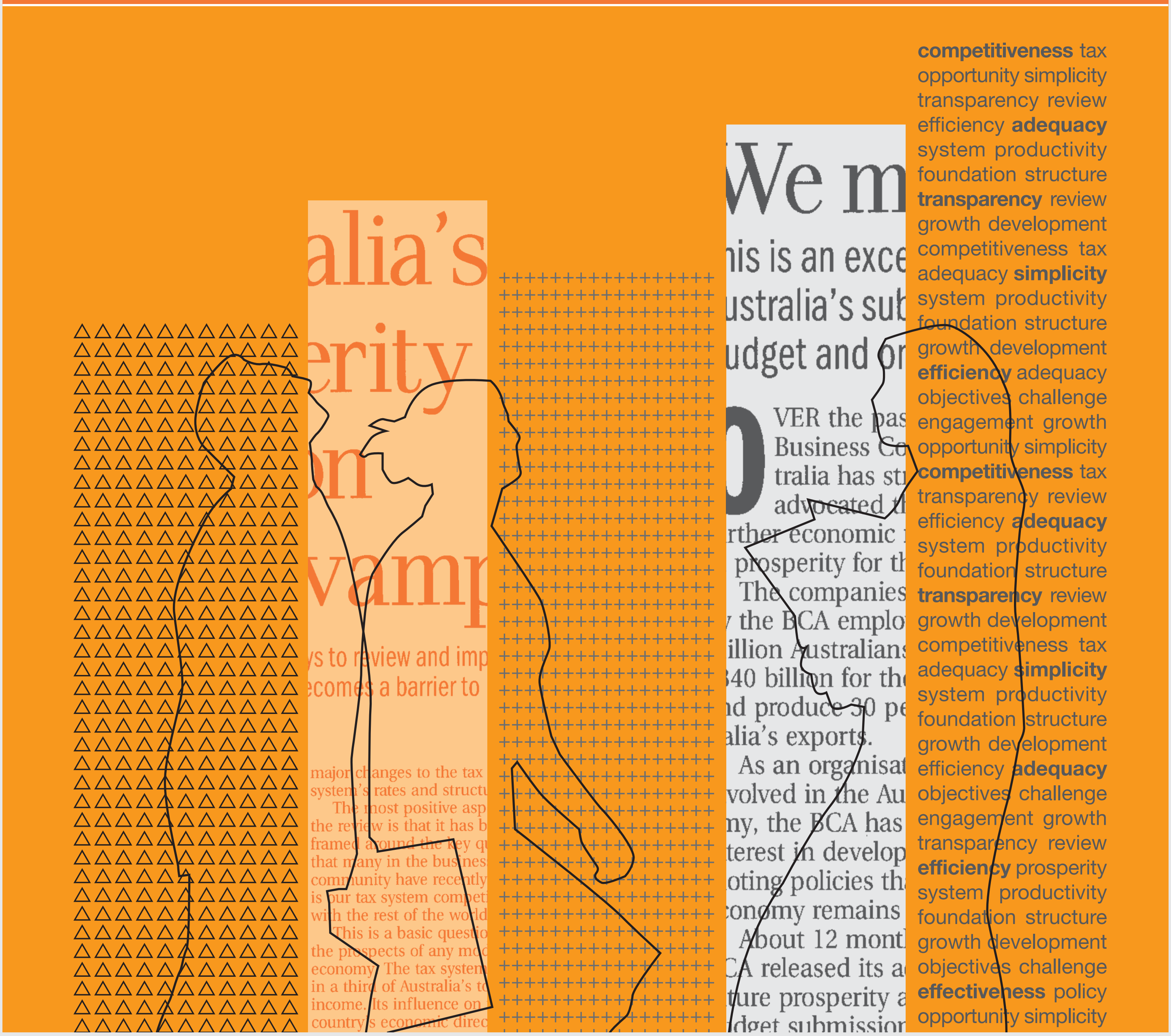
Business Council of Australia

Keeping a Permanent Watch on Australia's Tax System



TAX REFORM MUST BE A PERMANENT ITEM ON THE REFORM AGENDA OF ANY NATION THAT IS DETERMINED TO STAY COMPETITIVE AND SUSTAIN ECONOMIC GROWTH.

Contents

PART 1

Overview

1.1 Why Australia's Tax System Cannot Stand Still

The Business Council of Australia (BCA) is an association of Chief Executives of 100 of Australia's leading corporations. BCA Member companies employ nearly one million Australians, generate $340 billion in the economy and produce 30 per cent of Australia's exports. They also contribute a significant proportion of the $49 billion in federal taxes that companies are forecast to pay this financial year.

The BCA has a deep interest in policies that promote sustained growth and prosperity in the economy through strengthening Australia's economic competitiveness. In February 2005, the BCA released its *Action Plan for Future Prosperity and Budget Submission 2005–06*, a four-part reform agenda aimed at sustaining Australia's economic growth in the long term. This identified taxation, and in particular the ongoing competitiveness of Australia's tax system, as one of four economic reform priorities.

The Howard Government's *A New Tax System* (ANTS) package, released in 1997, was a significant step forward for the Australian tax system. It outlined a clear vision, proposed a timetable for reform, and was well articulated. Combined with the report of the Ralph Review of Business Taxation, released in 1999, the plans resulted in genuine reforms that helped position Australia for growth.

Key developments in this period included the introduction of the goods and services tax, and the staged reduction in the corporate tax rate from 36 to 30 per cent.

However, the economic and political environments in which those plans were created have changed, meaning many of those original reform goals need to be updated for the future and new reform directions set.

In April 2005 the BCA launched its *Taxation Action Plan for Future Prosperity*, which was a comprehensive overview of the tax system. It identified immediate and longer-term reforms to:

+ Help make the tax system more competitive.
+ Help Australia attract the necessary investment, workers and skills.
+ Support levels of innovation needed to sustain strong economic growth.

In the year since the BCA's *Taxation Action Plan* was released the calls for tax reform have only increased.

EXHIBIT 1: THE CASE FOR CHANGE

"The next ten years of tax reform is pivotal to the next twenty years of economic development."

Australian Chamber of Commerce and Industry, *Taxation Reform Blueprint: A Strategy for the Australian System 2004–2014*, November 2004.

" … the economic literature is quite clear: *High tax rates cause the damage* … True, the government has put money back in people's pockets, but it has done so in the least efficient manner possible."

Sinclair Davidson, *Are There Any Good Arguments Against Cutting Income Taxes?*, Policy Monograph 69, Centre for Independent Studies, 2005.

"Australia's high reliance on income taxation is a challenge to international competitiveness and to domestic economic efficiency … This pattern of taxation is a serious flaw in Australia's social infrastructure. In an increasingly global operating environment, an excessive reliance on the most mobile tax base – the income tax base – is a competitive disadvantage."

Peter Burn, *How Highly Taxed Are We? The Level and Composition of Taxation in Australia and the OECD*, Policy Monograph 67, Centre for Independent Studies, 2005.

"… now is the appropriate time to take action in order to strengthen our underlying growth sustainability and deliver impetus to the crucial next step in national economic reform."

Business Coalition for Tax Reform, *Personal Income Tax Reform: Public Discussion Paper*, February 2006.

"To date, Australia's tax reforms have been reactive, aimed at either catching up with a 'backlog' of tax reforms already implemented in other countries, or responding to clearly uncompetitive features of Australia's tax laws."

Ernst & Young, *Taxation of Investment in Australia: The need for ongoing reform*, February 2006.

"Reform that 'broadens the base and lowers the rate(s)' would improve the incentives inherent in the income tax system in important ways, especially in the areas of central importance to Australia's economic performance in coming years – labour force participation and productivity."

Allen Consulting, *Reforming Income Tax: Broader base, lower rates, simpler system*, June 2005.

"Whilst acknowledging the numerous business tax reforms that have already been introduced, Australia needs to consider its competitive position in the Asia Pacific region particularly in light of the desirability of locating operations closer to China and India."

Ernst & Young, *Taxation of Investment in Australia: The need for ongoing reform*, February 2006.

This reflects growing concerns that there is no strategic plan in place for the implementation of changes to Australia's tax system, and that there is a disparity between the importance of taxation to our nation's competitiveness and the absence of a reform agenda. The international benchmarking study announced by the Australian Government on 26 February 2006 will contribute to reform in Australia by stimulating and informing debate around one important aspect of the Australian tax system, namely how it compares in a quantitative sense to our competitors at present. However, a reform agenda cannot be guided by this consideration alone.

At a time when Governments around the world are aggressively reviewing and changing their tax structures to attract more investment and skilled workers, the BCA remains concerned that Australia has no overarching plan or vision for its tax system beyond the immediate pressures and opportunities associated with each annual budget and each election campaign.

In no other area of the economy have the calls for reform been so concerted and consistent but progress so disappointing. Australian Governments have committed (separately and/or collectively) to significant reform of workplace relations, infrastructure and business regulation systems, all of which are aimed at making sure that Australia remains positioned for sustained growth. But similar commitments have not been made in regard to taxation.

Significant short-term tax relief has been provided in recent years, but in such a way that it has little, if any, long-term structural benefit to the Australian economy. Each tax cut since the Government's 'A New Tax System' (ANTS) reforms of 1 July 2000 has done little but restore the ANTS promise that 80 per cent of taxpayers would pay a marginal tax rate of 30 per cent or less. There have been very few lasting changes to personal tax, and it is not clear what the longer-term intentions are.

In fact, against the backdrop of the Australian Government's Intergenerational Report and recent research by the Productivity Commission,[1] the expectation seems to be that Australian taxpayers must come to accept a significantly increased tax burden in the not-too-distant future. Given the central role the tax system plays in attracting and stimulating investment and skilled workers and encouraging savings and workforce participation, the BCA does not consider this to be a tenable position.

The BCA considers that longer-term economic growth and fiscal strategies are required for Australia, and that tax reform must be part of this broader agenda.

1.2 Five Principles of Tax Reform

In order to respond to the fiscal challenges associated with population ageing and rising health care costs, as well as the broader challenges associated with increasing global competition, steps must be taken now to establish appropriate fiscal structures and to lay the foundations for sustained strong economic growth. The BCA considers that longer-term economic growth and fiscal strategies are required for Australia, and that tax reform must be part of this broader agenda.

Reform must be undertaken with a view to ensuring that the tax system supports:

+ **Competitiveness** – of both personal and business taxes, which in turn supports strong economic growth through the ability to attract and retain labour and capital.
+ **Adequacy** – so that the system provides for spending needs, but not at the expense of damaging future growth prospects.
+ **Simplicity and transparency** – to ensure the system is capable of being easily understood and applied, and gives taxpayers certainty.
+ **Engagement** – so the system encourages people to engage in economic activity and pay their taxes accordingly.
+ **Efficiency and effectiveness** – so that tax structures are as cost-effective as possible over time and do not create a cost and compliance burden on the economy.

In many ways these issues are mutually reinforcing.

According to research by the Federal Treasury, maintaining a strong-growth environment is the best approach to dealing with the fiscal challenges of the coming decades.[2] Any reform to taxation must take this objective into account. Sustaining strong economic growth must be a prime objective of all reform. Failure to acknowledge this will compromise Australia's ability to achieve and sustain other policy objectives, including the provision of services and support.

Tax reform need not compromise the adequacy of the system and can enhance it, particularly over the long run. The more complicated the system, the more opaque and uncertain it is and the more likely that tax structures will unnecessarily weigh on economic activity. The aim should be to ensure the tax system has the lightest touch possible to achieve its broader goals.

1.3 Australia's Tax System Must Be under Permanent Watch

Taxation impacts almost every transaction in our economy. For example, it influences key decisions about investment and workforce participation that in turn underpin economic performance. Tax reform must therefore be a permanent item on the reform agenda of any nation that is determined to stay competitive and sustain strong economic growth.

In maintaining a 'permanent watch' on the tax system, the BCA considers the following issues deserve particular attention:

+ Trends in revenue growth over time and the sustainability of those trends.
+ Whether tax policies are significantly distorting behaviours and decisions to the detriment of the economy's long-term growth potential.
+ How the system (i.e. its rates and structures) compares with key competitors and other dynamic economies.
+ Emerging tax trends and policy developments overseas.

1.4 Assessing Trends in Tax Competitiveness, Not Just Tax Rates

Consideration must be given to the trends in tax policy internationally. Given the fast-moving nature of global tax reform, as countries compete with each other to attract more workers and a greater share of investment, a competitive tax rate now may become uncompetitive within a short space of time.

The onus on tax decision-makers is not simply to react to a more competitive tax environment globally or regionally, but to anticipate it. Staying ahead of the competition is even more important for Australia, which continues to face strategic disadvantages in a global economy, including relative remoteness from major global markets and a relatively small population. As the BCA has consistently argued, Australia should not simply aim to play catch-up through periodic, short-term changes to rates and thresholds, but should anticipate global trends in tax reform through a considered, forward-looking plan of reform.

Australia's tax decision-makers must anticipate global and regional tax changes.

EXHIBIT 2: THE TYRANNY OF DISTANCE

Policy settings and structures in competitor economies are key benchmarks for Australia, but in undertaking these comparisons, it is important to acknowledge the competitiveness 'hurdles' that Australia must overcome just to get to same starting point as many of its key competitors.

The Australian economy is relatively small, with a widely dispersed domestic market. Although production in Australia is relatively concentrated in a geographic sense, production centres and markets are found in locations that are relatively distant from one another.[3] For example, within a 1000 kilometre radius of New York City, there are approximately 30 metropolitan areas with populations higher than 500,000, yet within a 1000 kilometre radius from Sydney there are only two such metropolitan areas: Sydney and Brisbane.[4] This means that firms located in Australia can face higher costs because of the smaller scale of operations, and the distance and barriers between regional markets.[5]

Australia is also geographically isolated from global markets. By various measures Australia is either the second most remote OECD country (behind New Zealand), or on average the 211th most remote nation in the world (out of a total of 222).[6] Evidence shows that physical distance and the existence of borders between countries increases transaction costs associated with transport, communications, cultural ties and currency regimes.[7] For example, exporting a good to a country 1000 miles away has been estimated to be equivalent to an import tariff of between 7 and 17 per cent.[8]

While the BCA's *Taxation Action Plan* focuses on the need to maintain competitiveness, this should not be confused with a desire to achieve 'comparative' advantage only (i.e. the lowest tax rates across all fronts). Consideration should also be given to how the tax system operates in practice and the behavioural implications of specific taxes and tax structures in Australia.

1.5 While Reform Is Never Easy, Managed Reform Is Easier

The BCA recognises that tax reform is not easy. Because of the all-encompassing nature of the system, even small changes can have significant costs and can affect many people. However, as Australia's reform journey over the past two decades has demonstrated, ignoring the imperative for and long-term benefits of reform because of concerns about short-term fiscal and political cost is not an effective way of managing change.

As the past two decades have successfully shown, managed reform involves:

+ Developing a strategic plan that anticipates changes in the domestic and global environment. In the case of taxation, this means taking account of increasingly competitive tax systems around the world, but balancing these against future imperatives.
+ Demonstrating that the adjustment costs and changes required will be larger, and the choices fewer if reform reacts to, rather than anticipates change.
+ Establishing that some individuals will bear a cost for improving the system overall, while outlining a commitment to managing adjustments through appropriate safety nets.
+ Exercising political leadership to convince a sceptical public that short-term costs and adjustments associated with reform will be outweighed by long-term benefits.

One argument that is often mounted in response to calls for comprehensive tax reform is that those calling for it rarely take into account the implications for revenue and spending needs. These criticisms miss the fundamental points being raised.

In the first instance, efforts to enhance the efficiency and effectiveness of the tax system are worthwhile, regardless of spending needs. Although tax and spending are closely linked, the fact that nearly all tax revenues are raised for the general purposes of Government (and not hypothecated to specific purposes) means alternative tax policies can be meaningfully compared separately from the programs that they fund. The BCA and other bodies calling for tax reform would welcome the opportunity to contribute to a debate about future spending needs, priorities and strategies for addressing them in a sustainable way. However, like tax reform, a strategic plan for the spending side of the fiscal ledger is also lacking. The update of the Intergenerational Report, due in 2007, may provide an opportunity for such discussions.

Part 2 of this paper examines some of the issues with Australia's taxation system in more detail.

Part 3 of this paper outlines immediate actions that should be taken to establish a strategic approach to tax reform, following the release of the Australian Government's tax benchmarking study.

PART 2

Australia's Tax System: Priorities for Reform

As Australia's reform journey over the past two decades has demonstrated, ignoring the imperative for and long-term benefits of reform because of concerns about short-term fiscal and political cost is not an effective way of managing change.

In the context of the guiding principles outlined above, the BCA is particularly concerned about the following aspects of the tax system. The BCA has emphasised many of these issues in past reports and their substance is reflected in the research and analysis of many other parties similarly concerned with aspects of Australia's tax system. The Government's benchmarking study may refer to some of these issues. However it is important to reinforce, from a business perspective, their centrality to a managed program of tax reform.

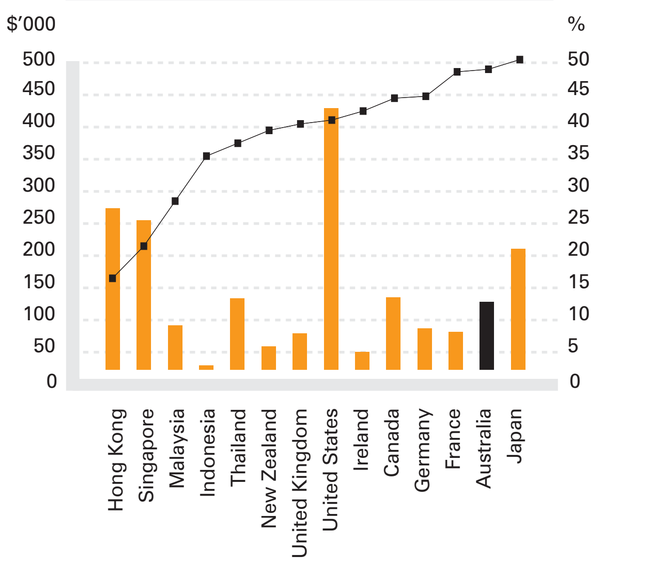
2.1 Competitiveness

PERSONAL TAXATION: HIGH MARGINAL TAX RATES

As Figure 1 shows, Australia's top marginal tax rate for personal income is significantly higher than most of its international competitors; and the income threshold at which this rate applies is also very low.

As Figure 2 illustrates, Australia has reduced its rates on personal income, but other countries have been far more aggressive.

FIGURE 1
COMPARISON OF TOP MARGINAL TAX RATES AND THRESHOLDS 2006

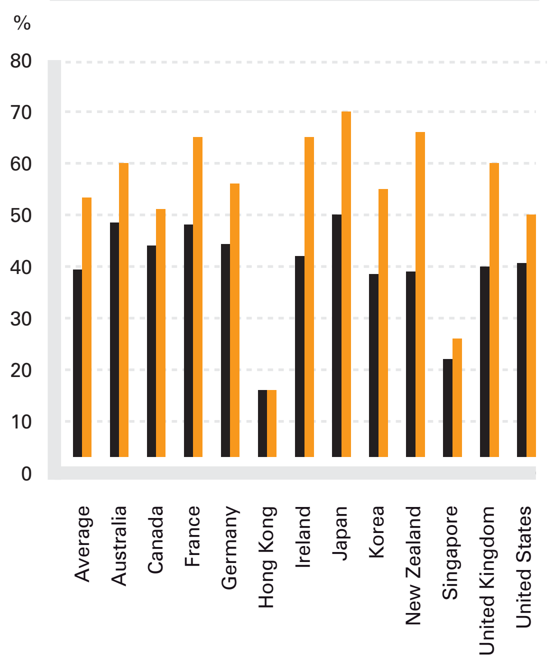


Top tax rate threshold (A$) (LHS)

Top marginal tax rate (RHS)

Source: KPMG employment taxes data, Hong Kong Internal Revenue Department; exchange rate data from XE.COM on 20/10/2005. http://www.cra-arc.gc.ca/tax/individuals/fag/taxrates-e.html and http://www.taxadmin.org/fta/rate/tax_stru.html.

FIGURE 2
CHANGE IN TOP MARGINAL RATES IN SELECTED COUNTRIES 1985–2005



1985

2005

Source: Business Coalition for Tax Reform (2006), *Personal Income Tax Reform: Public Discussion Paper*.

The question remains as to whether high marginal rates are appropriate for Australia in an increasingly competitive environment.

Decisions about whether to work additional hours, or years, and where to work are complex, and the rate of taxation is only one influencing factor. However, the question remains as to whether or not having such high marginal rates is appropriate for Australia in an environment where more and more countries are competing to attract and retain skilled workers, and where opportunities in dynamic (and lower-taxed) economies like China are rapidly increasing.

Over one-third of respondents in a recent survey of Australian emigrants cited higher incomes, of which taxation treatment is an element, as important factors influencing their decision to leave Australia.[9]

Two-thirds of all Australian-born emigrants leave for one of five top destination countries: the UK, New Zealand, the United States, Singapore and Hong Kong. All of these countries offer employment benefits to skilled workers in terms of income opportunities and/or taxation benefits. As Table 1 shows, the majority of Australian-born emigrants to these countries are categorised as skilled workers.

TABLE 1
SKILLED EMIGRATION TO MAJOR DESTINATION COUNTRIES – 2004–05

Country	**Percentage of Australian-born emigrants employed in major competitor countries**	
	Skilled	Unskilled
Hong Kong	83.6	16.4
Singapore	80.8	19.2
United Kingdom	78.0	22.0
United States	76.4	23.6
New Zealand	66.9	33.1

Source: Department of Immigration and Multicultural and Indigenous Affairs 2000, *Population Flows: Immigration Aspects*, 2004–05 edition, Canberra.

China is likely to become an increasingly important competitor for skilled labour in the global labour market at a time when most developed countries will also be facing slower growth in labour supply. The number of Australian-born Australian residents emigrating to China on a permanent or long-term basis increased nearly 120 per cent from 1998–2002.[10]

The level at which Australia's top marginal tax rate is set also acts as a constraint on investment. Top marginal tax rates impose a high tax burden on the investment income of individuals who are the main source of savings in the economy. As a result, the cost of capital for Australian companies reliant on Australian resident investors is also very high.[11]

High marginal tax rates, in conjunction with superannuation and pension arrangements, can have an effect on individuals' propensity to save. Australia's hybrid arrangements for the taxation of superannuation savings; the means-testing of age pensions and like transfers; and the taxation of the income of persons aged over 65 combine to produce extraordinary complexity and extremely high marginal tax rates on savings.[12]

COMPANY TAXES: A VERY HIGH BURDEN

The international competitiveness of the corporate tax system is increasingly becoming an important factor in the ability of countries to attract foreign investment. The BCA report, *Corporate Taxation: An International Comparison*, noted a number of studies that show that cross-border investment is highly sensitive to the corporate tax burden of a country.

The reduction in Australia's statutory corporate tax rate to 30 per cent means that Australia has a tax rate broadly comparable with many of its traditional competitors. However the rate remains significantly higher than several of Australia's regional competitors, including those of rapidly growing trade and investment importance.

The Government's tax benchmarking study is focused on Australia's rates of taxation compared to OECD nations. But do these benchmarking parameters reflect the reality of Australia's trading and export environment?

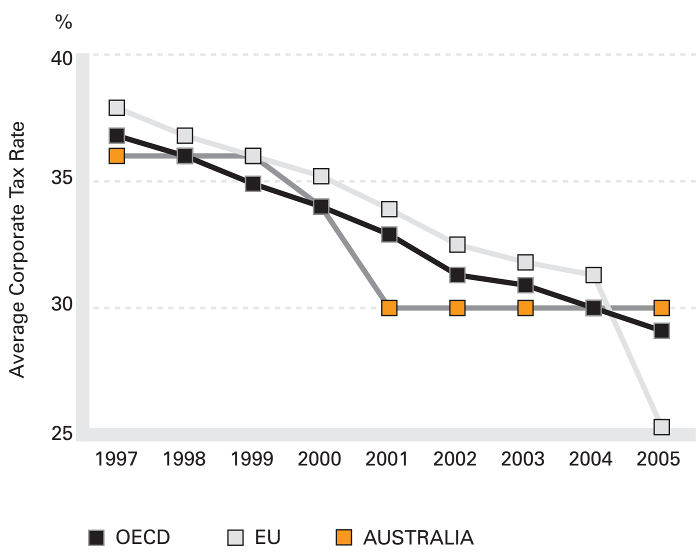
Of the four nations with which Australia already has free-trade agreements (FTAs), only two – New Zealand and the United States – are OECD members. Singapore and Thailand are not.

Australia is currently negotiating or considering five FTAs: with ASEAN, China, Malaysia, the United Arab Emirates and Japan. Of these, only Japan is an OECD member. None of ASEAN's ten member economies (which includes Singapore and Thailand, with which Australia has already completed individual FTAs) are OECD members.

Of Australia's top twenty export markets in 2004, 13 were not OECD countries. These non-OECD countries (including China, India and Singapore) accounted for over one-third of Australia's exports (35.5 per cent).

In addition, although the lowering of Australia's corporate rate put Australia below the OECD and European Union (EU) average rates in 2001, these countries have continued to reform. Both economic groupings have progressively lowered their average rates since that time, passing Australia again in 2004, as Figure 3 illustrates. The BCA report, *Corporate Taxation: An International Comparison* (October 2005) noted that in the preceding 12 months, more than one-third of OECD member states and more than one-third of the EU member states reduced their statutory corporate tax rates.

FIGURE 3
OECD, EU AND AUSTRALIAN HEADLINE CORPORATE TAX RATES



Source: KPMG Corporate Tax Survey 2004.

Statutory tax rates typically receive the greatest attention when comparing the competitiveness of different tax systems because they are easily identifiable and provide a relatively simple comparison. It is true that a low statutory corporate tax rate sends a clear signal to global business, perhaps the simplest example being the decision by Ireland to lower its statutory corporate tax rate to 12.5 per cent several years ago. However, global investment decisions are generally not made solely on the basis of the statutory rate without an assessment of the actual burden of taxation and the complexity of respective taxation systems.

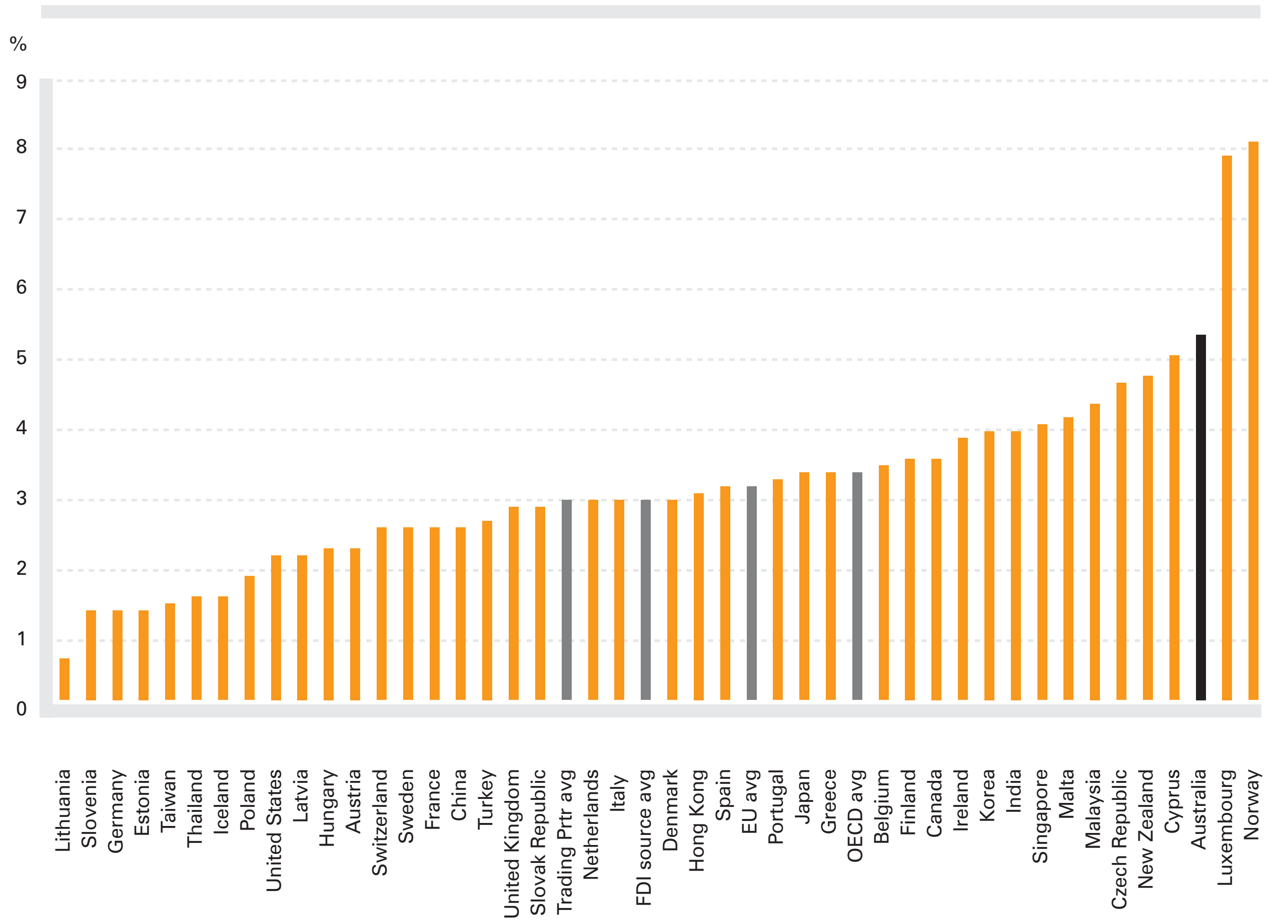
With this in mind, the BCA is particularly concerned at the level of Australia's corporate tax burden, as it can impose significant deadweight costs on the economy. The BCA defines the corporate tax burden as a combination of the statutory or 'headline' rate and the treatment of business income. The total tax burden on companies reflects the total tax take extracted from company income and is therefore considered a more important indictor of Australia's competitiveness.

The BCA's *Corporate Taxation: An International Comparison* report showed that Australia's corporate tax burden is one of the highest among all key competitors (see Figure 4). This is largely due to the fact that the Australian company tax base is one of the broadest in the world.

The reasons for this include the following:

+ Australia does not allow write-offs for the acquisition of goodwill or many other intangibles, unlike key competitor countries such as the US and UK.
+ Australia, unlike many of its competitors, no longer allows accelerated depreciation.
+ A number of other competitor countries offer tax loss carry-back provisions.
+ Full capital gains tax is levied on companies without discounts or inflation relief.
+ There are relatively few tax concessions, and complex specific and general anti-avoidance provisions apply to a wide range of activities including foreign source income, infrastructure investment and capital management transactions.

FIGURE 4
COMPARISON OF CORPORATE TAX TO GDP RATIOS – SELECTED COUNTRIES



Source: KPMG, November 2005; *OECD Revenue Statistics 1965–2004* (2005); 'Structures of the taxation systems in the European Union', European Communities (2004); budget and economic data for China, Hong Kong, India, Malaysia and Singapore (2005).

Australia has a very high tax take from business income (tax to GDP ratio) and one that has grown faster than expected. This adversely affects Australia's ability to attract the investment funds that are vital for improved productivity growth and long-term prosperity.

Given the importance of investment to productivity and economic growth, particularly in areas such as long-term infrastructure or high-risk projects, measures that both improve the competitiveness of the business taxation system and remove barriers and distortions to investment should be considered. Australia's heavy corporate tax burden could be reduced in two ways, namely by:

+ Changing the way in which business income is treated in Australia so that it is more comparable with our key competitors.
+ Reducing the statutory company tax rate to well below the statutory average of our competitors in order to achieve at least an average company taxation burden comparable with our competitors.

In addition, compared with many foreign competitors, Australia's tax system is not sufficiently favourable to higher-risk business investment. More favourable treatment of capital expenditures would reduce this bias. A wide range of uncertainties, complexities and anomalies in the business tax base combine with a relatively unfavourable treatment of tangible investment to continue to reduce Australia's competitiveness.

A number of Australia's competitors are actively pursuing ways to make their corporate tax regimes more attractive.

" ... other countries are not standing still. The German government has proposed a cut in the federal corporate income tax rate from 25 to 19 percent. The U.S. will be cutting corporate income tax rates by 3 percentage points by 2010, and an expert panel will soon be reporting on recommendations for fundamental changes to the U.S. tax system that could bring lower U.S. taxes on investment. As several other countries have reform proposals in mind that will lead to substantial changes to their corporate tax systems, effective tax rates around the world could be sharply lower by 2010."

J Mintz, D Chen, Y Guillemette & F Poschmann, *The 2005 Tax Competitiveness Report: Unleashing the Canadian Tiger*, C.D. Howe Institute Commentary No. 216, Toronto, September 2005, p. 9.

2.2 Adequacy

INTERNATIONAL TAX ARRANGEMENTS

There is currently a tax bias against investing offshore via Australian multinational companies with offshore investments. Individuals and superannuation funds can face higher effective tax rates on their dividend income if they invest offshore through Australian multinational companies than if they invest offshore directly. This is particularly so for investors in private companies who face the problem of double taxation of foreign earnings much more acutely than public investors. This is because investors in private companies are more likely to need to pay out the earnings as dividends (and therefore be taxed at high marginal rates of tax on already taxed foreign earnings) to meet private expenditures compared to public investors who may have the luxury of reinvesting earnings for some time.

There is also a tax bias in favour of investment through Australian superannuation funds. Individuals who invest in Australian or foreign companies directly face higher effective tax rates than if they invest in those companies through a superannuation fund. This bias is intended to reduce the disincentive to save and invest for retirement. In so doing, however, it also unintentionally distorts the pattern of investment and the choice of entity through which to make that investment.[14]

The major role of taxation is to ensure there is adequate revenue to meet the spending needs of government. Given the consistently strong state of the economy, issues of adequacy have not been a problem in recent years. Instead, there is a pattern of larger-than-expected surpluses and small adjustments to return what is 'left over' each year. However, it is clear that adequacy requirements will present challenges in the future.

The extent to which the tax system undermines competitiveness and economic performance will adversely impact its ongoing adequacy. This underscores the BCA's focus on sustaining strong growth and competitiveness. In addition, adequacy cannot be seen from only one side of the fiscal ledger. Australia needs a more vigorous debate on spending priorities and strategies for the future. Business and individual taxpayers cannot and will not passively accept projections of ever-expanding spending needs and therefore, tax burdens.

2.3 Simplicity and Transparency

Australia's tax system is overly complex and lacks certainty and transparency. There are numerous examples that could be cited in this regard, but perhaps the most telling is the high proportion of individual taxpayers (around 80 per cent) who seek professional assistance in completing tax returns.

The consequence of such complexity is twofold. First, it creates a significant cost burden on administering and complying with the system. Second, it reduces the level of accountability and public engagement in tax reform. Therefore, it is very difficult for the public to participate in any meaningful debate about the system. Given the importance of these issues, much more ambitious goals for tax simplification need to be set, based particularly on the policy reforms necessary to reduce tax workload.

OECD figures (in US dollars for 2002) show that Australia spends $1.19 on tax administration per 100 dollars of tax collected. There are higher-cost countries, but in Sweden the figure is 42 cents, the US 53 cents and Ireland 95 cents. Other surveys suggest the total deadweight costs of taxation in Australia could be greater than $46 billion.[15]

Reforms to tax administration should be based on a published, strategic assessment of the role of the tax system; its interrelationships with other fiscal programs; goals for simplification (particularly generated by creative policy review); and opportunities generated by new technologies.[16]

A number of countries have developed comprehensive, genuine and ongoing plans for tax policy development that contribute greatly to the transparency and certainty of their taxation reform processes.

New Zealand's Generic Tax Policy Process (GTPP), for example, seeks to clearly define the roles and accountabilities at each stage of the tax policy development process at both ministerial and departmental levels.

The GTPP has five distinct phases, beginning with the development of a clearly defined economic strategy, fiscal strategy and a three-year revenue strategy. This is followed by the development of a publicly available three-year work program and annual resource plan, a detailed policy design phase, and a legislative drafting phase. Finally, the process has an implementation and review phase, which covers the implementation of legislation, the post-implementation review of legislation, and the identification of remedial issues.

A key feature of the Generic Tax Policy Process is the emphasis it places on consultation at each of the main stages of the process, with taxpayers, their advisers, and professional and industry bodies, to increase transparency and improve the quality of advice at both the conceptual and detailed design stages. The GTPP system, which was introduced in 1995, has been widely praised internationally.

Although Australia has made important steps forward with the development of a consultative body like the Board of Taxation, the BCA remains concerned that Australia does not have a process to deliver ongoing strategic reform.

2.4 Engagement

Many features of the tax system in Australia discourage engagement in the paid workforce and payment of taxation. In addition to several issues discussed above, including the complexity of the system and the high tax burden applying to companies, the following are also areas of concern.

HIGH EFFECTIVE MARGINAL TAX RATES

High effective marginal tax rates (EMTRs) for many Australians receiving family allowances and other transfers continue to present significant disincentives to workforce participation. The elimination of barriers to workforce participation will be particularly important for sustaining economic growth in the future as the demographics associated with population ageing increasingly restrict labour supply growth.

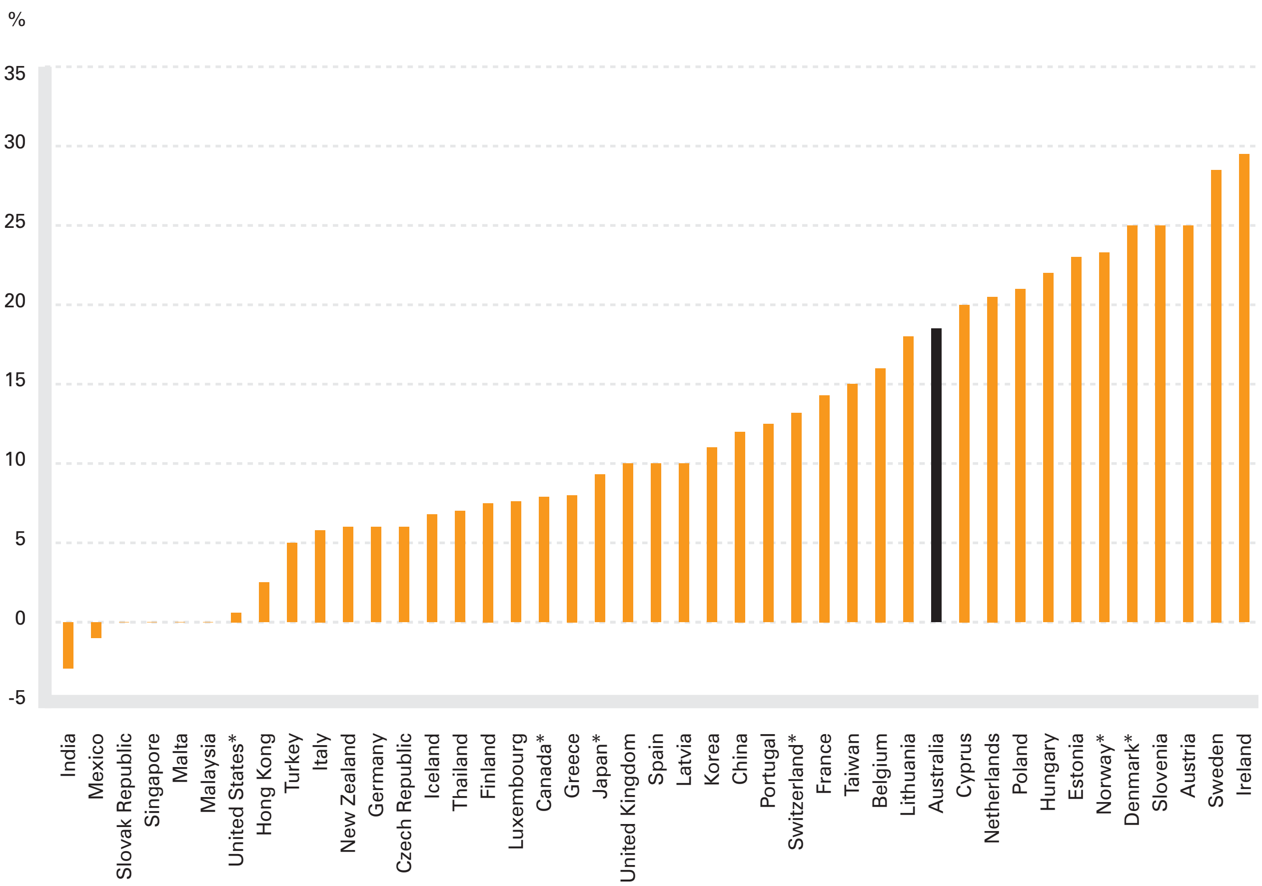
The BCA *Taxation Action Plan for Future Prosperity* highlighted a number of groups that are subject to very high effective marginal tax rates due to the interaction of the progressive scales of personal tax and means-tested benefit schemes. These groups included those aged over 65 years for much of the income range beyond the pension-free area, families over the income range where family payments are reduced by means tests – this can particularly affect work incentives for second earners in a family, most often women – and for individuals with income ranges subject to the withdrawal of the low-income tax offset.[17]

THE PERSONAL INCOME AND COMPANY TAX RATE WEDGE

The gap between Australia's top personal and company tax rates is very large. With a top rate of 48.5 per cent (including the Medicare levy) and a corporate rate of 30 per cent, Australia's 18.5 per cent gap is larger than in many countries. Out of 43 countries listed in Figure 5, more than half have gaps of ten points or less.

The large gap between personal and corporate taxes in Australia increases the incentive for high-income individuals to devote time and resources to excessive tax planning to reduce their tax liabilities. Conversely, the smaller the gap between personal and corporate rates, the lower the marginal benefit to be gained and therefore the lower the incentive to engage in tax minimisation. Recent trends towards incorporation and the growth of contracting rather than traditional employee relationships for tax planning advantages supports this view, as does recent Australian experience with mass-marketed tax effective investment schemes in agribusiness-type ventures and employee benefit schemes. Other tax planning strategies that have grown sharply in recent years include the use of service trusts by some professionals as a way of facilitating income splitting; and the exponential growth in negatively geared rental properties, both of which are now listed as major concerns by the Australian Taxation Office.

FIGURE 5
PERCENTAGE GAP BETWEEN CORPORATE TAX RATE AND
TOP PERSONAL MARGINAL TAX RATE – SELECTED COUNTRIES



Source: KPMG (2006).
* inclusive of sub-national income taxes.

2.5 Efficiency and Effectiveness

The goal of economic efficiency for the tax system relates directly to the competitiveness of the economy and the extent to which tax structures enhance or impede competitiveness. The higher the rate of tax, the greater the distortion to the allocation of resources. Worse still, the costs to allocative efficiency actually rise disproportionately with the rate of tax. This generally favours uniform rates of taxation and a broad tax base (greater neutrality in the system). Achieving greater neutrality in the system has been a central focus of past tax reforms in Australia with the basic approach of reducing and flattening tax rates but preserving revenues by broadening the tax base.

THE GOODS AND SERVICES TAX (GST)

The GST represented a major improvement in the Australian tax system, but it is capable of making a better contribution to national tax performance. The GST design, including thresholds, could be altered to significantly reduce compliance costs without major revenue losses, and improvements in the tax base could make a worthwhile contribution to broader reform.

In the long run, the GST rate and arrangements for GST revenue distribution as the basis for general purpose funding of the States and Territories should be treated like any other policy variable: i.e. open to review and restructuring if better alternatives emerge.

STATE TAXES

The BCA and the Business Coalition for Tax Reform (BCTR) have long campaigned for the removal of remaining inefficient State taxes. It is critical that the remaining State taxes listed as part of the Intergovernmental Agreement be abolished or substantially reduced.[18]

PART 3

Where to Now?

The development of a comprehensive reform agenda to lock in prosperity for the long term has been at the forefront of public policy for more than a year. Some progress has now been made in many of these areas including in workplace relations, regulation, infrastructure, and education and training policy. Because of its fundamental importance to future prosperity, it is now time to add taxation to this list. The Government's tax benchmarking study is an opportunity to commence the process of structural tax reform and ongoing review of the tax system.

The groundwork needs to be laid for more comprehensive change. Certainly, people like tax cuts. But with education and a proper debate, the public is more likely to support, or at least accept, policies that ensure the long-term sustainability of Australia's revenue raising capacity and which, in turn, reduce the likelihood that there will need to be significantly higher taxes in the future.

Tax reform can only occur after a fully informed debate, and the BCA believes the Federal Government's tax benchmarking study will contribute to the discussion. However, an international comparison, while important and much needed, will not of itself constitute reform.

Tax reform must have clearly articulated goals and a clearly articulated path for their attainment. Actions must be prioritised, and agreed upon. The benefits and drawbacks must be fully explained, not politicised for short-term gain.

Reform, by definition, is about improvement. Piecemeal changes and tinkering with the taxation system are not enough to ensure the five principles of competitiveness, adequacy, simplicity, engagement or efficiency. Piecemeal changes and tinkering do not equal reform.

Only a strategic, structured, transparent and comprehensive plan, properly implemented, will achieve the growth needed for Australia's future prosperity.

With this in mind, BCA calls on the Australian Government to:

+ Release the report of its tax benchmarking study as soon as it is complete;
+ Initiate a series of public consultations around the key findings and implications for Australia's tax system;
+ Develop a set of tax reform priorities and commit to their implementation; and
+ Commit to a process of continuous improvement of the tax system, based on comprehensive and transparent reviews of the system to be undertaken at least every two years.

Only a strategic, structured, transparent and comprehensive plan, properly implemented, will achieve the growth needed for Australia's future prosperity.

Notes

1 Productivity Commission 2005, *Economic Implications of an Ageing Australia*, Canberra.

2 Commonwealth of Australia 2004, *Australia's Demographic Challenges*, Canberra.

3 V Speizia, 2002, 'Geographic Concentration of Production and Unemployment in OECD Countries', Mimeograph.

4 Figures calculated from data obtained from www.citypopulation.de.

5 The fragmentation of the domestic economy into regional markets also amplifies the disadvantages faced by Australian firms operating in a small economy. Dispersed regional markets further reduce the size of home markets, making it difficult for firms to achieve scale economies.

6 See I Evans & P Hughes, 2003, *Competition Policy in Small Distant Open Economies: Some Lessons from the Economics Literature*, New Zealand Treasury Working Paper 03/31; R Ewing & B Battersby, 'Geographic Remoteness: Does the Growth of Asia Improve Australia's Position?', paper presented to the Conference of Economists, September 2003.

7 D T Coe, A Subramanian & N T Tamirisa, 2002, '*The Missing Globalisation Puzzle*', IMF Working Paper WP/02/171; J McCallum, 1995, 'National Borders Matter: Canada-US Regional Trade Partners', *American Economic Review*, Vol. 85, pp. 615–23.

8 B Blum & E Leamer, 2002, 'Can FTAA Suspend the Laws of Gravity and Give the Americas Higher Growth and Better Income Distributions?', Mimeograph, UCLA/University of Toronto.

9 G Hugo, D Rudd & K Harris, 'Australia's Diaspora: Its Size, Nature and Policy Implications', CEDA Information Paper No. 80, Melbourne, December 2003.

10 G Hugo, D Rudd & K Harris, 'Australia's Diaspora: Its Size, Nature and Policy Implications', CEDA Information Paper No. 80, Melbourne, December 2003.

11 For a further discussion see Chapter 8 of the BCA's *Taxation Action Plan*.

12 For a further discussion see Chapter 8 of the BCA's *Taxation Action Plan*.

13 See R Gropp & K Kostial, 2001, 'FDI and Corporate Tax Revenue: Tax Harmonization or Competition?', *Finance & Development*, Vol. 38, No. 2, available at www.imf.org/external/pubs/ft/fandd/2001/06/gropp.htm; M Devereux & R Griffith, 1998, 'Taxes and the Location of Production, Evidence From a Panel of US Multinationals', *Journal of Public Economics*, Vol. 68, pp. 335–67; Buettner and Ruff, 'Tax Incentives and the Location of FDI: Evidence from a Panel of German Multinationals', available at www.bundesbank.de.

14 Additional information on the corporate taxation burden can be found in the BCA's report *Corporate Taxation: An International Comparison*, while additional information on issues in the corporate taxation system generally can be found in the BCA's *Taxation Action Plan*, Chapter 9.

15 A Robson, 2005, *The Costs of Taxation*, Policy Monograph 68, Centre for Independent Studies, Sydney, p. 7.

16 For additional information on issues in taxation administration and compliance, see the BCA's *Taxation Action Plan*, Chapter 12.

17 For additional information see Chapter 8 of the BCA's *Taxation Action Plan*.

18 For additional information on issues in the indirect tax system, see the BCA's *Taxation Action Plan*, Chapter 11.

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

© Copyright March 2006 Business Council of Australia ABN 75 008 483 216

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

Business
Council of
Australia