Business Council of Australia

BENCHMARKING

Reform Action

+ BCA BUDGET SUBMISSION **2006–07**

PRODUCTIVITY

COMPETITIVENESS

PARTICIPATION

GROWTH

PROSPERITY

OPPORTUNITY

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Overview

Over the past year, the Business Council of Australia, which represents the Chief Executives of 100 of Australia's leading companies, has strongly advocated the need for further economic reform to lock in prosperity for the long term.

The companies represented by the BCA employ nearly one million Australians, generate $340 billion in the economy and produce 30 per cent of Australia's exports. As an organisation deeply involved in the Australian economy, the BCA has a major interest in developing and promoting policies that ensure the economy remains strong.

In February 2005 the BCA released its *Action Plan for Future Prosperity and BCA Budget Submission 2005–06*. The document combined the BCA's immediate priorities for the 2005–06 Federal Budget while identifying the four areas of economic reform – workplace relations, infrastructure, red tape and taxation – required in the medium term to lock in strong, sustainable economic growth for Australia.

Since the release of the *BCA Budget Submission 2005–06*, the BCA has developed individual Action Plans in each reform area, based on independent research and analysis. Together, these four Action Plans outline an integrated reform agenda aimed at ensuring that Australia's economy remains competitive, and continues to deliver the rising living standards and prosperity to which many Australians have become accustomed.

The *BCA Budget Submission 2006–07* argues that the same challenges and risks to sustained growth – including slowing economic growth and productivity, demographic changes and upward pressure on wages and inflation – that were identified in the *BCA Budget Submission 2005–06* continue to demand broad-based policy responses.

The purpose of this submission is to:

+ review the imperative for economic reform 12 months on;
+ benchmark Federal and State Government progress on economic reform over the past year;
+ highlight a reform program to be achieved over the next 12 months and the forums through which further reform can and should be progressed; and
+ focus on the need to utilise the 2006–07 Federal Budget to commence a program of major tax reform.

1.1 The BCA's Reform Agenda

The four reform areas identified by the BCA that are required for Australia to sustain strong economic growth are:

+ addressing the blow-out in costly and inefficient business regulation, as well as reforming the way in which red tape is made;
+ renewal of Australia's economic infrastructure such as roads, rail, energy and water to support future growth;
+ reform of workplace relations to increase workplace productivity and flexibility, and to simplify the system of agreement making between employers and employees; and
+ reform of the tax system to make sure Australia's personal and business tax systems remain competitive.

The *BCA Budget Submission 2006–07* argues that the same challenges and risks to sustained growth that were identified in the *BCA Budget Submission 2005–06* still demand broad-based policy responses.

1.2 2005 – What Has Been Achieved

NEW CONSENSUS AROUND ECONOMIC REFORM

Since the *BCA Budget Submission 2005–06*, significant consensus has emerged among politicians, policy makers and opinion leaders on the need for further economic reform to meet a range of new challenges to Australia's economy and assure continued strong growth.

In particular, there is now wide agreement that the four areas of the economy highlighted by the BCA are priority areas for reform.

SPECIFIC REFORM ACTIONS

In response to this new consensus for reform, Federal and State Governments have acted quickly to make changes in some important areas. The BCA in particular welcomes:

+ the Federal Government's WorkChoices package of workplace reform, the first major change in workplace relations legislation in a decade;
+ the Federal Government's review of Australia's regulatory blow-out;
+ significant spending increases by Governments on important infrastructure such as transport and roads; and
+ the Federal Government's commissioning of a special taskforce to remove bottlenecks within Australia's export infrastructure.

AUSTRALIA NEEDS A BOLD REFORM AGENDA

These initiatives are notable and are welcomed. Workplace relations reform in particular will help underpin increased competitiveness, a new round of productivity growth, and job creation.

Yet, as a whole, they do not represent a broad-based response to those underlying challenges that Australia's economy continues to face. The basis of the *BCA Budget Submission 2005–06* was a call for Governments to agree on and implement an integrated reform plan across the economy that would deliver sustained growth and prosperity in the long term.

The alternative is an increasing risk that Australia will face an extended downturn, similar to countries such as Germany that have been unable to sustain economic momentum.

> Comprehensive, not piecemeal, reform is required if we are to live up to our expectations and potential.
>
> *Action Plan for Future Prosperity and BCA Budget Submission 2005–06*

While reform action to date has been limited, the BCA acknowledges that platforms for reform have been assembled in important areas. In particular, the BCA welcomes agreement by the Federal and State Governments to pursue a concerted program of micro-economic reform through the Council of Australian Governments (COAG), particularly in improving infrastructure planning and development, and red tape reform.

+

Significant consensus has emerged among politicians, policy makers and opinion leaders on the need for further economic reform.

+

Economic Reform: A New Consensus

Reform 'boosts economic strength'

The Australian 13 July 2005

Reforms other than IR needed

The Australian Financial Review 12 October 2005

+

Economists sing out for more reform

The Age 11 July 2005

+

Plenty more scope for major reform

The Australian Financial Review 5 November 2005

Time never more right for tax reform

The Courier-Mail 16 December 2005

Don't waste reform chance: IMF

The Australian 14 September 2005

Reform needed to stay competitive

The Australian 29 September 2005

+

Nation needs real income tax reform

The Daily Telegraph 27 December 2005

Time is running out to get the pricing of infrastructure right

The Australian 22 June 2005

Reform will keep good times going

The Sydney Morning Herald 30 November 2005

A clarion call to cut red tape

The Australian Financial Review 28 December 2005

+

Energy reform must continue

The Australian Financial Review 12 October 2005

Reform must target red tape

The Australian Financial Review 23 May 2005

+

Economy needs more reform: OECD

The Age 4 March 2005

+

Reform must keep rolling

The Courier-Mail 8 December 2005

True tax reform is needed

The Australian Financial Review 14 December 2005

+

Tax in need of change

Herald Sun 16 November 2005

IMPORTANCE OF A RENEWED NATIONAL COMPETITION POLICY

There is an acknowledgement by COAG that National Competition Policy (NCP) – the basis of a number of important reforms in the 1990s – needs to be revitalised to sustain strong growth.

The BCA, in its *2005 Annual Review*, outlined a strategy to achieve this objective. It argued the new national productivity reform agenda should incorporate unfinished NCP reforms; develop a new NCP agenda dealing with those issues raised by the Productivity Commission in its review of NCP (health, education, human services and natural resources); and establish a new productivity agenda.

> Australia has been transformed over the past 20 years as governments have pursued sustained economic and social policy reform. The COAG agreement of 10 years ago to implement National Competition Policy was a key part of this reform...The challenges facing Australia over the next decade are significant. They are structurally based and a sustained and co-operative effort is again required to meet them.
>
> *Council of Australian Governments Communiqué,* 3 June 2005

The BCA welcomes COAG's commitment to broad reform, particularly through a re-energised National Competition Policy. However, reform rhetoric must be matched by concerted action.

Given the urgency of progressing reform and the clear consensus around what needs to be done, significant reform needs to be progressed in key areas of the economy. The BCA considers there are two key opportunities to substantially progress reform in 2006:

+ **Through agreement by Federal and State Governments to a reform program to reduce red tape and institute renewal of vital infrastructure at the meeting of COAG in February 2006.**
+ **Through the commencement of major tax reform in the 2006–07 Federal Budget.**

TAX REFORM IS LAGGING

Of the four areas of economic reform identified by the BCA, taxation has been slowest in terms of reform progress.

This is despite numerous reform options proposed by politicians, peak groups and policy think-tanks over the past 12 months. The resurgence of the tax debate reflects a growing consensus that tax policy is one of the key tools a country has to enhance the competitiveness and dynamism of its economy and that a fundamental shift in tax policy is needed to lift Australia beyond its currently slowing growth curve.

The central focus of this submission is a renewed and urgent call for major tax reform. As our regional and other international competitors increasingly use their tax systems to attract more investment and skilled workers, the question is not if major tax reform should occur, but when.

The BCA's strong view is that the time for reform is now. Current economic and fiscal conditions mean there is no better time for action. Leaving it until some future time when less favourable conditions force us to act will restrict our choices and make what are inevitable reforms less palatable.

Central to the tax reform process is the need to address fundamental issues of budget forecasting and analysis. Tax reform has lagged behind reform in red tape, infrastructure and workplace relations because inaccuracies in budget forecasting and costing analysis necessarily limit reform to short-term, piecemeal and often politically driven change.

In this submission the BCA argues that an improved system of revenue forecasting and cost-benefit analysis would provide the basis for a more strategic approach to reform in an important area of the economy that will increasingly require constant review and change.

1.3 Risks to Sustainable Growth Remain

TWELVE MONTHS AGO

In February 2005, the *BCA Budget Submission 2005–06* argued that Australia could not take its prosperity for granted.

The economy had performed very strongly over the previous decade in terms of GDP growth, leading to increased wages and individual wealth. Low inflation and unemployment meant that Australia was well placed to make the economy more productive and meet future challenges and demands.

At the same time, the *BCA Budget Submission 2005–06* highlighted a number of factors that made continuing strong growth difficult to sustain. It noted the increasing reliance of recent economic growth on unsustainable debt-fuelled consumer spending driven by housing and commodity price booms.

It also argued that a lack of recent economic reform, combined with strong domestic demand, had led to increasing capacity constraints in the economy. Left unaddressed, these constraints would restrict potential growth. Looming demographic trends of population ageing, particularly the exit of baby boomers from the workforce, present significant risks to long-term economic growth.

> The BCA's central message is this: Australia must act now to make the fundamental reforms to lock in its current prosperity and enable the conditions for sustainable growth in the long term.
>
> *Action Plan for Future Prosperity and BCA Budget Submission 2005–06*

In order to address these structural barriers, the *BCA Budget Submission 2005–06* argued that the economy needed to adjust to growth based on business investment and strong export performance.

It noted that such a shift required an integrated agenda of appropriate macro-economic policy and micro-economic reform to ensure our tax system remains globally competitive, regulation is reduced, Australia's infrastructure is renewed and our workplace relations system made more flexible.

Despite weaker real GDP growth over the year, the economy experienced increased wages and inflation pressures driven by skills shortages and higher oil prices.

TWELVE MONTHS ON

Australia continues to experience the strengths and successes it did a year ago. Employment levels remain at record highs, inflation and interest rates are still low. In all, the economy continues to enjoy one of its most prosperous periods on record.

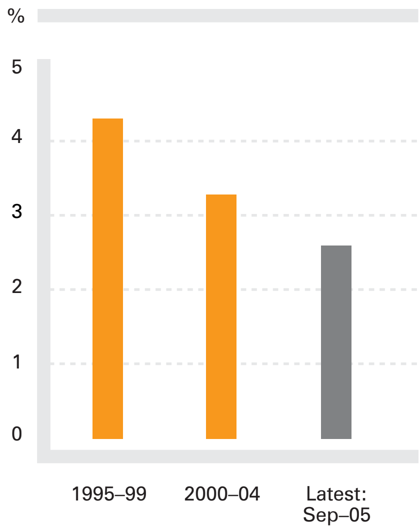
However, the *BCA Budget Submission 2006–07* argues that the underlying issues and risks to Australia's economy outlined in the *BCA Budget Submission 2005–06* remain and they have become even more pressing.

The transition from growth based on consumer spending which had partly begun by the beginning of 2005 has continued. The moderation of the housing market has led to a dampening in consumer demand following the retail boom years of 2002–2004.[1] While investment growth has emerged as an important source of growth, an improved export performance required to place growth on more sustainable settings has not eventuated, despite strong global demand.[2]

Instead, Australia has become increasingly reliant on the income it derives from the current global commodity price boom. Over-reliance on the commodity boom to fund growth is a concern given there are indications that the commodity price boom may be reaching its peak.

Australia has also experienced weaker real GDP growth over the year, continuing a trend towards lower growth over the past five years. While there are forecasts of a slight upturn in GDP growth over the next year, there is a danger over the medium term that without reform that addresses underlying weaknesses Australia could lock itself into a low-growth trajectory.

FIGURE 1
AUSTRALIA'S DECLINING GROWTH
Average yearly GDP growth



Source: ABS.

Capacity constraints continue to hamper the economy. Productivity growth throughout the year has been negative, underscoring the worst performance in over 18 years. Despite weaker real GDP growth over the year, the economy is experiencing increasing wages and inflation pressures driven by skills shortages and higher oil prices. As a result the Reserve Bank continues to hold a tightening bias on interest rates.

1 Annual growth in household consumption for the September Quarter 2005 was 2.7 per cent, compared to 6.4 per cent in the June Quarter 2004.

2 Between 2000–01 and 2003–04, annual export volumes decreased by 0.1 per cent. In 2004–05, they grew by only 2.5 per cent. This is despite the fact that from 2000 to 2005, the world economy grew by nearly 4 per cent a year.

1.4 2006 – The Year for Action

This year, the need for concerted reform action to address the economy's imbalances and constraints and minimise the risks to growth from external factors remains.

With wide agreement on the need for reform and the overall direction this reform should take, 2006 must be the year for action.

Action over the next 12 months that translates reform consensus into a concerted program of economic reform is vital for two reasons:

+ The risks to economic growth remain substantial. Australia has been fortunate in being able to rely on high commodity demand and prices. However, we cannot continue to rely on the commodity boom, given forecasts of major downward commodity price adjustments.
+ The political cycle means an increasing likelihood that strategic, long-term policy making will become overridden by policy attuned to achieving short-term electoral gains. Between September 2006 and April 2007, four State Governments will have elections. Speculation over the timing of the next Federal Government election will peak during 2007. This means that the window for significant agreement and progress on reform is limited.

This submission also includes:

+ **Economic and budget outlook** for this year – examining the conditions and medium-term risks to the economy that make a comprehensive round of economic reforms an even greater imperative than 12 months ago.
+ **Benchmarking reform progress** – examining progress over the past 12 months on the four reform steps that are vital to locking in future prosperity and how this progress can provide a platform for comprehensive reform over the next year.
+ **A competitive tax system for the 2006–07 Federal Budget** – outlining a program of reform in a key area of the economy that will allow Australia to stay ahead of its competitors.

With wide agreement on the need for reform and the overall direction this reform should take, 2006 must be the year for action.

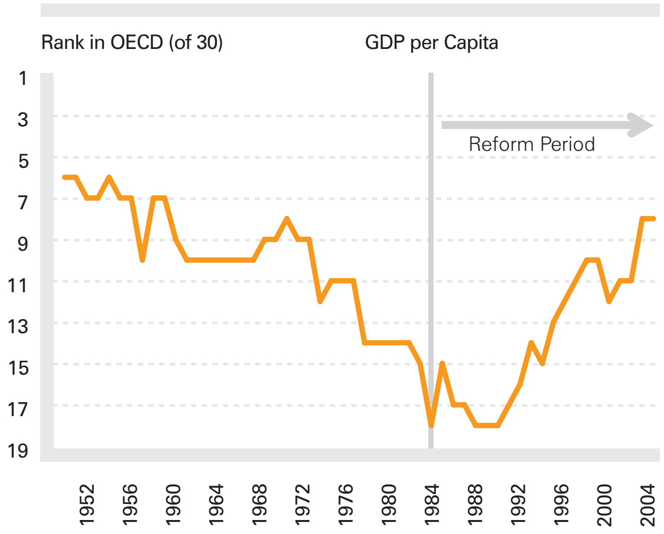
Economic and Budget Outlook

2.1 Economic Outlook

The recent strength of Australia's economy has been based on three main factors:

+ Economic reforms of the past two decades – including the implementation of National Competition Policy, tax and labour market reform, financial market liberalisation and the floating of the Australian dollar – have seen the living standards of Australians improve significantly.
+ Long-term demographic and social factors – such as the transition of the baby boomer population bulge into the working age bracket and the increasing participation of women in the paid workforce – have resulted in a substantial upswing in the employment to population ratio.
+ Housing and commodity price booms have provided windfalls of income and wealth to many Australians and have helped to support strong levels of domestic demand.

FIGURE 2
IMPORTANCE OF REFORM TO AUSTRALIA'S PROSPERITY



Source: BCA (2005) *Locking In or Losing Prosperity: Australia's Choice.*

BENEFITS OF A STRONG GROWTH ECONOMY: 1983–2004

In July 2005, the BCA released its report, *Locking In or Losing Prosperity: Australia's Choice*. For the report, the BCA commissioned Access Economics to quantify the impact of the last 20 years of reform on the living standards and wealth of ordinary Australians.

The report found that:

+ the average Australian is better off in terms of real wealth by more than **$83,000** as a direct result of economic reforms of the last two decades;
+ without the reforms undertaken since 1983, unemployment in Australia would have been 8.1 per cent in 2003–04 compared to the actual rate of 5.8 per cent. This equates to **315,000 more people in jobs**; and
+ productivity improvements alone – the direct result of workplace relations and other economic reforms – have meant on average Australians are at least **$3,000 better off a year**.

However, these strengths are also potential barriers to long-term growth unless action is taken to re-energise the economy. Without a revitalised reform program, Australia will risk being locked on a trajectory of low growth which, as the BCA demonstrated in *Locking In or Losing Prosperity: Australia's Choice*, will have lasting and negative impacts on:

+ living standards compared to other developed countries;
+ relative individual wealth; and
+ the capacity of Governments to provide services, funded from taxes from a static number of workforce participants, to cope with an ageing population.

HOUSING AND COMMODITY PRICES

In the short term, Australia's economic prospects rely heavily on current housing and commodity price cycles. While housing prices have moderated over the last 18 months, they remain at historically, unprecedented high levels.

It is clear that housing prices have risen too far and too fast, leaving housing prices, as a multiple of incomes, very stretched. How this dynamic plays out in the short term will have important implications for the economy. A large downward adjustment in housing prices could impact on consumption and demand by reducing household wealth and dampening consumer sentiment.

Weaker consumption and demand could also have second-round effects on the housing market and the broader economy, as reduced income and increased unemployment impact on householders' ability to finance their mortgages.

BENEFITS OF A STRONG GROWTH FUTURE: 2005–2025

The *BCA's Locking In or Losing Prosperity: Australia's Choice* report included modelling by Access Economics that quantified the impact of further economic reform over the next 20 years. The results demonstrated there are significant consequences both for the economy and the prosperity of average Australians of pursuing a low or strong growth future.

The modelling results found that if Australia can sustain growth close to 4 per cent per year over the next 20 years through sustained economic reform then, compared to the 'no-reform scenario' of 2.4 per cent growth per year, by 2025:

+ Australia's economy would be **39 per cent larger**;
+ GDP per capita would be **31 per cent higher**;
+ The average Australian would be **$74,000 better off** (in today's dollars); and
+ Federal Government taxation revenues would increase by nearly **9 per cent of GDP**.

Figure 3 illustrates the trajectory of asset prices in Australia, the US and the UK over time. It demonstrates that Australian housing asset prices are currently at a potential tipping point and could follow a similar correction path to that of the US stock market correction earlier this decade or the UK house price bust of the early 1990s.

The impact on Australia's economy from slowing housing prices has been masked by the current global commodity boom being driven primarily by China's increasing demand for resources. This boom in commodity prices is pumping $40 billion of extra income into the Australian economy each year.[3]

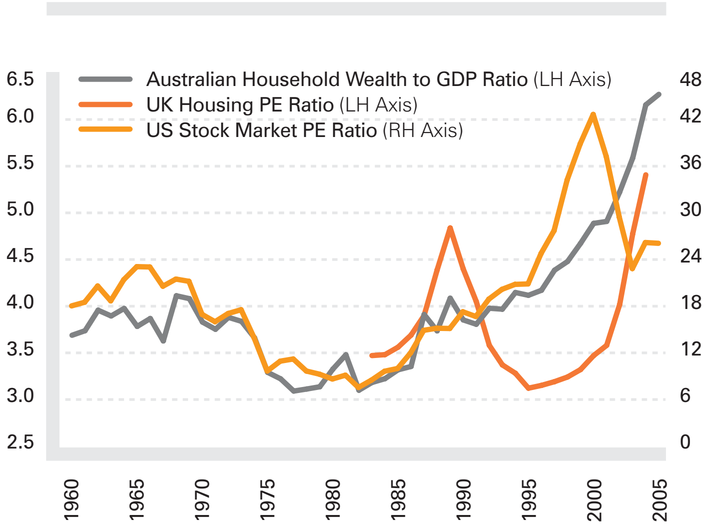
Strong commodity demand is likely to be a continuing feature of the world economy in line with sustained strong industrial activity in China and India. Yet, the outlook for commodity prices is less optimistic. Additional supplies from other producers are already coming on line as major mineral producers across the world have boosted investment and productive capacity in response to high commodity prices.

Access Economics in its November 2005 *Budget Monitor* noted that the current consensus among commodity forecasters is that prices for alumina will halve by early 2008. Copper, oil and nickel prices are estimated to fall by some 30 per cent over the same period. Prices for lead, platinum, aluminium and silver are all expected to decline by around 10 to 20 per cent. Furthermore, the consensus is that coking coal will halve in price from early 2008, and iron ore prices will drop by around 30 to 40 per cent at that time as well.

In short, the interplay between housing and commodity prices creates downside risks to the short- to medium-term outlook of the Australian economy.

In addition to these risks, there is also the possibility of higher interest rates – despite weaker economic growth – due to ongoing capacity constraints; increasing global interest rates driven by inflation concerns from high oil prices; and the dynamics of the US current account deficit.

FIGURE 3
HARD LANDING FOR AUSTRALIA'S HOUSEHOLD WEALTH?



Source: Access Economics, Halifax House Price Index.

Note: US PE ratio is the price/earnings ratio of the US stock market. Australian household wealth is significantly influenced by housing prices as most household wealth is composed of housing. A 2004 Melbourne Institute report found that housing assets constituted close to 75 per cent of the assets of the average Australian household. [4]

3 Access Economics, *Budget Monitor,* November 2005.

4 Headey, Marks and Wooden, "The Structure and Distribution of Household Wealth in Australia" Melbourne Institute Working Paper No. 12/04, 2004.

WANING OF BENEFITS OF PREVIOUS REFORMS

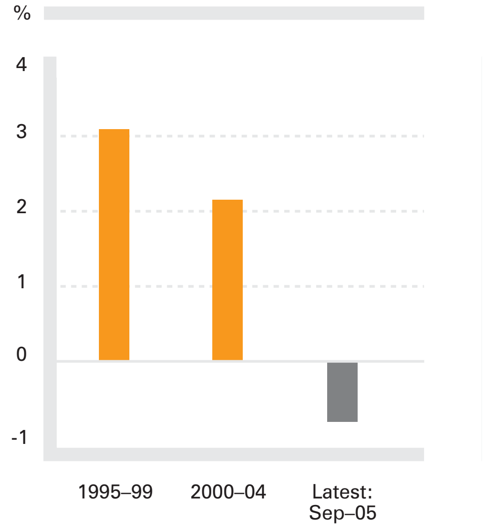
In addition to these short-term risks, structural factors underpinning Australia's recent growth and prosperity create a number of challenges. Australia's recent productivity performance suggests the economic benefits of past reform are starting to wane. In the last year, labour productivity fell by 0.8 per cent, underscoring the worst performance in 18 years in this vital indicator of future prosperity.

Workplace relations reforms will go some way to addressing this decline as well as reducing barriers to job creation and creating more streamlined systems for workplace agreements. However, reforms in other areas of the economy that are also major productivity levers, such as streamlined business regulation and improved infrastructure planning and taxation reform, are also needed to drive future growth.

EXIT OF BABY BOOMERS FROM THE WORKFORCE

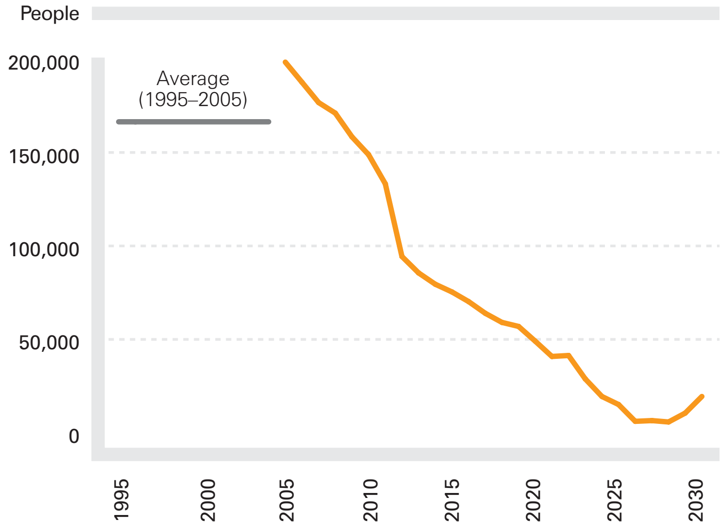
The looming retirement of the baby boomers will reduce the employment-to-population ratio over the next two decades. In fact, while Australia's working age population currently grows by approximately 170,000 people each year, there will be only a projected 190,000 net gain in Australia's working age population in the entire decade from 2020 to 2030. As this decline accelerates in the next decade, it will limit labour supply and economic performance over the longer term if not addressed effectively by encouraging continued baby boomer workforce participation, finding alternative sources of labour, and achieving stronger productivity growth.

FIGURE 4
AUSTRALIA'S FALLING PRODUCTIVITY
Average yearly productivity growth



Source: ABS.

FIGURE 5
DECLINING GROWTH IN AUSTRALIA'S WORKFORCE
Net growth in Australia's working age population 1995–2030



Source: ABS; Access Economics.

2.2 Budget Outlook

The Federal Budget position continues to be strong. The 2005–06 Mid-Year Economic and Fiscal Outlook (MYEFO) showed an estimated surplus of $11.5 billion in 2005–06 and $9.7 billion in 2006–07.

The strength of the Budget over recent years has become increasingly reliant on company tax receipts. Corporate taxation collections continue to be the fastest growing revenue stream for the Commonwealth. The total corporate tax take is estimated to be $52.2 billion in 2006–07, almost double the $27.1 billion collected in 2001–02.

This strong corporate tax growth can be partly explained by the continuing impressive profit performance of Australian companies, in part related to the recent commodity boom. But much of the corporate tax growth relates to the high taxation burden on Australian business compared to other countries.

Despite the current strength of taxation revenues it should be noted that the positive revenue surprises experienced by the Government in recent years are not guaranteed to continue. As previously noted, a number of risks to the economic environment remain in the short and longer term, particularly the predicted fall in commodity prices which in turn will impact on Government revenues.

Strong tax revenues rely on a strong economy, and unless fundamental reform, including taxation reform, is undertaken, the Australian economy's ability to maintain robust growth and a sustainable taxation base is less than certain.

The strength of the Federal Budget over recent years has become increasingly reliant on company tax receipts. Much of the corporate tax growth relates to the high taxation burden on Australian business compared to other countries.

2.3 Long-Term Fiscal Challenges

In May 2002 the Commonwealth Government's Intergenerational Report (IGR) noted that Australia faces two challenges which would significantly affect Government finances in coming decades:

+ Australia's ageing population means there will be a big increase in numbers of the aged relative to numbers of workers; and
+ because of health spending/subsidies, for the aged in particular, health care costs to Government will rise relative to other costs.

In the absence of action, the IGR estimated that, by 2041–42, the Australian Government Budget would be in deficit by 5 per cent of national output each year – over $40 billion a year in today's money. By 2041–42, the calculations in the IGR imply a reduction in annual national output – compared with where it would otherwise be in the absence of population ageing – of 13.5 per cent.

There are good reasons to suggest that the longer-term fiscal challenges facing the Federal Government are even larger than those enumerated in the IGR, notably because the population estimates released since the IGR have seen a considerable upward revision to the number of the population aged 85 and above in coming decades. The IGR forecasts also exclude the interest bill for financing rising deficits needed to cover additional health and social service costs associated with the ageing of the population.

The challenges articulated in the Intergenerational Report nearly four years ago still require significant policy responses. They also highlight the importance of economic reform to raise productivity growth and encourage higher participation to boost the size of the economy and address many of the risks associated with slowing growth and rising deficits.

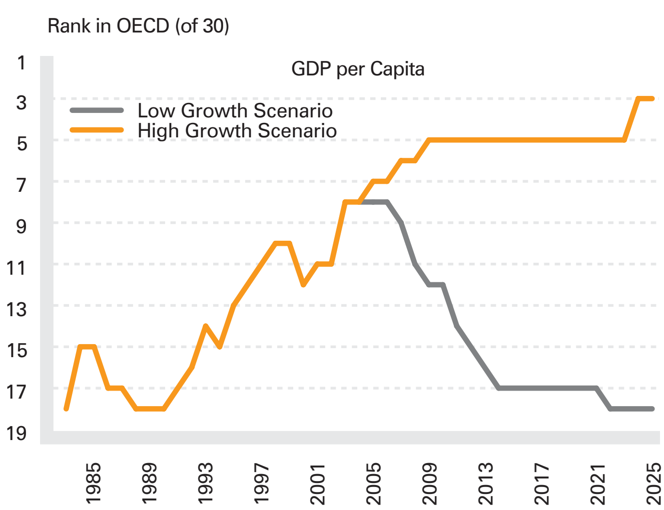
Focus also needs to be applied to areas of ageing-related spending pressures which, if left unchecked, will ultimately constrict Budget flexibility, and restrict scope to deal with non-ageing spending pressures such as domestic and regional security, and the environment.

IMPACTS OF A LOW GROWTH FUTURE

The BCA's *Locking In or Losing Prosperity* research found that if Australia continues on a path of low growth – defined as 2.4 per cent growth per annum – as a result of not undertaking vital economic reforms, our living standards will fall from 8th to 18th among OECD countries.

This is the position Australia occupied in 1983 when it first started its reform journey.

FIGURE 6
AUSTRALIA'S LIVING STANDARDS
UNDER HIGH AND LOW GROWTH SCENARIOS



Source: BCA, Access Economics.

The challenges articulated in the Commonwealth Government's Intergenerational Report nearly four years ago still require significant policy responses. They also highlight the importance of economic reform to raise productivity growth.

Benchmarking Reform Progress

Benchmarking Reform Progress

The following section summarises the four areas of economic reform and reform proposals identified by the BCA over the past 12 months. By outlining responses to date by Federal and State Governments to the proposals put forward by the BCA, it highlights there is still a significant body of reform that needs to be agreed to and undertaken.

It reiterates the importance of the February 2006 meeting of COAG and the Federal Budget in May 2006 as two important mechanisms to address these outstanding reform issues.

+

There is still a significant body of reform that needs to be agreed and undertaken.

+

3.1 Improving Workplace Productivity

THE PROBLEM

Despite reform to the workplace relations system throughout the 1990s, the BCA's *Workplace Relations Action Plan* noted that the system was still overly complex – creating large administration and compliance burdens – and maintained barriers to improvements in productivity, employment and participation.

Removing these barriers is of vital importance to enhancing Australia's competitiveness. Australia's productivity levels are still significantly lower than many of its economic peers, and its participation rates amongst groups such as men aged over 55 years and most women are internationally low.

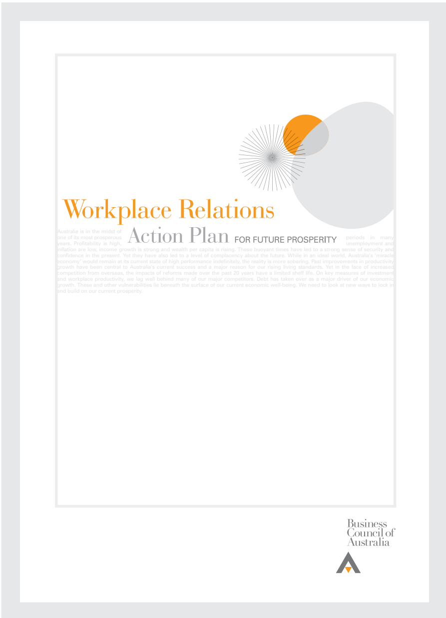
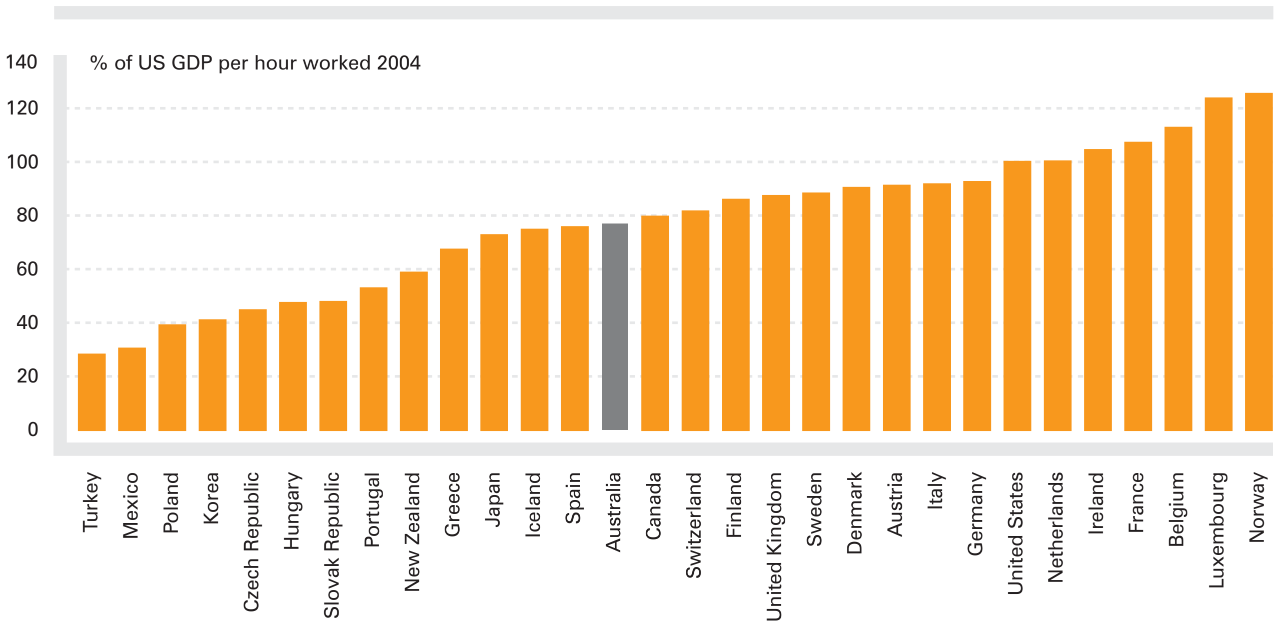


FIGURE 7
INTERNATIONAL PRODUCTIVITY LEVELS



Source: OECD.

WHAT THE BCA PROPOSED

The BCA's *Workplace Relations Action Plan* released in February 2005 outlined a reform agenda that, while extensive, represented the continuation of changes and reform in the workplace that have been undertaken since the 1980s. The BCA considered that implementation of the proposed workplace reform agenda outlined in the *Workplace Relations Action Plan* was essential to improve productivity and support high levels of employment through aiding job creation and encouraging workforce participation.

The *Workplace Relations Action Plan* focused on reforms to achieve three critical outcomes:

+ greater flexibility in agreement making;
+ reduced barriers to job creation and workforce participation; and
+ more efficient workplace regulation.

In particular, it proposed simplifying awards by reducing the content and number of awards; improving flexibility of agreement making; reforming minimum wage setting processes and unfair dismissal provisions to reduce barriers to job creation; and developing a single, national system of workplace relations to remove duplication between State and Federal systems.

RESPONSE TO DATE

Since the release of the BCA's *Workplace Relations Action Plan* significant progress has been made by the Federal Government in the area of workplace relations reform, culminating in the passage of the WorkChoices legislation through Parliament in December 2005.

The WorkChoices legislation provides for major reform improvements to support all three of the critical reform outcomes identified.

In particular, WorkChoices:

+ creates a national workplace relations system;
+ establishes the Australian Fair Pay Commission to set minimum wages;
+ sets up a process for simplifying and rationalising awards;
+ creates a single set of statutory conditions;
+ simplifies the procedures to making workplace agreements; and
+ reforms unfair dismissal laws.

The Federal Government should be congratulated for its formulation and passage of the WorkChoices legislation. The WorkChoices package will significantly reduce impediments to workplace flexibility and productivity and decrease barriers to greater job creation and workforce participation.

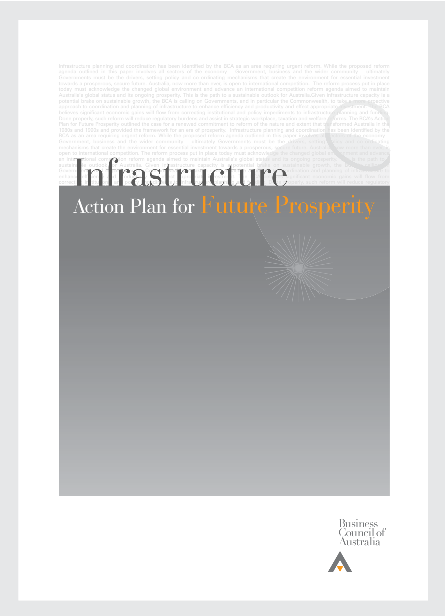
Businesses now have an important opportunity to constructively use these reforms to implement changes to work practices that achieve higher productivity and higher employment, and build mutually beneficial partnerships between employers and employees.

FURTHER ACTION REQUIRED

Despite the comprehensive nature of workplace relations reforms under the WorkChoices package, a major stumbling block remains: the refusal by States to cede their workplace relations responsibilities to a national system. For many businesses, this means a continuation of costly overlapping and differences between State systems.

While the announced High Court challenge by the States to the WorkChoices legislation suggests that a unified approach is unlikely in the short term, the BCA believes strongly that it would be in the national interest for the States to cede their residual workplace powers to a national system. In addition, transitional arrangements established to implement the new workplace relations changes will need to be monitored over the next few years to ensure they do not lead to an increase in regulatory burden for businesses.

3.2 Infrastructure Renewal



The *BCA's Infrastructure Action Plan* found serious bottlenecks in key areas of the economy that, unless addressed, would pose major constraints to future growth.

THE PROBLEM

The BCA assessed the current state of a selection of Australia's economic infrastructure assets with the release of its *Infrastructure Action Plan* in March 2005. It found that as a result of poor institutional arrangements and policy choices, Australia's infrastructure is in urgent need of expansion, reform and repair.

It found serious bottlenecks in key areas of the economy that, unless addressed, would pose major constraints on future growth. It found that:

+ traffic congestion costs will increase from $13 billion to $30 billion a year by 2015;
+ energy demand will exceed supply by 50 per cent by 2020; and
+ nearly all of Australia's main cities will be consuming more water than is sustainable by 2025.

The *Infrastructure Action Plan* concluded that despite Australia's infrastructure base being worth an estimated $300 billion, there was no overarching database with which to judge the quality and quantity of the country's infrastructure which could provide a basis to assess existing use and projected constraints.

WHAT THE BCA PROPOSED

The *Infrastructure Action Plan* concluded that the development of quality infrastructure is essential to alleviate capacity constraints within the economy and ensure Australia's continued international competitiveness.

However, the *Action Plan* noted that funding was not the primary issue. Rather, the major barrier to better infrastructure to support future growth has been a lack of proper strategic planning by and between Governments. The *Action Plan* stated that a sustainable system of infrastructure cannot be achieved without structural and systematic change in the governance and planning of infrastructure policy in Australia.

To achieve a sustainable basis for Australia's economic infrastructure, the *Infrastructure Action Plan* called on COAG, or an alternative intergovernmental body to:

+ develop a national integrated infrastructure reform agenda covering urban and rural water, energy, road and rail transport, and urban growth;
+ set down specific roles and responsibilities between levels of Government to reduce buck-passing on infrastructure problems and solutions;
+ agree on specific plans and timetables with firm targets for action, and robust mechanisms to prevent backsliding; and
+ establish an independent, transparent and regular assessment of reform progress, asset performance and condition through the publishing of a regular state of the nation infrastructure report which encompasses all jurisdictions.

RESPONSE TO DATE

In response to the concerns raised by the BCA and others regarding the current state of infrastructure and infrastructure policy in Australia, there have been some measures undertaken by Government to address the issue of infrastructure reform.

In June 2005, the Export and Infrastructure Taskforce released its report into Australia's export infrastructure. The Taskforce made a number of recommendations covering regulatory reform for Australia's export-oriented infrastructure, improved planning and coordination and an infrastructure audit to be conducted by the Productivity Commission.

State Governments have significantly lifted their spending on infrastructure to address capacity constraints. The issue of revitalising Australia's infrastructure base was a major topic of discussion at last year's COAG meeting, although agreements from that meeting were too narrowly focused on export-oriented infrastructure.

FURTHER ACTION REQUIRED

Recognition of the challenges in relation to infrastructure and developments to address the issues is welcomed by the BCA. However, much remains to be done in the area of infrastructure reform, which to a great degree is due to a lack of urgency among decision makers that the constraints on growth need to be addressed quickly.

Unlike other policy areas where problems and shortfalls can be addressed relatively quickly, infrastructure requires long-term planning. If we wait for the bottlenecks to fully manifest themselves, we will have missed the opportunity to plan and develop solutions that invariably take some 10 or 15 years to put into train.

The BCA believes that the focus of infrastructure policy over the next 12 months needs to be on the effective implementation of a broad agenda for reform. Therefore, the next COAG meeting in February should agree on a framework for improved infrastructure coordination and planning between the Commonwealth and States across key areas such as transport, water, energy and urban infrastructure.

In particular, it is imperative that COAG reconsider its intention to have a five-year audit of the nation's infrastructure produced by each Government. Five-year intervals will not adequately address the current lack of transparency and accountability regarding the capacity and health of Australia's infrastructure.

A regular two-yearly audit of national infrastructure through the Productivity Commission is critical if we are to get consistent, transparent and publicly available information that will aid in removing impediments to infrastructure development, establish the basis of effective planning, and provide a robust, up-to-date way of tracking reform progress.

ON INFRASTRUCTURE RENEWAL, THE BCA CALLS ON COAG WHEN IT MEETS IN FEBRUARY TO OUTLINE A BROAD NATIONAL INFRASTRUCTURE REFORM AGENDA THAT:

+ specifies responsibilities across levels of Government;
+ establishes specific plans and timetables with firm targets for action;
+ creates robust mechanisms to encourage implementation and prevent backsliding; and
+ establishes a state of the nation infrastructure audit to be conducted every two years by the Productivity Commission.

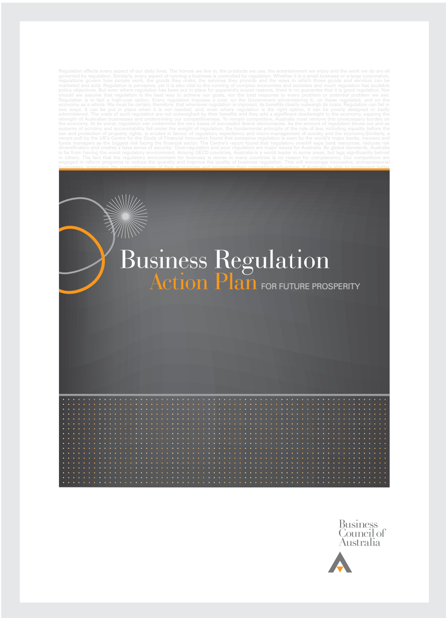
+

The next COAG meeting in February 2006 should agree on a framework for improved infrastructure coordination and planning between the Commonwealth and States across key areas such as transport, water, energy and urban infrastructure.

+

3.3 Addressing the Regulatory Blow-Out

Commonwealth and State Parliaments added 33,000 pages in new laws, rules and regulations in 2003 alone.



THE PROBLEM

The economic costs of the spiralling volume of business regulation in Australia were highlighted with the release of the BCA's *Business Regulation Action Plan* in May 2005.

The *Business Regulation Action Plan* noted that regulation in Australia had increased substantially in recent years. It found that:

+ new laws and regulation are increasing by 10 per cent a year – more than three times as fast as Australia's rate of economic growth;
+ Commonwealth and State Parliaments added 33,000 pages in new laws, rules and regulations in 2003 alone; and
+ half of all legislation passed by the Commonwealth Parliament since Federation has been passed in just the last 14 years.

The *Business Regulation Action Plan* found that the growing burden of complexity and overlapping regulation among Federal, State and local jurisdictions was placing significant administrative, compliance and efficiency costs on the economy that impeded competitiveness and economic dynamism. For example, in 2001–02 the Commonwealth Government alone spent $4.5 billion on the administrative costs of Commonwealth regulatory bodies.

WHAT THE BCA PROPOSED

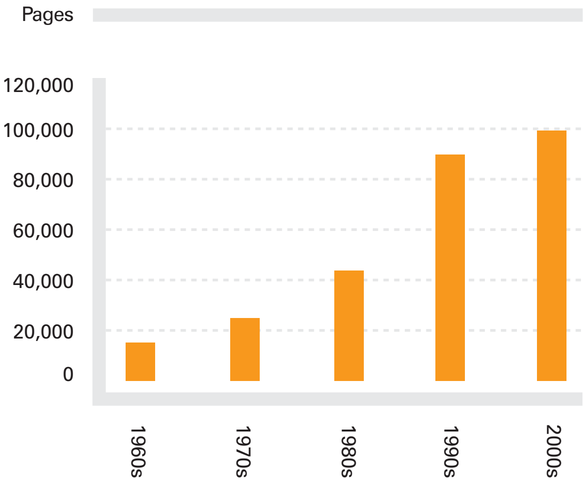
The *Business Regulation Action Plan* outlined a number of measures that Governments needed to undertake to reduce and improve business regulation in Australia. It recommended that Governments at the Commonwealth, State and Local levels:

+ fix the systems that continue to produce poor business regulation;
+ clean up the existing stock of regulation to improve or eliminate redundant, inefficient and inconsistent regulation; and
+ tackle the overall problem of overlapping and inconsistent regulation at different layers of Government.

In particular, the *Business Regulation Action Plan* provided detailed recommendations for improving regulation making systems, focused initially at the Commonwealth Government level, with the aim to create a best-practice model for State Governments to adopt.

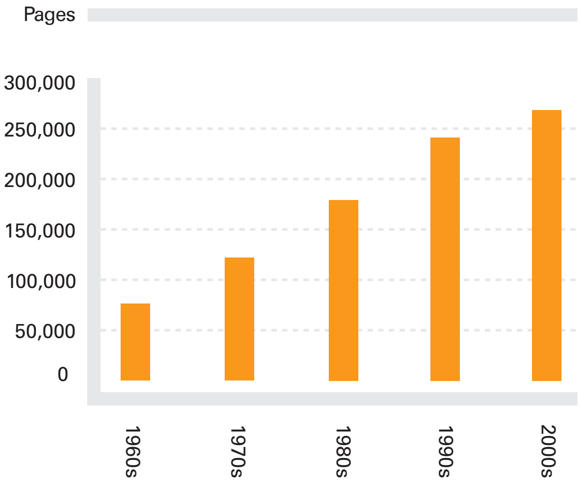
To achieve better regulation making, it recommended a number of specific proposals including the creation of a Ministerial Task Force and Business Regulation Advisory Council to prioritise and advise on regulation reform, and the development of a standardised methodology for identifying and measuring the likely costs to business of proposed regulations.

FIGURE 8
GROWTH IN TOTAL
COMMONWEALTH LEGISLATION



Source: BCA. Figures for the current decade are extrapolated from the actual amount of legislation passed in 2000–2003.

FIGURE 9
GROWTH IN TOTAL
STATE LEGISLATION



Not including Territories

Source: BCA. Figures for the current decade are extrapolated from the actual amount of legislation passed in 2000–2003.

RESPONSE TO DATE

Since the release of the *Business Regulation Action Plan* there has been good progress by the Commonwealth Government to address the issues raised by the BCA.

In October 2005, the Prime Minister and the Treasurer announced a Taskforce, chaired by the Chairman of the Productivity Commission, aimed at reducing the regulatory burden on business.

The Taskforce has been charged with identifying some immediate steps that could be taken to alleviate the regulatory compliance burden on Australian business, particularly at the Commonwealth level, and signalling the direction of further, more sweeping changes that could be made to reduce Australia's regulatory burden over the longer term.

The Commonwealth Government has also announced its intention to introduce a new annual review process to examine the cumulative stock of Australian Government regulation and identify an annual red tape reduction agenda.

It has also agreed to put in place arrangements that will involve a more rigorous use of cost-benefit analysis before new regulations are introduced.

In addition, COAG is currently considering reform options for regulation and regulation making processes at all levels of Government as part of its review of National Competition Policy.

FURTHER ACTION REQUIRED

These outcomes are welcomed by the BCA. However, much more needs to be done to address the issues raised by the *Business Regulation Action Plan*.

The agreement to undertake more rigorous use of cost-benefit analysis of new red tape and the establishment of the annual Productivity Commission stocktake of regulation addresses some of the recommendations suggested by the *Business Regulation Action Plan* concerning the reform of regulation making processes at the Commonwealth level.

However, the BCA argues a more comprehensive evaluation of the current stock of regulation in Australia is needed. No process of regulation reform can be effective in the long term if undertaken only by one tier of Government. This is why the BCA is calling on Federal and State Governments to use COAG as an effective forum to address the costly and unnecessary duplication of red tape between Federal, State and Local Governments as part of a major intergovernmental program of regulation reform. This is in addition to programs of red tape reduction and reform that should be committed to and undertaken by individual jurisdictions.

ON RED TAPE REFORM, THE BCA CALLS ON COAG WHEN IT MEETS IN FEBRUARY TO:

+ produce clear objectives and timelines to address the issue of regulatory overlap between different levels of Government;
+ collectively agree to reduce the regulatory burden on Australian business and to commit to a joint reduction program; and
+ agree on a program of clear incentives and penalties based on the performance of Governments in reducing their respective regulatory burdens.

3.4 A Competitive Tax System

The lack of substantial tax reform in recent years highlights a number of problems relating to the ongoing review of Australia's tax competitiveness and in turn, the policy management of tax reform.

+

A summary of the BCA's tax reform agenda and the importance of this year's Federal Budget in commencing a process of major tax reform is contained later in this submission.

3.5 Summary of Reform Actions and Forums for Further Reform Action

The following table summarises the four key areas of economic reform identified by the BCA, responses to date by Governments, what further action is required, and the importance of COAG and the Federal Budget in driving a broader agenda of economic reform.

TABLE 1

CHALLENGE/ BARRIER TO GROWTH	ACTION REQUIRED	GOVERNMENT RESPONSE TO DATE	FORUM FOR FURTHER ACTION
+ WORKPLACE RELATIONS			
Complex and costly workplace relations system that created barriers to productivity, employment and participation	Simplification of award system	✓	
	Improving flexibility of agreement making	✓	
	Reform of minimum wage setting and unfair dismissal provisions	✓	
	Creation of national workplace relations system	Partially – Full reform will require the referral of State powers	**COAG**
+ INFRASTRUCTURE			
Poorly planned infrastructure framework that is in urgent need of reform, repair and expansion	Develop a national integrated infrastructure reform agenda	Partial reform measures. However a broad, nationally-coordinated agenda needed	**COAG**
	Establish specific plans for action which identify responsibilities across Governments and create mechanisms to encourage implementation	X	**COAG**
	Establish two-yearly national infrastructure audit by the Productivity Commission	Commonwealth has proposed five-year audit by each Government	**COAG**

CHALLENGE/ BARRIER TO GROWTH	ACTION REQUIRED	GOVERNMENT RESPONSE TO DATE	FORUM FOR FURTHER ACTION
+ BUSINESS REGULATION			
Rapid growth in complex, costly and overlapping regulation in Australia	Reform of regulation making processes	Limited progress made at Commonwealth level and by some States	**COAG**
	Clean up existing stock of regulation	Limited progress made at Commonwealth level and by some States	**COAG**
	Tackle the problem of overlapping and inconsistent regulation at different levels of Government	X	**COAG**
+ TAXATION			
Internationally uncompetitive taxation system that restricts Australia's ability to attract and retain labour and investment	Review and reform of Australia's personal taxation system – including:		**Federal Budget**
	+ reducing the two top marginal tax rates	Changes made to tax thresholds but no real reform of personal tax system	**Federal Budget**
	+ removal of biases against saving	X	**Federal Budget**
	+ simplify laws relating to temporary residents	Some changes made but competitors have moved on	**Federal Budget**
	+ review and remove barriers to workforce participation	Some progress made in the last Budget, but significant EMTR problems remain, particularly for women re-entering the workforce	**Federal Budget**
	Further review and reform of the company tax system, including:	X	**Federal Budget**
	+ removing the bias against dividends paid from foreign source income	X	**Federal Budget**
	Simplification of the tax administration system including a comprehensive review by the Board of Taxation	Some basic steps taken, including removal of surplus pages from the Tax Act, but little substantial simplification	**Federal Budget**
	Review and reform of Commonwealth–State taxation structures, including:	X	**Federal Budget**
	+ removing all remaining IGA taxes	Some States have progressed further than others	**COAG and Federal Budget**

A Competitive Tax System

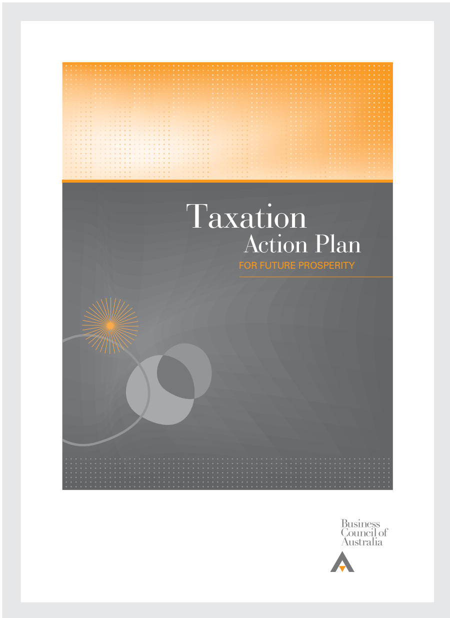
FOR THE 2006–07 FEDERAL BUDGET

4.1 Importance of a Competitive Tax System

In April 2005, the BCA released its *Taxation Action Plan*, which called for a broad review of fundamental aspects of the tax system that posed major barriers to Australia's future prosperity, while proposing a series of reforms to address immediate problem areas.

At the time of the release of its *Taxation Action Plan*, the BCA stated:

'As with business, economies are in competition with each other. Governments cannot be wedded to tax structures and rates without considering their impact to their economy's competitiveness internationally…The economies that Australia will be increasingly competing with for growth and investment are building far more competitive tax policies than we have had to confront in the past… We need to move beyond the piecemeal changes and periodic catch-ups that characterise the current tax debate and put all the cards on the table.'



The *Taxation Action Plan* noted that one-third of Australia's total income is paid in tax. As a result, its influence on Australia's present and future economic direction – from business and personal investment to decisions to enter the workforce – is profound.

In the short term, the *Taxation Action Plan* called for an initial round of tax changes to be implemented by the 2006–07 Budget, to protect Australia from immediate threats to its competitiveness. These included changes to improve Australia's ability to: retain and attract highly skilled people; increase new entrants to the workforce; boost investment and savings; and ensure the business tax regime is competitive.

In the medium term, the *Taxation Action Plan* called for more comprehensive changes to personal income tax rates, major simplification of tax legislation and streamlining Commonwealth–State taxing powers.

Importantly, the BCA called for faster, better processes to regularly review areas of the tax system that in turn would provide a sound basis to identify and remove barriers to Australia's tax competitiveness.

WHAT HAS BEEN ACHIEVED?

Since the release of the *Taxation Action Plan* there have been a number of welcome reforms to the taxation system including adjustments to personal income tax thresholds, changes to expatriate income taxation, some effective marginal tax rate reform through the welfare-to-work changes, the scheduled elimination of a number of inefficient State taxes, and the announcement of the removal of up to 2,000 redundant pages from the tax law.

However, there has been little progress made towards comprehensive reform at any level of Government.

While many of the short-term proposals of the *Taxation Action Plan* recommended implementation in the 2006–07 Federal Budget, there is little indication to date they will be acted upon. Despite significant evidence showing Australia's personal income tax rates and company tax burden are higher than those of our competitors, there has been little enthusiasm on the part of Government to deliver reductions in income tax rates.

The BCA believes the dominant theme of the 2006–07 Federal Budget needs to be comprehensive tax reform. The lack of substantial tax reform in recent years highlights a number of problems relating to the ongoing review of Australia's tax competitiveness and in turn, the policy management of tax reform.

Consistent underestimation of corporate and general review collections by Treasury creates a far tighter spending environment than is actually the case, and discourages decision makers from implementing strategic reform measures.

4.2 Barriers to Reform

The BCA believes that the ongoing culture of conservatism in Treasury revenue forecasts and the current approach to costing individual reform measures has had, and continues to have, a negative impact on tax reform decisions.

INACCURATE BUDGET FORECASTS

Consistent underestimation of corporate and general revenue collections by Treasury creates a far tighter spending environment than is actually the case, and discourages decision makers from implementing strategic reform measures.

In the last five years, Treasury forecasts of corporate tax revenues have been regularly underestimated, in most cases by billions of dollars.

As Table 2 illustrates, corporate tax revenues have come in above original forecast almost every year, by almost $5 billion. Even where the estimates are revised upwards during the following Budget, the final outcome is often significantly higher.

TABLE 2
DIFFERENCES BETWEEN BUDGET FORECASTS AND FINAL OUTCOMES – COMPANY TAXATION

FISCAL YEAR	ORIGINAL BUDGET ESTIMATE ($m)	REVISED ESTIMATE AT FOLLOWING BUDGET ($m)	FINAL BUDGET OUTCOME ($m)	DIFFERENCE BETWEEN ORIGINAL BUDGET ESTIMATE AND FINAL OUTCOME ($m)	DIFFERENCE BETWEEN REVISED ESTIMATE AND FINAL OUTCOME ($m)	DIFFERENCE BETWEEN ORIGINAL BUDGET ESTIMATE AND FINAL OUTCOME (%)
2000–01	30,857	34,720	35,136	4,279	416	13.9
2001–02	27,209	27,480	27,133	-76	-347	-0.3
2002–03	28,400	31,260	33,365	4,965	2,105	17.5
2003–04	32,370	37,310	36,337	3,967	-973	12.3
2004–05	39,400	40,610	43,106	3,706	2,496	9.4

Source: Commonwealth Government Budget Papers 2000–01 to 2004–05.

TABLE 3
DIFFERENCES BETWEEN BUDGET FORECASTS AND FINAL OUTCOMES – UNDERLYING CASH BALANCE

FISCAL YEAR	ORIGINAL BUDGET ESTIMATE ($b)	REVISED ESTIMATE AT FOLLOWING BUDGET ($b)	FINAL BUDGET OUTCOME ($b)	DIFFERENCE BETWEEN ORIGINAL BUDGET ESTIMATE AND FINAL OUTCOME ($b)	DIFFERENCE BETWEEN REVISED ESTIMATE AND FINAL OUTCOME ($b)	DIFFERENCE BETWEEN ORIGINAL BUDGET ESTIMATE AND FINAL OUTCOME (%)
2000–01	2.8	2.3	5.6	2.8	3.3	100
2001–02	1.5	-1.2	-1.3	-2.8	-0.1	-187
2002–03	2.1	3.9	7.5	5.4	3.6	257
2003–04	2.2	4.6	8.0	5.8	3.4	264
2004–05	2.4	9.2	13.6	11.2	4.4	467

Source: Commonwealth Government Budget Papers 2000–01 to 2004–05.

The picture in Table 3 is even more stark. With the exception of one year, the projected underlying cash balance has been underestimated by 100 per cent or more.

The BCA understands that the Treasury has made some modifications to its forecasting methodology, particularly as it relates to corporate tax revenues.

However, the BCA remains concerned that these changes have not been clearly explained, with little clarification of exactly what adjustments have been made. In addition, the accuracy of the changes used in the 2005–06 Budget cannot be judged until the final Budget outcome is released in 2007.

POOR UNDERSTANDING OF COSTS AND BENEFITS OF TAX REFORM

Focusing on the specific costs of reform, rather than the broader benefits, means that many reforms appear more costly on paper than they actually are. This gives the impression that many reforms are unaffordable, despite the broader boost to the economy that they are likely to provide.

Again, this discourages decision makers of all political persuasions from adopting sensible reform.

Measuring the broader economic impacts of specific reform measures is difficult. Business concerns in relation to this issue have grown over several years.[5] In recent times, a number of legitimate reforms have been delayed or abandoned on the grounds that they are too costly, based on the financial estimates available to Parliamentary decision makers at the time.

The BCA notes that Treasury has stated that it is general policy that 'second round' or flow-on effects are not included when costing the fiscal impact of proposed tax reform measures.[6] However, it is clear that effects have been used in certain circumstances.

For example:

+ The Review of Business Taxation, while noting the difficulties of accurately forecasting the flow-on economic effects of such a large reform package, estimated a 'conservative' growth dividend of up to 0.75 per cent of GDP by 2009–10 ($1.8 billion); and
+ The *A New Tax System* package assumed a growth dividend of $1.6 billion accruing to the Federal Government, and $0.9 billion accruing to the States and Territories, over four years.

The following case studies highlight how even relatively minor tax reforms have been put at risk by Treasury because of either conservative revenue forecasting, or the lack of proper assessment of the broad benefits of the measures, or both.

5 See, for example, Australian Federal Senate Economics Legislation Committee, Hansard (13 October 2003), pp. E2–3.

6 See, for example, Australian Federal Senate Economics Legislation Committee, Hansard (13 October 2003), pp. E13–15.

CASE STUDY
TAXATION OF TEMPORARY RESIDENTS

Following initial recommendations from the Ralph Report, on 15 October 2001 the Federal Government announced it would introduce a tax exemption for foreign source income derived by temporary residents.

The measures were designed to attract skilled foreign workers and assist in retaining and attracting corporate headquarters to Australia, and had the broad support of business and the tax community.

However, the measures were opposed on cost grounds by Labor and the Democrats in the Senate.

In December 2003 the Treasurer announced that, as the measure had been defeated twice in the Senate, the Federal Government would withdraw it. The failure to implement change has been criticised by international tax commentators as short-sighted and a wasted opportunity to attract skilled workers.[7]

The measure was costed by Treasury at between $40 and $50 million per year.

Although it was opposed on cost grounds, the measure could easily have been afforded. Corporate tax revenues in the year the measure was withdrawn were more than $4.9 billion above the original budget estimates, and more than $2 billion above the revised estimate released during the following Federal Budget.

7 'Few Incentives For Expats', *Australian Financial Review,* (27 February 2004), p. 12.

CASE STUDY
BETTER TREATMENT FOR OFFSHORE EARNINGS

In February 2003 the Board of Taxation, in its review of international taxation, recommended that the Federal Government address the inherent bias against offshore earnings that results from Australia's dividend imputation system. The report recognised that the existing system, which allowed credits only for Australian sourced income, increased the cost of capital for Australian companies wishing to expand offshore.

The board recommended allowing streaming of foreign-sourced income (directing dividends paid from foreign-sourced income to foreign investors and others who could not utilise Australian franking credits) and a 20 per cent credit on unfranked dividends paid from foreign-sourced income.

The Federal Government decided not to proceed with the measures on cost grounds, noting that the board only considered its recommendations to be an 'on balance' judgement and that the move could disadvantage companies wishing to stay domestic-focused.[8] The report gave a preliminary costing of the measures of $520–590 million per annum, although listing several factors that were likely to partly defray this amount.[9] Despite concerns over the cost, in the financial year ending 30 June 2003, corporate tax revenues alone were more than $4.9 billion above the original budget estimates, and more than $2 billion above the revised estimates released during the following Federal Budget.

8 'Review of International Taxation Arrangements', Federal Treasurer Press Release No. 032, (13 May 2003).

9 The Board of Taxation, 'International Taxation: A Report to the Treasurer', (28 February 2003), p. 14.

CASE STUDY

UPDATING AUSTRALIA'S TAX TREATY WITH THE UNITED STATES

In 2001 Australian and United States negotiators struck a deal to attach an amending protocol to the Double Tax Agreement, the first since the Treaty was signed in 1982. The proposals, which included reducing the US withholding tax on dividends flowing to Australia from 15 per cent to 5 per cent, and reducing the Australian withholding tax on royalty payments flowing to the US from 10 per cent to zero, had the unanimous support of both business and tax experts.

At the time, more than half of Australia's foreign investment was in the US, with almost $92 billion in Australian profits potentially subject to effective tax rates of more than 50 per cent if repatriated to Australia, compared to the Australian corporate tax rate of 30 per cent. Market advisers estimated that the market value of Australian companies in this situation was approximately $2 billion less than it should have been, as a result of the tax impost.

Despite widespread support for the measures, in June 2002, the Joint Standing Committee on Treaties recommended against ratifying the amending protocol, on the grounds that Treasury estimates put the cost of the changes at $190 million per year. These estimates were largely based on the cost of reducing Australia's withholding tax on royalties, with no account taken of the economic benefits flowing to Australia from the reduction in US withholding tax rates. The committee Chair, Julie Bishop MP, stated that 'no quantitative evidence' of the benefits of the amending protocol had been provided, and as a result, the Treaty could not be justified. It was only resurrected following provision of further information from the Federal Treasury leading to the Committee reversing its recommendation two days later.

It was subsequently reported that, largely as a result of the Treaty changes, Australian companies with substantial US investments were repatriating up to $1 billion in additional profits from the US to Australia.[10] Several companies reported that the changes meant decisions to repatriate income were no longer limited by taxation concerns and were made on their business merits. One company reported that the changes had enabled it to lift its Australian dividend payout ratio, directly benefiting its Australian shareholders. The changes resulted in some companies being encouraged to restructure their debt arrangements, resulting in additional Australian corporate tax being paid.

As a result of conservative costings, the changes were initially rejected on the basis of a projected cost of almost $450 million over the first three years. In fact, during the first three years of the amending protocol's operation, corporate tax revenues alone were $12.6 billion above original budget estimates, and $3.6 billion above revised estimates released some 12 months later.

Although difficult to quantify, evidence from Australian companies suggests the second-round effects of the changes have resulted in broad benefits to the Australian economy. These include greater Australian corporate tax payable, increased dividends to Australian shareholders, and greater capital available to Australian companies for reinvestment in the Australian economy. Had the potential for such effects been made clearer, the changes may not have suffered their initial rejection.

10 'Investors reap $1bn tax windfall', *Australian Financial Review*, (31 August 2005), p. 1.

SUMMARY

Major reform decisions that are as important to Australia's future as those relating to taxation should not be clouded by inadequate forecasting or costing methodologies.

The BCA acknowledges that measuring the broader economic impacts of specific reform measures is difficult. The BCA also acknowledges the challenges of accurately forecasting tax revenue generated by a national economy. However, just as significant deviations between projected and actual revenue are not acceptable in the private sector, it should not be considered best practice for the public sector.

In order to ensure that even minor tax reforms do not continue to run up against claims that they are too costly and that potential reforms are without clear and immediate benefits, these issues must be addressed.

The BCA acknowledges the challenges of accurately forecasting tax revenue generated by a national economy. However, just as significant deviations between projected and actual revenue are not acceptable in the private sector, it should not be considered best practice for the public sector.

+

Significant reform of Australia's taxation system will be required if Australia is to move itself to a higher growth path.

+

4.3 Summary of Tax Reform Recommendations

Following are the recommendations on tax reform set out in the BCA's initial submission to the Federal Budget 2006–07 process. The full initial submission, including detailed explanations of the recommendations below, can be found at www.bca.com.au.

REMOVING BARRIERS TO TAX REFORM

ONE

Unnecessary constraints on the reform agenda due to conservative costing of reform measures can and should be avoided.

+ The Treasury should attempt to incorporate flow-on economic effects as a standard approach for costing taxation and spending policies.
+ As a minimum, greater information should be provided to decision makers on each reform option, detailing exactly what is and is not included in the costing figures.
+ It is important to ensure that the full costs and benefits of each reform measure for the economy are understood by policymakers and that beneficial reform measures are not limited by less than accurate and inappropriately conservative forecasting and costing models.

CUTTING PERSONAL TAX

TWO

The two highest steps in the personal tax rate scale should be substantially reduced to no higher than 40 per cent, and preferably lower to gain a competitive edge:

+ The initial steps should involve reducing the second highest rate from 42 per cent to 40 per cent, and the highest rate from 47 per cent to 45 per cent as part of the 2006–07 Budget.
+ The top rate could then be reduced to 40 per cent in the 2007–08 Budget.

THREE

Biases and distortions against saving should be removed. A robust and transparent review of tax-related distortions against savings should be undertaken by Treasury in time for implementation in the 2006–07 Budget.

Australia's high marginal income tax rates provide disincentives for saving. Domestic investment is still influenced by domestic savings, and therefore high marginal personal income tax rates are likely to affect investment levels.

The key disincentives to save would be addressed by a reduction in the top two marginal tax rates.

Australia's personal taxation system creates biases against investment in productive assets. The tax system favours lower-risk investment, especially when geared, compared with higher-risk business investment.

BUSINESS TAXATION

FOUR

The Government should commence an immediate review of the company tax system in time for measures to be included in the 2006–07 Budget to assess and remove pressures against Australia's long-term competitiveness.

+ The best method for reducing the overall burden of company taxation in Australia should be established, including options such as reducing the company tax rate or bringing the treatment of business income more into line with our competitors.
+ The review should take into account both international competitive pressures and progress in lowering the top marginal personal taxation rates.

A competitive corporate taxation system is vital for encouraging greater domestic business investment and ensuring that Australia remains an attractive destination for foreign capital. However, the recent BCA report, *Corporate Taxation: An International Comparison*, released in October 2005, shows that the Australian corporate taxation system is not internationally competitive and imposes a significant taxation burden.

This report can be accessed at www.bca.com.au.

In addition a wide range of uncertainties, complexities and anomalies (such as deductions for black holes) in the business tax base combined with a relatively unfavourable treatment of tangible assets continue to reduce Australia's competitiveness. Compared with many foreign competitors, Australia's tax system is not sufficiently favourable to higher-risk business investment. This is a concern given the importance of such investment for innovation and productivity, particularly in areas such as long-term infrastructure or high-risk innovation projects.

Compared with many foreign competitors, Australia's tax system is not sufficiently favourable to higher-risk business investment.

ENCOURAGING MORE SKILLED MIGRANTS

FIVE

Temporary residents should not be discouraged from working in Australia because of the unnecessary burden or complexity of Australia's tax system. The Government should introduce measures in the 2006–07 Budget to:

+ simplify the tax law that applies to temporary and permanent migrants;
+ ensure that the ATO is adequately staffed to deal with individual migrant issues through the establishment of a specific ATO division so that complexity and administration do not become a block for temporary and permanent migration flows; and
+ review and remove competitive barriers to the attraction of mobile skilled workers in:
  - Australia's superannuation system;
  - the treatment of employee share ownership; and
  - the deemed imposition of capital gains tax applying to temporary workers' world-wide assets on the fifth anniversary of their arrival regardless of whether assets have been sold.

The growing pool of highly skilled, internationally mobile individuals who are working for both short and relatively long periods is becoming increasingly important for the prosperity of Australia. In this context, it is particularly important to ensure that the tax system does not result in the double taxation of the income derived by temporary residents or impose excessive costs on the Australian businesses that employ them.

The Government undertook a number of important measures to reduce the capacity of Australia's taxation system to act as an impediment to attracting skilled workers. However, these measures were significantly delayed (having been rejected by the Senate twice). In the meantime, our competitors have moved on.

REMOVING TAX BARRIERS TO WORKFORCE PARTICIPATION

SIX

Barriers to the participation of workers in the workforce should be reviewed and removed:

+ the Government should request that the Productivity Commission undertake an analysis of the impacts of high effective marginal tax rates (EMTR) on workforce participation of different groups and possible recommendations flowing from this. The analysis should take into account the economic and social implications of disincentives to work; and
+ the current limited Fringe Benefit Tax exemption for employer-sponsored childcare should be extended so that all employer-sponsored childcare is effectively FBT-free.

In addition to reducing Australia's competitiveness in attracting and retaining skilled workers, the current structure of the personal taxation system also provides a number of disincentives to increased workforce participation.

Although some progress was made in the last Federal Budget, effective marginal tax rates (EMTRs) must be further reduced where these unavoidably and significantly weaken workforce participation. High EMTRs create disincentives for those individuals to re-enter the workforce or work additional hours. Despite a number of recent changes by the Government, EMTRs of above 60 per cent still apply to incomes of some individuals who are moving off benefits and re-entering the workforce. Such high EMTRs impact on individuals' incentives to look for work or increase their working hours.

The lack of availability and rising cost of childcare has become a serious impediment to the workforce participation of Australians with children, particularly women. Thirty-five per cent of employees with caring responsibilities say they would increase their working hours if childcare were more affordable.[11]

The BCA believes that one of the best, and most cost-effective, ways to encourage more businesses to engage in employer-sponsored childcare is to increase the scope of the existing FBT exemption for on-site childcare, effectively making all employer-sponsored childcare FBT free.

11 Taskforce on Care Costs 'Creating Choice: Employment and the Cost of Care' (24 February 2005) p. 5.

REMOVING THE BIAS AGAINST LOCAL COMPANIES INVESTING OFFSHORE

SEVEN

The bias against dividends paid from foreign source income should be removed.

A 20 per cent non-refundable notional franking credit should be introduced to take account of offshore tax paid on offshore profits on behalf of Australian shareholders.

An overall bias continues to exist at both the shareholder and company level against Australian companies investing offshore. Australia's imputation regime only provides a credit for Australian company tax paid on income that has an Australian source. This creates a bias in favour of direct investment offshore rather than investment offshore via an Australian company, at a time when we should be supporting, not hindering, the offshore growth of our companies and their capacity to compete globally.

The Board of Taxation recognised that this bias was not in Australia's longer-term interest and recommended its removal.

REVIEWING COMMONWEALTH–STATE TAXING POWERS

EIGHT

The Commonwealth Government should work actively with the State and Territory Governments to ensure that the remaining most highly inefficient State taxes that impact on business are abolished.

+ In addition, the efficiency and transparency of Commonwealth–State spending and revenue raising responsibilities must be improved with an aim to reduce the overall tax burden.
+ The Government should request the Productivity Commission to undertake a review of Commonwealth–State financial and tax sharing arrangements and the appropriateness of the tax mix across jurisdictions. This work should build on the Productivity Commission report, *The Economic Implications of an Ageing Australia*.

The need for further tax reform is not just an issue for the Federal Government. The overall tax burden on companies has a direct effect on levels of investment in Australia.

The States' powers to raise taxation revenue are limited. As such they have resorted to a range of lesser taxes and imposts, while remaining highly dependent on fiscal transfers from the Commonwealth.

There is little uniformity in tax rates and bases across States. As well as distorting location and other economic decisions, these disparities impose significant compliance costs on firms operating across State borders.

As part of the Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations of 1999 (the IGA) the removal of nine inefficient State and Territory taxes was listed as a priority. Six years later a number of these taxes still remain. As a minimum all States and Territories should remove all remaining IGA listed taxes as soon as they have the financial capacity to do so from their share of the (growing) GST revenue.

REDUCE TAX UNCERTAINTY AND COMPLEXITY

NINE

Tax compliance and administrative tasks must be substantially simplified.

The Board of Taxation should be charged with preparing a full report on the costs associated with complexity, compliance and administrative burdens, and the scope and possible means of achieving greater simplification in tax systems in Australia.

Australia's taxation system is overly complex, contradictory and prescriptive. The compliance burdens of the tax law arise in many ways – such as unclear law, excessive choice, concepts and timing of valuation unrelated to ordinary business practice, frequency of payment, complexity and opacity of language, unreasonable approaches to record keeping and more.

Certainty in tax laws should be a clear policy objective. Though recent moves to reduce the number of pages in the tax law are helpful, certainty and clarity will not come simply from an attempt to reduce the volume of legislation or write it in 'plain English'. Rather, simplicity will only result from a serious reconsideration of the law making and law administration processes.

ONGOING REVIEW OF NEW TAX LAWS

TEN

A formal program to regularly review new tax laws must be put in place to allow for adjustment and updating of laws as necessary.

Certainty in tax laws should be a clear policy objective. Simplicity will only result from a serious reconsideration of the law making and law administration processes.

No tax change, no matter how thorough the consultation process, can foresee all permutations and implications.

A formal, regular procedure would allow a recognised mechanism for minor adjustments as well as an opportunity to review major structural changes, such as the introduction of the GST, after the first few years of operation.

Such reviews and amendments should be recognised as good tax system management.

TABLE 4
MEASURES FOR IMMEDIATE IMPLEMENTATION – INDICATIVE COSTING

MEASURE	REVENUE ($b)			
	2006–07	2007–08	2008–09	2009–10
The BCA's highest priority – removing the largest deadweight costs for the economy:				
Move the $70,001–$125,000 threshold rate from 42 per cent to 40 per cent and the $125,000+ threshold rate from 47 per cent to 45 per cent.	1.52	1.71	1.92	2.16
Undertake the next steps towards a more competitive personal tax system, taking the $125,000+ threshold rate from 45 per cent to 40 per cent.	–	2.20	2.40	2.60
Initiatives outstanding from the Review of International Taxation Arrangements:				
Implement Board of Taxation recommendation to remove bias against Australian companies investing offshore (20 per cent tax credit).	0.40	0.40	0.40	0.40
Total Revenue Cost ($b) (of broad estimates where available)	1.92	4.31	4.72	5.16

LONGER-TERM AGENDA

These recommendations represent the immediate tax reform priorities that the BCA believes must be addressed in order to remove the most significant barriers to ensuring Australia's future prosperity. These reforms are based on both securing immediate competitiveness and incrementally improving future tax design on a year-by-year basis.

However, while these reforms are necessary they will not be sufficient to ensure that the taxation system will improve Australia's competitiveness over the longer term.

A more strategic view, backed by a more robust revenue projection and reform costing process, will be required in order to ensure that our tax system is sufficiently robust to support the economy through the future challenges of globalisation and demographic change.

Significant change in a taxation system as large and complex as Australia's requires thorough assessment, long-term planning, and does not come without cost. However, significant reform of Australia's taxation system as part of reform in other key public policy areas will be required if Australia is to move itself to a higher growth path.

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

BCA’s ‘Four Reform Steps’ Advertisements

Between October and December 2005, the Business Council of Australia funded a major advertising program to promote further reform to lock in Australia’s current prosperity.

A national opinion poll commissioned by the BCA after the program concluded found that:

+ 71 per cent of those polled believed it was ‘very important’ that Australia’s infrastructure needed to be renewed to support economic growth;
+ 79 per cent believed it was ‘very important’ or ‘somewhat important’ that red tape on business is cut; and
+ nearly 60 per cent believed lowering tax to provide greater incentive for people to work was ‘very important’, while 70 per cent of people believed lowering company tax to help business grow and employ was either ‘very important’ or ‘somewhat important’.

The four steps that need to be taken to assure Australia’s future.

Business
Council of
Australia