STRUCTURE AND DISTRIBUTIVE EFFECTS OF THE AUSTRALIAN TAXATION SYSTEM

ACCI SUBMISSION
TO THE
SENATE ECONOMICS REFERENCE COMMITTEE

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Background

The Australian Chamber of Commerce and Industry (ACCI) is the peak council of Australian business associations. ACCI's members are employer organisations in all States and Territories and all major sectors of Australian industry.

Through our membership, ACCI represents over 350,000 businesses nation-wide, including the top 100 companies, over 55,000 enterprises employing between 20-100 people, and over 280,000 enterprises employing less than 20 people. This makes ACCI the largest and most representative business organisation in Australia.

Membership of ACCI comprises State and Territory Chambers of Commerce and national employer and industry associations. Each ACCI member is a representative body for small employers or sole traders, as well as medium and large businesses.

Introduction

Australian business bears a large proportion of the national tax burden. Taxes levied on business account for roughly 40 per cent of total national receipts while private industry generate the incomes that support the rest of the tax base. Accordingly, ACCI is a key stakeholder in relation to national taxation matters.

In this submission ACCI focuses its concerns on the equity issues raised in the terms of reference of the Committee. In a wider context ACCI has decided to place a high priority on taxation issues and is working up detailed policy proposals in a range of areas.

However, the following submission outlines some of ACCI's priority issues for reform and their underlying economic justifications. Key amongst these is the need to restructure the top marginal rates of income tax, improve the welfare-to-work transition, ease the compliance burden on business, lower the rate of payroll tax and maintain fiscal discipline.

Personal Income Taxes

Australia's high rates of personal income taxation continue to impede the international competitiveness of the Australian economy and stand as a major barrier to higher labour force participation. Personal income tax reform, with the aim of removing the disincentives to work faced by wage earners should feature prominently in the Senate Committee's deliberations.

At its current level, the top marginal rate of income tax is not only high, 48.5 percent including the Medicare levy, but it is also applied at a relatively low level of income. A taxpayer earning just over 25 percent more than Average Weekly Earnings is confronted with the top marginal rate of personal income tax.

Personal income tax relief gains its greatest economic and social impetus when we look at the international context. Australian rates of personal income taxation stand in marked contrast to those in most other advanced economies, particularly in respect of the low threshold for the top marginal rate. The fact is well illustrated in the following table reproduced from KPMG's recent research[1].

Top Marginal Tax Rate Trends for Selected Economies

Economy	Current Top Marginal Tax Rate	Proposed Top Marginal Tax Rate	Current / proposed Income Threshold (A$)
Australia	48.5	48.5	60,000
Canada	45.7	45.7	114,800
France	52.75	-	82,600
Germany	48.5	42	98,000
Hong Kong	15	15	330,900
Ireland	42	42	106,900
Korea	36	36	118,300
New Zealand	39	39	53,400
Singapore	26	20	323,400
United Kingdom	40	40	83,900
United State	47.4	44.3	549,100

While equity considerations are said to underlie Australia's highly progressive income tax system, this objective is met at a cost measured in terms of efficiency, labour force participation and the international competitiveness of the Australian economy. These costs will grow over time, creating more pressure to lower the top marginal rates of income tax.

[1] KPMG, *Australian Taxation in an International Context*, December 2002.

To the extent that high marginal income tax rates reduce investment, work effort and innovation in the economy they actively work against social equity. Slower rates of economic growth and job creation lead to higher rates of unemployment and lower real wages for those able to find work, both factors which adversely affect equity.

At the most basic level high marginal income tax rates act to discourage personal initiative and effort. With impaired incentives to work harder, seek promotion or augment their human capital through vocational training, there is a corresponding reduction in the willingness on the part of employees to undertake these activities.

This can also have an effect on business owners. It is not just employees who are discouraged from additional income producing efforts but so too are other income earners, such as self-employed professionals and business owning entrepreneurs.

The effect on the broader economy is detrimental. Reduced workforce participation results in lower GDP per capita, while a less skilled workforce means decreased productivity. This adds up to a lower standard of living for all Australians.

As outlined in the government's *Intergenerational Report*[2], declining workforce participation is also a problem for the sustainability of the Federal budget position. If measures are not adopted to maintain the proportion of the population in the workforce Australians can expect a long run deterioration in government finances. Personal income tax relief should be a core component of measures designed to encourage participation.

It is important to consider that the effect of lowering personal income tax rates on revenue collection need not be entirely negative. To the extent that lower marginal rates of taxation lead to an increase in hours worked this will generate additional income tax revenue. An increase in hours worked may flow from increased labour force participation or an increase in work effort by individual workers.

In addition, with professional workers becoming increasingly mobile internationally we are faced with a choice between personal income tax reform or failing to attract and retain highly skilled workers. Australian-born professionals are at risk of departure, while international expertise will tend toward those countries with

[2] Commonwealth Department of the Treasury, *Budget 2002-03: Budget Paper No. 5 – Intergenerational Report,* May 2002.

less onerous income tax burdens and which deliver higher after-tax incomes.

A clear economic case exists for reducing the income tax burden on the Australian taxpayer. An anticipated long-run decline in the participation rate will need to be countered by increasing incentives to remain in the workforce, while internationally we must maintain our competitiveness. ACCI urges restructuring of the top marginal rates of taxation as a matter of priority, having particular regard to not only reducing the top rate but also significantly raising the threshold at which it is applied.

Poverty Traps

It is widely recognised that the interaction of welfare payments and the personal income tax system can give rise to high effective marginal rates of taxation for low-income earners. Research has indicated that this is especially the case for sole parents and families with children.

As a worker moves from welfare to work, government allowances are reduced, eligibility for certain forms of support cease and income tax begins to be paid on earned income. Faced with the prospect of receiving little extra disposable income for entering paid employment, there can be an incentive to choose welfare dependency over work.

In addition to being damaging to the wellbeing of the individual, and often by extension their family, unemployment represents a loss of productive capacity in the economy and a further burden to be borne by taxpayers. Rather than trap people in welfare dependency, the tax system and welfare payments should be structured in such a way as to promote movement into paid employment.

Welfare reform will enable Australia to move away from wage fixing as a *de facto* income support device. The current system of industrial relations seeks to address equity concerns through increases in the federal minimum wage. Given the fairly even distribution of minimum wage earners over the spectrum of household incomes[3], increases to the living wage are rendered a fairly ineffective instrument for addressing inequality.

[3] Sue Richardson and Ann Harding, *Low Wages and the Distribution of Family Income in Australia*, August 1998.

The benefits of increased wages flow equally to minimum wage earners in both high income and low-income households. Further, the high effective marginal tax rates experienced by income earners in low income households mean that they receive proportionally less of an increase in their disposable incomes following a rise in the minimum wage.

Inequality may actually be increased as a direct consequence of the adjustments to the safety net. Setting a minimum wage above the market clearing level will in many cases lock people out of paid employment. Inequality is exacerbated to the extent that higher unemployment is created as a result of artificially inflated wages for low-income earners.

The inequality stemming from unemployment far exceeds that which derives from wage differentials. It is of a longer-term nature, has broader social costs and is financially debilitating for those affected. It is more likely than not that those relegated to unemployment come from lower income households.

Accordingly, there is a strong argument for further reform of the industrial relations system. ACCI's case for reform and detailed proposals are contained in *Modern Workplace: Modern Future – A Blueprint for the Australian Workplace Relations System*.

Restructuring of the income support system is a necessary adjunct to addressing equity considerations. The Government has already taken the initiative on the welfare to work transition with the imminent introduction of the *Working Credits* scheme, to commence on 20 September 2003.

Effectively it encourages welfare recipients to enter the workforce by allowing them to retain their income support entitlements for a period of time after they acquire paid employment. This occurs in circumstances where the payment would otherwise be reduced or cease altogether as a result of the recipient's new income.

An earned-income tax credit, conditional upon family size and income, is another means of ameliorating high effective marginal rates of taxation for low-income earners in low-income families. Those eligible would be provided a tax credit for taking up paid employment that can be used to offset their tax liability.

Tax credits should be implemented in such a way that, in combination with eligibility for income support payments, there would be sharp increase in work incentive. Simultaneously an appropriately targeted earned-income tax credit would reduce effective marginal rates of taxation and provide higher disposable incomes to its recipients.

However, ACCI has examined the proposals of the so-called '*Five Economists*' which were first presented to the Prime Minister in 1998. Their program calls for nominal wage freeze to be implemented through the industrial relations system in conjunction with an earned-income tax credit as a compensating measure. ACCI has very strong reservations about this proposal. Although it has a new name, it is simply a variation of the 1980's *Prices and Income Accord*.

The Government's *Working Credits* scheme is a step in the right direction but there is the potential to do more. ACCI urges the Committee's inquiry to consider the effectiveness of a targeted earned-income tax credit as a means of both increasing work incentives and real incomes for low-income workers in receipt of welfare benefits.

Compliance Burden

The increasing complexity and sheer volume of Australia's tax law represents an ongoing burden for Australian business. Resources devoted to compliance with an unnecessarily complex tax system are entirely wasted in terms of added productivity. Consequently, overall social wellbeing could be improved if these costs were reduced.

Not only is there a net cost to the economy arising from compliance burdens, but it stands as a barrier to greater levels of activity. For virtually the entire history of the ACCI *Survey of Investor Confidence*, business taxes and government charges have been identified as the number one constraint on the level of investment. At least in part this reflects the compliance burden associated with these taxes.

TOP TEN CONSTRAINTS ON INVESTMENT

July 2003

1. **Business Taxes and Government Charges** (1)
2. **Wage Costs** (4)
3. **Local Competition** (6)
4. **Non-Wage Labour Costs** (3)
5. **State Government Regulations** (2)
6. **Availability of Suitably Qualified Employees** (7)
7. **Federal Government Regulations** (5)
8. **Insufficient Demand** (8)
9. **Local Government Regulations** (10)
10. **Current Levels of Debt** (9)

The figures in brackets show the ranking in the previous quarter

Source: *ACCI Survey of Investor Confidence*, July 2003

There will always be some level of cost incurred by business, or individuals, in complying with the tax system. It is the extent to which these costs are unnecessary, or arise as a result of complexity or ambiguity that is capable of remedy, that there exists scope for improvement. Identifying these areas is the province of good government.

The first stage in addressing the issue is to gauge the magnitude of compliance costs through an in-depth study on the topic. Given the large public benefits that would flow from such an undertaking, the task is best funded by government and conducted in consultation with business groups, academics and tax professionals.

Measurement of these costs would underpin suggestions for general and specific reforms that could be implemented to reduce the compliance burden. This may include some form of concessional treatment for small business.

It is widely accepted that complexity and its resulting compliance burden fall disproportionately on small business. Economies of scale exist in tax compliance, which, due to their size, small business are unable to realise. A differential level of compliance costs argues strongly for differential tax treatment for small business where that would enable reduced compliance costs.

The issue of the compliance burden on business is a perennial one and largely reflects the increasingly complex economic relationships that characterise modern economies. Nevertheless, it would be detrimental to our national interest to dismiss consideration of the issue as being too difficult. ACCI would welcome comprehensive research into the area of compliance costs, and supports continuing effort to alleviate this deadweight loss to the economy.

State Taxes

State governments continue to rely upon a range of narrowly based, highly distorting taxes for their revenue collection. In themselves these taxes represent large impositions on the business community, as well as through high compliance costs and reduced overall economic efficiency. A large number of these taxes were to be abolished as part of *The New Tax System*.

Instead, following the Senate compromise, their removal has been postponed until 2005 and subject to the financial circumstances of state governments. These taxes fall disproportionately upon business, and include debits tax and stamp duties on business conveyances, credit arrangements, instalment purchase arrangements and hire agreements.

It is a business priority to see that those taxes which are scheduled for review in 2005 by the Ministerial Council under the *Intergovernmental Agreement on the Reform of Commonwealth State Financial Relations* are reviewed in a proper manner and that they are indeed removed by the States.

A more immediate concern for business is payroll tax. Australia is one of the few countries in the world to levy substantial payroll taxes for general revenue raising. Payroll tax is a tax on employment and represents a major cost of doing business. The principal state tax priority for business is a reduction in the rate of payroll tax in order to enable the creation of more jobs and lower the rate of unemployment.

Opposition to an Increase in the GST Rate

The possibility of raising the *Goods and Services Tax* rate from its present ten per cent has been raised in submissions to the Senate. It is therefore essential to state unequivocally that business is opposed to any increase in the GST rate. The ten per cent rate must be seen as set in stone. No increase in its rate would be acceptable to the business community.

The original intention was to place the *Goods and Services Tax* on all goods and services which would have made the tax simpler to apply and would have raised sufficient revenue to eliminate a number of the more burdensome state taxes, including payroll tax. It is one of the most important missed opportunities of the tax reform process that the *Goods and Services Tax* ultimately did not encompass a wider range of goods and services sold in Australia and is unable, therefore, to finance the removal of a range of currently existing state taxes.

But this is now water under the bridge. The important issue now is to ensure that increases in the *Goods and Services Tax* rate are not seen as a source of government revenue. It had always been the concern of the business community that once a broad-based consumption tax was introduced, that it would become the floor upon which further increases would take place. Such taxes are nearly invisible and can provide rapid increases in public revenue that divert expenditure from private purposes to those of the government.

It was only because the government implemented a series of safeguards that hopefully have made increases in the rate almost impossible to introduce that business was willing to see the *Goods and Services Tax* legislation passed. This remains as true today as it was then. Business does not want to see the proportion of national income utilised by Australian governments at all levels increased, but rather would like to ensure that outlays as a proportion of GDP are continuously reduced.

If governments would like to see growth in the real level of public spending, then such increases should occur only as part of a growing national economy. In that way, real outlays can increase even while the proportion of national income utilised by governments is reduced. This is the ideal approach sought by business.

Within this framework, it is imperative that the *Goods and Services Tax* rate not be raised. Business would strongly oppose any move to increase the *Goods and Services Tax* from its present rate of ten per cent.

Tax Receipts and Government Spending

The strength of the Australian economy is dependent not upon government spending, but upon the health and vitality of private industry whose exertions in fact fund public sector outlays. The proper role for government is one of facilitator of commercial activity rather than an economic alternative.

Rather, it is through informed, competitive and dynamic markets that the wellbeing of the Australian people is best served. Any consideration of the current structure of the Australian taxation system would be incomplete without regard being had to the issue of the proper role and extent of government spending. The following international comparison gives some indication of the detrimental effect of structural rigidities within the economy arising from pervasive government intervention.

Government Spending and Unemployment

Government spending as a percentage of GDP and levels of unemployment as a percentage of the Labour Force, 1999

	GDP	Unemployment
Australia	31.5	6.7
Britain	39.1	6.1
Germany	45.9	8.8
France	52.1	11.3
Italy	48.3	11.3
Euro Area	46.8	10.0
USA	30.0	4.2
Japan	38.1	4.7

Source: *OECD Economic Outlook*, December 2000: Annex Table 28

Raising revenue to fund government outlays is in itself costly. Not only are there direct costs involved in the collection and administration of tax obligations, but there are broader unseen economic costs that result from the distortion of economic decision-making. Both may be difficult to measure precisely, but these costs are real, of a substantial magnitude and represent a loss to the economy.

Ultimately, tax revenues are used to fund government expenditure on goods and services and the various income supplements it provides to individuals and business. While some level of public sector involvement in private affairs is inevitable and desirable, the question of degree is constantly the subject of debate.

Consideration of the appropriate level of government spending requires a proper weighting of the supposed benefits from current expenditures against the costs, properly construed, of raising the revenue required to meet that expense. It is only where these benefits exceed the costs that government has a clear economic mandate to intervene in the economy.

The counterpoint is well illustrated by the continuing malaise being experienced by the Japanese economy. Failed attempts to stimulate economic growth through the construction of large public infrastructure projects with little social value – so called ‘bridges to nowhere’ – have succeeded only in producing a mountain of public debt which represents an increased tax burden for the next generation of Japanese taxpayers.

Tax revenue diverted toward unproductive or marginally productive uses are doubly costly, in the first instance when raised, and subsequently when they are misspent. It is of fundamental importance that clear economic rationales are provided for proposed future government spending, and that current wasteful expenditures are eliminated.

While taxation revenue as a percentage of GDP in Australia is around levels experienced in other English-speaking countries, there remains scope to remove the drag on the economy from the public sector. ACCI supports the maintenance of fiscal discipline and an ongoing effort to lower the general level of taxation within the economy.