Australian economy, along with the rest of the world, is undergoing significant transition, the dimensions of growth will be different.

We are moving to:

- a more diverse economy with a greater emphasis on services such as health, education, tourism, professional and financial services
- a more sophisticated, technologically advanced economy where our exports feed into fragmented global supply chains
- a more open economy where a greater variety of goods and services are traded, giving Australia unparalleled export and investment opportunities
- an economy where the education, skills and capabilities of people will increasingly determine our success.

Our proximity to the growth markets in Asia, our highly educated population and abundant natural resources put Australia in an extraordinarily strong position to make a successful transition – for the nation and all Australians.

But this is not going to happen if we don't update our policy settings to reflect the new realities of our economy and the pressing need to be competitive with the dynamic economies in our region.

The Business Council identifies four main areas that need to be fixed:

- We need to address the high cost of doing business in Australia imposed by over-regulation.
- We need to lift our international competitiveness by increasing the efficiency of producing our goods and services.
- We need governments to stop spending more than the economy has the capacity to pay for, and to spend it more wisely.
- We need to renew our outdated tax system, which was established for a different economy and a different world.

Of these priorities, the two most important and urgent are updating the tax system and getting public spending under control. Unlike many economic forces that are outside of our control, Australia's tax settings and our budgets can be controlled.

Because the tax system affects so many decisions that influence how quickly we can grow the economy, doing nothing on tax is not an option.

You can't have a new economy and new jobs with an old tax system.

What is wrong with our current tax settings?

Our tax system is impeding successful economic transition.

Our outdated tax arrangements are holding Australia back because they are holding back people and businesses from realising their full potential in a very different economic environment.

- When a person considers getting a new job or taking on additional work, they face high marginal tax rates that distort the work/reward trade off.
- When people get a pay rise to keep up with cost of living increases they end up worse off because of higher taxes through bracket creep.
- When a business is considering a new investment in Australia, it compares our uncompetitive rates, which increase the rate of return hurdle, with other countries where it is easier to invest and do business.

Our tax system needs to support the transition:

- lower rates of personal income tax so that people are encouraged to participate in the workforce, make an effort and be entrepreneurial
- lower the rate of company tax so that businesses are encouraged to invest, innovate and create jobs in Australia.

We can make the changes in a staged, careful and purposeful way. The pace and scale of change will have to be carefully calibrated according to fiscal and global economic circumstances.

What is the pay-off?

If our approach is adopted, we estimate that within a decade or so the Australian economy could be $9 billion bigger from a lower company tax rate alone. Australian households would gain from higher real wages or the equivalent of as many as 50,000 new jobs. Budget revenues could be $2 billion higher.

We will also have significantly slowed the number of Australian taxpayers tipping into higher tax brackets through inflation.

Australia will be better able to compete with other countries for valuable, job-creating investment and innovation.

We will be a more attractive destination for global companies to do business, creating more jobs, and bringing new technology, and new goods and services to consumers.

If our economy can return to the rate of 3.5 per cent average annual GDP growth Australia has experienced over the last 50 years, in 40 years' time it will be $1.5 trillion dollars bigger than it will be if we stay on the projected, weaker growth trajectory.

We hope that this paper will steer the tax debate towards changes that will improve the living standards of all Australians by growing the size of the economy.

Real growth needs real tax reform.

PART A

AN OPPORTUNITY WE CANNOT AFFORD TO IGNORE

Australia's economic imperative and where tax reform fits in

Without strong economic growth, Australia's capacity to maintain its enviable high living standards – including the capacity to fund high-quality health, education and other social services – will be significantly impaired.

But the economy faces headwinds from declining terms of trade, intense global competition and economic uncertainty, disruptive technology, and changing demographics and fiscal pressures. At the same time it also faces great opportunities from global economic shifts and technological innovation.

Our economy must make and is making the transition in response to these forces.

But improving economic growth in these circumstances will not be easy. There is no simple, single, one-off fix. Growth requires continual effort to get the most value over time from our scarce resources – that is, our people, our built capital and our natural resources.

Ultimately it is individuals and enterprises that drive economic growth through the decisions they make and risks they take every day, year in year out.

Economies and real incomes grow when people work, save and invest, including investing in their skills.

Economies and real incomes grow when businesses invest in people and capital and innovate to produce goods and services more efficiently or to develop new ones.

Economies grow when people and enterprises have the flexibility and capability to grasp opportunities as well as deal with challenges.

Economies grow when they are globally competitive and an open and attractive destination for foreign capital and skilled labour.

Policy settings can either help or hinder this continual (and unrelenting) process. Encouraging growth and economic resilience requires a business environment that incentivises risk-taking and entrepreneurship, and encourages investment, innovation and job creation in Australia.

We must use every lever we can within our control

It is self-evident that we should be doing everything that we can do within our control to drive growth, to meet head on known and unknown challenges and to grasp opportunities.

This means taking action across a number of policy fronts – workplace relations, regulation, skills, government spending – and not least tax.

Tax policy is a key lever within our control. Taxes influence virtually every economic decision that enterprises and individuals make. The current tax system is holding back growth unnecessarily. It is discouraging new investment, innovation and entrepreneurship.

Put simply, it is no longer fit for an economy making the transition to a globalised, technologically driven, digital world.

The tax system is impeding productive behaviour

Taxes affect business decisions about hiring people, taking risks and investing. Uncompetitively high company tax rates mean that otherwise profitable new investments do not take place. Driving out otherwise profitable investments 'at the margin' reduces innovation. It reduces new job opportunities because there is less capital for workers to work with.

Enterprises will hire an extra person when the value of what that person produces at least matches the wage paid. If the value of what is produced increases because of new machinery, equipment or new technology, then people can be paid more and more people can be hired.

Taxes affect individuals' decisions about entering the workforce, working overtime, training, buying or selling a house, buying insurance, saving and spending, and whether to work in Australia or overseas. High personal tax rates that cut in at relatively low income thresholds mean that people may choose not to work overtime, or not to seek promotion.

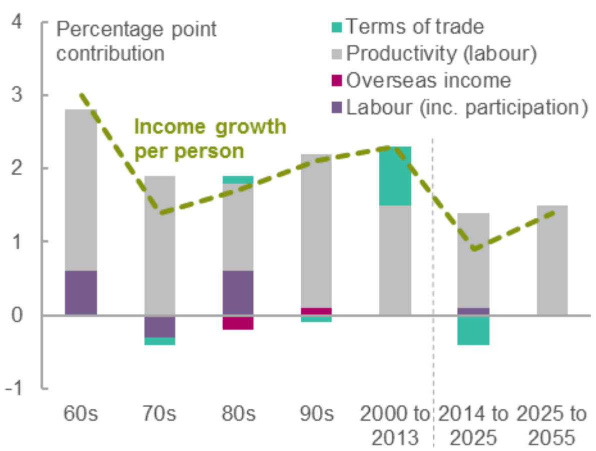
The bottom line is that Australia's tax settings are unnecessarily hindering wealth and job creation and slowing the necessary transitions underway in the economy. Recently released Treasury modelling confirms this: continuing bracket creep leading to higher average taxes is estimated to reduce GDP by 0.55 per cent or around $9 billion (in today's dollars).[1]

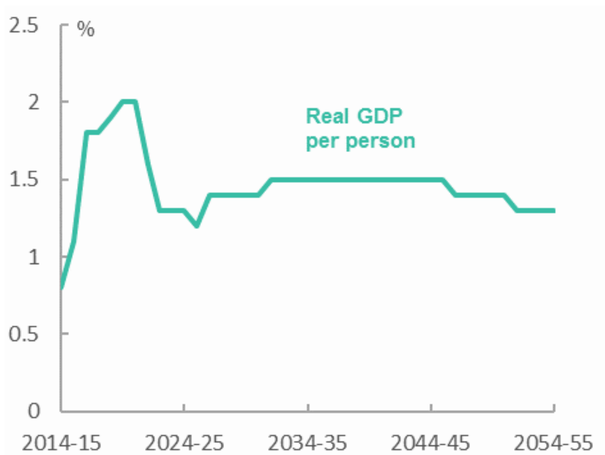
Economic performance is slipping

Australia's past rates of strong economic growth cannot be taken for granted.

We are facing the prospect of a decline in trend GDP growth in the foreseeable future. Real per capita incomes have actually been falling for the last eight quarters.[2]

Figure 1: Income growth has slowed and the outlook is for more of the same





Source: Australian Government, *Re:think tax discussion paper*, 2015; Australian Government, *2015 Intergenerational Report*, 2015.

Future income and revenue growth will have to come primarily from investment and innovation to lift productivity and competitiveness. We cannot wait and hope for serendipitous gains in the terms of trade.

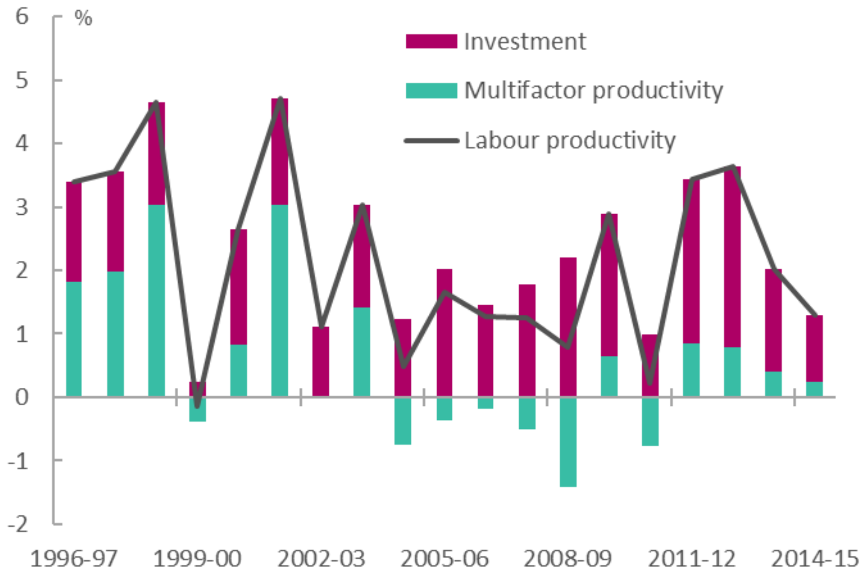
Investment and innovation, which together are measured by labour productivity, have always been and will continue to be the main drivers of real income growth per person in our economy.

Yet private business investment has slowed. For the last three years non-mining investment has been around 4 per cent of GDP, the lowest in over half a century.[3] And innovation-led productivity growth has all but stalled at less than 0.5 per cent.[4] There are many reasons for this, but a high-cost, uncompetitive business environment is not conducive to risk-taking and new investment and will inevitably deter innovation.

Australia's global competitiveness ranking has fallen from 10th a decade ago to 21st today. We have slipped behind New Zealand.[5]

Lower income growth is not just a statistic. The consequence of protracted lower income growth is that living standards are now at risk. Real income growth is how we can afford goods and services, including social and environmental goods and services, which improve our wellbeing.

Figure 2: Investment and multifactor productivity growth (= labour productivity growth) have declined



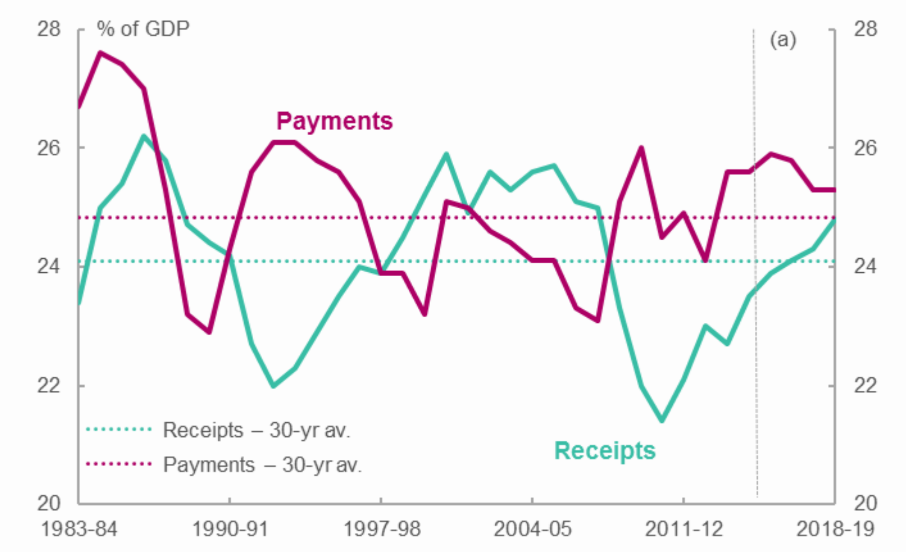
Source: ABS, *Estimates of Industry Multifactor Productivity, Australia,* cat. no. 5260.0.55.002; ABS, *Australian System of National Accounts, 2014-15,* cat. no. 5204.0.

The budget situation remains precarious

The budget will have been in structural deficit for a decade by the end of the forward estimates. In other words, the gap between spending and revenue growth is due to government decisions, not the economic cycle.

Nor can the continuing deficit be blamed on low revenues. Tax receipts are forecast to return to their 30-year average share of GDP (thanks largely to bracket creep). The culprit is spending growth which has averaged 3.5 per cent a year since 2007. The annual average rate of real spending growth was 3.6 per cent over the decade, compared to real GDP growth of 2.7 per cent. Total spending today is almost 26 per cent of GDP, just a whisker shy of its post-GFC stimulus peak.[6]

Figure 3: Government payments continue to outpace revenue



Note: (a) Forecasts. Dotted line denotes 30 year average to 2014-15.

Source: Australian Government, *Mid-Year Economic and Fiscal Outlook 2015-16*, 2015.

While there have been some recent important and sensible reductions in the rate of growth of spending, much remains to be done. Net national debt is now around $280 billion and approaching 18 per cent of GDP.[7]

This debt has to be serviced each year – currently to the tune of $11 billion even with low borrowing costs – and eventually paid back by future taxpayers.[8]

What $11 billion of interest payments could pay for …

The current interest bill on net national debt is more than one-third of the education budget, 40 per cent of defence spending and one-quarter of age pension outlays. Alternatively, it is the equivalent of an average tax cut for households of more than $20 per week.

In short, we have a substantial growing structural mismatch between our capacity to pay as a country and what we spend.

The *2015 Intergenerational Report* shows that without intervention, in coming decades government spending will be increasing by 3.1 per cent per year, outstripping an economy growing at 2.8 per cent. This will create an ever-growing fiscal gap.

There are, therefore, two tasks. We must step up the growth rate of the economy to strengthen revenues that flow to governments, *and* we must get spending under control.

Redesigning major programs – such as health care, which currently consumes about one-quarter of all government expenditure – is needed to slow the rate of spending growth at the same time as improving program delivery and effectiveness.

Progressively returning the budget to surplus is needed to maintain Australia's AAA credit rating to prevent higher interest rates for both government and business, build economic resilience and the capacity to deal with economic shocks.

Spending redesign will also ensure the sustainability of priority services, including an adequate social safety net, which are integral to community living standards. The focus should be on large programs such as health care and education. The National Disability Insurance Scheme is a stand-out example of where we must get the design right from the outset to avoid having to harshly impact the most vulnerable people in the community down the track.

The objective of tax reform, on the other hand, must be to promote economic growth, not pay for and prop up additional spending. Continually increasing taxes to pay for spending growth would lead to lower growth and be self-defeating.

The tax system is out of kilter with Australia's emerging challenges

The Australian economy is facing immediate and long-term challenges and uncertainties from its ageing population, shifting global economic forces and digital technologies.

An ageing population and declining participation

Like many industrialised countries, our population is ageing. One in five Australians will be 65 years or older by 2055 compared with one in seven today. An older population will drive increased government spending in health, aged care and age pensions while reducing labour force participation and thus the capacity to pay. By 2055 there will be only 2.7 workers for every person over 65, compared with 4.5 today.[9]

With an ageing population, the last thing we need is a tax system that through relatively high marginal tax rates unduly discourages people from working. High effective marginal tax rates (reflecting the interaction of the tax and transfer systems) particularly discourage workforce participation of low and secondary income earners and older workers.

Yet if income tax continues to represent the same share of total taxes as today (and the overall tax burden is not significantly lower), this implies a significantly increased burden on future income earners. In short, the personal income tax base will narrow further.

The tax system must also support higher productivity and economic growth in order to fund the services that an ageing and affluent population will demand.

Intensifying global competitive pressures and an economy in transition

As a relatively small economy, Australia depends on commerce with the rest of the world to earn the high incomes that support living standards. But as we have learnt in recent years, we cannot expect other countries to underwrite our living standards indefinitely. There are many exciting opportunities in China and elsewhere, but we will have to compete with other countries for them.

Realistically, these global competitive pressures will intensify, not abate, over time. Australian enterprises will need the flexibility to respond.

In particular, investment is urgently needed across the economy in both new and traditional sectors as the economy transitions from the mining boom. Policy settings will need to facilitate this adjustment not stymie it.

Global mobility and competition mean that capital is increasingly responsive to corporate tax rates and other costs. It is imperative that Australia offers an internationally competitive tax regime to attract diversified investments that build a resilient economic base and provide attractive jobs.

Yet Australia's materially higher company tax rate seriously detracts from the business case for investing in Australia. The statutory rate of 30 per cent competes with an average of 23 per cent in Asia and 25 per cent across the OECD. Two in three OECD countries have reduced their company tax rates since 2006.[10]

The marginal effective tax rate (METR) on investment in Australia is also much higher than competitor countries. The METR takes into account offsets such as depreciation allowances which are necessary for reducing disincentives to invest in long-lived assets. Australia's METR ranked 7th highest among OECD countries in 2014 and is much higher than many competitors in our region including China, Singapore, Indonesia and Hong Kong.[11] In particular, our competitors have improved their competitiveness over the past decade while Australia has stood still.

How high company tax rates deter business investment

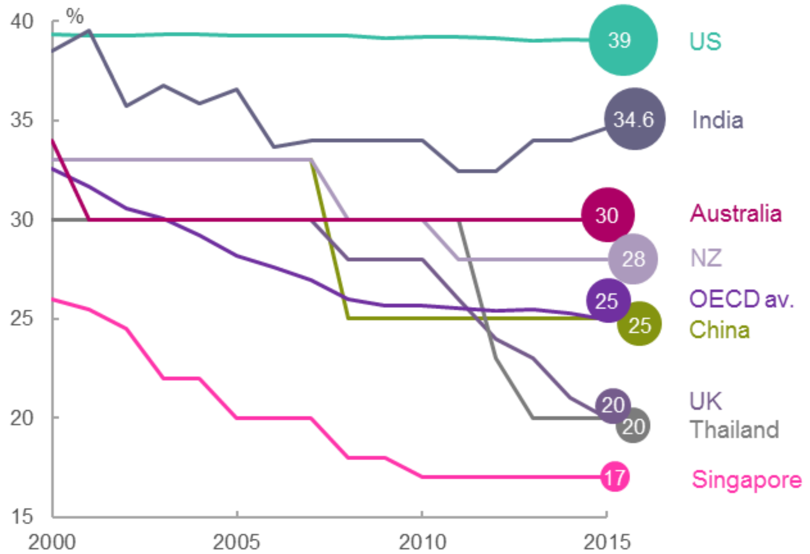
Businesses invest when the expected rate of return from an investment adequately compensates investors for their capital, including taking into account the riskiness of the investment.

Company taxes increase the required pre-tax rate of return for investments so that investors receive an adequate (post-tax) return. This higher hurdle means that some marginal but profitable investments will not go ahead.

The higher the company tax, the higher the hurdle and the greater the deterrent effect on new investments. The higher the degree of capital mobility, the greater the deterrent effect on new investments for any company tax rate.

The costs of not reducing Australia's high corporate tax rate will grow inexorably as other countries continue to lower their company tax rates. For example, the company tax rate in the United Kingdom will be 18 per cent by 2020.

Figure 4: Our competitors are lowering their corporate tax rates



Source: OECD, *Tax Database*, 2015; KPMG, *Corporate Tax Rates Table*, 2015; KPMG, *Corporate and Indirect Tax Rate Survey*, 2007.

As a result, business investment, innovation and jobs increasingly will shift overseas, lowering living standards and undermining tax revenues. And there is a real risk Australia's most talented people will follow. Competitive personal income tax rates will become increasingly important as people, particularly those with specialist skills, have more opportunities to work overseas.

A transitioning economy driven by technological innovation and digital disruption

Like the rest of the world, our economy is transitioning. We are facing great opportunities, challenges and uncertainties from rapid technological advances. Technology has long driven structural change but the pace of change today is arguably unprecedented.

Digitisation is disrupting business models and corporate structures and fragmenting global supply chains. The costs of direct exchange are being reduced, more goods and services are becoming tradeable, with opportunities to buy and sell to almost anyone with internet access. In the case of e-products, producers do not have to be physically located in a country to offer services there. Share economy services between individuals challenge traditional business, tax and regulatory structures. Innovating is essential to successfully transition the economy through these disruptions.

'Over 70% of global trade is in intermediate goods and services and in capital goods.'

OECD, WTO and World Bank, *Global Value Chains: Challenges, Opportunities, and Implications for Policy*, 2014.

Greater mobility of production and highly-skilled workers will compromise Australia's company and personal income tax bases, requiring greater reliance on less mobile and more geographically defined bases such as land and consumption.

The rapid growth in relatively mobile, intangible production inputs such as intellectual property, which encompasses patents, brands and copyright, pose particular challenges for traditional company taxes.

And at a time when innovation-led growth is paramount, high business taxes hurt innovative firms that drive growth *at the margin* the most. OECD analysis finds that reducing the corporate tax rate appears to be particularly beneficial for total factor productivity (TFP) growth of the most dynamic and innovative enterprises.[12] It will be imperative to ensure that our tax system doesn't impede innovative investment and risk-taking.

> '… corporate taxation affects performance particularly in industries and firms that are likely to add to growth.'
>
> OECD, *Tax Policy Reform and Economic Growth,* 2010.

Why our current tax system is simply not up to the task

These economic challenges demand a tax system that supports growth through increased competitiveness, innovation and participation. We also need a tax system and revenue base that are more resilient to economic volatility and global disruption.

Our current tax system relies too heavily on income taxes set at high rates that discourage people from taking risks, investing, innovating and working.

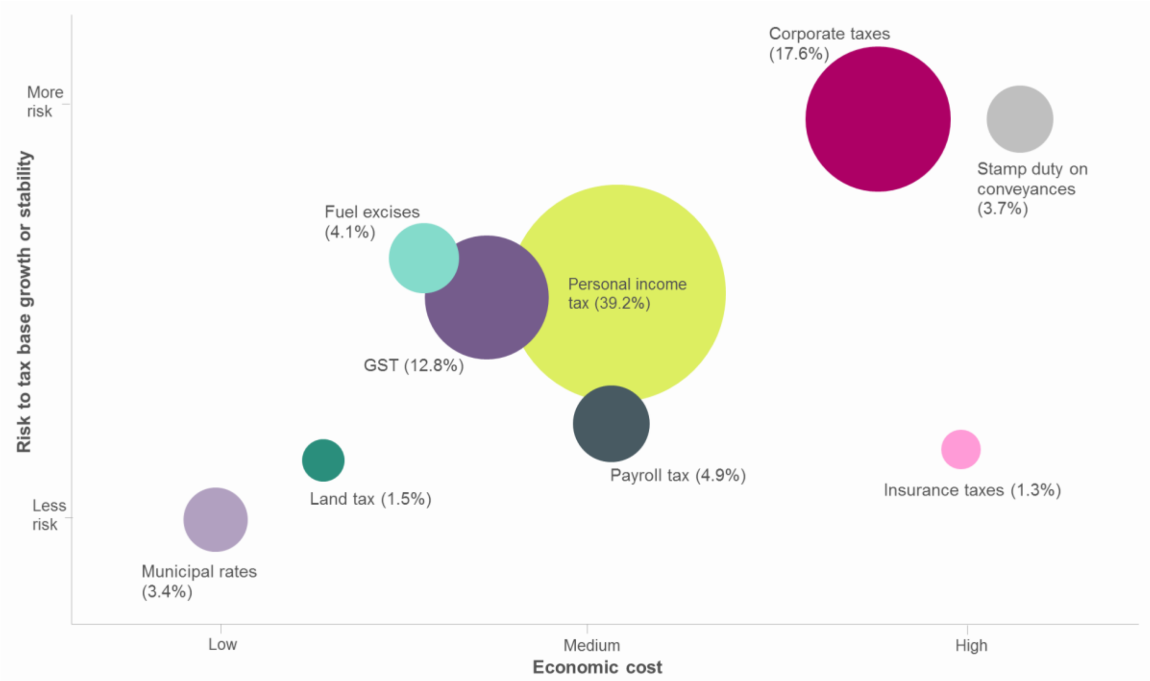
It relies too heavily on taxes that are volatile, have narrow bases or rely on a small number of taxpayers.

Company tax is Australia's second largest source of tax revenue yet it is heavily reliant on the profitability of just 12 of the largest companies. Combined, they contributed more than $20 billion or one-third of the $66 billion company tax total in 2014-15. But this year profits have slumped as the result of lower commodity prices, jeopardising billions of dollars of tax revenue. Technology is also disrupting the business models of major corporations.

Because of their reliance on property transactions, state tax revenues rise and fall with property market cycles.

In short, Australia relies too much on relatively 'bad' taxes. That is, taxes with narrow bases and high rates that impose disproportionately high costs because they discourage highly productive activities such as investing. And overly complex taxes that impose unduly high compliance costs.

Figure 5: Australia relies too much on taxes that reduce growth and risk revenue stability



Source: Roger Brake, *An inside perspective on the Tax White Paper*, 2015.

High personal income taxes discourage people from entering the workforce, from working additional hours and from working in Australia

Our personal income tax system influences decisions by people considering moving from welfare to work, by those deciding whether to work additional hours or to seek promotion, and those deciding whether to pursue careers in Australia or overseas.

Effective marginal personal income tax rates can exceed 80 cents in the dollar because of the withdrawal of benefits as incomes increase, creating a barrier to people wanting to enter the workforce.

Australia's top marginal income tax rate is nudging 50 per cent with the Temporary Budget Repair Levy. The average top rate in Asia is around 30 per cent. Australia's top rate cuts in at a little over double average earnings, compared with countries such as the UK and Germany whose similar top rates cut in at 4 and 6 times average earnings respectively.[13]

High marginal rates of income tax discourage some people from investing in skills improvement if they do not consider the eventual rewards from higher paid jobs are worth the effort. People will be reluctant to incur the cost of studying (the fees and forgone income) if they consider that after-tax rewards are inadequate. High marginal tax rates also encourage tax planning – that is, people seek out ways to reduce their taxable income.

Bracket creep means that workers face ever-higher average and marginal tax rates even though their real pre-tax wage hasn't changed

Bracket creep increases taxes by stealth through inflation and disproportionately and unfairly hurts lower and middle-income earners. Bracket creep is regressive and hidden.

Over the next three years, a person currently earning $150,000 will be paying 11 per cent more tax, while a person earning $36,000 an exorbitant 27 per cent more just because their wage increases to keep up with the cost of living.[14] The average tax rate for a person on average earnings of around $75,000 will increase from 23 per cent to 28 per cent within ten years.[15] In other words, they will be left worse off after tax, simply because their wage keeps pace with inflation.

Uncompetitively high taxes on business profits reduce investment, innovation and jobs growth

The company tax increases the rate of return hurdle and reduces the expected pay-off from an investment project. For example, a company considering building a new manufacturing plant has options about where to build. Of course tax is not the only consideration, but a high company tax rate is an important factor that makes Australia a less attractive investment destination.

Treasury estimates that raising an extra dollar of company tax imposes a real cost on the economy of around 50 cents, reflecting the value of investment forgone. This means 50 cents that is irretrievably lost for every additional dollar of company tax raised.

The recently introduced two-tier company tax system adds complexity and distorts business decisions

The two-tier company tax system, where small companies pay 28.5 per cent and medium-to-large businesses pay 30 per cent, adds complexity and, more importantly, discourages small businesses from expanding.

The impact of company taxes is largely borne by workers

As former Treasury Secretary Ken Henry has stated:

> '… the consensus of public finance theorists is that in Australia **if the company income tax were to be cut, the principal beneficiaries will be workers**. They would be the principal beneficiaries.'
>
> (Ken Henry, comment on Day 1 of Tax Forum, 4 October 2011)

Treasury has modelled the long-run welfare effect of a cut in company tax showing two-thirds of the benefits from a tax cut go to households, primarily through higher real wages, while only around one-third of benefits from a tax cut go to shareholders (Rimmer, Smith and Wende, 2014).

Real wages growth is generally closely related to labour productivity. Labour productivity growth reflects both the level of capital deepening (investment) and innovation-led (multifactor productivity) growth. With weaker terms of trade, labour productivity will again become the dominant driver of real wages growth.

Figure 6: Real wages and labour productivity growth tracked closely until the mining boom but are converging again

Source: ABS, *Australian National Accounts*, cat. no. 5206.0.

Lower investment because of a high company tax translates to lower labour productivity and real wages than if the investment had taken place.

Taxes imposed on narrow bases are highly inefficient

Narrowly based taxes such as taxes imposed on one type of activity are generally inefficient because the higher tax-inclusive price deters some people from engaging in the activity. For example, stamp duties on property purchases and insurance discourage property transactions and the purchase of insurance.

Payroll tax and land tax have substantial exemptions that require a higher tax rate to raise any given amount of revenue. Exemptions encourage people to engage in exempt activities at the expense of activities that are taxed. For example, payroll tax exemptions for small businesses can deter them from growing into larger businesses.

Many taxes are unnecessarily complex and impose a high compliance burden

Treasury estimates the total compliance burden could be as much as $40 billion annually.[16] Compliance costs are unavoidable, but even a modest 10 per cent reduction would deliver $4 billion savings to the economy each year.

Businesses operating across state borders are confronted by a bewildering array of inconsistent payroll tax and stamp duty regimes, which add to their production costs and ultimately the prices they charge for goods and services.

Superannuation tax arrangements are also highly complex and have been changed repeatedly, undermining confidence in the system.

Capital income from different sources is taxed differently, distorting investment allocation

Some forms of capital income are taxed at concessional rates and some not, leading to inefficient investment allocation and perceived unfairness. For example, nominal interest on bank deposits is taxed at personal tax rates while half of nominal capital gains is taxable.

Taxes reduce growth when they discourage productive behaviour

Taxes are a means to an end. Tax revenues are needed for funding a range of welfare payments, community services and public goods.

But taxes influence virtually all our economic decisions. They inevitably distort prices, incentives and rewards, all of which change people's behaviour.

How tax revenue is raised matters because some taxes are worse than others. 'Bad' taxes are ones that discourage people and businesses from engaging in value-creating, productive activities (or which make them engage in too much wasteful and unproductive activity).

Generally speaking, the narrower the tax base and the higher the rate, the less efficient the tax. Higher tax rates generally drive greater price distortions or 'wedges' that discourage increasingly higher-valued activities.

This is why, as a rule of thumb, broader tax bases and low rates deliver a given amount of revenue more efficiently. Or put another way, a tax system is more efficient when the marginal deadweight losses of different taxes are roughly equivalent. Yet Treasury estimates indicate that the marginal deadweight costs and revenue risks of Australia's taxes vary widely.

What needs to be done

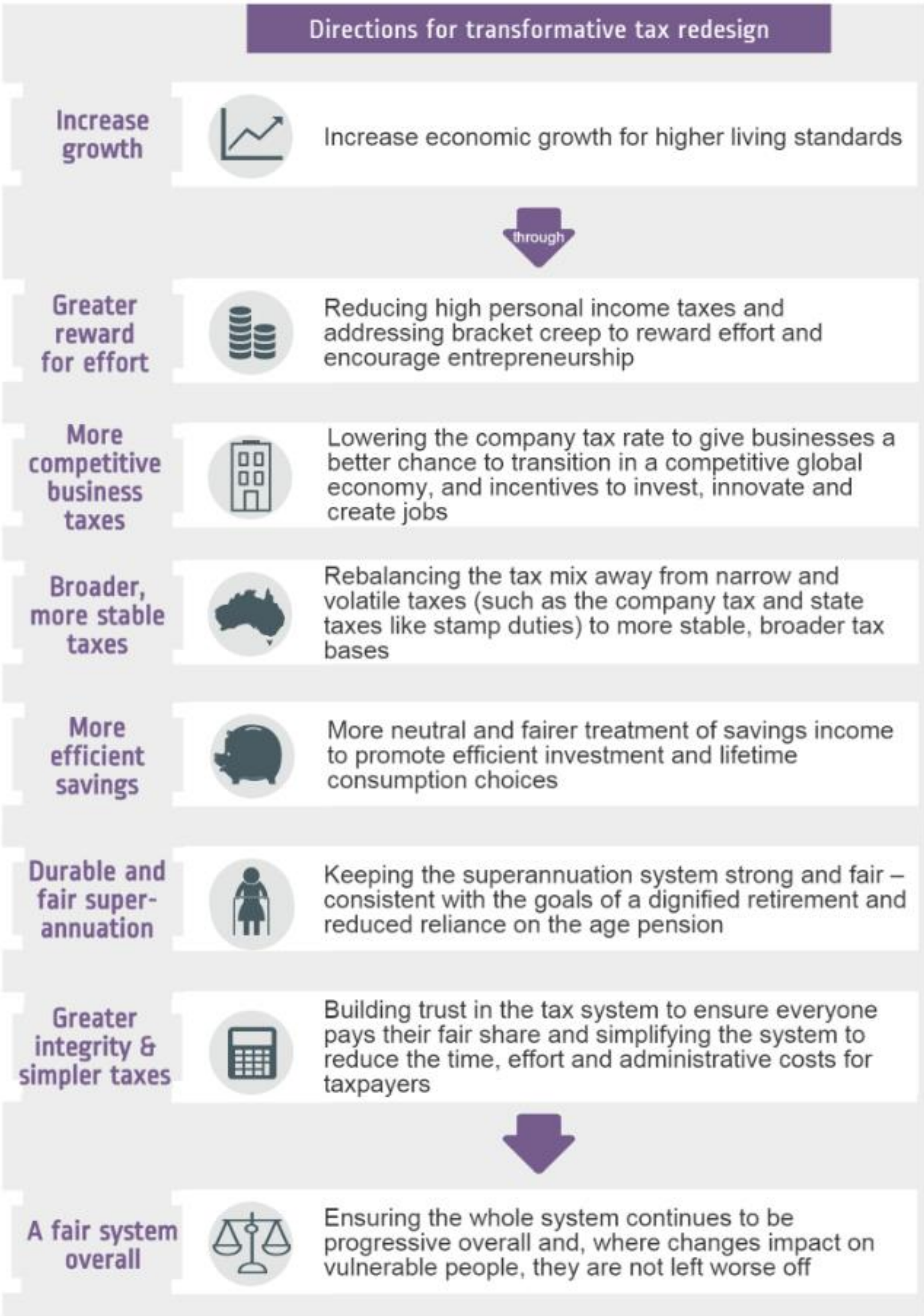
Australia needs to move to a more modern, sensible mix of taxes that will best promote the wellbeing of the Australian community and support the creation of jobs for the future. It's not about one tax. It's about the combination of taxes and the capacity of the overall tax mix to influence decisions that will achieve the goal of growing the economy and creating jobs.

The overarching objective of tax reform over the medium term must be to redesign and improve the tax system by shifting from less efficient taxes to more efficient ones, so that the average economic burden of raising each dollar of revenue falls.

This requires a tax package that overall reduces the tax burden on investment, working and other highly valuable and productive activities by addressing the deficiencies in the tax system outlined above.

While a tax system that promotes economic growth must be the primary objective of reform, the tax system as a whole must also be equitable, have integrity, provide a stable revenue base and be as simple as possible.

Fortunately, these objectives are often mutually reinforcing. Growth-enhancing tax reform delivers jobs and higher household incomes, as well as a revenue dividend.



Transformative tax reform must be about increasing growth not increasing taxes

Fixing the tax system must not be about increasing the overall rate of taxation to support higher, often wasteful levels of spending of taxpayer dollars. Increases in one tax must be used to reduce others. Changes in tax concessions must be consistent with clearly defined objectives to ensure they are fit for purpose and not made simply to raise revenues.

Higher overall taxation levels and higher spending are the low road and will dampen growth and lead to unsustainable budget positions that will inevitably necessitate blunt corrections over time.

Some counter that additional spending may be highly valuable to the community. But even if the value of some additional spending exceeded the costs of raising extra revenue, this would not justify persisting with an inefficient, growth-sapping tax system. And by undermining growth, higher tax rates will perversely undermine the tax base, not shore it up.

Moreover, this argument ignores the enormous scope for efficiencies from existing outlays by all levels of government, which are currently a staggering $560 billion or the equivalent of 35 per cent of GDP.[17] At the same time as we fix our tax system we *must* get spending under control.

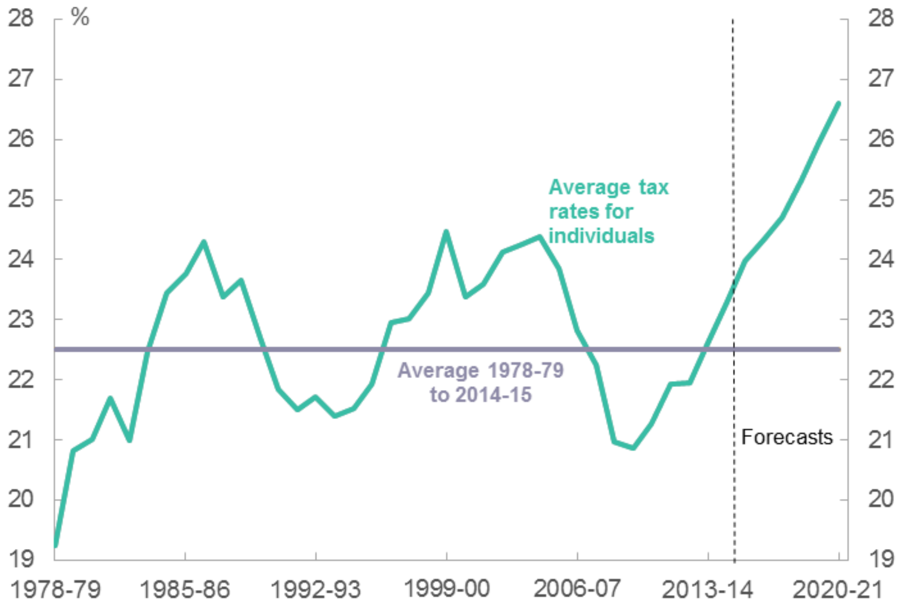
Tax ‘reform’ that does not promote economic growth would be a wasted opportunity and only cruel the pitch for making necessary changes in future.

Doing nothing does not mean nothing will happen

Doing nothing to improve the tax system will only ensure that its existing fissures widen.

Personal tax revenues will continue to rise as the result of bracket creep. According to Treasury this would eventually reduce GDP by around 0.55 per cent over the long term.[18] That’s the equivalent of almost $9 billion being thrown away or every household giving up around $1,000.

Figure 7: Doing nothing ensures a higher tax burden for average income earners



Source: ATO, *Taxation Statistics 2012-13*, 2015; Australian Government, *Release of Tax Modelling*, 2016.

Left unchecked, bracket creep will steadily make the personal tax system less progressive. Lower- and middle-income earners will be hurt proportionately more than higher income earners.

By 2024, the average tax rate for the average income earner (currently earning about $75,000 a year) will increase from 23 per cent to 28 per cent.[19]

The share of taxpayers in the top two tax brackets will increase from around 27 per cent to 43 per cent by 2025.[20]

The company tax rate will become even more uncompetitive, driving investment, innovation and jobs abroad. The UK company tax rate, for example, will be 18 per cent by 2020. The big losers from lower investment will be Australian workers who, as a result of lower investment and productivity, are estimated to bear around two-thirds of the company tax. This is because lower investment means lower labour productivity and lower real wage income.

An already volatile revenue base will become even more so, compromising budget planning and certainty. Company tax revenues are more than twice as volatile as the consumption base.

To be blunt, if we don't make comprehensive changes to our tax system as well as other actions to grow the economy, we will go backwards as a country. We need to be honest with the Australian public about this: living standards will be and already are being seriously compromised.

Transformative tax reform is achievable

Both sides of politics have outlined the boundaries of tax reform, notably ruling out a comprehensive tax-mix switch involving the GST.

It would have been preferable for the GST to remain on the table, as much as for structural reasons (including reducing revenue volatility) as its capacity to fund growth-enhancing company and personal income tax cuts, and appropriate compensation.

However, transformational tax reform that drives stronger growth is still achievable over time.

It will require a combination of containing spending, implementing other policies that promote growth, as well as sensible revenue measures that give room to reduce business and personal income taxes over time.

Raising taxes to pay for tax cuts can generate net economic gains where the economic cost of the taxes being raised is lower than the cost of the ones being reduced. But it will be absolutely crucial that any tax changes that raise revenue are demonstrably more efficient and place less of a drag on growth than the taxes they replace. Piecemeal and ill-conceived changes to raise additional revenue that add further distortions to the tax system would be counterproductive. They would risk reducing growth rather than promoting it.

'Paying' for tax cuts by going further into deficit is not an option. This would shift an even higher tax burden to future taxpayers, bring uncertainty and risk higher interest rates and undermining growth.

There may be a need to consider deeper rebalancing of the tax system in the next decade from direct to more broadly based indirect taxes, to deal with structural challenges from digital technologies and an ageing population.

What a transformative tax package looks like

The Business Council is proposing a three-staged approach to achieve structural tax reform by 2025.

A staged approach is not a convenient excuse to defer necessary changes. The Business Council believes there is a big distinction between ambitious reform, staged and implemented incrementally over the medium term, and cherry-picking.

This means that it will be absolutely essential to have clear, coherent objectives and a commitment to the reforms that will deliver them, not just vague promises.

Each and every step of the way will need to be demonstrably consistent with delivering the objectives and directions for growth-enhancing tax reform outlined above. But also as indicated above, there are considerable risks in some of the changes currently being debated, and a fine line between improving the tax system and distorting it further.

Phasing also offers the scope to moderate adverse transitional impacts on the community while still delivering a significant economic growth dividend over time.

A considered, incremental approach would also avoid costly mistakes in wickedly complex areas such as taxation of superannuation and capital income. Offsetting revenue measures must be carefully designed and consistent with clear objectives to ensure they lead to better overall outcomes for the economy.

Design principles for changing tax provisions

In some areas such as taxation of superannuation, capital gains and negative gearing, potential impacts of tax changes are highly complex. Careful assessment is required to avoid unintended and possibly perverse economic, fiscal and distributional impacts.

This is why any changes being contemplated must be carefully designed and consistent with clearly defined objectives to ensure they are fit for purpose and lead to better overall outcomes for the economy.

For example, the Business Council believes that there is some scope to tighten superannuation concessions. However, changes must be consistent with the objectives of retirement income policy: reducing reliance on the age pension and providing comfortable retirement incomes.

Proposals to increase taxes on superannuation contributions and balances for lower and middle-income households would increase their effective marginal tax rates in much the same way as higher income tax being imposed through bracket creep. It would also risk creating a much larger age pension liability down the track.

Any changes to tax provisions should be part of a restructuring of the tax system rather than for higher spending.

Complementary spending and other economic reforms will be essential

Tax reform must be complemented by structural spending reforms. Spending reforms are urgently needed regardless of tax reform to return the budget to surplus. They will also provide more room to move on the tax front.

Broader growth-enhancing economic reforms will also increase revenues over time.

In addition, the gains from tax reforms that encourage investment, participation and risk-taking will be even larger if they are accompanied by other complementary economic reforms that improve business competitiveness and promote growth. Reform of workplace relations and regulation will be critical for supporting new investment.

The pay-off from an integrated package of economic reforms will exceed the sum of the individual parts because of the synergies and interconnections between them. For example, lower company taxes and streamlined planning regimes would be a powerful combination for encouraging new investment.

The revenue dividend from tax and other reforms should be used to fund further tax restructuring over time.

A strategy for growth-enhancing tax reform

Horizon 1 now	Horizon 2 2020	Horizon 3 2025
Immediate realignment to set the direction for growth	Locking in more competitive taxes	Lower taxes overall with more stable and broader revenue bases
Begin to address bracket creep for lower and middle-income households and prepare the ground for improving the tax-transfer interface	Flatter personal income tax schedule including increasing the top threshold, and improve the tax-transfer interface	Lower personal income taxes and tax-transfer interface addressed
Correct current distortion – move to a uniform company tax rate of 28.5%	More competitive company tax rate of 25%	Competitive business taxes – company tax rate of 22%
Revenue offsets through improved integrity, transparency and compliance	Continue to implement improved integrity, transparency and compliance	Restructure the tax system – consider changing the rate and/or base of the GST
Carefully targeted tightening of superannuation concessions	Review superannuation scheme against long-term goals	Durable and fair superannuation
Carefully targeted changes to savings taxation	Neutral treatment of capital gains, rental and interest income	Neutral taxation of savings
Payroll and land tax bases harmonised	Further reform of state taxes, to broaden bases	Broaden payroll and land tax bases to phase out stamp duties

Growth and revenue dividend from reform
Spending restraint through program redesign

Sequenced tax reform

The approach outlined below is illustrative. The precise timing and detail of possible tax measures in practice will depend on many factors. The pace and scale of change will have to be carefully calibrated according to fiscal and global economic circumstances.

Some of the issues and complexities are further explored in the attachments to this paper.

The Business Council is not in a position to model the precise fiscal, economic or distributional impacts of each of the elements. This is appropriately Treasury's role.

But the core drivers of economic gain are unarguable – personal and company income tax cuts, and broader and more neutral tax bases with lower rates and compliance costs.

Horizon 1

- Revenue-neutral tax reforms including slowing the impacts of bracket creep for lower and middle income earners and a uniform company tax rate for all businesses of 28.5 per cent.
- Offsetting revenue measures to be explored include several business and personal tax integrity measures as well as targeted changes to taxation of superannuation consistent with promoting the objectives of the superannuation system. Any changes to taxation of other savings income should be consistent with the objective of achieving more neutral concessional tax treatment over time.
- The groundwork should also be laid for reforms of state taxes, a better interface between the tax and transfer systems (as set out by the McClure review) and lower tax compliance costs. Structural redesign of major expenditure programs should continue.

Horizon 2

- By 2020 there would be further income tax cuts (including for example increasing the top threshold from around 2.3 to at least 3 times average earnings) and a reduction in the company tax to 25 per cent to bring the rate into line with the OECD average.
- Funding would come from a combination of reduced spending, the full effects of revenue measures and revenue dividends from tax and other growth-enhancing reforms.

Horizon 3

- By 2025, overall tax revenue should be lower as a proportion of GDP and consistent with long-term fiscal rules to contain the size of government.
- Company taxes should be further reduced to 22 per cent, bringing Australia in line with our Asian competitors. There should be more neutral taxation of savings income, and more stable and broader revenue bases at the national and state levels. Depending on economic performance and pressures on various tax bases, changes to the GST could be considered (in other words, do not take this off the menu) within this horizon.

Horizon 1 – now

Setting the direction for economic growth

Personal income tax	Modest income tax cuts to begin to address bracket creep (approx. $3–5 billion) and prepare the ground for improving the tax-transfer interface
Company tax	Reduce company tax to 28.5% for all businesses (approx. $2 billion)

Possible offsets

Savings	Changes consistent with achieving more neutral, concessional treatment of savings income over the long term
Super-annuation	Carefully targeted tightening of superannuation arrangements
Integrity	Tighter work-related expenses; better targeting of R&D tax incentives; multinational tax transparency and compliance measures
Simpler taxes	Simplify the personal income tax system including through streamlined FBT rules
Contain spending growth	Commence structural redesign of major expenditure programs to change the trajectory of spending growth

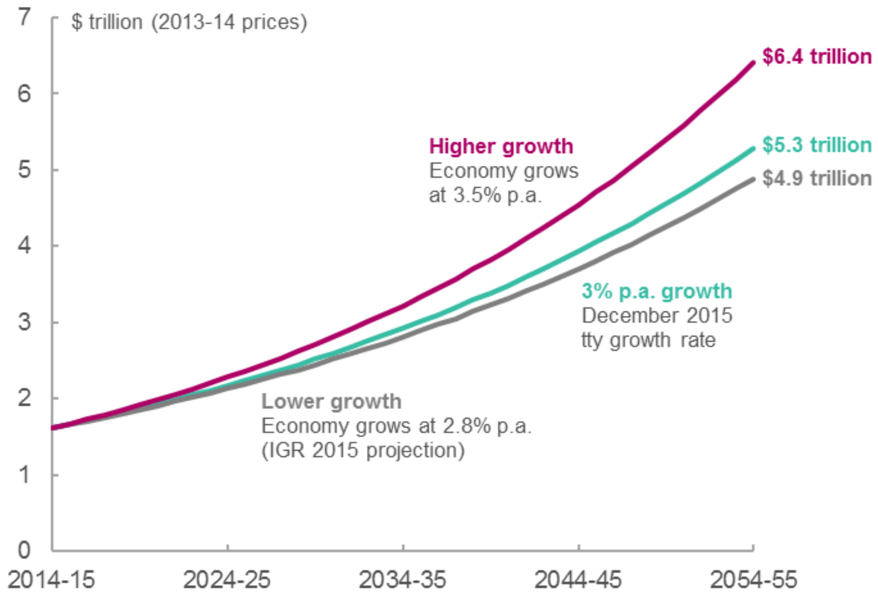
State tax and spending reform

State taxes and spending	State payroll and land tax bases should be harmonised; contain spending growth through program redesign

The pay-offs from transformative tax reform will be substantial and fairer than doing nothing

A tax system that better promotes investment, innovation and growth can deliver income benefits to all households over time. Even a small increase in economic growth translates to significant gains. As shown in Figure 8, GDP growth of 3.5 per cent per year leads to an economy worth more than $6 trillion by the middle of the century compared with one worth around $5 trillion if annual growth averages 2.8 per cent.

Figure 8: A small increase in the growth rate makes a big difference



Source: ABS, *Australian System of National Accounts, 2013-14*, cat. no. 5204.0; ABS, *Australian National Accounts*, cat. no. 5206.0 and BCA calculation.

Much discussion about tax reform focuses on the immediate impacts of selected tax changes rather than the net impacts on jobs and household incomes of a comprehensive package of reforms over time.

But the longer-term growth gains – which inevitably are harder to measure – are the reason for undertaking tax reform in the first place. Tax reform that doesn't promote economic growth at best means shuffling money among taxpayers (a zero-sum game) and at worst a negative-sum game that makes the tax system even less efficient.

A lower company tax rate will stimulate investment and jobs

According to Treasury modelling a one percentage point cut in company tax could increase GDP by 0.15 per cent to 0.35 per cent.[21] Scaled up, a five percentage point cut to 25 per cent could increase GDP by 0.75 per cent to as much as 1.75 per cent. But cutting the company tax must be paid for and the size of the *net* GDP increase will depend on the efficiency of the offsetting tax.

Based on conservative assumptions about the cost of offsetting taxes and the sensitivity of investment to tax changes, a 25 per cent company tax rate over time could realistically lead to a GDP increase of at least 0.5 per cent of GDP (or around $9 billion in today's dollars), and an increase in real consumer spending of 0.3 per cent or $5 billion in today's dollars over time.

The biggest beneficiaries would be workers who gain from higher wages and more jobs associated with stronger investment and higher labour productivity. A 25 per cent company tax could increase annual wage income by more than $4 billion, the equivalent of around 50,000 full-time jobs paying average earnings.

Government revenues would also increase as a result of higher wage and capital income and GDP growth. Treasury estimates that a one per cent increase in real GDP from improved productivity and participation increases Commonwealth receipts by more than $4 billion, as well as reducing payments slightly.[22] Accordingly, a 0.5 per cent increase in GDP flowing from a company tax cut that increases labour productivity has the potential to increase Commonwealth revenues by $2 billion. State revenues would also benefit from higher payroll tax and GST revenues.

If the company tax rate is not reduced, the counterfactual will be lower investment and innovation. Realistically, global competitive pressures will intensify, not abate, over time, which would mean that the costs of not reducing Australia's corporate tax rate would grow inexorably as we fall further behind.

There would be further dynamic benefits from innovation and multi-factor productivity growth

The estimates above do not capture technology and innovation benefits that would flow from increased capital investment, driving higher multi-factor productivity and household incomes.

The OECD concludes that reducing the corporate tax rate appears to be particularly beneficial for multifactor productivity growth of the most dynamic and innovative firms.[23] In other words, relatively high company tax rates hurt innovative firms that drive growth *at the margin* the most.

Nor do the estimates account for the benefits of reducing the reliance of the tax system on the volatile company tax base.

Arguments against cutting the company tax do not stack up

Foreign investors will invest in Australia whatever the company tax rate

– Some investments may occur even with a very high company tax rate but not all will. It is the investments at the margin that are being lost because investors increasingly have choices about where to put their capital.

Cutting company taxes will just benefit foreign investors

– With highly mobile capital, company tax is ultimately borne largely by Australian households because lower investment translates into fewer jobs and lower wages.

– With dividend imputation, the company tax is essentially a withholding tax on foreign investment. A cut in the company tax cut increases the after-tax return on existing foreign investments. Phasing in cuts in the company tax rate will encourage new investments while limiting transitory windfall gains accruing to existing foreign investors.

The effective rate of company tax paid is lower than the statutory rate

– The effective rate of tax paid often reflects timing issues around losses and investment expenses. These provisions are legitimate and necessary to ensure that the company tax does not distort efficient investments. Australia's marginal effective tax rate on investment is high compared with most other countries.

Many companies do not pay the tax they should

– The Business Council believes companies must meet their tax obligations and if where arrangements do not keep pace with community norms, they should be reviewed.

– Australia already has highly robust integrity measures and is either already compliant with or acting on the OECD's BEPS recommendations.

– Ensuring business tax integrity will be an important accompaniment to more competitive business tax arrangements. But responding to tax avoidance by delaying company tax cuts would not target the issue and only harm jobs growth.

– The Tax Commissioner has indicated that he believes the laws are adequate for ensuring that companies pay their fair share of tax.

Interest rates are low

– Interest rates may be low but businesses remain reluctant to invest, reflecting uncertainty about future economic conditions. For any given interest rate and economic outlook, lower company taxes will reduce the required rate of return hurdle for new investment.

How would companies react to a tax cut?

A company tax cut would make Australia a more attractive place to invest by reducing the cost of capital for enterprises. Some projects that were previously unviable will now be profitable and proceed, which will increase investment and economic activity.

Increased investment, for example in machinery and equipment, makes workers more productive as they have more, and typically more technically-advanced equipment, to work with. Labour and capital together become more productive. As has always been the case in Australia, higher investment and labour productivity flow through as higher real wages for workers. Further income gains would come from innovation associated with new investments.

Medium and large businesses alike will respond to company tax cuts to expand their businesses.

Richard Goyder, CEO, Wesfarmers, recently told the ABC 7.30 program:

> 'If there was a cut in tax, that means on any project we're looking to invest in, the after-tax returns will be higher. Therefore, the hurdle, if you like, for us to invest is lower. So, likely we'd invest more money in either new stores or new plants or acquisitions. Otherwise it'll go to our shareholders and they're pretty good at spending money and efficient at spending money and that's good for the economy as well.'

Similarly, at the recent Australian Financial Review–BCA Roundtable, Elmer Funke Kupper, CEO, ASX, noted that a cut to 25 per cent:

> 'would allow us to increase staff by 10 to 15 per cent beyond what I have today relatively quickly, to accelerate investment and probably increase capital investment by somewhere between 15 and 25 per cent'.

Other measures would generate additional benefits

Lower stamp duties, offset by better use of payroll and land taxes, also offer great potential to deliver large efficiency and income gains. Indeed, broadening of the payroll and land tax bases in itself would generate efficiency gains by promoting more efficient business structures and size and land use. The groundwork for these changes will need to start now given the long transitions they will require.

Reducing stamp duties would deliver sizeable benefits for households

Deloitte Access Economics estimates that replacing property stamp duties with more efficient taxes could increase real consumption by $6.0 billion to $9.7 billion per year. This is equivalent to around $20 per household per week, or around half of weekly spending on fuel and power.

Deloitte Access Economics, *The economic impact of stamp duty: Three reform options*, 2015.

Full harmonisation of payroll tax exemptions and rules across states would significantly reduce business compliance costs.

While their overall impacts are difficult to assess because of the diversity of individual circumstances, lower personal income tax rates, particularly reductions in high effective marginal tax rates will encourage people to enter the workforce, work more and improve their skills. Modelling undertaken for Treasury indicates a growth dividend from personal tax cuts of around $30 billion of up to 1.32 per cent of GDP.[24] Of course, if this is undertaken in a revenue neutral manner then the ultimate size of the *net* GDP increase will depend on the efficiency of the offsetting tax.

More neutral treatment of savings income would promote more efficient savings and investment allocation across different asset classes as well as reduce compliance costs and inefficient tax planning.

Simplification measures would substantially reduce the time, effort and administrative costs for individual taxpayers and businesses and deliver real income benefits.

As for past economic reform packages, the benefits of all the measures, small and large, are additive, generating a permanent increase in GDP and household incomes.

Challenges can and must be dealt with

The degree of difficulty of comprehensive tax reform in Australia is undoubtedly high, but the costs of not embarking on a reform pathway are simply unacceptable.

Current fiscal constraints have admittedly made the task more difficult but there never has been, nor will there ever be, a magic pudding. As for any investment, something has to be given up in order to generate a return.

The Business Council believes the Australian community would support a staged tax reform strategy along the lines in this paper, provided they are properly consulted and given the facts.

This is because the facts largely speak for themselves.

The community deserves nothing less. Pretending that there are not serious challenges for the Australian economy or that there is an easy fix, sells the Australian community short.

There is always a temptation in difficult public policy areas to make piecemeal, ad hoc changes.

This would be dishonest and ultimately unfair because it would create a false impression that we have ‘done tax reform’. Cherry-picking a few ‘easy’ measures will only make what is an inevitable and unavoidable task much harder.

It is time to begin an open, frank and mature discussion and clear the path for real tax reform. That is, implement changes that set the right trajectory and directions for reform for an economy in transition.

PART B

THE KEY DIRECTIONS FOR REFORM

The following sections analyse in further detail some of the possible measures available to begin to progress transformative tax reform. The analysis is organised around eight key reform directions:

1. Personal taxes that better reward effort
2. A simpler and more equitable personal tax system
3. A competitive company tax system
4. Stronger business tax system integrity
5. Complementary business tax measures that support investment
6. Durable and fair superannuation concessions
7. More neutral treatment of savings
8. Moving to more efficient state taxes.

For each of these reform directions, we have sought to identify the key issues raised in the current tax debate, the relative urgency or need for change, possible reform measures, the impacts of change and the risks that must be confronted if change is pursued.

In assessing the possible measures available under each of these reform directions, we have sought to categorise each of the measures according to whether they are:

- **Growth enhancing**: these are the most critical measures that will reduce the drag of taxes that discourage the critical ingredients of growth including risk-taking, investment, innovation and working. In some cases, this involves maintaining critical measures within the current tax system, particularly those that support business investment.
- **Increasing effectiveness:** these are targeted measures that will enhance the effectiveness and integrity of various tax bases and in the process raise revenue. This revenue should then be used to offset growth-enhancing options for reform. In many cases, these measures will require careful assessment even for small changes given risks from unintended consequences, interactions with other parts of the tax system and/or implementation challenges. This is particularly the case for areas such as superannuation, capital gains and negative gearing.
- **Simplification:** these are options that can be pursued to reduce compliance burdens within the tax system. In most cases these measures would be expected to have a minimal impact on revenue.

Table 1 provides a summary of the possible measures explored under each reform direction and which of the three categories each measure falls into. As noted earlier, the package of possible measures is illustrative only and the analysis does not model the precise fiscal, economic or distributional impacts of each measure.

Table 1: Summary of possible measures

Reform direction	Possible measures	Key drivers	Revenue impact
Personal taxes that better reward effort	• Increase second tax threshold from \$37,000 to \$40,000 to compensate for bracket creep since 2012-13	Growth enhancing Simplification	-
	• Increase the third tax threshold from \$80,000 to \$87,000 to compensate for bracket creep since 2012-13		
	• Increase the second and third tax thresholds to \$38,000 and \$82,000 respectively to compensate for bracket creep next year		
A simpler and more equitable personal tax system	• Tighten work-related expenses	Increasing effectiveness	+
	• Simplified tax returns	Simplification	NA
	• Streamline and tighten Fringe Benefits Tax	Simplification Increasing effectiveness	NA
A competitive company tax system	• Reduce company tax rate to 28.5 per cent for all businesses • Reduce company tax rate to 25 per cent within five years	Growth enhancing	-
Stronger business tax system integrity	• ATO enforcement of recently introduced reform measures	Increasing effectiveness	+
Complementary business tax measures that support investment	• Improve R&D Tax Incentive	Simplification Increasing effectiveness	Nil
	• Maintain current arrangements for interest deductibility of business expenses	Growth enhancing	Nil
	• Maintain dividend imputation	Growth enhancing	Nil
	• Maintain current Fuel Tax Credit Scheme	Growth enhancing	Nil
	• Maintain current Accelerated Depreciation arrangements	Growth enhancing	Nil
Durable and fair superannuation concessions	• Adopt clear objectives for superannuation system	Increasing effectiveness	+
	• Carefully targeted tightening of annual concessional and non-concessional contributions caps		
	• Effective tapering to accompany any move to more progressive tax rates		
	• Address impediments to greater use of annuities		
	• More consistent concessional treatment of non-superannuation savings income to accompany any tightening of concessional tax treatment of superannuation		
	• Explore Henry review proposal to reduce the earnings tax to 7.5 per cent and apply it to earnings in the retirement phase		
More neutral treatment of savings	• Explore a dual-income tax approach	Increasing effectiveness	NA
	• Explore reducing the capital gains tax discount to 40 per cent as part of longer term changes to establish more consistent concessional taxation of all savings income	Increasing effectiveness	NA
Moving to more efficient state taxes	• Harmonise both the land and payroll tax bases as the first step to a more efficient state tax system	Simplification	NA
	• Broaden the base of both land and payroll taxes with carefully managed implementation over a long transition	Increasing effectiveness	+
	• Reduce reliance on stamp duties over time	Growth enhancing	-

1. Personal taxes that better reward effort

- Personal taxes influence decisions to work, save and invest. The interaction between the tax and transfer system can create high effective marginal tax rates, particularly for low and secondary-income earners or older workers, and discourage participation.
- Australia's tax system is highly progressive, and bracket creep is a growing issue that disproportionally affects lower-income workers. Not addressing bracket creep will be regressive.

Personal taxes influence decisions to work, save and invest

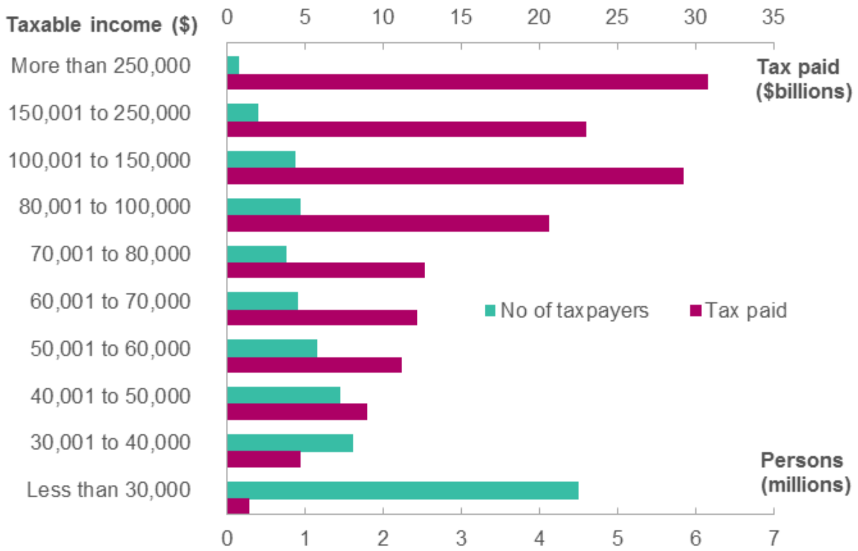
Taxes on individuals influence decisions to work, save and invest by creating a tax wedge that drives post-tax income below pre-tax income. High effective marginal tax rates through the interaction between the tax and transfer system, particularly on low and secondary-income earners, or older workers, may discourage participation.

Australia's tax system is highly progressive

Australia's tax system is highly progressive, meaning the burden of taxation increases with income. For example, the top 3 per cent of taxpayers account for almost 30 per cent of personal tax revenue.[25] By comparison, these taxpayers account for around 16 per cent of taxable income. Similarly, the transfer system is highly targeted, with the ratio of benefits received by households in the bottom quintile relative to the top quintile the highest in the OECD.[26] The bottom quintile receives 42 per cent of welfare spending, while the top quintile receives 4 per cent.[27]

To assess progressivity in Australia, the tax and transfer system should be looked at holistically. The highly progressive nature of Australia's tax and transfer system is supported by targeting of transfer payments, whether that be through the type of support, such as allowances or pensions, or income and asset testing. Australia spends almost 80 per cent of all benefit spending on means-tested benefits. This level of means-tested benefits is high relative to other OECD countries and more than four times the OECD average.[28] A means-tested transfer system is generally targeted by the type of assistance, such as for the unemployed or those of retirement age, and through income and asset testing, which lead to a tapering of benefits as income increases.

Figure 9: The income tax system is highly progressive



Source: ATO, *Taxation Statistics 2012-13*, 2015.

The transfer system could be redesigned in staged phases

The 2015 review of Australia's welfare system, *A New System for Better Employment and Social Outcomes,* found that the social security and welfare system is complex, lacks coherence across payments, needs a stronger focus on work and could better support people's transitions over their lifetime.

The review has mapped out a road for reform including:

- providing incentives to work for those who are able to work
- providing adequate support to those who are not able to work
- supporting participation in the workforce through measures that build capability
- being affordable and sustainable now, in the future and through economic cycles
- being easy to access and understand, and delivered efficiently and effectively.

A key recommendation of the review is that Australia adopts an investment approach to welfare payments similar to the scheme introduced by the New Zealand Government.

What are some of the problems with the personal tax system?

Bracket creep is a growing issue

Bracket creep refers to inflationary wage increases, as opposed to real wage increases, pushing workers into higher income tax brackets. Taxpayers will face higher marginal tax rates as they move into higher tax brackets, but also higher average tax rates due to the progressivity of personal tax rates and thresholds. This reduces the rewards for effort and creates a disincentive to work, and gradually reduces the progressivity of the tax system. Put another way, it amplifies the other issues inherent in the personal tax system.

Workers are becoming increasingly mobile

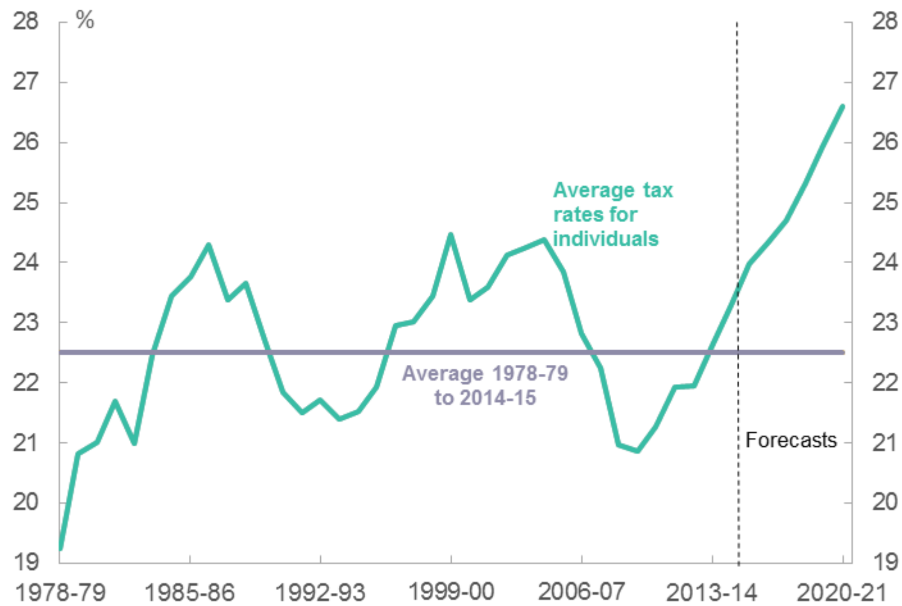
Workers, particularly highly skilled ones, have become increasingly mobile over recent decades. Immigration can increase the size of the workforce, and also bring in new skills, ideas and connections that can ultimately improve productivity and economic growth. As labour mobility increases, tax differentials increasingly influence worker decisions about where to locate.[29] In Australia's case, the top marginal tax rate starts at around 2.3 times the average wage, making us less attractive compared with other OECD countries. For example, the UK and Germany have top rates that cut in at 4 and 6 times average earnings respectively.[30]

The consequences of inaction will grow

Allowing income tax thresholds and rates to remain unchanged will be a regressive policy decision in and of itself. This is because the increases in marginal and average tax rates from bracket creep disproportionately affect lower and middle-income earners. Risks and costs of inaction will grow. Treasury estimates that the effect of allowing bracket creep to go unchecked will detract 0.55 per cent from GDP by 2020-21.[31]

Most personal taxpayers have not received any income tax relief since changes in 2012-13, and there is no relief currently planned (with the exception of the expiry of the Temporary Budget Repair Levy). As a result, the average personal income tax rate went from 22.0 per cent in 2012-13, is forecast to be 24.4 per cent in 2016-17, and is forecast to continue to rise to 26.6 per cent by 2020-21 if left unaddressed.[32]

Figure 10: Left unchecked, average tax rates will reach levels not seen in recent history



Source: ATO, ***Taxation Statistics 2012-13***, **2015; Australian Government,** ***Release of Tax Modelling***, **2016.**

How can bracket creep be addressed?

There are a number of ways to address bracket creep. Changes can be made to adjust tax thresholds for the period since changes were last made, or to head off future bracket creep. Some options that could be considered include:

- Increase the second tax threshold from $37,000 to $40,000 to compensate personal taxpayers for bracket creep since 2012-13. This is estimated to cost around $4 billion in 2016-17.
- Increase the third tax threshold from $80,000 to $87,000 to compensate personal taxpayers for bracket creep since 2012-13. This is estimated to cost around $1 billion in 2016-17.
- Increase the second and third tax thresholds to $38,000 and $82,000, respectively, to compensate personal taxpayers for bracket creep next year. This is estimated to cost around $1.5 billion in 2016-17.

While Australia has a top marginal tax rate higher than many other countries in our region, it is relatively comparable to other OECD countries. However, as noted earlier, the threshold at which the top marginal tax rate comes into effect, relative to average wages, makes Australia less competitive compared with other OECD countries.[33]

What are the impacts of these proposals?

These changes will improve incentives to work by reducing taxes on workers. The impact of each respective proposal is:

- For someone earning $40,000, this will represent a $405 tax cut. This is equal to a one percentage point decrease in their average tax rate.
- For someone earning $87,000, this will represent a $315 tax cut. This is equal to a 0.4 percentage point decrease in their average tax rate.
- For someone earning $38,000, this will represent a $135 tax cut, while someone earning $82,000 will receive a $225 tax cut. These are equal to a 0.4 and 0.3 percentage point fall in average tax rates, respectively.

What other changes can be pursued?

Changes beyond the scope of those outlined above require broader reform of the tax system. For example, further changes to personal taxes would do more to improve decisions to work, save and invest, while the scope and benefits of the changes proposed are more limited. Similarly, addressing bracket creep requires constant recalibration or indexation of tax thresholds.

A competitive tax system should be mindful that high-skilled worker mobility, and competition for those workers, is increasing. While changes to ameliorate bracket creep will partially address this issue, Australia's relatively low top tax threshold should also be increased. Australia's top tax threshold of $180,000 has been at this level since 2008-09, despite wages having grown around 30 per cent over this period. This threshold could be increased to $250,000, or around three times average earnings, that is, retain the rate but change the threshold to restore its relationship with average earnings.

2. A simpler and more equitable personal tax system

- There is scope to improve personal tax integrity and simplicity through targeted changes to tighten the scope of work-related expenses, simplify and tighten Fringe Benefits Tax (FBT) and streamline personal tax returns.
- These changes would make a contribution to reducing the $40 billion of annual tax compliance costs and raise a small amount of additional revenue to fund personal income tax relief to address bracket creep.

There is scope to enhance integrity and simplicity in the personal tax system

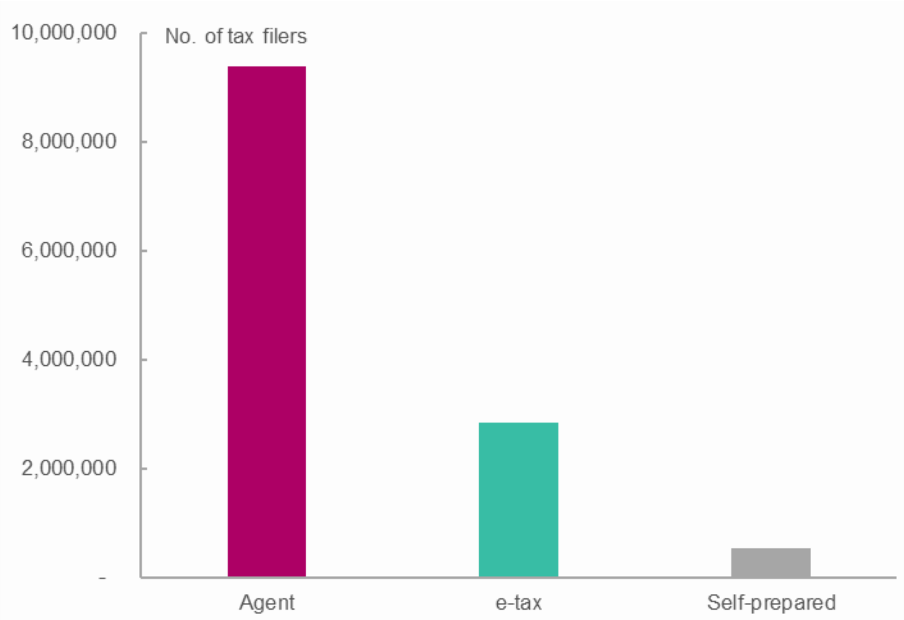
Areas such as work-related expense deductions and FBT aim to ensure equity and integrity in the personal tax system.

Work-related expense deductions exist to ensure equity between those employees who incur expenses and those who do not in the course of employment. FBT ensures that non-cash remuneration benefits, such as the use of a car as part of an employment relationship, are taxed.

While these systems have the objective of enhancing equity and integrity, they have evolved over time, promoting overuse by some taxpayers to minimise tax paid and also contributing to complexity. Key concerns raised include:

- **Over-claiming of work-related expenses**: the Henry review suggested that based on experience in Canada, the over-claiming of work-related expenses represent around 10 to 15 per cent of all claims.
  - To the extent that some Australian workers are over-claiming work-related expenses, tightening work-related expenses could uphold the original rationale of maintaining equity as long as it does not unintentionally capture legitimate expenses.
  - This measure would recover some of the $1.4 to $2.1 billion in forgone personal income tax revenue that the Henry review estimated as the consequence of over-claiming.[34] This would assist in funding personal income tax relief to address bracket creep.
- **Complexity of FBT:** it raised just 1.2 per cent of all Commonwealth Government tax revenue in 2014-15 but its compliance costs are exponentially greater than other taxes due to multiple methods of valuing fringe benefits and burdensome paperwork.[35] National Australia Bank estimates $1,250 of compliance costs for every $1 million of company tax paid, but $50,000 for every $1 million in fringe benefits tax paid.[36] There are also some benefits like cars where concessional treatment could be tightened to bring it further into line with other forms of benefits.
  - Streamlining FBT rules will make a substantial contribution to reducing the estimated $40 billion of annual tax compliance costs.[37] Tightening the concessional treatment of cars will ensure more neutral treatment of benefits across the FBT system.
- **Increasing complexity of personal tax affairs:** taxpayers have been using pre-filled information to complete their tax returns for over a decade now and last year 10.5 million taxpayers utilised pre-filling.[38] Despite this, around three-quarters of Australian taxpayers now use a tax agent to complete their tax return. There is an opportunity for the Australian Tax Office (ATO) and Treasury to work with the Digital Transformation Office (DTO) to enhance the effectiveness and take-up of simplified online tax returns. This would also contribute to reducing the $40 billion annual tax compliance burden.

Figure 11: Individual tax returns by lodgement type



Source: ATO, *Taxation Statistics 2012-13*, 2015.

Enhanced integrity and simplicity can be pursued now

The government should move immediately to tighten work-related expenses, with the revenue proceeds funding personal tax relief that addresses the impacts of bracket creep.

Streamlining and tightening FBT rules, and enhanced online personal tax returns should be advanced by Treasury as deregulation initiatives contributing to the government's regulatory reform program commitment to reduce red tape by $1 billion annually. Working closely with the ATO and the DTO, Treasury should seek to implement these initiatives within one to two years.

3. A competitive company tax system

- Capital is becoming increasingly mobile, and with the disaggregation of supply chains around the world, tax can play a larger role in influencing where and how to invest.
- Company tax revenue is highly volatile and reliant on a relatively small number of corporations.
- The Business Council considers that a decrease of the company tax rate to 25 per cent should be pursued over the medium term to encourage investment, reward innovation and maintain Australia's competitiveness. Over time, a lower company tax rate would mainly benefit Australian households, primarily through higher real wages.

Company tax is levied on profits

Company tax is a profits tax levied on a company's taxable income at a rate of 30 per cent, or at a rate of 28.5 per cent for companies with annual turnover of less than $2 million. It is calculated as assessable income minus allowable deductions. Assessable income includes income from selling goods and services, while allowable deductions include expenses incurred in carrying on the business, such as employee wages and salaries, costs of goods sold, investment, advertising, utilities and interest.

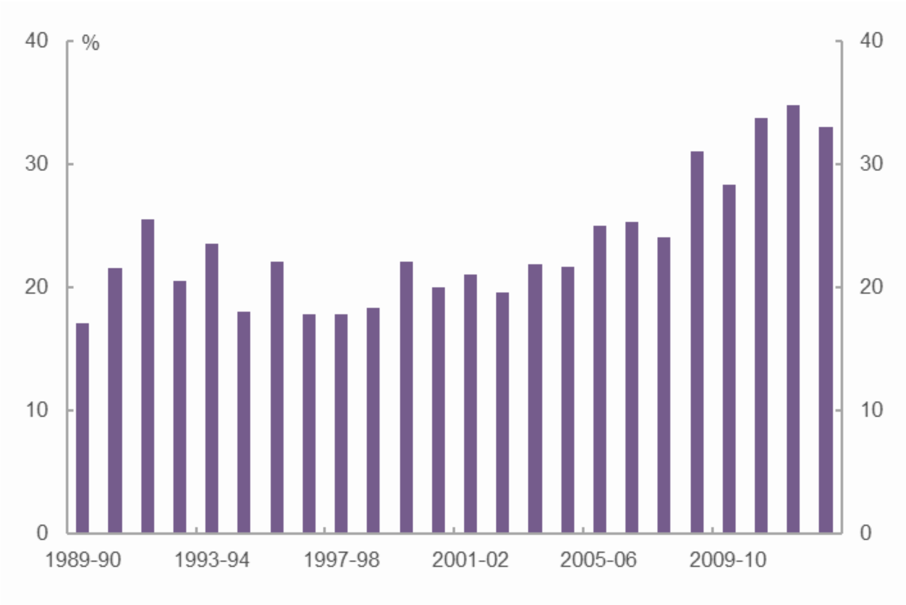
Australian companies pay a large amount of tax, especially large companies

Company tax is the second largest source of national tax revenue, with collections expected to be around $70 billion in 2016-17, or around a fifth of Commonwealth tax revenue.[39]

Company tax collections account for a large degree of the volatility in the Commonwealth tax base, despite their size. This has meant that government revenues and forecasts are more susceptible to uncertainty, for example, due to commodity price swings in recent years.

The company tax base is also relatively small, with around 2,000 companies paying approximately two-thirds of company tax in 2011-12.[40] The 12 largest taxpayers paid one-third of company tax in 2012-13, up from around a fifth a decade ago.[41] They are represented by sectors such as resources, financial services, retail and telecommunications. With the corporate tax base reliant on a relatively small number of taxpayers, it is inherently susceptible to the global forces these companies face. These include commodity price changes, disruptive technology and intense global competition.

Figure 12: Twelve companies pay one-third of company taxes



Source: Heferen, *Future of the Income Tax*, 2015.

Table 2: Company tax paid by top 12 companies, 2013-14

	Tax paid, $ million
BHP Billiton	3,951
Rio Tinto	3,051
Commonwealth Bank of Australia	2,872
Westpac	2,429
National Australia Bank	2,260
ANZ	1,965
Telstra	1,742
Wesfarmers	1,093
Woolworths	911
Fortescue Metals Group	738
Suncorp Group	533
BP	515

Note: The data in this table only reflect the highest taxpaying entity, and not the tax paid by each economic group. The data only include Australian and foreign public entities as well as foreign private entities.

Source: Australian Government, Corporate Tax Transparency, 2015.

Australia's company tax system is not globally competitive

Australian companies pay a large amount of tax compared with international peers. Compared with the OECD average, Australia is more than twice as reliant on corporate income tax as a share of all taxes, and corporate tax revenue as a share of GDP is second only to Norway.[42] In part, this reflects the integration of the personal and company tax systems through the imputation system. As a result, company tax acts as a withholding tax on Australian shareholders.

Australia's 30 per cent company tax rate is uncompetitive and other countries continue to lower their company tax rate while Australia stands still. Australia's company tax rate is out of step with the average of our competitors in the OECD (25 per cent) and Asia (23 per cent).[43] When the company tax rate was last reduced, the Treasurer's rationale at the time was to be 'internationally competitive and bring Australia's rate more into line with the rates of other countries in the Asia Pacific region'.[44] At the time of announcement, the OECD average was 35 per cent compared with Australia's 36 per cent. When Australia's rate reached 30 per cent, the OECD average was 32 per cent. The OECD average reached 30 per cent in 2003 and has fallen below the Australian rate thereafter.

Another way to measure competitiveness is the marginal effective tax rate (METR), which is the share of capital-related taxes paid as a share of the pre-tax rate of return on capital for marginal investments. Under this approach, Australia's METR ranked 7th in the OECD in 2014 and is high compared with competitors in our region. In particular, our competitors have improved their competitiveness over the past decade while Australia has stood still.[45]

Table 3: METR estimates for Australia and selected Asian economies (%)

Country	2005	2014
India	37.8	35.1
Australia	25.9	25.9
Indonesia	24.0	19.6
China	45.2	18.1
Malaysia	18.9	16.6
Vietnam	14.7	10.7
Taiwan	16.4	10.7
Singapore	11.1	9.2
Hong Kong	3.7	3.4

Source: Chen and Mintz, *The 2014 Global Tax Competitiveness Report*, 2015.

Why is Australia's company tax system a problem?

Competitiveness matters because global competitive pressures continue to intensify, and countries around the world continue to improve their tax systems while Australia stands still. The consequences for Australia of falling competitiveness are that investment, innovation and jobs will increasingly shift overseas, lowering growth and undermining tax revenues. The already high marginal excess burden of company tax (which measures the economic loss associated with raising an extra dollar of tax revenue) of 50 cents for every extra dollar of revenue raised, could increase further as we fall further out of line with competitors.[46]

Increased investment is needed across all sectors as the economy transitions from the mining boom. Policy settings, including on tax, should not stymie the adjustment to the increasingly globalised and digitised world.

The world has changed since the last company tax review

The last comprehensive review of the company tax system was the Review of Business Taxation, or the Ralph review, in 1999. Since then, there have been enormous changes to the domestic and global economy, as well as the world of business. For example, the stock of foreign direct investment in Australia has increased from around 30 per cent of GDP to around 50 per cent of GDP. The world of trade and trade exposure has changed significantly with the rise of China, which has grown from GDP of $US1.1 trillion in 1999 to an estimated $US11 trillion in 2015 (IMF, World Economic Outlook Database, 2015). China is now Australia's number one two-way trade partner, with the value of total goods and services traded increasing from $12 billion in 1999, to $152 billion in 2014 (DFAT, *Trade time series data*).

The nature of commerce and household connectivity has also changed. In 1999, 22 per cent of all households had internet access. This compares with a figure of 86 per cent in 2014-15. The way they access the internet has also changed dramatically, which has opened up the possibilities for interactions with business. To illustrate, dial-up access accounted for 97 per cent of internet access in September 2000, while today dial-up represents less than 1 per cent of internet access. Mobile internet access use has also grown dramatically over a relatively short period of time. In 2008, 8 per cent of adults used the internet via a mobile phone, while in 2014 this figure rose to 70 per cent.

This has fundamentally transformed the way people engage in commerce, with 5 per cent of adults purchasing a good or service on the internet in 1999. In 2014-15, 61 per cent of people surveyed purchased a good or service online. Similarly, while transferring funds or paying bills online is ubiquitous today, just 3 per cent of adults did this in 1999.

More than 70 per cent of international trade now comprises trade in capital and intermediate goods and services.

What should be done about Australia's uncompetitive company tax system?

The Business Council is proposing a reduction of the company tax rate to 25 per cent for all businesses. This is the minimum reduction required simply to restore competitiveness of the company tax system. Further reductions will be required in time given foreshadowed tax reductions in competing jurisdictions.

In terms of implementation, the company tax rate should be reduced to 28.5 per cent for all companies as a priority. This will remove distortions from the current two-tier system and will make a start on improving the competitiveness of the system. The reduction to 25 per cent should be legislated over five years to provide investors with confidence to invest, while also providing an early signal to help lock in future growth. This is a similar approach to that adopted by the UK.

There should be no changes to dividend imputation, which removes the double taxation of profits earned and taxed in Australia. Dividend imputation improves tax system integrity by providing an incentive for companies to pay tax in Australia. Any changes to dividend imputation would be highly risky, particularly in terms of the impact on capital markets. Changes may reduce domestic investment in Australian companies, reduce share ownership, lower distributions, increase the bias towards debt financing and lead to double taxation of profits.

What is the revenue impact of this proposal?

A reduction in the company tax rate to 25 per cent is estimated to cost around $8 billion in 2016-17, while a reduction to 28.5 per cent, to align the company tax rate for all companies, is estimated to cost around $2 billion in 2016-17.

What are the economic impacts of this proposal?

Based on conservative assumptions about the cost of offsetting taxes and the sensitivity of investment to tax changes, a 25 per cent company tax rate (on a revenue neutral basis) could realistically lead to a GDP increase of at least 0.5 per cent of GDP (or around $9 billion in today's dollars) over time, and increase real consumer spending by 0.3 per cent or $5 billion in today's dollars.

The biggest beneficiaries over time would be workers, who gain from higher wages and more jobs associated with stronger investment and higher labour productivity. A 25 per cent company tax could increase annual wage income by more than $4 billion, or the equivalent of over 50,000 full-time jobs paying average earnings.

How would companies react to a tax cut?

Richard Goyder, CEO, Wesfarmers, recently told the ABC 7.30 program: 'If there was a cut in tax, that means on any project we're looking to invest in, the after-tax returns will be higher. Therefore, the hurdle, if you like, for us to invest is lower. So, likely we'd invest more money in either new stores or new plants or acquisitions. Otherwise it'll go to our shareholders and they're pretty good at spending money and efficient at spending money and that's good for the economy as well.'

Similarly, at a recent Australian Financial Review roundtable, Elmer Funke Kupper, CEO, ASX, noted that a cut to 25 per cent 'would allow us to increase staff by 10 to 15 per cent beyond what I have today relatively quickly, to accelerate investment and probably increase capital investment by somewhere between 15 and 25 per cent'.

4. Stronger business tax system integrity

- The OECD's Base Erosion and Profit Shifting (BEPS) project is the key multilateral forum for progressing tax integrity reforms.
- Australia is already either compliant or acting on the OECD's BEPS recommendations.
- The Tax Transparency Code will be an important addition to Australia's already robust suite of tax integrity measures, and the Business Council will encourage member companies to adopt it.

Australia's already robust integrity laws have recently been tightened

Australia has 'some of the strongest tax integrity rules in the world'.[47] These laws have been recently tightened, including to better align Australia with BEPS recommendations by the OECD. Recent changes include the introduction of country-by-country reporting, the Multinational Anti-Avoidance Law, a doubling of penalties that apply to large companies who engage in tax avoidance, public disclosure of the tax information of large companies and the development of a Tax Transparency Code for further company tax disclosure by large companies.

The revenue gains from tax integrity measures

Revenues from tax integrity measures will be realised as changes are enforced.

There is a risk in overstating the potential revenue gains from tax avoidance measures. Chris Jordan, Commissioner of Taxation, speaking about revenue to be raised from ATO arguments with companies, said 'our best estimate is that it would be more than hundreds of millions of dollars and less than billions of dollars – perhaps up to $1 billion'.[48]

Potential revenues may also be offset if measures deter investment and harm business confidence. It will require careful balance to ensure Australia's attractiveness as an investment destination.

Global tax issues require a global solution

There is a legitimate debate underway at the global level about the suitability of long-standing international tax arrangements due to globalisation and increased digitisation of the economy. Laws have been challenged by these phenomena as they have been either not robust enough or mismatches have emerged.

Changes should align with the OECD's BEPS project, recognising that Australia is already either compliant or acting on the OECD's BEPS recommendations.[49] In addition, being mindful of numerous recent changes to tax law, further changes to the law should not be pursued until their impact can be properly assessed. For example, any changes to thin capitalisation laws should be carefully considered, being mindful that recent changes make them arguably the most robust in the world. Debt deductions are also vital for supporting large infrastructure and resources projects with long lead times.

The OECD has also issued a warning that countries which act alone on global tax issues do so at their own peril. As the BEPS Action Plan notes, '*the emergence of competing sets* *of international standards, and the replacement of the current consensus based framework by unilateral measures, could lead to global tax chaos marked by the massive re-emergence of double taxation.'*[50]

Table 4: Australia's status on OECD BEPS recommendations

#	Action Item	Status	Where is Australia?
1	Tax challenges of the **digital economy**	☑	The OECD has determined that other Action Items, such as permanent establishment and transfer pricing, will help address digital economy issues, therefore no specific action under this item is required. In addition, Australia will apply the GST to imported digital products and services from 1 July 2017.
2	Neutralise the effects of **hybrid mismatch arrangements** A hybrid is an entity or instrument (e.g. loan or transaction) that is treated differently in two countries for tax purposes.	☑	The Board of Taxation is currently consulting and will report in March 2016.
3	Strengthen **controlled foreign company (CFC) rules** CFC rules are designed to protect the tax base and draw a fine line between the appropriate right to tax income earned overseas.	☑	Australia's CFC rules are considered to be among the most robust in the world and already meet OECD best practice guidance.
4	Limit base erosion via **interest deductions**	☑	The OECD's recommendations allow for Australia's thin capitalisation rules. Australia recently tightened its thin capitalisation laws, with most multinational investors now required to hold $1 of equity for every $1.50 of debt.
5	Counter **harmful tax practices**	☑	The ATO has already implemented exchange of rulings. OECD work in this area will continue, as will monitoring of implementation and engagement with other countries.
6	Prevent **treaty abuse**	☑	Australia has committed to adopt this in its negotiation of new and updated treaties. The purpose is to limit the unintended abuse of tax treaty benefits.
7	Prevent artificial avoidance of **permanent establishment**	☑	The recently introduced *Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015* is consistent with this item, and Australia's treaty practice is in line with other recommendations.

#	Action Item	Status	Where is Australia?
8–10	Assure that **transfer pricing** outcomes are in line with value creation – **intangibles, risks and capital, and other high-risk transactions**	☑	No fundamental changes required to Australia's transfer pricing rules, which ensure transactions between related businesses are priced comparably with those between independent businesses. These were previously updated to meet international best practice in 2012 and 2013. Treasury released a consultation paper in February to discuss implementation, noting that current provisions already reflect the underlying intention of these action items.
11	Establish methodologies to **collect and analyse data on BEPS**	☑	No action required from Australia other than to participate in further work, such as data collection and analysis. This will assist in measuring the scale and economic impact of BEPS, as well as in evaluating the effectiveness of the actions taken to address BEPS.
12	Require taxpayers to **disclose their aggressive tax planning arrangements**	☑	The ATO is considering the cost and benefits of adopting this for Australia.
13	Re-examine **transfer pricing documentation**	☑	This has been enacted in legislation as part of the *Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015*. Country-by-country reporting requires multinationals to provide an annual report to the ATO on the global activities of an entity, including the location of its income and taxes paid. This report can then be shared among tax authorities around the world.
14	Make **dispute resolution** mechanisms more effective	☑	Australia has committed to binding arbitration. Australia is one of 20 countries in total which has committed, including the US, UK, New Zealand and Japan.
15	Develop a **multilateral instrument** to allow countries to implement BEPS measures and amend bilateral treaties	☑	Australia is working with 86 other countries on the instrument. The group is to conclude its work and open it for signature by the end of 2016.

Source: Australian Government, *OECD Report Supports Australian Government Action on Multinational Tax Avoidance*, 2015.

There are risks in acting alone on global taxation arrangements

International tax issues are broad and complex, and a solution will take both time and a coordinated, multilateral approach. Acting alone or prematurely may lead to unintended consequences such as double taxation, deterring investment, or distorting genuine commercial activity. Unilateral action outside of the BEPS project may encourage other countries to act alone and splinter international taxation norms.

A coordinated and consultative approach to implementation will also maximise the effectiveness of proposed laws.

The way forward

The Business Council believes companies must meet their tax obligations and where arrangements do not keep pace with community norms, they should be reviewed. Robust integrity measures are an integral complement to more competitive business tax arrangements.

The Tax Transparency Code will be an important addition to Australia's already robust suite of tax integrity measures, and the Business Council will encourage member companies to adopt it.

Australia should continue to progress tax integrity reforms through the OECD. The international community is the appropriate forum in which to agree on multilateral action on how to tax the global profits of multinational companies. Consultation on the implementation of the OECD's recommendations is vital to ensure investment and competitiveness are not compromised.

5. Complementary business tax measures that support investment

- There are a number of business tax measures that are critical to the competitiveness of Australia's corporate tax system.
- These measures have been scaled back over recent decades, leaving a small number of critical measures that, if removed, would reduce investment and erode the competitiveness of trade-exposed, capital intensive sectors.
- All of these measures should be retained without change, except for the R&D Tax Incentive where there is some scope for simplifying and reducing compliance costs.

A range of measures in the tax system are critical to investment

There are many elements contributing to the overall competitiveness of the tax system. Measures such as interest deductibility, dividend imputation, the Fuel Tax Credit Scheme, accelerated depreciation, exploration and the R&D Tax Incentive support investment, innovation and growth. For example:

- Interest deductibility recognises that companies require finance to invest and grow, with interest, an expense incurred in operating a business, which should therefore be deductible.
- Dividend imputation removes the double taxation of dividends paid from profits earned and taxed in Australia to Australian resident shareholders, thereby encouraging widespread share ownership and a more efficient allocation of capital. Submissions to the tax white paper process demonstrated that the net benefits of dividend imputation remain substantial and franking credits are positively valued by companies and shareholders. A reversion to double taxation would still mean relatively high taxation of dividends.
- The Fuel Tax Credit Scheme ensures that fuel tax is not paid on critical business inputs or by those who do not use public roads, including the heavy equipment used off road in mining and agriculture. It is not a concession, but a measure to better target excise tax.
- Accelerated depreciation and depreciation of exploration expenditure support investment by improving the cash flows of major capital investments, recognising the long lead times and risks involved in such investments.
- The R&D Tax Incentive recognises that the benefits of much R&D activity cannot be adequately recouped by those bearing the costs.

There are few remaining business tax measures

Over the past two decades, successive governments have scaled back concessional tax treatment for certain business activities in a range of areas. As the Business Tax Working Group noted in 2012, previous reforms now make it much more difficult to identify ways to broaden the business tax base to bring down the corporate tax rate.[51]

The quantum of revenue that would be raised by removing or restricting such measures is also limited. For example, when the Business Tax Working Group examined possible changes to accelerated depreciation, the most significant change was estimated to raise just over $2 billion across the forward estimates.[52]

Fuel Tax Credit Scheme

The Fuel Tax Credit Scheme was established to ensure that fuel tax is not paid by those who do not use public roads. The Commonwealth Treasury holds that the scheme is not a subsidy but 'a mechanism to reduce or remove the incidence of excise or duty levied on the fuel used by business off-road or in heavy on-road vehicles'.*

It is important to recognise that fuel tax credits are simply the mechanism through which the scheme is administered. For example, from 1957, off-road diesel users were exempt from fuel excise through an exemption certificate scheme. This scheme had integrity issues and was difficult and costly to administer. As a result, the Diesel Fuel Rebate Scheme was introduced which allowed eligible users to claim back the excise paid. The Fuel Tax Credit Scheme is an evolution of this scheme.

* Treasury submission to G20 Energy Experts Group in 2011.

These measures should not be used to fund a corporate rate reduction

Some groups have suggested that rationalising these sorts of measures to broaden the tax base is the most appropriate means of funding a corporate rate reduction.

In many cases this would be in contrast to Australia's competitors. Australia's competitors have both lower statutory corporate tax rates and broader business tax measures in areas such as interest deductibility, accelerated depreciation and R&D tax incentives that are at least equivalent to if not more favourable than Australia.

Similarly, for trade-exposed industries like agriculture and mining, removal of the Fuel Tax Credit Scheme would simply erode competitiveness and see a loss of global market share.

In the case of dividend imputation, a reversion to double taxation would mean relatively high taxation of dividends, reducing domestic investment and share ownership.

All of these measures should therefore be retained.

Table 5: Possible impacts of changes to selected business tax measures

Measure	Possible impacts of removal or reduction
Interest deductibility	• Increased cost of debt financed investment • Significant transitional issues for highly leveraged businesses
Accelerated depreciation	• Reduced international competitiveness in key capital intensive sectors including utilities, IT, agriculture, transport, and mining relative to other jurisdictions • Reduced business investment and major projects, including associated employment

Measure	Possible impacts of removal or reduction
Exploration expenditure	• Reduced pipeline of future mining projects. Spending on exploration is already down 60 per cent since 2011-12[53] • Exploration expenditure is allocated to other jurisdictions with more favourable tax regimes
Fuel Tax Credit Scheme	• Trade-exposed industries such as agriculture and mining would see a loss of global market share • At current commodity prices, some mines would become unviable
R&D Tax Incentive	• Large companies will move their incremental R&D expenditure offshore
Dividend imputation	• Less domestic investment in Australian companies • Reduced share ownership • Less distribution of profits • Greater bias towards debt financing • Double taxation of profits

Improving the R&D Tax Incentive

Changes to the R&D Tax Incentive should be undertaken in two stages.

First, there is immediate scope to simplify the R&D Tax Incentive and reduce the reported compliance costs of $437 million borne by business.[54] As part of its review of the R&D Tax Incentive already underway, the government should seek to reduce administrative complexity to lower compliance costs including fees to tax agents and external consultants.

Reducing administrative complexity and cost, including through pre-registration, could open more funding for R&D.

Over the longer term, the R&D Tax Incentive should be redesigned to focus on incentivising the translation of R&D. The most appropriate way of doing this is to use the internationally recognised Technology Readiness Level (TRL) 1–9 scale and weight the incentive towards TRL levels 3–6. Targeted changes to eligibility based on TRL could shift the balance between research and the translation of research. The Australian system is good at the former but poor at the latter and, without an effective translation capability, our ability to deliver a return on our research investment will be compromised.

Changes to the R&D Tax Incentive should allow for appropriate transitions for all companies participating in the scheme to avoid the risk of incremental R&D being shifted overseas.

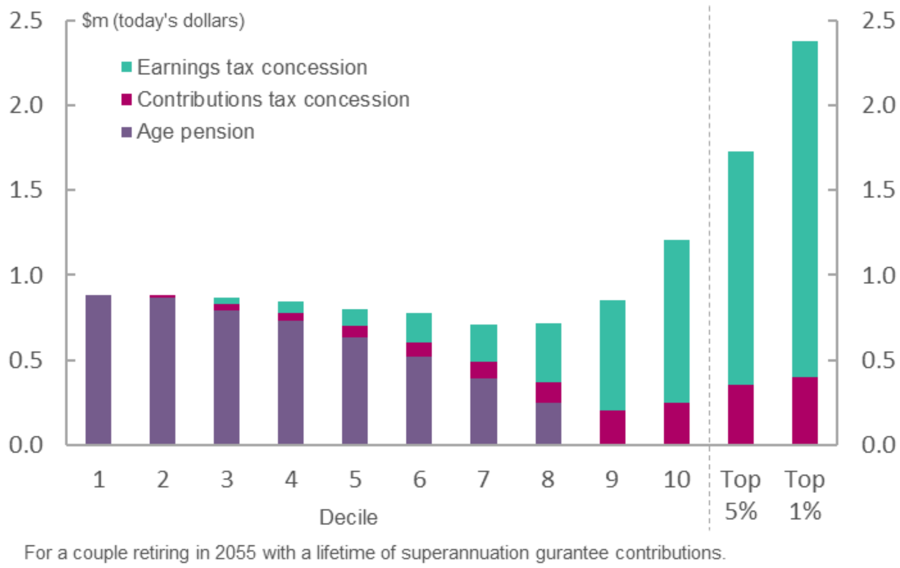
6. Durable and fair superannuation tax concessions

- The government should adopt clear objectives for the retirement income system to guide changes to superannuation tax concessions.
- As much as possible, the tax treatment of superannuation and other savings income should be consistent, while acknowledging that superannuation is a much less flexible form of saving.
- There is a strong case for concessional tax treatment of superannuation because savings are compulsory for employees and locked in for very long periods.
- The current system could be fairer and more cost effective through carefully targeted tightening of superannuation arrangements, with appropriate transitions.

Superannuation – more than just a tax issue

Superannuation is one pillar of Australia's three-pillar retirement income system, alongside the age pension and voluntary retirement savings.

Figure 13: Lifetime government retirement support by income decile



Source: Rice Warner, *Submission to Tax White Paper Task Force*, 2015.

In the Business Council's view, the dual purpose of the retirement income system should be to provide for comfortable living standards during retirement, and to reduce reliance on the age pension.

Concessional tax treatment of superannuation should remain. However, there should be reasonable limits on the total balance of superannuation accrued through concessions. The tax system should facilitate superannuation balances large enough to provide for comfortable living standards during retirement, not large-scale wealth accumulation.

Any reforms must be undertaken with a clear sense of how the changes will achieve these policy goals, and a careful and holistic analysis of the interactions between the three pillars. Appropriate transitional arrangements that account for the long-term horizons over which retirement decisions are made will be necessary.

Superannuation taxation should be concessional

There is a strong case for concessional tax treatment of superannuation because savings are compulsory for employees and locked in for very long periods. Compulsion comes at a cost to those individuals who would otherwise choose to have higher disposable income for current consumption or more liquid forms of savings. These costs need to be accounted for, particularly if the scheme is to retain taxpayer support.

The compounding tax effects, as for any savings, can lead to high effective marginal tax rates with punitive impacts over time. As an overriding objective, the choice between consuming today and saving (and then consuming tomorrow) should not be skewed by the tax system.

The total value of superannuation tax concessions is smaller than some estimates suggest

The major superannuation tax concessions for employer contributions and fund earnings were valued by Treasury at around $30 billion in 2016-17, on a revenue forgone basis.[55] These estimates assume a counterfactual where personal income tax rates apply to contributions and earnings including in retirement phase (but not benefits paid).

Using income tax rates as the comparator is problematic as no one is seriously suggesting this treatment of superannuation would be desirable. In other words, the revenue forgone estimates do not indicate the potential pool for budget savings.

The appropriate comparator is the 'ideal' tax treatment of superannuation, which is generally considered to be one where contributions and earnings are tax free and benefits are taxed at marginal income tax rates (the so-called post-paid expenditure tax treatment).

Treasury has calculated experimental superannuation tax expenditures using a 'pre-paid' expenditure tax benchmark where contributions are taxed at marginal tax rates and both earnings and benefits are tax exempt. Treasury estimated that total concessions would fall to around $14 billion in 2016-17 (this is still probably higher than the amount using a post-paid counter factual).[56]

The current system could be fairer and more cost effective

There are concerns that the superannuation system allows high-income earners to accumulate wealth at concessional tax rates and that the system is not cost effective.

The distribution of total concessions is skewed towards the highest-income earners. This is due to the quantity of savings by income level and the progressivity of the personal income tax structure compared to the flatter tax rates paid on superannuation.

The revenue cost of concessions will continue to rise as fund assets build and as taxpayers enter higher tax brackets.

It is widely agreed that taxing superannuation income in the retirement phase only (at the personal income tax rate) and exempting contributions and earnings is the ideal approach as it achieves neutrality between current and future consumption. This is referred to as an E (fully exempt), E (fully exempt), T (fully taxed) approach.

However, this horse may have already bolted for Australia. Current account holders who have already paid tax on contributions and fund earnings would need to be grandfathered, leading to a protracted transition period with two quite different tax systems. Nevertheless, the EET approach is a useful benchmark when deciding appropriate tax treatment in the current Australian system.

The structure of taxes on superannuation is part of a larger question – whether the retirement income system is the least-cost way to achieve comfortable living standards during retirement and reduce reliance on the age pension.

The superannuation system will not mature for decades. The proportion of people receiving full pensions is projected to decline and part-pension recipients to increase. The Cooper review suggested retirement outcomes would improve, but the cost of age pensions would not necessarily decline.

Others have made numerous proposals to change superannuation

There are numerous proposals to change the tax arrangements for superannuation across the three phases of superannuation – contributions, earnings and drawdown.

Changes in the **contributions** phase could include moving to more progressive tax rates, tightening annual contribution caps or introducing lifetime caps.

There have been suggestions to change the tax rate on **earnings** or to tax earnings when people are in retirement (currently untaxed).

In the **drawdown** phase changes could include capping balances that receive tax-free treatment in retirement or to tax income streams from funds.

There are risks in changing superannuation settings

There is scope to improve the superannuation system but changes seeking to save large amounts of revenue risk undermining the system and leading to larger pension outlays down the track.

In the Business Council's view, the EET approach is the appropriate benchmark, combined with appropriately set annual caps. Reforms should seek to emulate the outcomes that would have been achieved if EET were used in Australia.

Some of the implications of proposed changes are analysed below.

More progressive contributions tax rates

- A uniform discount to personal income tax rates would need to be at least 20 per cent to avoid affecting superannuation balances of those on middle incomes. The tax treatment of middle-income earners will have a substantial impact on reducing reliance on the age pension.
- Linking superannuation contribution tax to personal income tax will be complex because funds may not know the incomes of contributors. The ATO would need to assess the contributions tax payable at the end of each year and send assessments to virtually all taxpayers. Taxpayers could pay the bill from their disposable income or request that their fund pay it from their balance.

- If a more progressive tax rate structure is introduced within the superannuation system – as was done by increasing the tax rate to 30 per cent for people earning over $300,000 – this would introduce high effective marginal rates as taxpayers enter higher tax brackets. This occurs because the marginal rate will apply to all contributions, not just the extra superannuation on an additional dollar of income. Bracket creep will exacerbate this effect.

Tighter contributions caps

- Tighter contributions caps may be easier to administer than progressive rates, although taxpayers would need to take care not to breach them.
- Flexibility would be required to accommodate people whose incomes are volatile or intermittent, for example women who temporarily leave the workforce. If caps are too strict and inflexible, this might only lead to greater reliance on part pensions.
- The caps should not be so low that they preclude a comfortable retirement, and this means they must factor in expected fund returns including earnings volatility.

Changing tax treatment of earnings

- The Henry review proposed taxing fund earnings in the retirement phase but this proposal was predicated on the earnings tax being halved to 7.5 per cent. This is worth considering.

Taxing in the drawdown phase

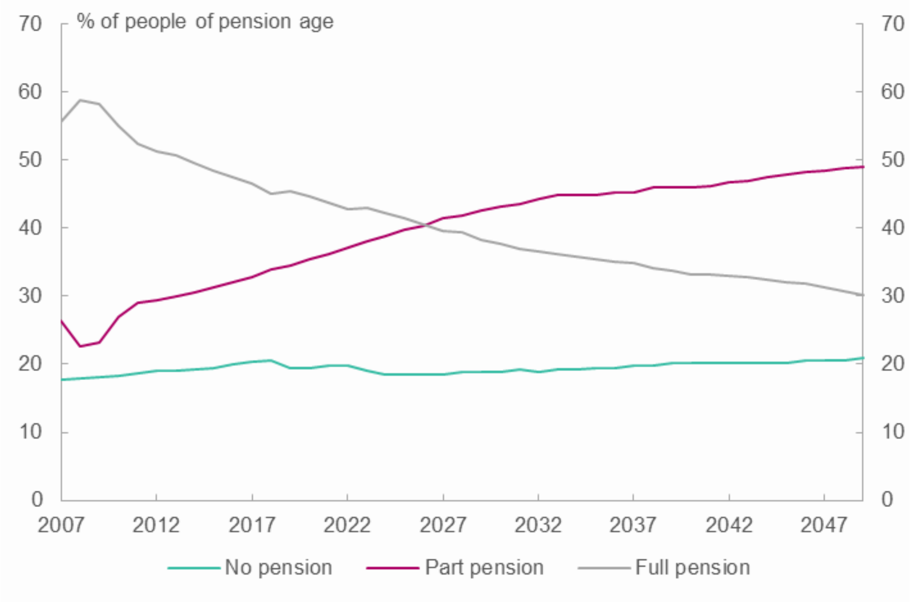
- Superannuation should not be taxed at every phase. Taxing superannuation drawdowns would be a move towards EET only if it were accompanied by removing taxation on contributions and earnings. Account holders who have already paid tax on contributions and earnings would need to be grandfathered – adding complexity, which may last several decades. It is likely there would be an upfront revenue cost to government.

Lower superannuation balances could increase reliance on the age pension

In general, the larger the sum raised from cutting or limiting access to superannuation concessions, there will be a greater impact on low to middle-income earners. This simply reflects the pool of high-income earners is limited.

Tighter caps or higher contributions taxes reduce fund balances, which translates to lower superannuation incomes. For lower to middle-income earners, this would likely increase their reliance on the age pension so the net fiscal impact would not be as great as initial revenue savings indicate.

Figure 14: Projected changes in the composition of people receiving the pension



Note: The report containing this modelling was released in 2013 and does not incorporate subsequent policy changes (such as delays to the superannuation guarantee).

Source: Australian Government, *A Super Charter: Fewer Changes, Better Outcomes*, 2013.

There are modest steps which could make superannuation fairer and more sustainable

Initial changes to the tax treatment of superannuation should include:

- adopting clear objectives for the superannuation system to guide policy changes
- some tightening of annual concessional and non-concessional contributions (but with the flexibility to carry allowances forward) to reduce the cost of fund earnings concessions and limit the accumulation of very large balances. Caps should be indexed and carefully calibrated so they do not undermine building comfortable retirement incomes
- addressing impediments to greater use of annuities.

Tightening of concessional tax treatment of superannuation should be accompanied by more consistent concessional treatment of non-superannuation savings income.

More fundamental structural change could be considered by a comprehensive review of the retirement income system and tax treatment of all saving income. Such a review could examine:

- a uniform discount to superannuation contributions and how to address the complexities of implementation
- the Henry review proposal to reduce the earnings tax to 7.5 per cent and apply it to earnings in the retirement phase. This would cost revenue in the immediate term.

7. More neutral treatment of savings

- Tax policy should not distort investment decisions – more neutral and fairer treatment of all savings is needed.
- Changes to the taxation of savings income should take a holistic approach.

Savings are vital for domestic wealth creation, providing funds for investment and smoothing lifetime consumption choices.

Currently, capital income from different forms of investment in Australia is taxed very differently, some at concessional rates and some not, leading to inefficient investment allocation and perceived unfairness.

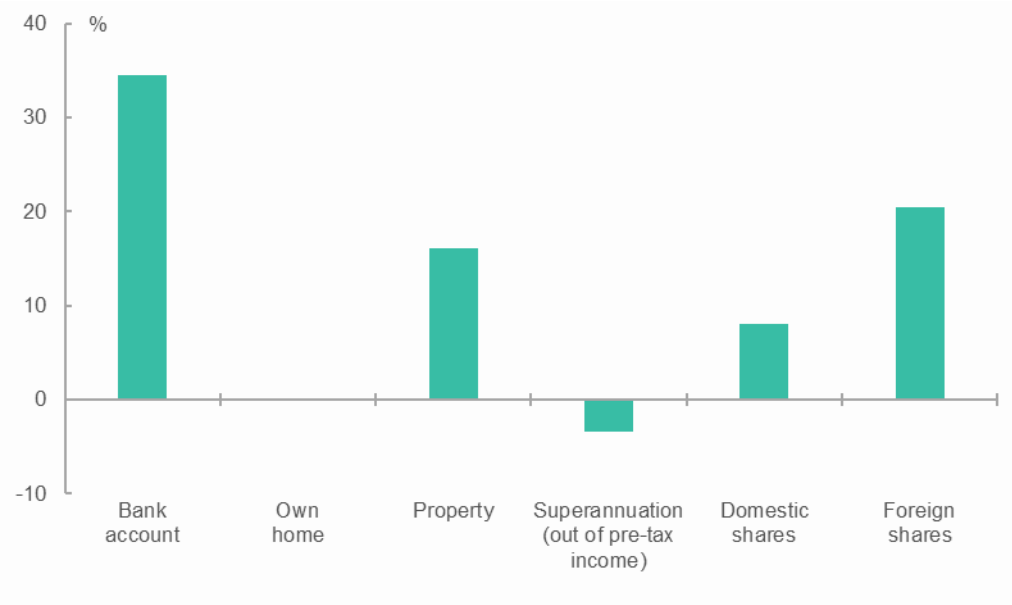
Ideally, income from savings should be taxed at a lower rate than current income to counteract the compounding effects of taxation, which generate higher effective marginal tax rates that erode the value of savings and discourage deferring consumption to the future.

There would be efficiency gains from more consistent concessional treatment of different forms of savings income such as capital gains, rental income and interest on savings deposits.

There are good reasons to continue to exempt the family home from capital gains taxation given both the social benefits of home ownership and the enormous practical complexity and compliance costs of introducing taxation for these assets (which would require deductibility of costs).

The figure below demonstrates how the tax treatment of savings differs by asset class. It compares the nominal effective marginal tax rate for different savings vehicles for an individual with a 32.5 per cent marginal tax rate (plus the 2 per cent Medicare levy).

Figure 15: The tax treatment of savings differs by asset class



Source: Australian Government, *Re:think tax discussion paper*, 2015.

Any measures to counter perceived inequities, such as restrictions on negative gearing and changes to tax arrangements for capital gains, should align with the overarching goal of promoting efficient savings and investment allocation.

Changes to negative gearing must be carefully assessed

There is much debate about the fairness of interest deductibility for rental properties (negative gearing). Interest deductibility applies to all investments, not just property.

Ultimately, reducing house prices will require increased supply and lower construction costs.

The principle of interest deductibility is sound

Interest deductibility is a general tax provision that applies to interest expenses incurred in producing income, for individuals and businesses. This treatment ensures neutrality between people who fund investments through equity and those who borrow.

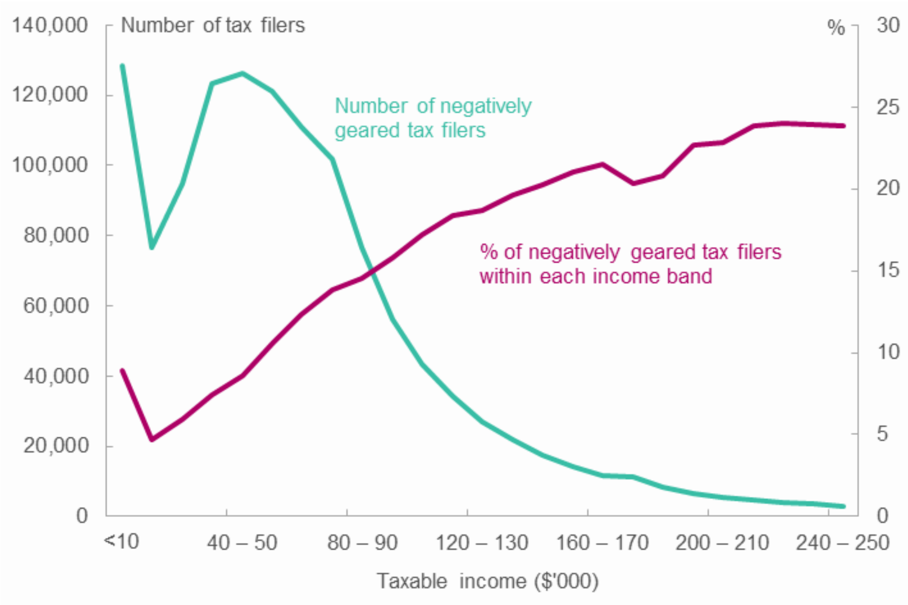
Changing investor behaviour limits the revenue available from negative gearing

The budget cost of negative gearing to purchase rental properties is estimated to be around \$3 to \$5 billion a year (it has declined due to low interest rates).[57] But removing negative gearing on properties is unlikely to raise this amount as investors would likely switch to holding other assets.

Negative gearing is widely used

Despite its general availability, when used for buying property, negative gearing is regarded as favouring high-income earners. Negative gearing is used across all income groups. One-third of rent received, one-third of interest and one-third of other deductions are claimed by those with taxable income between \$37,000 and \$80,000.[58] Despite its widespread use, it is estimated that most of the benefits of negative gearing accrue to higher-income earners. In part this reflects progressivity of the income tax system as the value of any deduction increases with the tax rate.

Figure 16: Negative gearing is widely used



Source: Australian Government, *Re:think tax discussion paper*, 2015.

Negative gearing must be considered together with tax treatment of capital gains, as ultimately there is only value in negative gearing if a net gain is obtained. It is considered by Treasury and others that to the extent there is a problem, it lies in the tax treatment of capital gains.[59]

Changes to negative gearing should align with treatment of other savings vehicles

There are numerous options for changing negative gearing, including:

- limiting the number of negatively geared properties
- capping the total amount of deductions for negatively geared property
- quarantining interest deductions against rental income
- limiting negative gearing to new dwellings only.

Any changes to negative gearing should be considered in the context of the tax treatment of other savings – where housing is just one asset class. As stated in the Henry review, a more neutral tax treatment of savings would ‘encourage households to seek the best pre-tax return on their savings and to invest their savings in assets that best suit their circumstances and risk-preferences’.

Tax policy should not distort investment decisions

Inconsistent tax treatment can lead to inefficient investment allocation, that is, overinvestment in one asset class relative to another. Yet capital income from different forms of investment in Australia is taxed very differently.

Any changes to negative gearing or other arrangements should align with the overarching objective of promoting more efficient savings and undistorted investment allocation.

Limiting the number of negatively geared properties would have a limited impact and would not raise much, if any, revenue – people could simply purchase fewer, more expensive properties.

A cap on deductions would likely affect mainly high-income earners (depending on the level of the cap). Those affected would shift to other assets to some degree, such as shares, which would reduce scope for revenue gains. A universal deduction limit (covering work expenses, interest, donations etc.) would essentially impose a minimum effective rate of tax on higher-income earners.

Quarantining interest deductions against rental income would limit the immediate benefits of negative gearing but losses would be carried forward to reduce taxable capital gains when assets are sold. This changes the timing of claiming losses, but not the capacity to claim them.

This would increase the cost of holding an asset for a long period of time, as the real value of the interest loss will degrade over time. A change of this nature could shift incentives to holding investments for shorter time periods.

This treatment is consistent with a dual-income tax approach where capital income from all sources is taxed at the same concessional rate (including rental income and capital gains). There would be immediate revenue gains, but lower future capital gains tax receipts.

Limiting negative gearing to new dwellings would distort the housing market. Currently, most negatively geared properties are existing dwellings, presumably reflecting demands in the rental market and that new housing will always be a relatively small share of the total housing stock.

If negative gearing is confined to new dwellings, investor demand will shift to new dwellings, pushing up prices of new dwellings in the short term (given a less than perfectly elastic supply response) and crowding out owner-occupiers. The price of the existing housing stock will decline immediately. The availability of rental accommodation in existing dwellings will also tend to decline and rental prices increase. Owner-occupiers will shift to the existing housing stock.

Overall there would be a likely decline in demand for housing. The extent of the decline in demand would be limited if losses can be carried forward in the cost base for capital gains, but this would also limit the scope for net revenue gains. Only expanded supply of housing can increase the housing stock and keep a lid on prices.

There are modest steps that could make treatment of all savings fairer and more neutral

Changes to negative gearing without more neutral tax treatment of savings across different asset classes are likely to shift investors into other assets. This would reduce any potential revenue gain.

A more neutral, concessional treatment of other forms of capital income could be achieved via a dual-income tax approach. This would be more equitable (particularly for those people who are constrained to save via interest-bearing deposits) and economically efficient.

Under a dual-income tax approach, interest and other property expenses could only be offset against rental income, which would still be taxed at a concessional rate. Losses would be carried forward until properties were sold and (concessional) capital gains tax paid. This would offer immediate revenue savings (depending on the discount on rental income), offset by lower capital gains tax receipts in future.

Any changes to negative gearing would need to be phased in or grandfathered to avoid fire sales of properties and negative impacts on existing borrowers. The impact on rental markets would need to be assessed.

The only sure way to reduce housing prices is to increase the supply of new dwellings and reduce the cost of constructing them.

Changes to capital gains tax should be carefully calibrated

There is value in exploring the Henry review proposal to reduce the capital gains tax discount to 40 per cent, but only in the context of longer-term changes to establish more consistent concessional taxation of all savings income. The consequences could be severe if changes are made that do not take a holistic approach to the taxation of savings.

If changes were made, existing asset holdings would either need to be grandfathered or a gradual reduction in the discount phased in.

Capital gains should be concessionally taxed

It is widely accepted that savings income should be taxed at a lower rate than labour income to offset the compounding effects of taxes and inflation over time. This is needed to encourage investment and risk-taking in a transitioning economy facing global competitive and mobility pressures. It is imperative that Australia offers an internationally competitive tax regime to attract diversified investments that build a resilient economic base and provide attractive, secure jobs.

The 50 per cent capital gains tax (CGT) discount on nominal gains provides a concessional tax rate within the progressive income tax structure.

The cost of the discount is significant

In 2015-16 the CGT discount on assets owned by investors for at least 12 months is estimated to be around $6 billion.[60]

The problem is that the tax treatment of savings is inconsistent

Two main issues have been raised with the current system – the size of the discount and that it applies to nominal rather than real gains.

There is broad consensus that savings income should be taxed concessionally. However, there is no theoretical guidance on how large the concession should be. The current discount of 50 per cent may be generous, particularly in a low-inflation environment.

Applying the discount to nominal capital gains can distort investor behaviour, particularly at a time of rapid capital gains, such as in a housing or equity boom. On the other hand, if capital gains lag inflation, the current regime works in the opposite direction to penalise investors.

Options for change

- Reducing the rate of discount. One proposal is to reduce the CGT discount to 25 per cent. The Henry tax review proposed a uniform discount of 40 per cent on nominal capital gains along with applying this treatment to some other forms of savings income.
- Prior to the introduction of the current arrangements in 1999, real capital gains (deflated by the consumer price index) were taxable at the individual's income tax rate (with the cost base indexed annually). Taxing real gains would remove the pro-cyclical bias of the current system, but add some complexity.
- Introducing a CGT tax-free threshold of $10,000 would reduce compliance costs significantly and is well worth considering. The revenue impact is likely to be small and would remove around 70 per cent of taxpayers from the CGT system.[61]

The impacts of proposed CGT changes should be carefully examined

The table below illustrates the effective marginal tax rates (EMTR) on a real capital gain, for a range of CGT discount options. The assumptions are: the asset was purchased for $100,000; sold for $110,000 a year later (nominal gain of $10,000); inflation is 3 per cent; and the taxpayer is in the highest tax bracket (49 per cent tax rate including levies).

Under the current treatment (involving a discount of 50 per cent) the EMTR on the real gain would be 35 per cent. The EMTR would rise to 53 per cent under a 25 per cent CGT discount, resulting in more tax being paid than if the real gain were taxed at the taxpayer's full marginal rate.[62]

The Henry review proposal for a 40 per cent discount on some sources of capital income including capital gains for all assets would be less distorting. Using the same example, the EMTR on the real gain would be 42 per cent, still below the full marginal income tax rate.

Table 6: Illustrative effective marginal tax rates of capital gains

	Taxed component ($)	Tax liability ($)	Nominal return post-tax ($)	Real return post-tax ($)	EMTR on real gain
50% CGT discount (applied on nominal gain)	5,000	2,450	7,550	4,550	35%
40% CGT discount (applied on nominal gain)	6,000	2,940	7,060	4,060	42%
25% CGT discount (applied on nominal gain)	7,500	3,675	6,325	3,325	53%
49% tax on real capital gain	7,000	3,430	6,570	3,570	49%

Source: BCA calculations.

It is estimated that around three-quarters of the benefits from the CGT discount goes to households in the top income decile. However, capital gains tend to be large one-off benefits, which can significantly raise taxable incomes, even pushing taxpayers into higher tax brackets than would otherwise be the case. This can skew the analysis.

If net capital gains are removed from taxable income to find a more reasonable indication of the income distribution, the benefit from the CGT discount that goes to the top decile could fall to about half. The benefit increases in all other deciles.[63]

A way forward

Explore reducing the capital gains tax discount to 40 per cent, but only as an initial step towards more consistent concessional taxation of other forms of savings income (for example, in moving towards a dual-income tax system). Existing asset holdings would either need to be grandfathered or the reduction in the discount phased in. Grandfathering would push out savings for many years.

8. Moving to more efficient state taxes

- Harmonise both the land and payroll tax bases as the first step to a more efficient state tax system.
- Longer term, the aim should be to broaden the base of both land and payroll taxes with carefully managed implementation over a long transition.
- Broader bases of the most efficient state taxes would enable governments to gradually reduce reliance on distortive stamp duties. These could eventually be phased out completely.

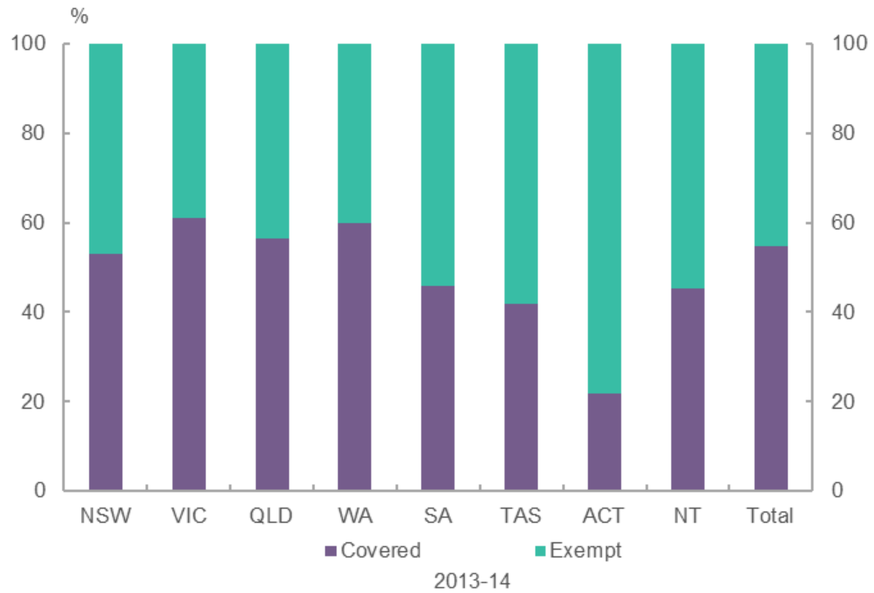
Payroll and land taxes have historically grown in line with or above economic growth – making them a potentially stable tax base for the states.[64] But their design hinders their efficiency.

Comprehensive state tax reform ideally involves a three-pronged approach: reforming land and payroll taxes to facilitate phasing out stamp duties. While broadening land tax and payroll tax would generate benefits to the economy independently, doing them as a suite of reforms would have a greater beneficial impact.

Payroll tax rules should be fully harmonised

Payroll taxes are efficient in theory because they are levied on a broad base (wages), which is relatively immobile. However, in practice around 95 per cent of Australian businesses are exempt from payroll tax.[65] This equates to not taxing around 45 per cent of the potential tax base.[66] A narrower base necessarily means higher tax rates to raise a given amount of revenue.

Figure 17: Close to half of the payroll tax base is exempt



Source: BCA calculation using ABS, *Taxation Revenue, Australia, 2013-14*, cat. no. 5506.0; ABS, *Australian System of National Accounts, 2013-14*, cat. no. 5204.0; State Revenue Offices.

Although progress has been made towards harmonising payroll tax across states, there are still differences. The rates vary from 4.75 per cent to 6.85 per cent, with annual tax-free thresholds ranging from $550,000 to $1.85 million, and differing activity and payment exemptions.[67] The tax-free threshold based on the number of employees is the largest exemption and indicates the largest source for efficiency gains.[68] Exemptions mean a more complex system and businesses potentially have to deal with eight different regimes if they operate nationwide.

Even though commonly viewed as a 'business tax' the ultimate impact of the tax is mainly on wages, not businesses – and the exemptions do not quarantine this effect. This is because although payroll tax is levied only on businesses with payrolls above a certain threshold, the effect of the tax is also felt by employees of exempt businesses through lower (net of payroll tax) wages. Competition in labour markets means that employees in similar jobs will receive similar wages regardless of whether the business they work for is liable for payroll tax. The higher tax rates required to raise a given amount of revenue from fewer business drives down wages further than if a lower rate were applied across all businesses.

Managing implementation

Payroll tax rules and exemptions should be aligned across states. Ideally the number of exemptions would be reduced to broaden the base. Base harmonisation is an essential prerequisite for creating a network of more efficient state taxes. Higher payroll tax rates on the existing base would only distort business structures further and drive wages lower.

Payroll tax rates could be examined as the second step. Uniform rates would further streamline the system, but it would be possible for states to continue to set the payroll tax rates to reflect their particular circumstances.

A transition to a harmonised base and more consistent rates could be managed over five years.

There is scope to use the land tax base better

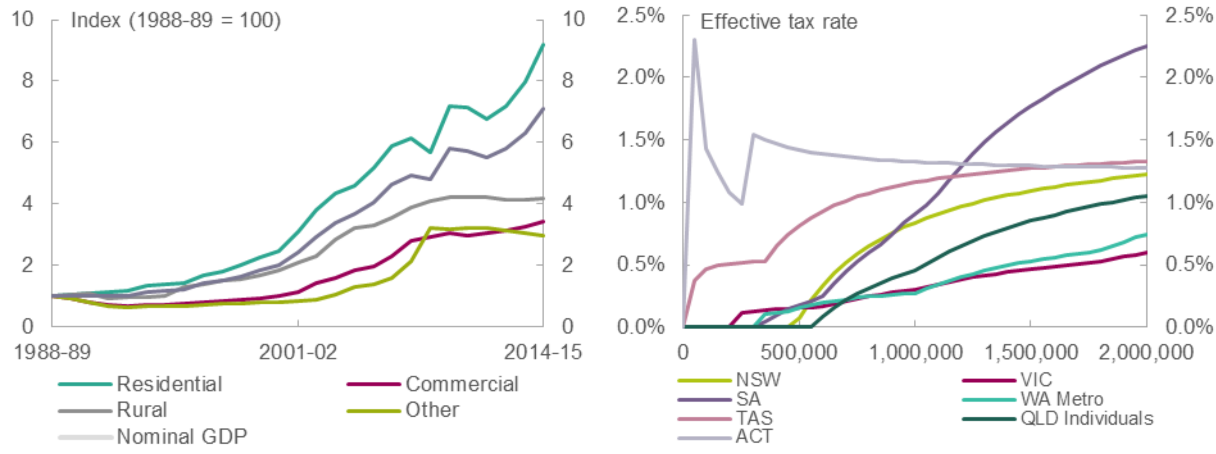
A broadly applied, well-designed land tax is efficient and has little impact on incentives to invest, work and save. The marginal excess burden of a broad-based land tax is estimated to be negative – that is, raising land taxes would deliver an economic benefit. The benefit would be even larger if the revenue is used to remove more economically harmful taxes like stamp duties.

Currently around 60 per cent of the value of land is exempt from land tax. Exemptions apply generally to owner-occupied housing and land used in primary production. Land tax largely applies to a limited range of commercial and investor-owned residential land and holiday homes. Significantly, these exemptions exclude from the tax base the land with the fastest recent growth in value.

There are also large variances in the land tax rates and base across states. For a property valued at $600,000 the effective land tax rate varies from 0 to 1.39 per cent, with a range of rates and thresholds.[69]

As a rule of thumb, an effective tax rate of around 0.2 per cent could be applied to all land (no exemptions) to raise the same amount of tax revenue as today.[70] In 2013-14, states raised $6.4 billion in land tax on land valued at about $1.7 trillion,[71] but total land values were $4.2 trillion.

Figure 18: Land values are growing, with varying effective tax rates across states



Source: ABS, *Australian System of National Accounts, 2013-14*, cat. no. 5204.0; State Revenue Offices.

Managing implementation

The land tax rules should be harmonised across states and the base expanded. Uniform rates would be ideal, but it would be possible for states to continue to set the land tax rates so they can adjust to their particular circumstances.

These reforms are difficult and transitional arrangements would need to be carefully designed to manage the switch from taxing property and insurance purchasers to all owners of property. Incumbent owners would bear the whole cost of a broader land tax through a reduction in property values, creating inequities between current and future property owners.

Stamp duty reductions and land tax increases could be phased in very gradually to avoid sudden shocks to the property market (similar to the approach taken by the ACT Government). Increasing land tax at the same time as reducing stamp duty has the additional benefit of some offsetting impacts on asset prices.[72]

Another approach, as recommended by the Henry review, could be to restrict the new land tax to property transactions that occur after a particular date, so that those who already paid stamp duty are not taxed twice.

Ideally, a reformed land tax would only apply to the unimproved value of the land, so there is not a disincentive to improve the land. Council rates could be used as the base for a low-rate broad property levy.

There may be circumstances where the land owner is asset-rich but income-poor (for example, some retirees). An optional loan arrangement system could be introduced so that the tax is paid when the property is sold, with interest imposed on the outstanding amount. Such arrangements currently exist for some local government rates.

Reduce reliance on stamp duties

Stamp duties are highly inefficient and volatile, making them harmful to economic growth and budget stability. The main stamp duties are on buying houses and insurance.

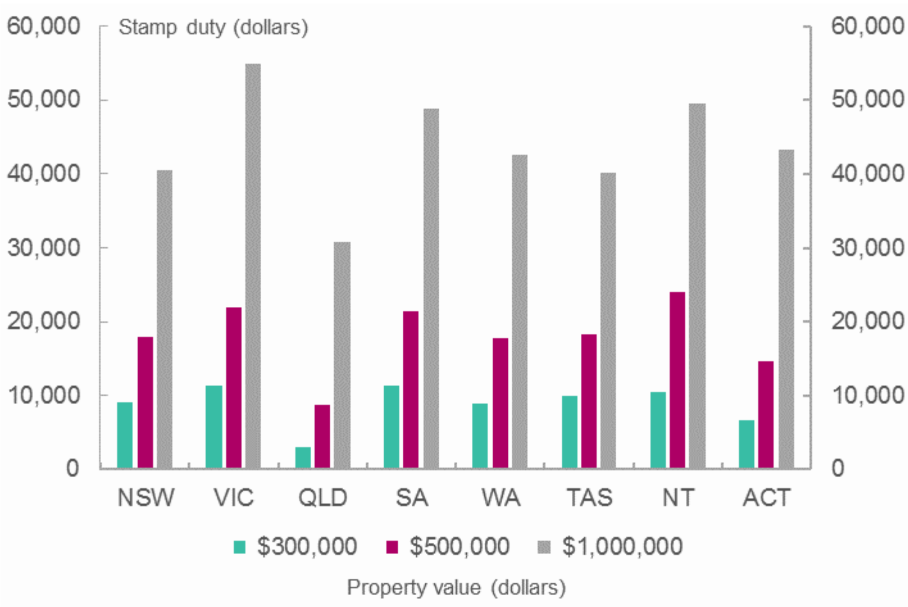
Treasury estimates that each dollar of revenue raised through stamp duties on property costs the economy around 72 cents for an extra dollar raised.[73]

Stamp duties increase the cost of buying a house and discourage people and businesses from moving. This causes an inefficient use of the building stock. Stamp duties can discourage new housing development as the tax is paid twice: once by the developer when the land is acquired and again when the final owner buys the new house.

While stamp duties increase with property values, they do not always treat people in similar circumstances in a similar manner. They place a higher tax burden on people who move more frequently and buy more insurance, which may not relate directly to their wealth or income.

Insurance taxes discourage people from taking out adequate insurance. This will have a regressive outcome if lower-income households underinsure and expose themselves to more risk (as rates of non-insurance decline with higher income).[74]

Figure 19: Stamp duty liabilities vary by state and property value



Source: State Revenue Offices (assumes residential property and that the purchaser is not eligible for a concessional rate of stamp duty).

Managing the switch away from stamp duties

Shifting reliance from stamp duties (particularly on land and insurance) to harmonised, broad-based land and payroll taxes could raise the same amount of revenue with a lower cost to society.

As discussed above, phasing out stamp duties on housing would need to be closely tied to implementation of a broader land tax.

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