# UNREALISED GAINS

## THE COMPETITIVE POSSIBILITIES OF TAX REFORM

BUSINESS COUNCIL OF AUSTRALIA

WHAT BENEFITS COULD A BETTER TAX SYSTEM DELIVER?

## ABOUT THIS SUBMISSION

The Business Council of Australia (BCA) is an independent leadership group comprising the chief executive officers of 100 of Australia's largest and most economically significant companies.

The BCA's goal is for Australia to be the best place in the world in which to live, learn, work and do business. Through research, communication and advocacy, BCA members pursue economic, social and environmental policy outcomes for the benefit of all Australians.

This publication, *Unrealised Gains: The Competitive Possibilities of Tax Reform*, is the Business Council of Australia's final submission to the Australia's Future Tax System Review, chaired by the Secretary to the Department of the Treasury, Dr Ken Henry.

# CONTENTS

EXECUTIVE SUMMARY 2
INTRODUCTION 5
THE GROWTH IMPERATIVE 6
LONG-TERM TRENDS AND CHALLENGES DEMAND TAX REFORM 8
TAX REFORM FOR GROWTH 16
THE STATE OF PLAY IN AUSTRALIAN TAX 18
PRIORITIES FOR STRUCTURAL REFORM OF THE TAX MIX 19
THE CASE FOR CORPORATE TAX REFORM 19
CORPORATE TAX: MORE DEVIL IN THE DETAIL 21
THE CORPORATE TAX WORLD IS CHANGING 22
WHO BEARS THE BURDEN OF HIGH CORPORATE TAX? 24
REDUCING RELIANCE ON CORPORATE TAX 24
REDUCING THE COMPANY TAX RATE 25
REFORMING THE CORPORATE TAX BASE 26
CAPITAL INCOME AND PERSONAL TAX: ENCOURAGING SAVING 28
PAYING FOR STRUCTURAL REFORM: GREATER RELIANCE ON MORE ‘EFFICIENT’ TAXES 29
LABOUR TAXES: STAY THE COURSE 31
THE COSTS OF UNWIELDY TAXATION 32
LOWER TAXES MEANS LOWER SPENDING 35
STATE TAXES AND INEFFICIENCY 35
CONCLUSIONS: WHERE TO BY 2020 38

# EXECUTIVE SUMMARY

**THIS SUBMISSION SETS OUT CHANGES TO AUSTRALIA'S TAX-TRANSFER SYSTEM THAT WILL MAXIMISE ECONOMIC GROWTH IN THE AUSTRALIAN ECONOMY OVER THE YEARS AHEAD. THE CORE OF SUCH GROWTH-GENERATING TAX REFORM IS A SET OF MEASURES TO SUPPORT INVESTMENT IN THE AUSTRALIAN ECONOMY.**

The boom of the 2000s made growth-generating tax reform appear less urgent. The global recession, however, should focus attention on the competitive possibilities of tax reform.

Australia faces much greater challenges to its ability to grow and provide employment in the next decade and beyond. It will continue to rely on global prices and global capital in an increasingly competitive world environment.

For the Australian economy to record strong growth, it must be restructured to:

- Attract and retain foreign capital investment.
- Increase productivity.
- Minimise distortions that deter Australian savings and investment.

We accept and endorse the conclusion reached by researchers (including the OECD) in recent years, which is that the correct tax system can provide strong benefits in support of these crucial aims.

Most Australians do not yet realise how much growth can be generated through tax system improvements. This submission sets out how Australia can realise those gains.

## THE REFORM PRIORITY: CAPITAL TAXATION

Research within the last ten years has confirmed a recipe for using the tax system to generate economic growth and create more jobs.

That recipe is: tax capital lightly, and mobile international capital most lightly of all, to attract more investment funds into the country.

For this reason, we recommend that the review consider reducing the corporate tax rate to 15 per cent over the years ahead.

Lower corporate tax rates deliver economic growth for all Australians, and in quantities greater than any comparable spending or taxing measure the government could make.

The benefits are far greater than most Australians would expect. Cuts of 10 percentage points in corporate tax rates have been estimated to deliver an increase in annual growth in GDP per capita of up to 1.8 per cent. These are much stronger gains than have been demonstrated for reductions in tax rates on personal income.

At the same time, the impact on equity of lower corporate tax rates will be less than most Australians realise, because only a minority of the effects of corporate tax actually fall on businesses and their shareholders.

The best United States estimate is that 70 per cent of corporate tax in fact ends up falling on workers, ultimately through lower wages, lower hours worked and loss of jobs. Consumers also feel the impact of higher corporate tax, through higher prices.

An alternative to lowering the corporate rate, an allowance for corporate equity (ACE) regime, also has the potential to be attractive for the economy.

The adoption of an ACE – whereby companies would be permitted to deduct an imputed normal return on their equity – removes a bias in favour of debt financing and has the potential to stimulate investment both for locally based companies and inbound investors.

An ACE has been adopted in other countries, but further detailed analysis of its application in Australia is warranted.

The review should also consider a dual income tax system for individuals that would apply differential taxation to the returns to saving (i.e. on their capital income) and work (i.e. on their labour income).

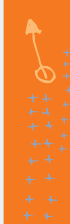
Countries including the Netherlands have adopted a dual income tax system.

Such a system would reduce the burden of tax on personal income derived from capital, encouraging more efficient savings decisions and higher levels of domestic saving and investment.

The reform of state taxation is far from complete. Inefficient state taxes should be eliminated and for the remaining state taxes, the tax base, tax calculation and tax collection arrangements should be harmonised.

## THE BROADER TAX MIX

In the medium to longer term, Australia must increase its reliance on more efficient broad-based indirect taxes, something that has not occurred in recent years despite the introduction of the Goods and Services Tax.



The OECD and others have convincingly concluded that greater reliance on consumption taxes – and specifically value-added taxes – can play a critical role in growth-generating tax reform.

Both broadening of the consumption tax base and an increase in the rate should be considered in the years ahead.

## ADMINISTRATIVE REFORM

Stronger governance arrangements should be considered for the Australian Taxation Office (ATO), possibly through an ATO oversight board to supervise the organisation's conduct, administration and management practices.

## SPENDING AND REVENUE NEUTRALITY

This submission does not present a revenue-neutral set of reforms. Rather, it aims to indicate the broad directions in which tax policy should move.

On multiple occasions – including in successive submissions to the federal budget process – we have highlighted the importance of returning the Budget to surplus over the coming years.

Similarly, we have stated that reductions in government spending can be achieved without substantially compromising the government's social and environmental aims. Such improvements to the targeting of government spending would allow a lower tax-to-GDP ratio.

We recommend that the federal government undertake a comprehensive review of spending – along the lines of the 1996 Audit Commission Review – to identify where savings can be found, and where programs can be delivered more effectively.

## MEASURING POTENTIAL GAINS

The review team, with Treasury assistance, has a unique capability to assess the economic and fiscal impacts of the growth-generating tax system options described above. It should undertake comprehensive long-term modelling of the projected effects of the tax changes on national income, investment, saving, employment and wages.

We call on the government to model four long-term reform options, each accompanied by increased reliance on broad-based consumption taxes. The four options are:

- A reduction in the corporate tax rate to 15 per cent.
- A reduction in the corporate tax rate to 15 per cent, coupled with the introduction of a dual income tax system with a 15 per cent flat tax on personal capital income.
- The introduction of an allowance for corporate equity tax arrangement with no change in the corporate tax rate.
- The introduction of an allowance for corporate equity arrangement and a dual income tax system with the rates of tax aligned at 15 per cent.

Such modelling will clarify the competitive possibilities available to Australia from tax reform.

# INTRODUCTION

Australia has been a standout economic performer for well over a decade. It is now well understood that this performance owes much to important economic reforms initiated in the early 1980s and carried on by successive governments. Tax reform was an important part of this broader reform agenda.

Those reforms provided the foundation for sustained strong growth and widespread individual prosperity, and have bolstered Australia's ability to negotiate significant shocks and challenges, including those now being experienced in the economy.

The challenge is to ensure that this recent past performance does not become Australia's 'high-water mark' but rather, is seen as a platform for future success.

The turbulence in global financial markets, collapsing global growth, an ageing population, technological change, and major changes on our doorstep as emerging markets develop into major new sources of competition, place Australia at a new crossroads.

While in many respects Australia's challenges are no different from its economic peers and competitors, in other ways the challenges Australia faces are unique. Looked at collectively, the challenges and opportunities our country faces will require further reform and policy innovation, new ways of thinking and the pursuit of new pathways to prosperity.

Reform of Australia's tax–transfer system will need to play an important role. The Australia's Future Tax System Review provides the opportunity to make better, and ideally the best, use of one of the most important tools of economic policy, our tax–transfer system.

### THE BCA PERSPECTIVE

The Australia's Future Tax System Review provides a 'once-in-a-generation' opportunity for tax reform, and this submission adopts a bold, long-term, aspirational approach. It outlines the key strategies that we believe should underpin long-term reform of the tax-transfer system in Australia. The issues raised and recommendations need to be viewed from the perspective of positioning the tax system over the next decades, not over the next year or two.

Rather than analysing the detail of problems with the current tax system – an approach that often leads to incremental solutions – our aim is to look forward to the benefits Australia could reap from major changes to the structure of the tax system.

In this submission we propose some ideas that have not been widely discussed in Australia, and make some recommendations that extend beyond the review's terms of reference. The BCA believes such ideas must be considered if the review is to lay the foundations for the best possible tax system to support growth and prosperity over the coming decades.

**THIS SUBMISSION ADOPTS A BOLD, LONG-TERM, ASPIRATIONAL APPROACH**

The current economic crisis is front-of-mind in all policy discussions at present, and there is little doubt that it has dramatically changed the economic outlook and the budgetary backdrop to the review. But we do not believe that the crisis has changed the key structural drivers of reform, nor diminished the need for reforms to better support future growth and prosperity.

Our members are the chief executives of more than 100 of Australia's leading corporations. The recommendations and directions for reform we outline in this submission reflect the long-term priorities that our members believe to be in the national interest.

The companies our members lead are large employers, with around 1 million employees collectively. They typically operate across states and territories within Australia, and are heavily engaged in global activities. Over 85 per cent of BCA members are directly engaged in global markets, and our members collectively account for over one-third of Australia's total exports.

Our central argument is that structural reform of the tax–transfer system can play a much more effective and prominent role in supporting the investment needed for economic growth, job creation and business competitiveness. The global context in which Australia competes for goods, services, skills, ideas and capital needs to be at the core of this restructure.

## THE GROWTH IMPERATIVE

Sustaining strong economic growth is fundamental to achieving the BCA aspiration for Australia to be the best place in the world in which to live, learn, work and do business.

One of the goals identified by the Economy Stream of the Australia 2020 Summit was for Australia to be ranked among the top five OECD economies in terms of living standards by 2012 (as measured by GDP per capita) and that it should seek to maintain that ranking. We strongly support this goal.

Although the global financial crisis has severely impacted many of the countries currently at the top of the OECD league table, countries that have enjoyed sustained strong growth in the lead-up to the crisis remain better placed to respond than those whose performance has languished. Certainly, Australia's position is far better than it would have been without the benefits of a reform agenda that had helped facilitate an unprecedented period of sustained growth and rising per capita income.

Australia should continue to aim to rank persistently among the most prosperous countries in the world based on policies that support sustained strong growth.

The strength of Australia's economy and viability of its businesses will generate individual opportunities and support higher living standards. A strong economy underpinned by a robust, dynamic and innovative business sector will generate the resources to better respond to future social, economic and environmental challenges and to invest in building better individual and community capabilities.

### EXHIBIT 1

## THE 'TOP-FIVE' GOAL

Over recent decades Australians have enjoyed a marked rise in living standards. This improvement provides the foundation to create new and better opportunities for Australians now and into the future.

Our goal is for Australia to rank among the top five OECD economies in terms of living standards by 2012, and to stay there.

This is a worthwhile and achievable goal. GDP per capita is the standard measure for comparing living standards. Higher GDP per capita is a good predictor of life expectancy, of where people want to live, and is correlated with 'fairness' in the sense that higher-income nations typically have a more even sharing of national income than poorer nations.

Other indicators of broader human progress are available, but they are highly correlated with GDP per capita. And the ABS notes that: 'Australia's national income provides the basis for many other dimensions of progress.'

However, for this goal to be achieved, we must work to maintain strong economic growth and build on the benefits that past reforms have delivered.

Source: Discussion of GDP per capita is taken from a report by Access Economics titled 'Workplace Relations – The Way Forward', pp. 12–13, published as part of the BCA *Workplace Relations Action Plan for Future Prosperity*, 2005.

Reform of the tax–transfer system is central to sustaining strong growth and a competitive business sector in Australia, particularly in the face of global competition, technological advance, population ageing, and some unique 'headwinds' to growth and productivity.

While tax reform cannot be driven by the objectives of economic growth and efficiency only, these objectives must be key points of focus.

There are also important trade-offs to take into account. Policies that on their own are regressive may nevertheless produce sufficient additional resources to compensate individuals in other ways.

Without a clear focus on the 'growth imperative' for tax reform, efforts to address other important issues such as distributional equity are likely to be undermined.

# LONG-TERM TRENDS AND CHALLENGES DEMAND TAX REFORM

If Australia's tax–transfer system is to better support long-run growth and competitiveness, reforms must anticipate and reflect key global and domestic challenges being faced by Australia and policy changes being adopted or considered by other countries.

### THE GLOBAL COMPETITIVE LANDSCAPE

Over the past 25 years, policy changes supporting more open markets around the world, coupled with advances in transportation, communication and information technologies, have radically changed the global landscape.

New markets and developing economies have grown rapidly, creating additional opportunities but also intense global competition. Capital, people, ideas, goods and services are all increasingly mobile (see Exhibit 2).

These trends are likely to be sustained and intensified over coming decades. Innovation and new technologies will deliver products and services unforeseen today and underpin businesses and jobs that do not currently exist and which are largely unpredictable.

Financial innovation will continue as a means of providing new services and opportunities for new markets, consumers and businesses, especially in the most populous and rapidly growing nations and in response to population ageing.

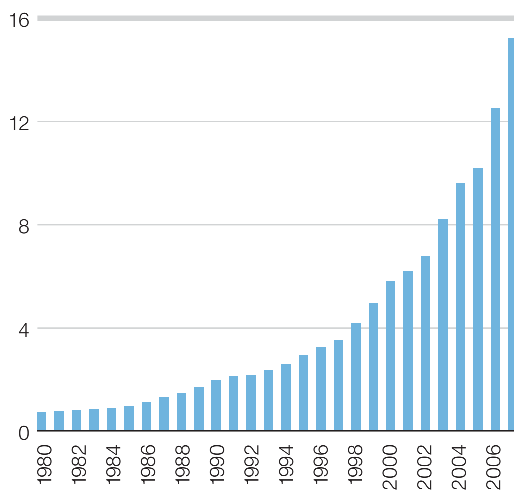
The pace of change and competition is expected to accelerate.

EXHIBIT 2

## THE RISE OF GLOBALISATION

Globalisation is leading to a continuing rise in foreign investment ...

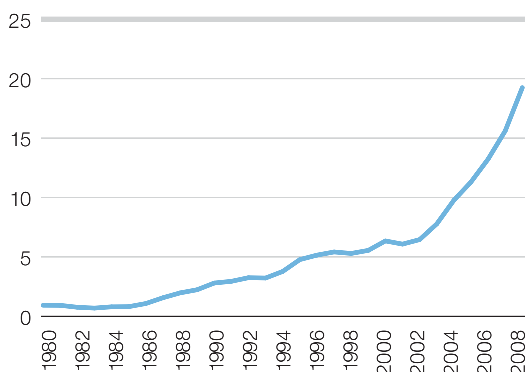
**WORLD FOREIGN DIRECT INVESTMENT STOCK**
**USD$ Trillion**




Source: United Nations Conference on Trade and Development FDI/TNC database.

... as well as greater trade in goods and services.

**VALUE OF GLOBAL TRADE IN GOODS AND SERVICES**
**USD$ Trillion**




Source: International Monetary Fund World Economic Outlook Database, October 2008.

Most countries around the world are seeking to respond proactively to the opportunities and challenges created by enhanced global mobility and technological change. The ability to improve, attract and retain investment and skills, and the capacity of domestic firms to compete in a global environment, will continue to be increasingly important contributors to growth and prosperity, and must shape domestic policy settings in the decades ahead.

Statements highlighting the need to prevent reversion to protectionist policies by the G-20, even in the face of global recession and significant disruptions to global capital markets, signal that the long-term benefits of open markets are well understood.

### POPULATION AGEING

Population ageing will have a significant impact on the nature and direction of capital flows and competition for capital as baby boomers retire from paid work and draw on, rather than add to, savings.[1]

Competition for labour, particularly skilled workers, is likely to intensify. And, as the proportion of the working age population falls in Australia and other developed countries, growth is expected to slow, increasing the importance of maintaining high rates of workforce participation and the significance of productivity in creating future growth and prosperity.[2]

While population ageing is an issue predominantly impacting developed countries, over 30 per cent of China's population is expected to be aged 60 or over in 2050.[3]

The magnitude of change coupled with technological advance and deeper global engagement means that irrespective of where it is occurring, the impacts of population ageing will reverberate through global markets.

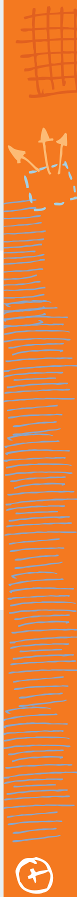
### AUSTRALIA'S UNIQUE GROWTH AND COMPETITIVENESS HEADWINDS

Australia must position itself to respond well to the structural and global forces impacting countries around the world, but it must also position itself to overcome, as best possible, some fairly unique challenges.

These challenges relate in large part to Australia's unique geography: its remoteness from global markets, its vast size and relatively small and disperse population. These 'geographic' influences are largely adverse in their impacts. They are significant. They are not diminishing as many would expect in the face of advances in transport and information and communication technologies. And they weigh on growth and productivity.

'Australia has a geography that is both sparsely populated and remote, which creates a set of impediments that are unique in the context of developed countries.'

*Does Distance Matter? The Effect of Geographic Isolation on Productivity Levels*, Department of the Treasury Working Paper, 2006.



## DISTANCE FROM GLOBAL MARKETS

Australia is the OECD country most disadvantaged by its distance from world markets.[4] Distance from global markets increases transport costs and reduces trade. Improved technology and falling transport costs have not diminished this impact over time.

The OECD has found that average real international transport costs for Australia and New Zealand more than doubled between 1973 and 2006, and that distance from global markets reduces trade to a similar extent today as it did in 1970. Based on measures of market access, others have concluded that countries on the periphery of global markets are becoming more economically remote over time.[5]

The simple conclusion is that if Australia weren't so far from global markets, its trade levels would be significantly higher. One estimate suggests that if Australia were as close to world markets as the United Kingdom, its level of trade would be expected to increase by around 50 per cent.[6]

Reduced trade in turn limits opportunities for specialisation and the scope to capture economies of scale.

Distance also limits the benefits of technological diffusion – a key driver of innovation and productivity. Estimates suggest that the distance over which the amount of spillovers is halved is around 1,200 km. While more recent research points to a lessening of the geographic impact on diffusion, it remains an important factor.[7]

Foreign sources of technology account for a very large share of domestic productivity growth for many countries. This technology is predominantly sourced from the leading developed economies – all of which are distant from Australia.[8] Research has confirmed that Australia's relative geographic isolation has limited its exposure to foreign R&D.[9]

All of this makes it harder to achieve higher levels of productivity, and it has been estimated that as much as 45 per cent of the gap in labour productivity between Australia and the United States can be explained by our geographic isolation.[10]

The OECD estimates that Australia's remoteness from markets relative to the OECD average reduces GDP per capita by as much as 10 per cent.[11]

Australia's economic size makes it a price taker in global markets, therefore higher transport costs typically result in lower prices received and lower wages paid to Australian workers.[12] This can discourage investment in human capital which undermines productivity directly and by limiting the benefits of technology diffusion embedded in imports, foreign direct investment and foreign R&D.

On the positive side, falling international communication costs in OECD countries have been found to have facilitated trade in services and some specialisation in production processes in more distant locations.[13] If Australia can capture more of these types of opportunities, distance from global markets may matter less in the future. To date, our trade in services performance, however, does not suggest we have done well on this front.[14]

### Dispersed and small domestic markets

Countries with large population centres in reasonable proximity to each other are likely to benefit from more effective labour and product markets, lower infrastructure costs and spillovers associated with the clustering of innovative activities. In contrast, geographically large countries with more dispersed populations are likely to find it harder to reap the benefits of specialisation, economies of scale and competition between producers, all of which support higher productivity.

Research from the Canadian Conference Board suggests that population density is positively related to productivity growth and that geographically large countries are at a disadvantage when it comes to productivity.[15] Their results have been supported by Australian research.[16]

### Resource endowments

On the other side of the geography ledger, Australia's natural resource endowments have contributed to GDP per capita being higher than it otherwise would have. But these benefits do not completely offset the disadvantages of Australia's relative isolation.

### UNIQUENESS HEIGHTENS THE POLICY CHALLENGE

Australia's economic geography – its location, population size and dispersion, and natural resource endowments – has important implications for policy and raises unique policy challenges and questions.

### The productivity and prosperity gap

All of the above provides some explanation for the fact that although Australia's economic track record has been remarkable and the envy of many, in many respects it could – and should – have been even stronger.[17]

For the 20 years from the mid-1980s, Australia's strong economic performance generally saw it climbing global league tables. However, in important areas its performance has continued to lag behind global leaders. This is particularly the case in terms of productivity, where Australia continues to lag behind global leaders. This means that we are less effective in the way we use our productive resources.

Most worryingly, in recent years, our productivity performance has dropped away sharply, both in terms of labour productivity and in multifactor productivity, which measures how smart or effective we are at combining labour and capital in production.

**AUSTRALIA'S PRODUCTIVITY PERFORMANCE HAS DROPPED SHARPLY IN RECENT YEARS**

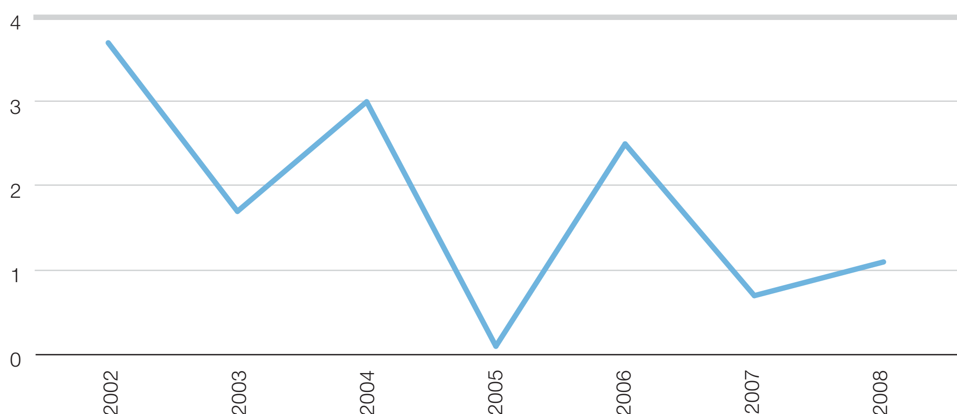
EXHIBIT 3

## AUSTRALIA'S PRODUCTIVITY REALITY: LAGGING BEHIND GLOBAL LEADERS

After a period of high growth in the early 2000s, Australia's labour productivity growth has stalled, recording growth levels of only around 1 per cent in both 2007 and 2008.

**LABOUR PRODUCTIVITY GROWTH – AUSTRALIA**

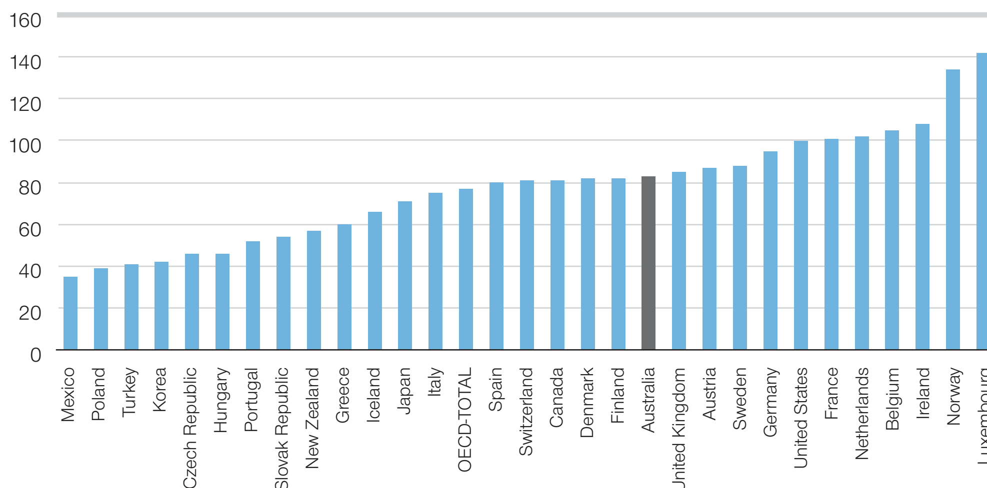
(Hours Worked Measure)




Source: ABS Catalogue No. 5204.0.

Comparative data from the OECD shows that Australia's productivity level is around 17 per cent lower than the productivity performance of the United States. Australia's labour productivity index in 2007 was 83.4 compared to the United States (index = 100).

**LABOUR PRODUCTIVITY – INTERNATIONAL COMPARISON 2007 (United States = 100)**




Source: Organisation for Economic Co-operation and Development.

Turning this performance around will be fundamental to lifting Australia's ability to compete in global markets. It will be fundamental to sustaining strong growth in the face of significant challenges and headwinds. It will also be fundamental to Australia advancing to be among the top-five performers in the OECD in relation to overall living standards.

Improving our productivity performance will require a lift in investment levels (i.e. the capital-to-labour ratio), an improvement in the quality of investment – including through effective innovation, improved skill levels and maximising the application of skills in production – and enhancing production processes through innovation and adaptation.

In simple terms, a larger capital stock permits a fixed amount of labour to produce more goods and services. The larger a country's capital stock, the more productive its workers and generally the higher its real wages and salaries. Increases in investment will tend to support increases in a nation's standard of living.

The tax system impacts on savings and investment decisions (i.e. the level of investment) as well as the efficiency of investment. By removing distortions across asset types, tax reform can improve the efficiency of investment within Australia, whether in housing, physical business assets, intangible assets, infrastructure and human capital.

### Capital availability and cost are crucial

Australia's geography, including resource endowments, also means its economy is relatively capital intensive and reliant on long-lived investments.

Coupled with a small population, this means investment opportunities outpace domestic savings and are likely to continue to do so. In other words, Australia is set to remain a net capital importer.

Our relative economic size means that Australia will remain a price taker in global markets – including in terms of investors demanding a globally competitive rate of return on Australian investments.

Australia's ability to compete effectively for global capital at a reasonable cost and/or price against the backdrop of greater capital mobility will be an important determinant of future business and investment prospects.

Correcting any biases in the tax system that work against saving or investment decisions will be essential to improving the economy's overall growth potential.

The tax system can play a role in improving the competitiveness of Australia's business environment by increasing its attractiveness as a location for investment and decreasing the cost of capital for business investment.

EXHIBIT 4

## THE BENEFITS OF FOREIGN DIRECT INVESTMENT

Foreign direct investment is an important enabler of economic growth. It helps to build links with the rest of the world, directly funds major economic projects, and supports the transfer of frontier technologies into Australia.

Foreign Direct Investment (FDI) in Australia and Australian Investment Abroad (AIA) have grown rapidly in recent decades, and this trend is expected to continue.

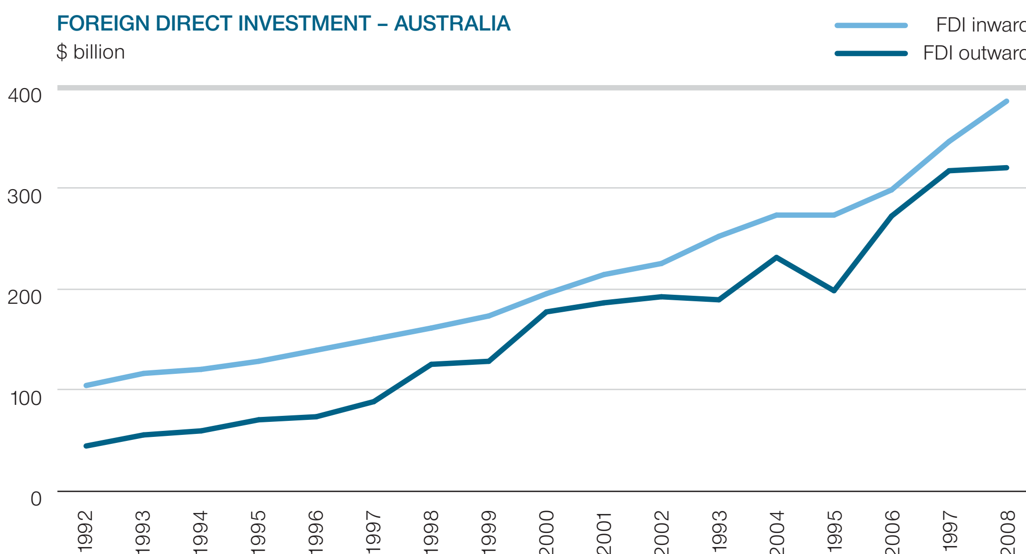
As at June 2008, Australia's inward FDI was $387.4 billion and outward FDI was $320.9 billion. Since 1992 when the ABS began to collect this data, inward FDI has grown at a compound annual growth rate of 8.5 per cent, and outward FDI has grown at a rate of 13.1 per cent per annum.

The standard economic case in support of foreign investment is that it raises the capital stock ('capital deepening') which increases labour productivity and, in turn, raises output and real wages. Endogenous growth theories also take into account the knowledge that is embedded in capital and labour factors of production as an important contributor to innovation and a determinant of growth.

So investment from 'foreign' sources not only provides an important addition to the stock of domestic savings, it also carries embedded technologies from outside the home country. This allows for the diffusion of technology, which can have positive spillover benefits.

The National Intelligence Council in the United States predicts that the greatest benefits of globalisation over the coming years will accrue to countries and groups that invest in integrating and applying new globally available technologies.

Several studies also show the benefits of encouraging investment by multinational corporations. Foreign affiliates of multinational enterprises are larger and more capital- and skill-intensive, invest more in physical and knowledge capital, pay higher wages and are more innovative than domestic firms. It is also possible that foreign affiliates indirectly raise the productivity of domestic firms, including through knowledge diffusion and spillovers and increased competition.




Source: ABS Catalogue No. 5302.0.

The benefits of direct investment work both ways. In a contribution to CEDA's 2008 report *Competing from Australia*, economist John Edwards shows how Australian companies are successfully investing abroad. The benefits of those investments flow back to Australian shareholders and employees through dividends and higher wages.

The report of the 2008 Review of Export Policies and Programs (the Mortimer report) identified the importance of Australia's continued integration into the global economy for continued economic prosperity and recommended that the Henry review 'attaches particular importance to measures that enhance Australia's export and investment performance, taking into account globalisation trends'. The report argued that 'an internationally focussed business sector will allow us to grow our economy, grow to pay for our imports, foster innovation through competition and exposure to new technologies, and help to build markets for Australian exports and investments'.

The level of inward and outward foreign investment is a critical driver of growth in the global economy and is fundamental to increasing prosperity for Australian businesses, governments, employees and consumers.

Sources: C. Criscuolo, 'Foreign Affiliates in OECD Economies: Presence, Performance and Contribution to Host Countries' Growth', OECD Economic Studies No. 41, 2005/2; W. Keller, 'International Technology Diffusion', *Journal of Economic Literature*, Volume XLII, September 2004, pp. 752–782; *Competing from Australia*, CEDA, 2008, and *Winning in World Markets*, report of the Review of Export Policies and Programs, 2008.

## Global engagement: competition and sources of competitiveness

The small size of Australia's domestic markets and lack of proximity to larger markets – even those in our own region – limits the benefits of establishing a domestic presence for foreign operators. Domestic firms seeking to exploit economies of scale must continue to grow market opportunities offshore through trade and investment.

The increasing internationalisation of Australian businesses means increasing amounts of business income will not be earned in Australia, and many 'Australian' activities will not be taxable here.

From a tax perspective, we should seek to encourage economic growth and activity that expands our domestic tax base. This includes bringing greater foreign direct investment into Australia and creating an environment that encourages companies to bring profits and other benefits of global engagement back home.

Trade and investment are also important sources of foreign technology and its diffusion, which in turn are important drivers of domestic productivity.

Our tax system should not be a barrier or disincentive to stronger trade and investment flows and/or new global market opportunities. On the latter, it is worth noting that global services trade is growing at a faster rate than trade in goods. Services trade also provides a possible means of 'avoiding' some of the hindrances and costs of Australia's geography. But Australia's services trade is not keeping pace with the global market.[18] Tax may have a role to play in this regard.

## IMPLICATIONS FOR TAX REFORM

Our chief priority is reform of the tax–transfer system and, more broadly, to ensure that the system is able to support sustained strong growth and provide a foundation for ongoing economic prosperity.

Productivity growth will be required as an important driver of economic growth in the future, particularly as population ageing will limit the capacity for growth to be driven by rising workforce participation.

Australia lags behind global productivity leaders and faces an ongoing productivity disadvantage by virtue of its economic geography. We need to recognise that the key drivers of productivity, particularly investment, skills and innovation, have become more and more mobile and global competition for these sources of growth is increasingly intense.

In this environment, Australia's tax system must aim to be close to, if not world's best, in terms of attracting investment and enabling productivity.

'An alternative and significantly more ambitious approach would be to transform the tax system in concert with other major public policy reforms to open up the possibility of shifting Australia onto a higher economic growth path.'

Business Council of Australia, *Taxation Action Plan for Future Prosperity,* 2005.

# TAX REFORM FOR GROWTH

## IMPROVING THE TAX MIX

There is now a relatively strong consensus on the taxes that are least damaging to economic growth, based on research and experience with reform overseas.[19]

In simple terms this consensus is that the ranking of taxes from most to least harmful to economic growth is as follows:

1. Corporate income taxes.
2. Personal income taxes.
3. Consumption taxes.
4. Recurrent taxes on immovable property.

The OECD has recently concluded that revenue-neutral, growth-oriented tax reform would involve shifting the revenue base from income taxes to less distortive taxes such as recurrent taxes on immovable property or consumption.[20] OECD surveys also point to the view that faster economic growth is associated with lower shares of capital taxation in the overall revenue mix. The OECD has drawn on decades of optimal taxation research in forming this view. A tax system that recognises this reality can be expected to create fewer disincentives to saving, investment, entrepreneurship and work.

The essential reasoning of this view is as follows. Corporate taxes impact on investment decisions. To the extent that corporate income taxes reduce after-tax returns, this weakens the incentives for firms to produce and create jobs, and therefore holds back investment. The distortions are exacerbated when capital is mobile and investment destinations exist elsewhere with lower corporate tax rates.

Personal income taxes can reduce employment and human capital investment, undermining productivity and dampening entrepreneurial activity.

By reducing investment in skills and human capital, income taxes can also limit the potential benefits from technology diffusion and overseas R&D.[21] While labour has become more mobile over time, it is not as mobile as capital.

Consumption taxes do not affect incentives to save and therefore create fewer distortions than income taxes, although, consumption taxes can weaken the incentive to work by reducing after-tax purchasing power. This effect is minimised if the main consumption tax is set to a single rate for all goods and services.

Taxes on immovable property are the least damaging to growth. They have relatively small effects on household and firm decisions in terms of labour supply, investments in education, how much to produce, and innovation. Property taxes can enhance growth if they reduce the tax advantages of housing relative to other forms of investment.

Much of the research also highlights that the adverse impact of taxing more 'mobile' inputs to production are greater for small, open economies.

This line of reasoning has already been highlighted by the Australia's Future Tax System Review in its *Architecture of Australia's Tax and Transfer System* report:

> 'There is a widely held view in academic circles that capital should be taxed at lower rates than labour or consumption, particularly for a small, open, isolated economy like Australia, because of the higher international mobility of capital relative to labour.'[22]

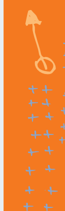
'In open economies the design of a national tax system will need to consider the design of tax systems in other countries, since countries are increasingly using their tax systems to improve their ability to compete in global markets.'

Source: OECD, *Taxation and Economic Growth*, 2008.

Over the past decade an increasing number of countries have sought to change the structure of their tax systems consistent with the emerging consensus on the taxes that are more supportive of growth.

Australia has not kept pace with these developments. Notwithstanding several rounds of taxation reform, Australia's tax system remains too reliant on those taxes that are more harmful to growth.

In the wake of the global slowdown, governments will be seeking to revive growth to meet social and budgetary pressures, and to attract a larger share of newly scarce global capital. This is likely to further heighten the focus of governments on the need to attract investment. Rebuilding a taxation framework that best encourages investment attraction should be a high priority. The alternative is a much slower Australian recovery from the global slowdown.



# THE STATE OF PLAY IN AUSTRALIAN TAX

A comprehensive picture of the Australian tax system is provided in the background papers informing the federal government's review.

We believe the following are key themes which stand out from the review's 'architecture' paper.[23]

### Low reliance on consumption taxes

- As a share of GDP, Australia's total tax burden on consumption is 9 per cent, making it the fourth lowest in the OECD.
- General consumption taxes (mainly the GST) contribute 13 per cent of tax revenue compared with an OECD average of 19 per cent.

### High reliance on taxation of capital income

As a share of tax revenue, Australia has the highest reliance on capital income taxation in total revenue within the OECD.

- Capital tax accounts for 35 per cent of total revenues.
- As a share of GDP, the total tax burden on capital is about 11 per cent, the fourth highest in the OECD.

### High reliance on corporate income tax

The contribution of corporate income tax to total tax revenue in Australia is higher than for most OECD countries.

- The share of corporate tax revenues to GDP is the fourth highest in the OECD.
- Australia's statutory rate is above the OECD average and is the tenth highest in the OECD.
- Company income tax is expected to account for a higher share of Australian government revenue in 2011–12 than in 2006–07.

### High tax on capital income at the personal level

The high share of corporate income tax is an important factor explaining Australia's reliance on taxation of capital income, but factors related to personal income taxation are also at play.

- Australia has one of the higher top personal tax rates on capital gains (notwithstanding the discount available for assets held for longer than 12 months).
- Australia has a relatively high rate of tax on interest income.
- On the other hand, full dividend imputation means that Australia compares favourably with its OECD peers in terms of taxation of dividends from domestic sources.[24]

### A staggering number of taxes, most of which collect little revenue

- There are at least 125 different taxes in aggregate applied by federal, state and local governments in Australia.
- If equivalent taxes levied by the states are counted as separate taxes, then there are as many as 160 state taxes and 259 taxes nation wide.
- Of the total tax revenue collected by Australian governments in 2006–07, 90 per cent was derived from just 10 taxes.
  - These 10 taxes accounted for 95 per cent of Australian government revenue and 70 per cent of state tax revenue.
- Ten per cent of tax revenue in 2006–07 was contributed by the remaining 115 taxes.

These key features are important and concerning when considered from the perspective of tax structures that best enable longer-term growth and prosperity.

## PRIORITIES FOR STRUCTURAL REFORM OF THE TAX MIX

Based on the above, we argue that the review should focus on restructuring the tax mix in Australia to better support growth. This can be done by:

- Reducing the reliance on corporate income tax, and capital income taxes more broadly.
- Increasing the reliance on the least distortive taxes – consumption and property taxes.
- Not increasing taxes on labour income.

## THE CASE FOR CORPORATE TAX REFORM

### THE VIEW FROM BUSINESS: CORPORATE INCOME TAX DISTORTS BUSINESS DECISIONS

Business has been putting the case for some time that the structure and level of taxation in Australia weighs on business investment and growth.

BCA members report that tax rates and structures in Australia are an important driver of business strategy, investment and financing decisions, the availability of capital and their ability to compete and grow in global markets.

Issues that have been raised include the impact of taxation on the cost of capital, compliance costs and uncertainty, unfavourable treatment of foreign sourced income, biases in favour of debt financing and against equity, and the impact of the Australian tax system on the ability to attract and retain foreign capital.

Given strong economic growth and investment outcomes achieved in Australia in recent years, there may be a tendency to overlook the perceived shortcomings and taxation challenges. However, the importance of these issues is now being supported by a significant body of research and empirical evidence as well as the direction, pace and scale of tax reform in other countries.

### EMPIRICAL EVIDENCE

#### Corporate tax weighs on growth: the investment impact

The review's 'architecture' paper and many submissions to the review provide detailed summaries of recent research findings. Following is a short synopsis of some of the key results pertaining to corporate income taxation.

Corporate income taxes reduce after-tax investment returns, raise the user cost of capital and can adversely impact the rate of capital accumulation and therefore GDP per capita. These impacts apply both to portfolio investment flows and foreign direct investment. Corporate taxes suppress investment by domestic firms and can deter foreign direct investment.

The architecture paper noted that, on average, the literature reviewed found that a one percentage point increase in the rate of corporate tax would result in a decrease in foreign direct investment of around 3¾ per cent.[25]

In terms of the impact on growth, one comprehensive study found that a 10 percentage point cut in a country's top corporate rate was associated with a 1.8 per cent increase in GDP per capita.[26]

Smaller countries with small markets, and those facing additional comparative disadvantages relating to distance or transactions costs, are likely to be impacted more sharply. And the responsiveness of foreign direct investment to tax has increased over time, with investments in physical capital particularly responsive.

Modelling by the Canadian Department of Finance also supports the view that lowering corporate income taxes increases the after-tax marginal product of capital, leading to higher investment and GDP.

Reducing corporate taxation (and eliminating differential treatment) can lift the quantity and quality of investment. Research also suggests that reducing corporate income tax can be more effective in lifting investment (both domestic and foreign) than reducing taxes on capital income at the personal level.[27]

### Corporate tax weighs on growth: the productivity impact

Research also suggests that high rates of corporate income taxation adversely affect productivity.[28] There are a number of channels through which this impact can work:

- More resources being directed to compliance and administration (more likely the higher the tax burden and the more complex the system).
- A discouragement of investment in more innovative activities[29] including those that are reliant on equity financing and risk capital.
- Higher effective corporate tax rates have been found to be associated with a greater reliance on debt as opposed to equity financing and slower economic growth.[30]
- Reductions in Foreign Direct Investment which would otherwise deliver wider productivity benefits through technology transfers and spillover benefits.

Lowering the statutory rate has been found to lead to particularly large productivity gains in firms that are more dynamic and profitable – in other words, those that have a larger tax base and which can make the largest contribution to GDP.[31]

### Corporate tax impacts business decision making

There is growing empirical evidence of the influence of tax on key investment and financing decisions.

One study showed that investment location decisions of US multinational corporations within Europe were affected by effective average tax rates. They estimated that the size of the effect of tax on the allocation of capital across countries was much greater than the estimated effect on the scale of investment within a given country.[32]

There is also a large empirical literature that investigates the impact of tax on the location of taxable income, much of which has found significant and large effects of tax on business decisions.

A 1999 review of literature on the international location of real investment concluded that the allocation of real resources is highly sensitive to tax policies.[33]

# CORPORATE TAX: MORE DEVIL IN THE DETAIL

This submission is not seeking to identify all of the detailed areas of concern as regard the structure and operation of the business tax system in Australia. However, there are a number of specific issues that warrant attention because they explicitly work against those areas in which Australia has, or should be seeking to build, competitive advantage.

## DEPRECIATION AND CAPITAL ALLOWANCES

Following the Ralph Business Tax (RBT) reforms, Australia has one of the broadest corporate tax bases in the world.

While base broadening in return for lower tax rates is accepted as an efficient reform strategy, the treatment of depreciation and capital allowances in Australia is now seen as undermining Australia's competitiveness as an investment location, particularly for long-lived investments, which have an important role to play in our comparative advantage.[34]

Australia's headline statutory rate is also now less competitive than it was following the RBT reductions. It is the 8th highest in the OECD and above the OECD average. It is also much higher than many non-OECD countries with which we trade and compete.

## POOR TREATMENT OF NEW SOURCES OF PRODUCTIVITY AND COMPETITIVE ADVANTAGE

Australia's tax treatment of business intangible assets, and in particular the inability to amortise intangible assets, is uncompetitive. This places Australian businesses at a competitive disadvantage in business acquisitions.

Intangible investment represents an important and growing source of investment and productivity, particularly in services industries. Recent research from the Productivity Commission concludes that growth in the real intangible capital stock is estimated to have averaged almost 5½ per cent since 1974–75.[35]

The Ralph review was in favour of reforms to address this concern, noting that the treatment disadvantages Australian entities in competitive takeover situations where they are competing with companies that can write off these investments. The imposed revenue neutrality of that review, however, prevented the adoption of reforms to overcome these disadvantages.

## DISCOURAGEMENT OF RISK TAKING

Australia's rules in relation to tax losses are too restrictive and are internationally uncompetitive. Other countries have more generous rules.[36]

Significant complexities in relation to the rules around tax losses also create disincentives to invest.[37]

## THE CORPORATE TAX WORLD IS CHANGING

Perhaps not surprisingly in light of the weight of evidence summarised above, World Bank measurements demonstrate a global trend towards lower business taxation.[38] In the past four years, the trend across all regions has been to lower the total tax rate paid by businesses.

Reducing corporate tax has been the most popular reform, pursued by more than 60 countries. In the 2009 *Doing Business* report compiled by the World Bank, Australia ranked 48 on the 'paying taxes' measure, although it is ranked ninth overall as a country in which to do business.[39]

Table 1 highlights the extent to which Australia's effective corporate tax rate is now out of line with the rates of many other countries that would be considered economic peers and competitors.

The high corporate tax take reflects the impact of Australia's statutory rate and the way in which the base is calculated.

- The headline company tax rate is now above the OECD average.
  - KPMG estimates that since 2001 Australia's statutory corporate tax rate has become progressively less competitive.
  - Based on their annual survey of corporate tax rates in 106 countries, the global average was 25.9 per cent, compared with 30 per cent in Australia.[40]

As noted above, Australia now also has one of the broadest corporate tax bases in the world.

Australia's corporate tax system is no longer internationally competitive. Moreover, failing to reform our tax treatment of capital, and in particular corporate income, will come at an increasing cost in terms of competitiveness and economic growth.

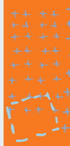
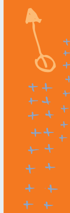
## AUSTRALIA'S CORPORATE TAX SYSTEM IS NO LONGER INTERNATIONALLY COMPETITIVE

TABLE 1

## EFFECTIVE CORPORATE TAX RATES, 2008

| RANK | COUNTRY | EFFECTIVE CORPORATE TAX RATE % |
|---|---|---|
| 1 | Ireland | 9.6 |
| 2 | EU-10 | 11.2 |
| 3 | Poland | 12.5 |
| 4 | Russia | 13.0 |
| 5 | Singapore | 13.2 |
| 6 | France | 14.4 |
| 7 | Sweden | 14.9 |
| 8 | Brazil | 15.5 |
| 9 | China | 15.7 |
| 10 | S. Korea | 18.4 |
| 11 | Spain | 18.6 |
| 12 | EU-25 | 19.0 |
| 13 | EU-15 | 20.5 |
| 14 | UK | 21.4 |
| 15 | Mexico | 22.5 |
| **16** | **Australia** | **23.0** |
| 17 | Germany | 23.6 |
| 18 | India | 24.3 |
| 19 | Canada | 25.9 |
| 20 | NAFTA | 29.2 |
| 21 | Japan | 31.6 |
| 22 | U.S. | 32.0 |
| | Average | 18.0 |

Source: The Information Technology and Innovation Foundation, *The Atlantic Century: Benchmarking EU and U.S. Innovation and Competitiveness*, 2009, p. 20 (based on 2008 World Bank data).

## WHO BEARS THE BURDEN OF HIGH CORPORATE TAX?

The simple presumption is that companies bear the burden of corporate tax.

Companies of course bear the legal responsibility for paying tax. And the amount of corporate tax paid reflects the activities of the company and in particular its success in generating profits from capital invested. But ultimately, the economic burden or cost of corporate tax is borne by either or all of:

- Consumers through higher prices.
- Workers through lower wages.
- Shareholders through lower returns.

Determining the true burden of corporate taxes across workers, consumers and shareholders is not straightforward. But research overseas indicates that, particularly for countries such as Australia (small, capital importing), the burden of higher corporate taxes is typically borne by ‘immobile’ factors of production, and in particular labour through lower real wages.

While this may appear counterintuitive, the logic is as follows. Australia cannot influence the global return on capital expected by global investors. The imposition of corporate tax reduces the after-tax return on capital and therefore an investment outflow will occur up until the point where the pre-tax return on capital is sufficient to compensate global investors for the tax paid in Australia. In this circumstance, less investment means lower productivity and lower real wages for workers.

In fact, according to one analysis, in an economy with near perfect capital mobility, domestic factors end up bearing more than the full burden of the corporate tax because of the negative impact on wages and growth. As a result they would be better off if they paid the tax directly themselves.[41]

One of the best-known studies, by the independent US Congressional Budget Office, concluded that workers bear 70 per cent of the US corporate tax burden.[42]

Reinforcing this finding, but from a different perspective is a study by Hassett and Mathur[43] which found that a 10 per cent cut in corporate taxes produced a near equal rise in domestic pre-tax wages in manufacturing. This study also found that the responsiveness of wages to corporate taxes is stronger in smaller countries.

This issue has significant practical considerations. Many will assume that higher corporate taxation is progressive. But if higher corporate taxation ultimately reduces investment, productivity, wages and GDP growth, then the progressivity argument is substantially weakened.

Even if a significant burden is found to be borne by shareholders, assumptions about progressivity will centre on the composition of share ownership. The strong growth in direct and indirect share ownership in Australia is an important development to consider.

## REDUCING RELIANCE ON CORPORATE TAX

Australia’s reliance on corporate income tax and elements of the system that seek to maintain the integrity of the tax base will increasingly weigh on future growth and prosperity.

At the same time, Australia has more to gain from ambitious corporate tax reform because of its size, location and reliance on foreign capital.

Australia should seek to be a global leader in establishing a competitive corporate tax system. Australia has not shown itself to be a particularly fast follower in the tax policy arena and can ill afford to be too far behind in the coming decades.

But given its circumstances and size, Australia could probably establish itself as one of the most competitive corporate tax jurisdictions without the risk of rapid response on the part of its economic peers, with the potential for significant early-mover benefits.

Australia has an opportunity to build its long-term growth prospects by reducing its reliance on corporate income taxation and minimising the adverse impact of measures aimed at maintaining the current integrity of the revenue base. The latter could be addressed through a package of piecemeal reforms. But such an approach is unlikely to reduce complexity and more likely to introduce unintended consequences and distortions. In addition, piecemeal reforms are less likely to keep pace with global policy developments and innovations, much less lead them.

More fundamental reform can, in general terms, be achieved by significant reductions in the rate of taxation and/or changes to the corporate tax base.

## REDUCING THE COMPANY TAX RATE

Reducing the headline corporate tax rate in the absence of base broadening measures would reduce the marginal and effective tax rate and the overall corporate tax burden.

This can be expected to positively impact investment, productivity and GDP growth. It would also reduce incentives for companies to profit shift to more competitive locations or to minimise tax. It will also lessen the impact of sources of complexity and distortion associated with the current system and integrity measures.

In determining what corporate tax rate Australia should aspire to, we are guided by the level and direction of rates overseas, the long-term aspirations of the federal government's review, the growing importance of capital mobility, and the growing challenges to revenue integrity posed by technological change and financial innovation.

Revenue implications also need to be taken into consideration, although we do not believe that revenue neutrality should be the necessary starting point for this review. Revenue impacts should be considered on a net basis – that is, taking account of the cost to government of raising a dollar of corporate tax revenue. In addition, expected behavioural impacts, and the 'second round' impacts including ongoing benefits flowing from higher investment, productivity and growth should be taken into consideration.

We recommend that the review consider reducing the corporate tax rate to 15 per cent. This would push Australia well up the ladder in terms of the competitiveness of our tax rate relative to our OECD peers and would position Australia very competitively with respect to regional competitor countries. It would support Australia's ongoing ability to attract investment, underpin productivity, and boost long-term economic growth.

### DIVIDEND IMPUTATION

The lack of equity and efficiency in the classical system of company tax provides a strong basis of support for dividend imputation. This arrangement has come to be well understood and is generally favourably regarded by BCA members.

The imputation system works well in a closed economy scenario where all firms competing for equity capital have their returns to shareholders taxed by imputing tax paid at the corporate level to individual shareholders on a gross-up and credit basis.

However, in an open economy scenario where firms operate globally and pay tax on their foreign earnings, the investment dynamics are altered and dividend imputation rules can work as a disincentive for Australian multinational companies to expand their foreign operations and seek to generate profits offshore.

As noted in the architecture paper,[44] the different treatment of non-resident shareholders creates incentives for dividend streaming and franking credit trading, and guarding against those practices necessarily adds complexity to the tax law and imposes additional compliance costs.

One of the key benefits of the existing dividend imputation arrangements is the in-built integrity characteristics of the system which encourage Australian companies to invest and pay tax in Australia so as to maximise franking credits. This point cannot be understated and is a fundamental reason why dividend imputation retains strong support among BCA members. Having strong, globally relevant companies is fundamental to Australia's future prosperity. Nevertheless, some aspects of the present dividend imputation system can work against Australian companies with a global presence. It is worth investigating adjustments to the imputation system including, among other considerations, revisiting whether imputation credits could attach to dividends paid by Australian companies to Australian shareholders from foreign earnings and whether Australian companies with global shareholders could be permitted to stream foreign income to foreign shareholders while retaining franking credits for Australian shareholders. Importantly, however, any changes to address the imputation bias should operate in conjunction with the existing imputation system.

Our position in this regard accords with views of the Business Coalition for Tax Reform and the Corporate Tax Association.

## REFORMING THE CORPORATE TAX BASE

An alternative to reducing the corporate tax rate is to re-examine the tax base in Australia.

In recent years alternative methods of determining the corporate income tax base have attracted greater attention in tax research and new approaches have been adopted in a range of countries.

There is a significant degree of variety in the approaches being considered and adopted. Some have the effect of significantly widening the base, whereas others deliver an effective narrowing of the base.

Our consideration of these alternatives has focused on identifying the approach most likely to:

- Support investment.
- Reduce complexity over time.
- Reduce investment financing distortions.
- Minimise transition and implementation costs.

Set against these objectives, one approach to reform is consideration of an allowance for corporate equity (ACE) framework. Such an approach has the potential to reduce overall reliance on corporate income tax and ameliorate some of the distortions in financing.

## AN ALLOWANCE FOR CORPORATE EQUITY

Currently, corporate income tax falls on the 'full return' to corporate equity – that is, the normal return and so-called 'pure' profit.

Under an ACE system, companies are allowed to deduct an imputed normal return on their equity from the corporate income tax base, in a similar way to deductions that are made for interest payments on debt. The effect of such an arrangement is that companies would incur tax only on 'above normal returns'.

The adoption of an ACE has the potential to deliver significant benefits. Assuming that the corporate tax rate remains unchanged, the ACE reduces the corporate tax burden by effectively narrowing the tax base. While we accept the conventional wisdom that, in general, broader tax bases are more efficient, the ACE has the potential to deliver benefits for a country like Australia while avoiding distortions to resource allocation and inefficiencies typically associated with narrower tax bases.

The ACE system has the potential to remove the bias in favour of debt financing that flows from the tax deductibility of interest on debt. Implementing new tax arrangements that work to reduce an excess reliance on debt will improve economic efficiency. It may also eliminate the need for thin capitalisation rules which, in turn, would materially reduce complexity within the tax system.

As for expenditure taxes generally, under an ACE the tax system should not affect the cost of capital of a firm, as the effective marginal tax rate (EMTR) is zero for an investment generating returns that just cover the cost of capital (that is, an investment that only produces 'normal returns').[45]

In addition, the ACE could eliminate potential problems and complexities that arise in having to distinguish debt from equity finance. In the face of financial innovation which has blurred the distinction between the two, the ACE approach may provide significant benefits in terms of greater simplification and improved resource allocation.

While current depreciation rules continue to apply, the ACE could also reduce distortions associated with the treatment of depreciation. Specifically, it offsets the investment distortions caused by deviations between true economic depreciation and depreciation for tax purposes.

From an implementation perspective, the ACE is likely to be relatively simple to introduce because it continues to rely on the current corporate income tax system. Initially the ACE approach could apply only to new equity capital, which limits the revenue implications and also minimises potential windfall gains to shareholders.

The benefits of an ACE would, however, be undermined if the corporate tax rate is raised to offset the impact of base narrowing.[46] This is one of the major disadvantages usually highlighted in respect of an ACE arrangement. However, the authors of this study concluded that there is no need to increase the corporate tax rate because in the long run the potential to stimulate investment both for locally based companies and from inbound investors will raise the pre-tax return to domestic factors of production by more than the revenue loss from the ACE.

An ACE arrangement warrants further investigation, and we recommend that the review panel examine the proposal in more detail.

## CAPITAL INCOME AND PERSONAL TAX: ENCOURAGING SAVING

While many countries have focused mainly on reducing the tax burden on capital by reducing corporate income taxes, some have also sought to reduce the burden of tax on personal income derived from capital.

Given the growing importance of capital mobility and the need to sustain high levels of domestic saving and investment, there are sound arguments in favour of applying differential taxation to the returns to saving (i.e. an individual's capital income) and work (i.e. an individual's labour income).

The risks associated with increased capital mobility may be seen to be less of an issue in terms of domestic capital because home country biases reduce the threat of domestic capital 'leakage'. However, the reality is that domestic investors are increasingly looking to overseas opportunities as a source of higher returns and portfolio diversification. This trend can be expected to continue. At the very least, Australia should position its tax system to respond quickly and effectively to these potential threats and challenges over time.

In addition, reforms to the taxation of returns to saving could improve savings outcomes in Australia. Because taxation of savings results in a higher tax burden on future consumption, it discourages savings. Reforms that reduce this burden can be expected to have a positive impact on domestic savings.[47]

Recent research suggests that returns to savings should be lower than that applied to labour income given that a large part of the domestic labour force is immobile.[48]

In addition, reforms that better align the tax treatment of different forms of savings can be expected to improve the efficiency of saving decisions with flow-on benefits in terms of the quality of investment and hence growth.[49]

In Australia, as elsewhere, the taxation of income from capital gains, dividends and interest is not uniform, while saving for retirement and investments in owner-occupied housing are also treated differently.

Concerns have been raised that differential tax treatment is adversely impacting on individuals' saving and investment decisions. For example, the relatively unfavourable treatment of interest-bearing accounts is considered to have undermined the ability of domestic banks to raise capital through this channel, and has thereby increased the reliance on overseas borrowing to fund domestic lending.[50]

The review consultation paper also highlights a number of areas in which differential tax treatment of investments appears to be delivering relatively higher benefits to higher income earners, for example in terms of rental property loses and the concessional treatment of superannuation. In all likelihood, the differential tax treatment in these cases is impacting on the type of saving and investment rather than the quantum of saving and investment, the economic benefits of which are unclear.

It is against this background that the potential benefits of implementing a dual income tax system for personal income tax – a so-called 'flat tax' arrangement on savings – should be considered.

### A DUAL INCOME TAX APPROACH

Under a dual income tax approach, progressive tax scales would continue to apply to labour income, but a lower, flat tax would apply to all capital income of an individual (including earned interest, dividends, realised capital gains and rental income).

As noted above, such a system is likely to be growth positive. It provides a framework for Australia to maintain a competitive tax system for capital income (including the capacity to quickly and easily reduce the rate of tax applying to capital income at the personal level). By eliminating distortions across different types of savings and asset classes, a dual income tax system could increase the efficiency of saving and investment decisions.

Because capital income tax is levied on all of the nominal return, applying a lower rate of tax to capital income would address the taxation of returns which are due to inflation (which should be avoided) in a relatively easy way.

In addition, as noted in the consultation paper, a flat tax approach reduces the likelihood of taxing returns to saving unequally over time, and it could also facilitate the adoption, over time, of withholding taxes on deposits and dividend distributions, which may expand opportunities to streamline personal tax administration.

The biggest potential challenge to such a system, however, is distinguishing between capital and labour income. In this context, the large number of small businesses operating in Australia and better understanding the characteristics of their income split will be an important consideration. In addition, depending on where the rate was set, a dual income tax system may see some lower income earners paying more tax on their capital income.

## PAYING FOR STRUCTURAL REFORM: GREATER RELIANCE ON MORE 'EFFICIENT' TAXES

Three in every five dollars of tax collected in Australia in 2007–08 was levied on income.

Given the OECD's finding, mentioned earlier, that taxes on income are the most harmful to growth, the review panel should critically examine whether Australia should continue to collect the majority of taxes from this source. If our tax system is to support future growth, we must give strong consideration to reducing the tax burden on the income base.

The broad thrust of our recommendations so far discussed aim to reduce the tax burden on income, and will significantly impact revenues.

As summarised above, taxes on immovable property and broad-based consumption taxes are relatively more efficient taxes because they tend not to distort those decisions that impact growth (namely saving, investment and participation decisions).

Australia's current taxation practices suggest we have considerable scope to make this transition (see Table 2). Not only does Australia collect most of its tax revenue from income, the collection of taxes on income has increased in recent years, while there has been a corresponding fall in the amount of tax collected from consumption.

In addition, Australia's reliance on broad-based consumption taxes is lower than the OECD average. Australia's use of 'general' consumption taxes as a proportion of total revenue (13.2 per cent) is below the OECD average (18.9 per cent) and Australia has the equal third lowest value-added tax rate in the OECD.[51] In contrast, Australia's reliance on property taxes is already above the OECD average.

Taxes on immovable property account for around 4½ per cent of tax revenue compared with 3 per cent in the OECD.

Australia should therefore increase its reliance on broad-based indirect taxes over the medium to longer term, and the best means of doing that would be through further consideration of broad-based consumption taxes.

We have expressed our strong disappointment that the GST, such a fundamental element of the existing tax architecture, was left off the list for consideration by the review. We urge the review panel to nevertheless give strong consideration to the conclusions of the OECD and others that consumption taxes have a critical and central role to play in growth-oriented tax reform.

In particular, if the review panel does not wish to consider examining the GST, it should be prepared to consider alternative types of consumption taxation arrangements. For example, Auerbach[52] has noted that there are different variants of consumption taxation with different potential efficiency and distributional effects and which can be imposed at either the business level or individual level and be either origin or destination based. Approaches are also being developed that allow value added taxes and consumption taxes to be more progressive (albeit at the risk of some additional complexity).[53]

TABLE 2

## THE INCREASING RELIANCE ON INCOME TAXES IN AUSTRALIA

**Per cent of tax revenue raised by tax base**

| | 2002–03 | 2003–04 | 2004–05 | 2005–06 | 2006–07 | 2007–08 |
|---|---|---|---|---|---|---|
| Taxes on income | 56.5 | 56.6 | 58.5 | 59.2 | 59.2 | 60.0 |
| Employers payroll taxes | 4.2 | 4.2 | 4.3 | 4.4 | 4.5 | 4.6 |
| Taxes on property | 9.0 | 9.5 | 8.7 | 8.7 | 9.1 | 9.0 |
| Taxes on provision of goods and services | 27.8 | 27.3 | 26.2 | 25.5 | 25.1 | 24.3 |
| Taxes on the use of goods and performance of activities | 2.5 | 2.5 | 2.3 | 2.3 | 2.1 | 2.2 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: ABS Catalogue No. 5506.0, *Taxation Revenue 2007–08*. Note: column totals may not add due to rounding.

## LABOUR TAXES: STAY THE COURSE

There are important trade-offs when it comes to getting the balance right on the taxation of labour income. On one side, most people support some degree of progressivity in the tax system – in other words, setting higher rates on higher incomes reflecting a greater capacity to pay.

On the other side, higher tax rates can reduce labour supply and create a disincentive to entrepreneurship and to undertaking additional education and training.

In order to support strong growth in the future, however, Australia must generate on an ongoing basis high levels of workforce participation and high levels of investment in human capital.

From our perspective there does not appear to be compelling evidence to support the prioritisation of further significant reductions in the level of personal income taxation. In particular it is worth noting that:

- Participation rates in Australia have risen strongly in recent years in connection with increased job opportunities and tax cuts.[54]
- The share of labour income tax in total revenues is low by OECD standards.
- The highest marginal tax rate and threshold are now in line with OECD averages.
- The majority of the domestic labour supply is immobile in an international sense.

In terms of the international mobility of skilled workers, we acknowledge that recent tax changes have enhanced the competitiveness of Australia's tax system. When the global economy returns to growth, however, it will be important to continue to monitor Australia's ability to attract and retain the skills it needs and the factors influencing that outcome.

Participation rates for those groups that continue to have relatively low rates of participation (sole parents, women with children, older workers, and those with disabilities) are more likely to be better impacted by targeted interventions on the transfer side than through changes to aggregate tax rates and/or through measures to support their employment skills and capabilities.

### A WORD ON TRANSFERS AND REDUCING EMTRs

Australia's tax–transfer system is highly redistributive. We strongly support this and consider that a good case exists to further strengthen this feature of the system.

Targeted systems which involve tapered withdrawal of benefits necessarily entail high effective marginal tax rates (EMTRs), and this point is generally well understood. The ongoing challenge is how to minimise as effectively as possible those EMTRs that are having the greatest bearing on participation decisions and economic activity.

EMTRs are a function of both paying tax and losing benefits. Greater emphasis should be placed on the benefits side, given that more tailored solutions in this area are likely to be more effective.[55]

One specific recommendation is to give consideration to stagger the withdrawal of benefits over time after a job has been obtained. This would allow individuals to 'become accustomed' to earning income and paying tax while still having access to some important benefits that support their work effort (for example child care). After a time, as household budget routines are established and as individuals become more secure in their employment, additional benefits can be withdrawn.

The current tax–transfer system is exceedingly complex and in urgent need of simplification and greater transparency. We would support significant consolidation in payments and tighter targeting to those genuinely in need. However, we acknowledge that the type of tailoring described above may work against enhancing the simplicity of the system.

## THE COSTS OF UNWIELDY TAXATION

We believe the Australia's Future Tax System review should not be confined by the requirements that it be revenue neutral.

While revenue and budget balance concerns are front of mind in light of the current economic slowdown, it must be remembered that this is a long-term review, and consideration should be given to longer-term revenue and spending aspirations. Consideration should be given to the benefits of achieving a lower tax burden.

### DEADWEIGHT LOSS

Collecting any tax imposes deadweight costs associated with money being collected to be forwarded to someone else to spend. The average rate of deadweight loss is estimated at around 27.5 cents per dollar of tax revenue raised (see Exhibit 5).

EXHIBIT 5

### HOW DEADWEIGHT COSTS ARISE

Suppose that a business will pay up to $20 an hour to have some work done, and that the cheapest workers with the necessary skills will also work for $20 an hour. Without taxes, it makes sense for the business to pay for the work. But if the government taxes the next dollar of each worker's income at 25 per cent, the most the workers can earn from the work is $15 an hour. So they will be unwilling to take on the work.

A similar example can be constructed for sales tax. The greater the tax, the greater the wedge driven between the prices that sellers are willing to accept and buyers are willing to pay, and the greater the lost opportunities for productive activity.

The examples become more complicated when we consider that:

- The size of the deadweight loss is also affected by 'substitution effects': workers gain utility from the leisure that they choose in preference to working.
- The final deadweight cost of a tax can be measured as the amount that would have to be paid to the people affected by it, taking into account the benefits of government spending, in order to make them indifferent to the presence of the tax.

Adapted from an example first published by J. Whyte, 'Why Taxes Should Be Slashed in Half', *The Times*, 21 May 2008.

## ADMINISTRATION AND COMPLIANCE COSTS

In addition, government taxation imposes administration and compliance costs on those paying taxes. These further divert resources away from more productive activities and impose social costs by reducing individual leisure time.

Taxation administration and compliance costs in Australia affect both taxpayers and governments. These costs are a feature of any taxation system. But in Australia they are exacerbated by the number of taxes, and by their complexity.

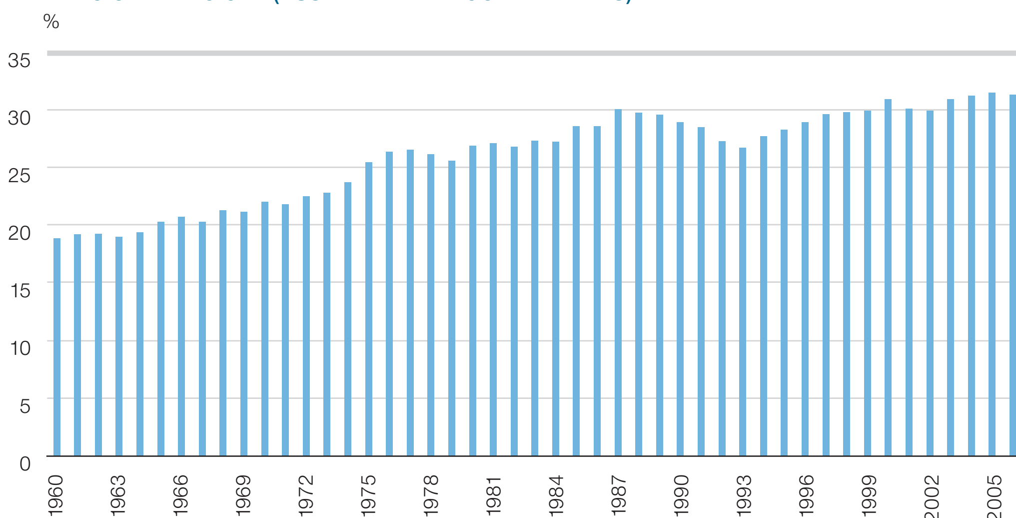
These costs directly reduce the competitiveness of the Australian economy. OECD figures for 2002 indicate that in Australia $1.19 was spent on tax administration per $100 of tax collected.[56] Administration costs are higher in other countries, however, in Sweden the figure is 42 cents, the United States 53 cents and Ireland 95 cents. Based on these figures, halving Australia's current tax administration costs would save approximately $2 billion.

Australia lacks comprehensive data on taxation compliance costs, and a robust compliance cost reporting mechanism should be a feature of all new tax law – at the design, implementation and administration phases.

EXHIBIT 6

### THE RISING TAX TAKE

RATIO OF TAX TO GDP (AUSTRALIA – ALL GOVERNMENTS)




Source: ABS; BCA calculations.

Tax reforms undertaken over the past three decades have not managed to deliver a sustained reduction in the burden of tax as measured by the tax-to-GDP ratio.

## ATO OVERSIGHT BOARD

As outlined in this submission, the shape of the tax system and the manner in which tax laws are implemented and administered will have a fundamental impact on our growth prospects.

We are concerned at the tendency for the Australian Taxation Office to often adopt positions which appear inconsistent with policy or fail to recognise broader business realities. We are aware of the governance benefits that arise whereby boards of directors provide oversight and guidance to company executives and indeed in the recruitment and appointment of company CEOs.

The merits of introducing a similar type of governance arrangement for the ATO should be investigated. This view is shared by other associations including the Business Coalition for Tax Reform, the Corporate Tax Association and the Group of 100.

The establishment of an ATO oversight board would provide guidance and oversight to the ATO in its activities and could be expected to have an influence in shaping the ATO's culture, for example to ensure that the ATO is more attuned to business needs and policy considerations.

The ATO oversight board could also be expected to play a role in the appointment of future tax commissioners who may be recruited from outside of the ATO, including possibly from the business community.

The Internal Revenue Service in the United States is overseen by a nine-member IRS Oversight Board, with the majority of members having professional experience in business and tax administration areas.

Similarly, the Board of Her Majesty's Revenue and Customs in the United Kingdom provides strategic leadership, approves business plans, monitors performance and ensures the highest standards of corporate governance. That board is currently headed by an independent chairman with extensive experience in the financial sector.

## PERSONAL COMPLIANCE COSTS

The costs of individuals' compliance with the personal income tax system have been estimated[57] at $346 per taxpayer in 2006 dollars.

The best-known proposal for simplification of personal income tax compliance, made by Andrew Leigh,[58] would remove most work-related deductions from the system and have all personal taxpayers provided with an ATO estimate of their liability. Taxpayers would have the option of disagreeing with the estimate if they wished. Such a reform would remove further compliance work for an estimated three-quarters of the taxpayer population. Self-employed workers, landlords and others with complex personal income would, however, still need to file returns.

Similar reforms have been implemented in New Zealand, and the ATO has most of the systems needed to implement such reforms here. As Leigh puts it: 'In an era when the ATO deducts most tax at source, it is difficult to see why the typical Australian should spend a full working day every year telling the tax office what it already knows.'

## LOWER TAXES MEANS LOWER SPENDING

Ultimately, however, we recognise that if we are calling for a lower tax-to-GDP ratio, we are calling for lower spending.

Spending can be cut. As our 2008–09 Budget Submission detailed:

- Real spending has grown strongly in recent years – but we have not produced better outcomes, particularly for those most disadvantaged.
- Higher workforce participation should lessen the need for income support.
- Each business cycle has seen increases in expenditure that may have been temporary in nature, but which have since become permanent.

Better outcomes can be achieved through more rigorous assessment of program objectives and outcomes and better targeted and effective spending.

We again call on the federal government to undertake a comprehensive review of all spending – along the lines of the 1996 Audit Commission Review – to identify where savings can be found, and where programs can be delivered more effectively.

The overall net benefits of higher levels of spending need to be critically assessed, including relative to the costs associated with higher taxation and the alternative benefits that could be achieved through tax reform.

At the very least, reviewing the efficacy and benefits of spending programs will better enable the prioritisation of public spending relative to tax options. It will assist the government in meeting its stated objective to keep taxation as a share of GDP on average below the level for 2007–08, which was 26.1 per cent. More ambitiously, such a review could provide the foundations for lower taxation over the long term.

## STATE TAXES AND INEFFICIENCY

### THE GENERAL STORY

While Australia's mix of indirect and direct taxes is more or less at the OECD average, tax collected from broad-based consumption taxes is lower than the OECD average. This confirms the widespread concern that we have an overreliance on inefficient and distortionary indirect taxes such as stamp duties.

The problems with these state taxes as described by the Centre of Independent Studies are their 'narrow and highly selective bases, complex structures, taxation of transactions rather than value added, impact on business costs, and the proliferation of small "nuisance" taxes that raise little revenue relative to the costs involved in complying with them'.[59]

Access Economics has said 'over the longer term, and despite the political difficulties of doing so, it would make considerable economic sense to replace some of the more inefficient taxes with a higher rate of GST'.[60]

Removing inefficient, distorting taxes, mostly at the state level, should be a priority for the review.

### THE UNFINISHED BUSINESS TAX AGENDA

The number of taxes faced by business and the need to deal with multiple tax collection agencies has resulted in complexity, inefficiency and an enormous compliance burden for Australian business (and the wider community).

EXHIBIT 7

## TAX NATION

A 2007 survey conducted by PricewaterhouseCoopers for the BCA and the Corporate Tax Association and incorporated in a report titled *Tax Nation: Business Taxes and the Federal–State Divide*, demonstrated the unnecessary complexities and inefficiencies in Australia's tax system, with a multitude of taxes imposed at each tier of government that collect small amounts of tax revenue.

Some of the key findings were:

- There are 56 different business taxes in Australia, including 21 federal taxes, 33 state and territory taxes and 2 local government taxes.
- By comparison, a similar survey in the United Kingdom – an economy almost three times larger than the Australian economy – identified only 22 business taxes.
- Of the 56 taxes identified, 51 taxes were potentially borne by businesses surveyed for the report. Of those 51 taxes:
  - One tax – corporate income tax – accounted for almost 66 per cent of tax revenue collected.
  - The other 50 taxes combined accounted for 34 per cent of tax revenue collected.
- A further breakdown of the 51 taxes borne exposed the large number of taxes imposed at the sub-national level of government that collect only a small minority of tax revenue:
  - The 16 federal taxes accounted for 83 per cent of revenue raised.
  - The 35 state, territory and local government taxes accounted for just 17 per cent of revenue raised.

These findings reveal a disparate tax system that imposes unnecessary administration and compliance costs on business. The survey also found that business is also a major collector of taxes; for every dollar of total tax borne, survey participants collected an extra $1.35 in taxes from other taxpayers.

Source: *Tax Nation: Business Taxes and the Federal–State Divide*, 2007.

The reform of state taxation and in particular the elimination of inefficient state taxes is far from complete. While some progress has been made following the signing of the GST-related agreements, progress overall has been disappointing. The New South Wales, Queensland and South Australian Governments recently announced delays to the removal of a number of inefficient taxes, reneging on commitments made almost ten years ago. Keeping these taxes will add to business costs. Removing these taxes must be a priority.

Many state taxes are levied on essentially similar transactions with little consistency across jurisdictions. Harmonisation of remaining state taxes should be a key priority, with recent reforms to payroll tax showing what can be achieved. Such harmonisation should focus on a consistent approach towards the tax base, tax calculation and tax collection; the tax rate and exemption thresholds should remain an opportunity for competition between the states.

Australia's governments can do a lot more to make Australia's complex tax system simpler and less costly. By doing so, they can create the conditions for higher levels of economic growth at no cost to government revenue.[61]

It would be a major step forward if governments worked together to design a system that starts from the premise of a consistent national tax system rather than a patchwork of nine different tax systems. The Council of Australian Governments (COAG) and the Council for the Australian Federation (CAF) are the ideal forums for agreeing and implementing meaningful reform.

We argue that all governments should commit to:

- Simplifying wherever possible the rules governing each individual tax, for example, the definition of the tax base.
- Reducing the number of taxes by replacing inefficient and costly taxes that collect small amounts of revenue with broad-based taxes.
- Committing to harmonising tax bases and collection procedures across the states and territories.
- Improving the efficiency of tax collection where possible by consolidating tax collection at the federal level (the Australian Taxation Office), thereby reducing the number of bureaucratic organisations for business to deal with.
  - Tax collection by one national taxing agency, replacing the various state revenue offices, would improve the efficiency of the current process for both business and governments. The collection of GST by the ATO on behalf of the states provides a useful model for this reform. Harmonisation of the states' tax bases would enhance the compliance cost savings. Centralisation would also deliver scale benefits, such as:
    - Lower tax collection costs.
    - Greater use of electronic reporting of tax data, and of electronic payment/refund arrangements.
    - Streamlined tax reporting.
    - Streamlined statistical collection.

The BCA *Tax Nation* report of 2007 called on the federal government to review the effectiveness of current revenue streams and revenue sharing arrangements, including issues such as the amount of revenue raised and the operating costs and the administrative burden of individual taxes on government and business, particularly taxes other than the top four revenue-earning taxes.

## CONCLUSIONS: WHERE TO BY 2020

Our vision is that by the year 2020, Australia should be well positioned among the top rungs of OECD countries in terms of GDP per capita – based on a population of around 24 million, a $2 trillion-plus economy, and GDP approaching $90,000 per capita.

Tax reform outlined and initiated by the Australia's Future Tax System review will have played an important role in achieving this by fundamentally shifting the structure of the Australian tax system to support economic growth.

The key priorities are to structurally:

- Reduce the reliance on corporate income tax.
- Reduce the reliance on taxation of personal capital income, and increase the economic efficiency of personal capital taxation.
- Increase the reliance on broad-based consumption taxes and immovable property taxes.

In this submission we have proposed a range of possibilities for reducing the tax burden on capital income. Evidence from overseas strongly suggests that these measures, coupled with increases in more efficient taxes like the GST, would have a significant and positive impact on the key drivers of growth and productivity.

Each option, however, will inevitably have both advantages and disadvantages, and a key factor influencing the choice of policy reforms will be the ultimate economic impact in an Australian context. Comprehensive, long-term modelling is needed to develop a better understanding of this to guide specific reforms.

This type of modelling exercise is beyond the scope and resources of the BCA, and we call on the review team, backed by Treasury resources, to consider modelling a range of proposals.

Taking account of the arguments and analysis outlined in this submission, including the need for further consideration of broad-based indirect taxes, we argue that there would be merit in modelling scenarios that include:

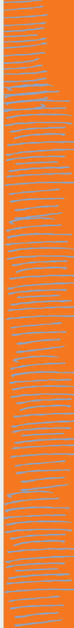
- A reduction in the company tax rate to 15 per cent accompanied by an increased reliance on broad-based consumption taxes.
- The introduction of an allowance for corporate equity (ACE) with no change in the corporate tax rate, accompanied by an increased reliance on broad-based consumption taxes.
- A reduction in the company tax rate to 15 per cent, coupled with the introduction of a dual income tax system with a 15 per cent flat tax on personal capital income, accompanied by an increased reliance on broad-based consumption taxes.
- The introduction of an allowance for corporate equity and dual income tax with the rates of tax aligned at 15 per cent, accompanied by an increased reliance on broad-based consumption taxes.

The modelling exercise will need to be forward looking over a ten-year time period and extend across both fiscal and economic impacts. In particular, it should provide specific estimates of projected effects on national income, investment, saving, employment and wages.

We see these results as being essential to help guide further consultation and deliberation.

The other immediate priority for tax reform must be the reform of state taxes. State tax arrangements must be harmonised and consolidated, starting with completion of the unfinished GST tax agenda. To deliver better federal–state tax arrangements in the future, all governments through COAG should commit to:

- Simplifying and harmonising tax rules.
- Reducing the number of taxes.
- Harmonising tax bases and collection procedures across the states and territories.
- Improving the efficiency of tax collection, where possible by consolidating tax collection at the federal level (the Australian Taxation Office).



# NOTES

1 The financial market implications of population ageing are discussed in various articles in C. Kent, A. Park and D. Rees, *Demography and Financial Markets*, Reserve Bank of Australia conference proceedings, 2007. See in particular A. Borsch-Supan, 'Demographic Change, Saving and Asset Prices: Theory and Evidence'.

2 See, for example, Commonwealth of Australia, *Intergenerational Report 2007*.

3 See D.E. Bloom and D. Canning, 'Global Demography: Fact, Force and Future', in *Demography and Financial Markets*, op. cit.

4 J. Wilkie and T. McDonald, 'Economic Geography and Economic Performance in Australia', *Treasury Economic Roundup,* 2008—03.

5 S. Redding and P. Schott, 'Distance, Skill Deepening and Development: Will Peripheral Countries Ever Get Rich?', NBER Working Paper 9447, 2003, and H. Boulhol and A. de Serres, 'Have Developed Countries Escaped the Curse of Distance?', OECD Economics Department Working Paper 610, 2008.

6 B. Battersby and R. Ewing, 'International Trade Performance: The Gravity of Australia's Remoteness', *Treasury Working Paper*, 2005—03.

7 See W. Keller, 'Geographic Localization of International Technology Diffusion', *American Economic Review*, 92, 2002, pp. 120–142, and W. Keller, 'International Technology Diffusion', *Journal of Economic Literature*, Volume XLII, September 2004, pp. 752–782.

8 W. Keller, 2004.

9 G. Tunny, 'Innovation across the OECD: A Review of Recent Studies', *Treasury Economic Roundup*, Summer 2006.

10 B. Battersby, *Does Distance Matter? The Effect of Geographic Isolation on Productivity Levels*, Treasury Working Paper, 2006—03.

11 OECD, *Going for Growth*, 2008, Chapter 6.

12 S. Redding and A.J. Venables, 'Economic Geography and International Inequality', *Journal of International Economics*, 62, 2004, pp. 53–82.

13 J. Wilkie and T. McDonald, op. cit.

14 Business Council of Australia, *Underserviced: Why Australia's Services Economy Deserves More Attention*, 2007.

15 The Conference Board of Canada, *Sluggish Productivity Growth in Canada: Could Urbanization Be a Factor?*, 2008.

16 B. Dolman, D. Parham, and S. Zheng, *Can Australia Match US Productivity Performance?*, Productivity Commission Staff Working Paper, 2007, and G. Davis and J. Rahman, '*Perspectives on Australia's Productivity Prospects*', paper presented to the Australian Bureau of Statistics and Productivity Commission 'Perspectives' Conference, March 2006.

17 T. Tressel, *Does Technological Diffusion Explain Australia's Productivity Performance?*, IMF Working Paper, 2008.

18 *Underserviced*, op. cit.

19 A succinct summary of key research is provided in Chapter 5 of the OECD *Going for Growth* report (2009).

20 ibid., p. 143.

21 Tressel, op. cit.

22 Commonwealth of Australia, *Architecture of Australia's Tax and Transfer System*, 2008, p. 176.

23 ibid.

24 ibid.

25 See for example R.A. De Mooij and S. Ederveen, 'Taxation and Foreign Direct Investment, A Synthesis of Empirical Research', *International Tax and Public Finance*, Volume 10 (6), 2003, pp. 673–693, and S. Djankov, T. Gansen, C. McLiesh, R. Ramahlo and A. Shleifer, *The Effect of Corporate Taxes on Investment and Entrepreneurship*, NBER Working Paper No. 13756, 2008.

26 Y. Lee and R. Gordon, 'Tax Structure and Economic Growth', *Journal of Public Economics*, Volume 90, 2005, pp. 1027–1043.

27 A. Johansson, C. Heady, J. Arnold, B. Brys and L. Vartia, *Taxation and Economic Growth*, OECD Economics Department Working Paper No. 620, 2008.

28 The exception being small firms, which are often not profitable and therefore unlikely to pay much tax; refer Johansson et al., 2008.

29 ibid.

30 Djankov et al., op. cit.

31 Johansson et al., op. cit., p. 39.

32 Devereux and Griffith (1998) as cited in A.J. Auerbach, M.P. Devereux and H. Simpson, 'Taxing Corporate Income', paper prepared for the Reforming Tax for the 21st Century Review (the Mirrlees review), 2008.

33 J.R. Hines, 'Three Sides of Harberger Triangles', *Journal of Economic Perspectives*, 13, 1999, pp. 167–188.

34 See for example submissions to the Australia's Future Tax System Review by Ernst & Young and the Corporate Tax Association (17 October 2008), BP Australia (5 November 2008), and Qantas and Virgin Blue (20 October 2008).

35 P. Barnes and A. McClure, *Investments in Intangible Assets and Australia's Productivity Growth*, Productivity Commission Staff Working Paper, 2009.

36 *Architecture of Australia's Tax and Transfer System*, p. 254.

37 See submissions to the review by Ernst & Young and the Corporate Tax Association, point 6, p. 8.

38 World Bank, *Doing Business 2009*, 'Paying Taxes', p. 39.

39 ibid., p. 88.

40 Refer to the submission to the review by KPMG and the Institute of Chartered Accountants, *Thinking Beyond Borders – Tax for Reform for the 21st Century*.

41 See in particular R. Griffith, J. Hines, and P.B. Sorensen, 'International Capital Taxation', paper prepared for the Mirrlees review, 2008. Other relevant references include R.A. Felix, *Passing the Burden: Corporate Taxation Incidence in Open Economies*, Federal Reserve Bank of Kansas City Regional Research Working Paper, 2007, and M.A. Desai, C.F. Foley, and J.R. Hines, 'Labor and Capital Shares of the Corporate Tax Burden: International Evidence', paper prepared for the International Tax Policy Forum and Urban–Brookings Tax Policy Centre Conference, 2007.

42 US Congressional Budget Office, *International Burdens of the Corporate Income Tax*, 2006.

43 K. Hassett and A. Mathur, *Taxes and Wages*, American Enterprise Institute Working Paper No. 128, 2006.

44 *Architecture of Australia's Tax and Transfer System*, p. 263.

45 Commonwealth of Australia, *Australia's Future Tax System Consultation Paper*, 2008, p. 277.

46 Griffith et al. (2008), op. cit.

47 These arguments are noted in the *Architecture of Australia's Tax and Transfer System* paper.

48 OECD (2008), op. cit.

49 OECD (2009) *Going for Growth*, Chapter 5, op. cit.

50 See the submission to the review by the Australian Bankers' Association.

51 OECD, *Consumption Tax Trends*, 2008.

52 A.J. Auerbach, *The Choice between Income and Consumption Taxes: A Primer,* NBER Working Paper 12307, 2006.

53 R. E. Hall, 'Guidelines for Tax Reform: The Simple Progressive Value Added Consumption Tax' in A.J. Auerbach and K.A. Hassett (eds), *Toward Fundamental Tax Reform*, The AEI Press, 2005.

54 For a discussion of the positive impact of recent tax changes on labour supply see K. Henry, 'The Fiscal and Economic Outlook', speech to the Australian Business Economists, May 2007.

55 OECD (2009), op. cit.

56 BCA, *Taxation Action Plan for Future Prosperity*, 2005, p. 50.

57 A. Leigh, 'Taxpaying Made Easy', *Agenda*, Volume 14, Number 1, 2007, pp. 81–86.

58 ibid.

59 R. Carling, *State Tax Reform: Progress and Prospects*, CIS Policy Monograph 82, 2008.

60 Business Council of Australia, *BCA Budget Submission 2008–09: Budgeting for Prosperity* (see Access Economics Paper No. 4 as incorporated as Appendix 4 of the submission, p. 19).

61 See *Axing the Alcabala: A Program for a 21st Century State Tax System*, report by Access Economics for the Business Coalition for Tax Reform (BCTR), 2004 and the submission to the review by the BCTR.

BUSINESS COUNCIL OF AUSTRALIA
42/120 COLLINS STREET MELBOURNE 3000 T 03 8664 2664 F 03 8664 2666 www.bca.com.au

© Copyright June 2009 ISBN 978 0 909865 60 3 Business Council of Australia ABN 75 008 483 216

All rights reserved. No part of this publication may be reproduced or used in any way without acknowledgement to the Business Council of Australia. The Business Council of Australia has taken reasonable care in publishing the information contained in this publication but does not guarantee that the information is complete, accurate or current. In particular, the BCA is not responsible for the accuracy of information that has been provided by other parties. The information in this publication is not intended to be used as the basis for making any investment decision and must not be relied upon as investment advice. To the maximum extent permitted by law, the BCA disclaims all liability (including liability in negligence) to any person arising out of use or reliance on the information contained in this publication including for loss or damage which you or anyone else might suffer as a result of that use or reliance.