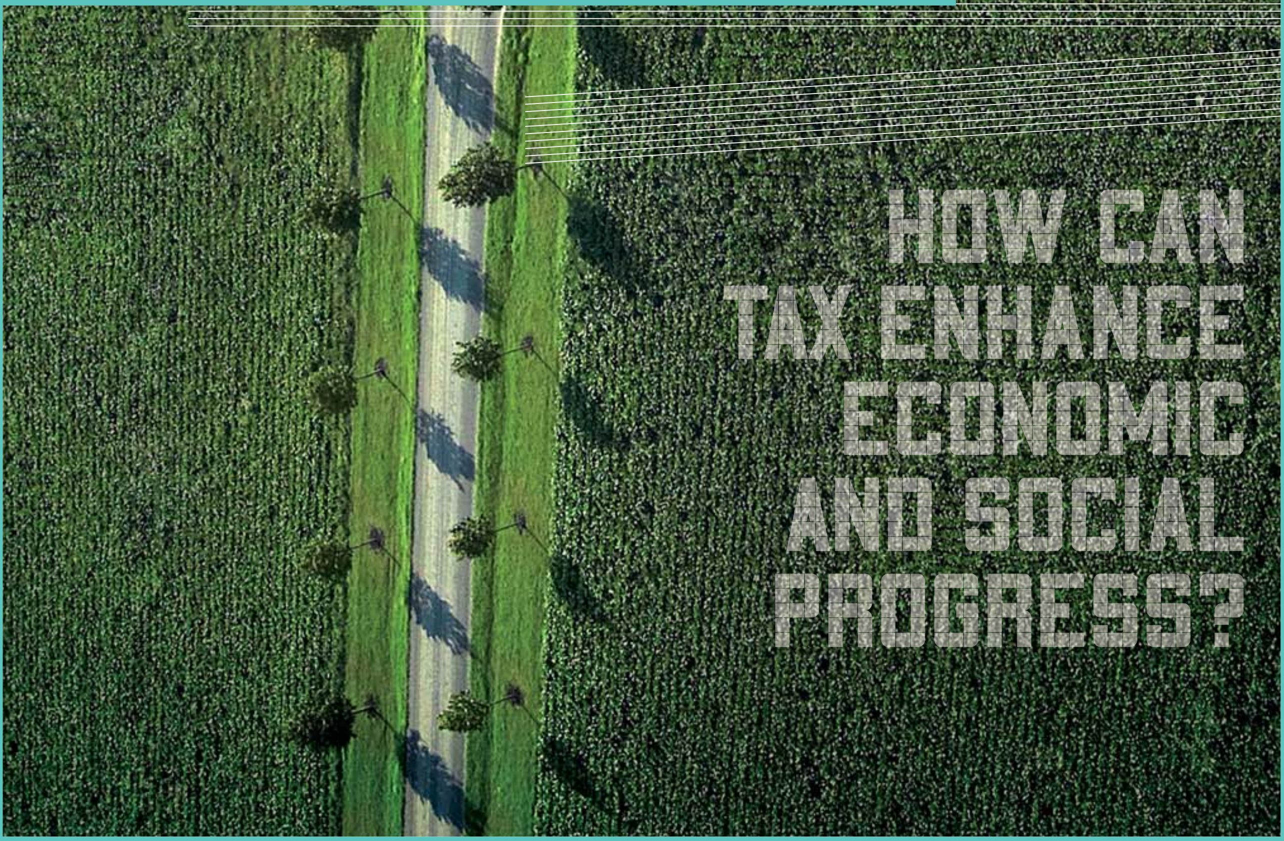
A BETTER TAX RETURN

RECONSIDERING THE ROLE OF AUSTRALIA'S TAX SYSTEM

THE BUSINESS COUNCIL OF AUSTRALIA



HOW CAN TAX ENHANCE ECONOMIC AND SOCIAL PROGRESS?

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INTRODUCTION
LOOKING TO THE FUTURE

Australia has been a standout economic performer for well over a decade, but it is facing new challenges. Few countries so clearly demonstrate the characteristics of a supply-constrained economy. By failing to invest substantively in a new reform agenda and in the critical inputs of economic growth – labour, infrastructure and skills – there is a risk that the strong growth of recent years will become the very thing that holds the nation back in the decades ahead.

Compounding domestic supply side constraints, deeper global integration and technological advances are heightening the immediacy and impacts of global competition.

While the rapidly growing economies of China and India are underpinning demand for resources and rising incomes, Australia's strengthening currency is raising the bar for other sectors as they seek to compete.

Population ageing and responding to the risks associated with climate change add further challenges and complexity to the policy environment in Australia.

The simple fact is that we have over-consumed the benefits of past reform and underinvested in the foundations of future growth and prosperity. Now is the time to change tack.

We must seize every opportunity to respond effectively to these risks and position Australia to deliver sustained economic growth and strong social and environmental outcomes into the future. Reform of Australia's tax system has a critical role to play in achieving these ambitions.

BUSINESS COUNCIL OF AUSTRALIA BUSINESS REFORM TASK FORCE

Mr Robert Milliner (Chairman)	Mallesons Stephen Jaques
Mr Michael Andrew	KPMG
Mr Mark Chellew	Adelaide Brighton Ltd
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Mr Stephen Roberts	Citi Australia and New Zealand

RATHER THAN SEEING TAX SIMPLY AS A NECESSARY BURDEN, WE MUST SEE IT AS AN ENABLER OF GROWTH AND PROSPERITY.

ACHIEVING THE 2020 AMBITION

A PROSPEROUS AUSTRALIA REQUIRES AN AMBITIOUS VISION.

The economy stream of the Australia 2020 Summit agreed that Australia should be the world's top place in which to live and do business. It also agreed on the need to set national economic goals in areas in which all Australians share, including full employment, low inflation, and a GDP per capita ranking in the top five countries in the world.[1]

The Business Council of Australia (BCA) strongly supports this ambition. Achieving it requires the implementation of wide-ranging reforms that are not just comprehensive, but coordinated and prioritised (see Exhibit 1).

Each area of policy – infrastructure, education, regulation, competition, trade, innovation and others – needs to pull its own weight but also complement and reinforce the direction and impact of other reforms.

This is where tax reform must play its part.

The tax system is one of the foundations on which a strong economy is built.

The level and structure of taxes imposed fundamentally impact the decisions – such as investment, saving and workforce participation – that shape our economic, social and environmental future. The revenues raised by the system can be used to strategically invest in future prosperity.

Getting the balance right, in terms of the amount of tax collected and the types of taxes imposed, is a key challenge for governments. All taxes change incentives and impose costs. If the tax system is to support the goals outlined above, we must be confident that unnecessary taxes and costs are minimised, and that the incentives or disincentives created by taxation enable the actions and outcomes needed to achieve our ambitions.

We must change our mindset about tax. Rather than viewing tax as a regulatory burden, or simply as a means of revenue, we should consider the role tax can play in underpinning our national reform agenda in the critical areas that will deliver a more prosperous future. Rather than seeing tax simply as a necessary burden, we must see it as an enabler of growth and prosperity. 'Tax and spend' needs to become 'tax and invest'.

EXHIBIT 1

STRATEGIC PRIORITIES FOR ECONOMIC AND SOCIAL PROSPERITY

The BCA has identified a number of necessary reforms to increase productivity, competitiveness, and participation, and therefore national prosperity. Changes to the taxation system should complement these broader reforms.

Boosting economic prosperity requires a long-term, strategic approach to developing a competitive and dynamic business sector that ensures resources are directed to their best use and used as efficiently as possible, and that entrepreneurship and risk taking are supported. Priority reforms include:

Infrastructure, including the establishment of genuine national markets, competition, and market-based pricing, with greater accountability.

Regulation, and in particular, the creation of a seamless economy for business regulation by 2010, and better regulation-making processes.

Workplace flexibility characterised by a wide range of enterprise-based options for agreeing employment terms and conditions.

Innovation, involving the implementation of a national innovation framework encouraging greater linkages and collaboration between business, research institutions and universities.

Workforce participation, including improved employability skills, more flexible job design, and improved childcare options.

Education, involving increased investment, greater focus on improving outcomes and performance across all sectors, and encouraging greater diversity and specialisation among universities.

Trade, involving strengthening the focus on and performance of services sector trade and investment to better capture new and emerging global opportunities.

To lift Australia's levels of social prosperity, including by addressing core issues relating to the sustained marginalisation of certain groups, reforms are needed in:

Education, through greater focus on the quality and consistency of educational outcomes, and increased attention at the primary/early intervention level.

Welfare and support programs, by ensuring adequate and appropriate support is given to those with genuine need (whether transitory or entrenched).

Health, by reforming the health sector to better target prevention, improving service delivery and encouraging greater personal accountability for health.

Boosting our national prosperity also means positioning Australia to deal appropriately with growing environmental risks and issues, particularly in regard to water and climate change including through the development and implementation of an emissions trading scheme.

Source: *Anticipating Success: BCA Submission to the Australia 2020 Summit*. The BCA has also produced detailed plans of action in many of these areas; see www.bca.com.au.

LEARNING FROM THE PAST

BECAUSE TAXES IMPACT EVERY ASPECT OF THE ECONOMY, TAX REFORM, ESPECIALLY COMPREHENSIVE REFORM, IS HARD WORK.

The costs of change, be they financial, administrative, or compliance costs, are felt almost immediately and present a significant challenge. This is compounded by the fact that the costs are often individualised, with intense scrutiny of who stands to 'lose' or miss out, or who may 'benefit' less than others. In contrast, the benefits of tax reform can be diffuse, longer in coming, and more difficult to articulate.

If past reform efforts tell us anything, it is that the costs of tax reform dominate public and political debate, turning it into a discussion about who will lose in the immediate term. This is usually to the detriment of good policy outcomes.

Without broader goals that can be articulated and understood by all, the tax system is too readily subject to the constraints of the electoral cycle, vested interests, and the needs of the next budget.

The difficult nature of tax reform means that governments are often prepared to examine the issues and develop recommendations, but far more reluctant to implement change. While there have undoubtedly been some notable achievements in tax reform, the gains that could have been made are often stymied by the limited scope afforded to reforms in practice and the piecemeal way in which those reforms are implemented.

EXHIBIT 2
A BRIEF HISTORY OF RECENT TAX REFORM IN AUSTRALIA

Over the past forty years Australia has seen a series of major tax system reviews with a mixed record of success.

Tax reform emerged as a major public policy issue in the 1970s largely in response to the rise of inflation and its effects on income tax under a progressive tax system, but also because of concerns about tax evasion and the integrity of the tax base. The consensus was that the tax system was not suited to an inflationary environment or one of growing international competition.

In 1972 the McMahon Government set up the Asprey Taxation Review Committee, the first comprehensive review since 1934. The review was independent, with broad terms of reference that provided a significant degree of scope, but was limited to Commonwealth taxes. The findings (reported in the 1974–75 Commonwealth Budget) recommended a substantial change to the tax mix, particularly greater reliance on indirect taxes on consumption, and proposed a value added tax. It also recommended lowering income taxes but broadening the base through the introduction of a capital gains tax. There was little community support for the recommendations and no significant reforms were implemented.

As inflation continued to climb, the Mathews Inquiry into Taxation and Inflation was announced in late 1974 with more specific terms of reference to examine the effects of inflation on tax paid by individuals and companies.

The inquiry's recommendations in the following year included indexation of income tax brackets and, for companies, the indexation of trading stock values.

The recommendations appeared to enjoy widespread support, but the indexation measures were opposed by Treasury. Implementation was limited, although personal income tax indexation was introduced by the Fraser Government in 1976–77, but full indexation lasted only twelve months before being scaled back and then abandoned altogether.

By 1984 taxpayers on average earnings faced a marginal tax rate of 46 per cent, and the growing concern over the increasing burden along with increasing levels of tax avoidance led to renewed calls for reform. In 1984 the Hawke Government announced it would hold a National Taxation Summit the following year, and in the lead-up Treasury produced a draft white paper that argued for the broadening of Australia's direct and indirect tax bases to improve economic efficiency and reduce tax evasion. The proposals included a 12.5 per cent broad-based consumption tax. The consumption tax failed to get key stakeholder support and was not implemented. But the process did lead to the introduction several key reforms first canvassed as far back as Asprey, including a capital gains tax and a dividend imputation scheme. It also resulted in the introduction of a fringe benefits tax.

In 1998, after a year of consultations, the Howard Government released details of its A New Tax System (ANTS) package, which included proposals for a 10 per cent goods and services tax to replace the wholesale sales tax and a raft of smaller state taxes, increases in personal tax thresholds and a lowering of rates, a broadening of the fringe benefits tax base, and changes to tax administration.

However, a number of compromises, most notably to the scope of the GST through the exclusion of food, were necessary to secure passage of the changes through parliament.

Alongside the ANTS package, the Howard Government announced a Review of Business Taxation to examine taxation in relation to business entities and business investments. The terms of reference required reforms to be revenue neutral. Its findings advocated a reduction in the company tax rate to 30 per cent, changes to capital gains tax, removing deductions for accelerated depreciation and further broadening of the business tax base, and a consolidations regime for company reporting.

Some further recommendations, including the introduction of a ‘Tax Value Method’ (TVM) system of determining assessable business income, were not implemented following lengthy community consultation.

In response to the Review of Business Taxation recommendation that there be an examination of Australia’s international tax regime, in early 2006 the Howard Government commissioned its Review of International Taxes. The report, prepared by the Board of Taxation, was restricted to international tax issues and made a number of recommendations, including in relation to the treatment of controlled foreign companies and foreign investment funds. A recommendation to reduce the double taxation of income on offshore corporate earnings through a limited expansion of the imputation regime was rejected.

Source: Information in this exhibit comes from a variety of sources including R. Eccleston, *The Thirty Year Problem: The Politics of Australian Tax Reform*, Research Study 42, Australian Tax Research Foundation, 2004.

BUILDING PROSPERITY THROUGH BETTER TAXATION

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

Business Council of Australia, *Keeping a Permanent Watch on Australia's Tax System*, 2006.

The Australia's Future Tax System review gives us a chance to make far better use of one of the most important tools of economic policy. We need to see this review not in terms of potential short-term costs, but rather in terms of the longer-term benefits and opportunities that will flow from comprehensive reform.

We should see this review as an opportunity to better support growth and prosperity through the development and maintenance of a truly world-class tax system.

An opportunity to better enable workforce participation, skill development, long-term investment, innovation, risk taking, and competitiveness. An opportunity to improve the interaction of welfare benefits and the taxation system. And an opportunity to fundamentally address federal–state tax and fiscal arrangements.

Reform on this scale is not undertaken often. For the first time in decades, we are approaching tax reform not in isolation, but at a time when there is active public support for vital reforms in other areas. This represents a unique opportunity to align the most important economic policy levers towards achieving the goals agreed by the Australia 2020 Summit.

THE STARTING POINT

What is achieved with this review, what we are bold enough to tackle, will have a very significant bearing on whether or not we achieve the aspirations set out by the 2020 Summit. That is, to climb the global league tables and become the best place in the world in which to live and do business.

We know that Australia is likely to reap substantial benefits by reforming the broader structures of the tax framework.

We also know the gains will be proportional to the scope of the review, which means that the review should be as broad as possible. Unfortunately, politics has already curtailed the benefits of potential reform by significantly limiting the terms of reference. In particular, the explicit exclusion of consideration of the GST – either base broadening or changes to the rate – is a fundamental weakness.

It is difficult to see how the Australia's Future Tax System review can fundamentally address core issues such as the balance of taxes on work, investment and consumption, without taking into account the key consumption tax. Political compromises made in order to secure the introduction of the GST have already undermined the efficiency gains of the tax and greatly increased its administrative complexity.

Refusing to examine the GST as part of a comprehensive review is all the more concerning given that demographic trends mean the proportion of income taxpayers in our total population is set to decline.

Likewise, it is difficult to see how the review can seek to simplify and reform taxation across state and federal jurisdictions while failing to consider the scope for possible changes to one of the key channels through which revenues are collected and transferred from the federal government to the states.

The extent of this shortcoming cannot be overstated. As a matter of priority, the government should reconsider the exclusion of the GST from the review.

The review is also likely to be constrained by an implicit assumption or goal of revenue neutrality. This again unnecessarily limits options. Revenues and spending have grown strongly in real and per capita terms. Now is the time to question whether these trends and settings are appropriate. While the 2008–09 Budget made a positive start to reining in spending, a more comprehensive consideration of what and where spending genuinely adds to future prosperity is warranted.

The review should explicitly consider the scope for a sustained reduction in the overall tax burden and how this might be achieved.

HEADLINE PRIORITIES

Consideration must be given to the impacts of tax across the economy and community and how those impacts relate to current and future risks and challenges. A summary of the BCA's key priorities in this context follows.

Economic growth and productivity

Capacity constraints, skill shortages and declining productivity make it clear that the review should focus on how the tax system can better enable economic growth and productivity. Important issues for consideration must include the impact of the tax system on:

- the type, quality, and quantity of investment;
- savings decisions;
- innovation, including through collaboration domestically and overseas;
- risk taking and entrepreneurship; and
- the incentives for individuals to develop and apply skills and knowledge (including as they approach retirement).

Supporting social prosperity

Many of the broader social gains we desire are only possible through sustained economic and employment growth. But broader economic growth, and the current tax and benefits system, are failing to deliver improved outcomes for some in our community. We must do better on this front.

Reforming transfer payments (and broader support programs) is fundamentally important, but we must also take into account how the tax system interacts with those payments, and more specifically, their withdrawal.

Progressive taxation scales coupled with targeted welfare mean that there will always be high effective marginal tax rates at some point in the system. The challenge is to ensure that we minimise their impact when and where they have the most significant influence on decisions related to workforce participation.

Given current high levels of participation and employment and the extent to which personal income tax rates have come down, an important issue for consideration is how we might be more creative in the delivery of benefits. More specifically, are there ways in which we can taper the withdrawal of benefits (or payment of taxes) or stagger these over time to ensure smoother transitions into the workforce – particularly for those that have been out of it for some time, or who face more significant barriers to ongoing participation?

A clearer understanding of the part tax plays in reaching broader goals – both in terms of design and the uses to which revenue is put – should contribute to the development of a system that is simpler and more equitable, rather than one that is too easily politicised for short-term gain.

Enhancing our engagement in the global economy

If we are to meet the challenges of globalisation head-on we must ensure the tax system supports businesses and individuals looking to capture new opportunities in global markets. In other words, our tax system must be competitive.

This is not an argument for always having the lowest tax rates or tax burden. It is an argument for understanding how the tax system impacts Australia's productivity performance and our ability to attract and retain investment, skills, and ideas. It is also about ensuring that we do not create or maintain tax barriers that undermine the capacity of businesses to expand into overseas markets, including through investment.

Simplicity and low cost

The Australian tax system is complex and costly. Tax reforms to date have tended to increase rather than reduce this problem and there is plenty of scope for improvement on this front.

The plethora of taxes imposes excessive administrative costs and creates uncertainty. To highlight this point, the BCA's *Tax Nation* report identified 56 business taxes in Australia: 21 federal taxes, 33 state taxes and 2 local taxes.[2] The report highlighted that the costs of tax compliance continued to be a significant burden in Australia, particularly on the business community. We should aspire to being among the best performers on measures related to cost and simplicity.

Providing fiscal stability

Last, but by no means least, the tax system must provide fiscal stability in a way that gives governments and others certainty to undertake long-term planning and decision making. This implies both achieving a sustainable tax mix and, as argued above, rethinking of the role of government spending in the economy.

REFORM ADVOCACY

Developing a tax system that meets the criteria outlined above is a tall order. Reform on this scale cannot be delivered effectively in the short term. Significant research and consultation is needed and in all likelihood tax changes will need to be phased in over time. It will take even more time for the real benefits to flow.

Against this background, reforms must be prioritised and clearly explained so that the public can understand the reasons for and benefits of change.

The BCA does not underestimate the size of the challenge, or the political realities that such a reform effort faces. That's why a clear ambition and vision about what can be achieved is so important. The BCA will seek to communicate and advocate not only its priorities but also the broad and long-term benefits that can flow from ambitious reforms.

CHARTING OUR COURSE

'Australia needs a tax system that supports the global competitiveness of our economy, provides incentives, minimises distortions, and supports fiscal responsibility.'

Australian Government, *Australia 2020 Summit: Initial Summit Report.*

SUPPORTING ECONOMIC PROSPERITY

Taxation impacts on almost every area of the economy and economic decision-making. Australia's federal, state and local tax systems collect the equivalent of around one-third of annual national income. In various forms we tax incomes, expenditures, capital transactions and some aspects of wealth.

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

BCA *Taxation Action Plan for Future Prosperity,* 2005.

The tax system affects consumption decisions, workforce participation, saving and investment decisions, business structures and business operations. Some taxes are specifically designed to influence outcomes.

Taxes are used to discourage some activities, like gambling and smoking, or to encourage others, like retirement savings.

In other cases, taxes can inadvertently create perverse incentives, like the imposition of multiple taxes on insurance policies that make insurance less affordable, or reductions in fringe benefits tax that encourage people to drive cars more amid rising concerns over greenhouse gas emissions.

Taxes create a gap between the prices paid and the prices received for goods, and between wages earned and wages 'taken home.' They create a gap between profits earned and profits able to be distributed to shareholders or re-invested in business growth.

In many cases, the person (or entity) who technically bears the tax is different to the person who actually ends up paying it, once the full effects of the tax have worked their way through the economy. Who ultimately bears the cost of a tax will depend on the type of tax and the activities it applies to, but there is always a cost.

The size of this distortion or 'wedge,' and where and how it falls, can have very profound impacts on the behaviours and decisions that underpin economic growth.

Taxes therefore have significant bearing on many of the drivers that contribute to improved productivity, participation and population, as described using the so-called '3Ps' framework.

Tax and the 3Ps

Sustaining economic growth at 3 to 4 per cent per annum will be essential if Australia is to move into the top-five band of countries with the world's highest living standards by 2012.

To achieve such a strong growth rate in the face of current supply constraints, we must adjust policy levers towards improving productivity, higher rates of labour force participation, and population growth (including through immigration).

Tax and productivity

Australia's productivity growth has slowed sharply. Multifactor productivity – essentially the additional output from the more efficient use of capital and labour – declined by 0.6 per cent in 2006–07 (see Figure 1).

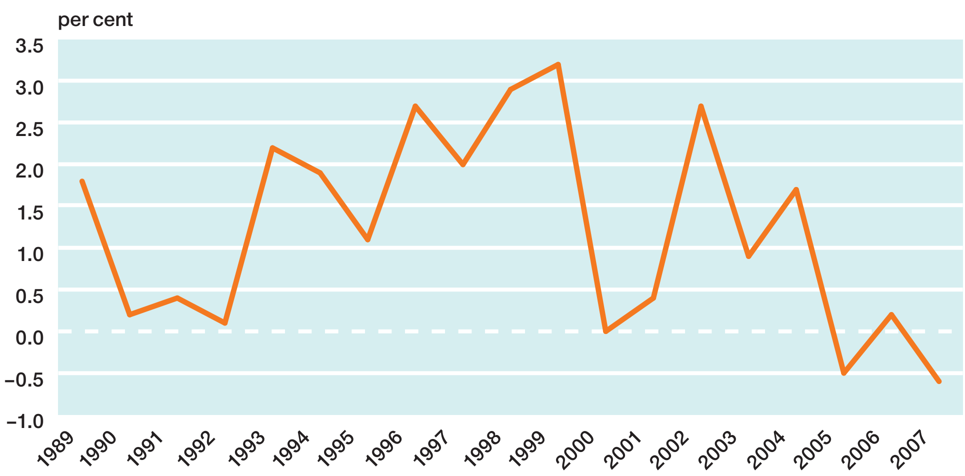
Turning this performance around will be fundamental to lifting competitiveness. If Australia is to sustain real annual economic growth in the range of 3 to 4 per cent, productivity growth will need to consistently sit in the range of 2 to 3 per cent per annum.[3]

Increasing productivity requires lifting investment levels and the availability of capital, improving the quality of investment – including through effective innovation, raising skill levels, maximising the application of skills in production – and enhancing production processes through innovation and adaptation.

A fundamental issue underpinning these drivers of future productivity is the incentive to take measured risks, and it is here that the taxation system comes into play. For example, does the tax system work in favour of, or against, individuals deferring current income to invest in the acquisition of education and skills? Does the system work against or in favour of companies seeking to invest in growing operations in new overseas markets from an Australian base? Does the tax system inhibit or enable collaboration on research and development? Does the tax system work against or in favour of overseas investors investing in Australian companies and markets? These are the kinds of questions we must ask in determining how our tax policy settings can better assist productivity growth.

FIGURE 1: ANNUAL GROWTH IN MULTIFACTOR PRODUCTIVITY

Multifactor productivity – hours worked



Source: ABS Catalogue No. 5204.0, *Australian System of National Accounts 2006–07*, p. 12.

Tax and participation

Australia faces a skills shortage. Participation rates have risen steadily over the past decade, reaching 65.2 per cent in May this year. As workers become harder to obtain, it is important that policy settings aim to maintain and build on this success.

The structure of the tax system, and importantly how it interacts with welfare benefits, has a significant impact on participation decisions. As our population ages, the way the tax system interacts with and impacts on superannuation, and hence retirement decisions, is also increasingly important.

While the 'participation' decision is often thought of in the context of 'to work or not', it also relates to decisions about how many hours to work, whether to take a promotion, or whether to invest in further education or training.

One of the biggest challenges for the forthcoming review will be to better understand and explain the impact of marginal tax rates and their interaction with the benefits system, in terms of how they affect the behaviours and decisions of different individuals and households.

In other words, how responsive are different groups to effective marginal tax rates? Do the different elements – tax rates versus benefit withdrawal – have the same influence on participation decisions and outcomes for different kinds of taxpayers?

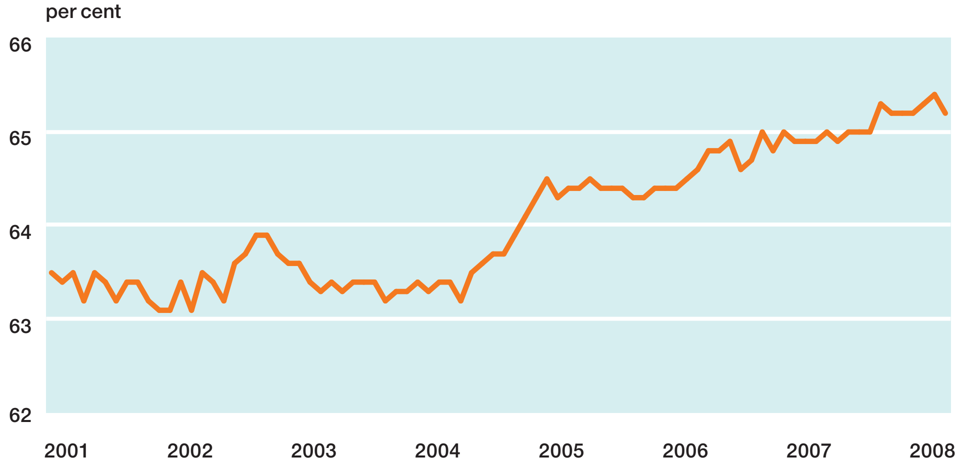
Tax and population

Australia's demographic profile and the skills mix of its workforce underlie its productive capacity. We know that population ageing is set to weigh on our ability to sustain strong economic growth as the proportion of non-workers to workers continues to rise (see Figure 3).

Ensuring that population developments have as positive an impact as possible is therefore important. While tax might, at the margin, impact decisions on whether or when to have children, the bigger driver of Australia's population future is net migration. Australia has benefited from strong net migration in the past and must continue to do so, particularly from skilled migrants.

We must also avoid discouraging Australians who leave to seek international opportunities from returning.

FIGURE 2: AUSTRALIA'S PARTICIPATION RATE



Source: ABS Catalogue No. 6202.0, *Labour Force, Australia*, May 2008. The participation rate measures the labour force (employed and unemployed) as a percentage of all citizens aged 15 and over.

The effect of marginal tax rates on the location decisions of Australia's skilled workforce have been hotly contested, but it is safe to say that global competition for labour will intensify, and Australia must ensure that its tax system does not create an obstacle to both attracting and retaining the best and brightest to our shores.

SUPPORTING SOCIAL PROSPERITY

'A more efficient, growing economy is likely to improve the chances of achieving a more equitable society.'

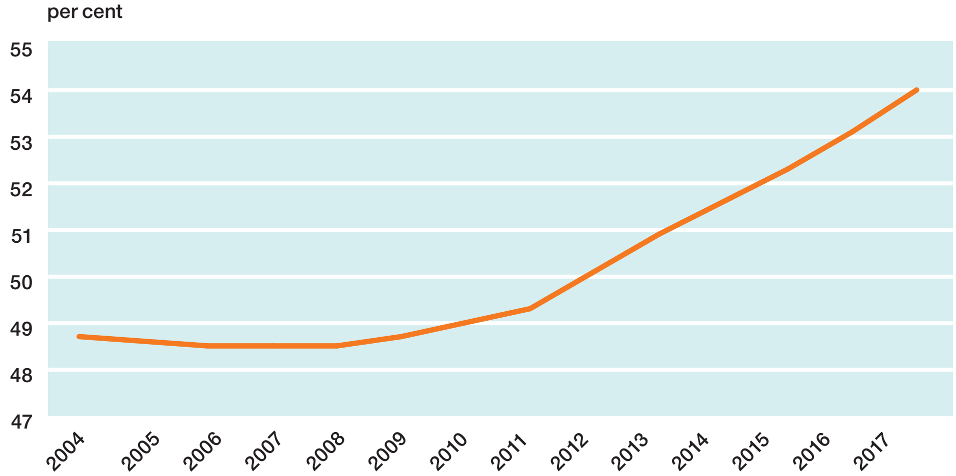
Australian Government, Commonwealth Budget 2008–09, Budget Paper No. 1.

Supporting social prosperity is critical to a nation that wants to count itself as among the best in the world. As Australia's economic prosperity has increased, it is important that we find meaningful and sustainable ways to improve the opportunities and circumstances of people experiencing entrenched disadvantage.

The tax system is integral to addressing some of these issues, particularly as it impacts on the participation and education decisions highlighted above. But the tax system by itself cannot be seen as the solution to all social ills. Introducing tax incentives without the requisite improvements to the education and welfare systems more broadly – or the federal–state reforms that are needed to facilitate them – will have a limited effect. Both business and government must begin to seek more creative solutions in this regard.

FIGURE 3: THE DEPENDENCY RATIO

Population aged 0–14 and 65+ as a percentage of population of working age (15–64)



Source: ABS Catalogue No. 3222.0, *Population Projections, Australia, 2004 to 2101*.

Equity

Equity in the tax system is critically important. However, as a relative concept, it means different things to different taxpayers and can be difficult to define. It is also emotive, which means objective debate can be easily distorted, particularly in the political context.

A culture of taxing for opinion polls is not only short-sighted, it increases complexity and creates division in the community. Rather than fostering an understanding of the benefits that economic growth can bring to society as a whole, it distracts the genuine reform debate with trite arguments about who is paying the 'fairest' share, and encourages Australians to believe that tax is a zero-sum game: if somebody else gains, they must lose as a result.

All too often, this rhetoric is used to disguise the fact that the reforms being offered are not really reforms at all, but a series of short-term measures whose benefits will be eroded within a few years – such as adjustments to tax bracket thresholds that do little more than return bracket creep.

An equitable tax system should encompass genuine incentives to participate, minimising disincentives created by effective marginal tax rates for people returning to the workforce and ensuring those already there have an incentive to stay longer. It should also remove the potential disincentive effects of tax rates at higher income levels, and attempt to alleviate their role in discouraging people to increase their productivity or upgrade their skills.

An assessment of the level of equity in the tax system is not possible without an analysis of the taxes being returned through the welfare system. Approximately half of Australia's welfare spending is returned to the people who paid the tax to fund it in the first place.[4]

Given the size of the welfare system, this generates extraordinary additional costs to the economy for no net benefit to taxpayers. Removing churn from the personal tax system should be a priority. It is better government spending, not more, that supports improved social prosperity.

An analysis of the interactions between tax and welfare should also consider the complexities caused by a welfare system that is calculated on a family basis and a tax system that operates on an individual level.

If comprehensive tax reform is to be accepted by all, there needs to be a clear explanation of the changes and their intention. Careful consideration should also be given to appropriate sequencing of changes and transitional arrangements.

Enhancing our place in the global economy

Globalisation presents additional challenges for tax systems. The ease and speed with which businesses, people, ideas and capital can move around the globe make revenue authorities understandably nervous. Concerns relate to the potential for tax evasion, and fears that downward competition on rates will erode revenue raising options.[5] At the same time, running continually higher tax rates runs the risk of turning investment and skills away, or worse, driving the investment and skills we currently have elsewhere.

We cannot change the reality of globalisation. Indeed, if the growth in our engagement since the last two tax reform processes is any guide, these international pressures will only increase (see Table 1). This means we have to seek a new approach in order to deal with them.

TABLE 1: AUSTRALIA'S CHANGING INTERNATIONAL CIRCUMSTANCES

	1985 Review of the Australian Tax System	1998 A New Tax System/Review of Business Taxation	2007
Level of Australian investment abroad (original)	$33b	$290b	$884b
Level of foreign investment in Australia (original)	$112b	$587b	$1,621b
Exports to GDP ratio	16.3%	20.3%	20.8%
Imports to GDP ratio	16.8%	20.3%	21.6%

Source: ABS Catalogue No. 5302.0, *Balance of Payments and International Investment Position*, Australia, December 2007.

AUSTRALIA NEEDS TO EMBRACE THE TAXATION IMPLICATIONS OF GLOBALISATION.

The increasing internationalisation of Australian business means increasing amounts of business income will not be earned within Australia and many 'Australian' activities will not be taxable here. In taxation, as in other policy areas, globalisation is a two-way street (see Exhibit 3).

This means that our international focus must be similar to our domestic focus: encouraging economic growth and activity that expands our domestic tax base. This includes bringing greater foreign investment into Australia, and creating an environment that encourages internationally successful Australian companies to bring their profits, as well as the other benefits of global engagement, back home.

Australia does not need the lowest tax rates in order to be internationally competitive. It needs to have the right taxes and rates, relative to the other factors that make it attractive as an investment destination.

In other words, we need to focus on our competitive advantages of the whole package, not a comparative advantage on rates alone.

This does not mean Australia can afford high rates. We all know Australia's inherent disadvantages as an investment location: a relatively small economy, a geographically dispersed population, situated a considerable distance from world markets. International research tells us that low tax rates – particularly corporate and personal income tax rates – are clearly important to making up for some of these concerns.[6] In and of themselves, however, they will not be enough to sustain the levels of growth Australia is looking for.

We cannot ignore the need to have well-positioned rates, but with proper planning and investment in the appropriate infrastructure to attract investment we should not have to compare ourselves to countries who have little else to offer. The dilemma for Australia is that, because we have neglected reforms in a number of these key areas, we have made ourselves more reliant on cutting tax rates in order to compete.

Long-term competitive growth needs to be supported with a skilled workforce, effective infrastructure, efficient government, strong research institutions and high levels of innovation – in fact, the very things the BCA has been advocating as part of its strategic priorities.[7]

Government has an inescapable role in creating this environment by setting the right rules and incentives and overseeing the appropriate level of public investment needed. In the modern environment, it is no longer enough for governments to simply avoid being a barrier to growth – they must actively seek ways to encourage the upgrading of competitiveness.[8]

The tax system can contribute to improvements in the competitiveness of Australia's business environment, by increasing the attractiveness of Australia as a location for investment and decreasing the cost of capital for business investment in Australia. It can also increase the level and efficiency of investment within Australia, whether in housing, physical business assets, infrastructure, human capital or the other intangible assets that play the major role in a modern knowledge-intense economy. All of these things can contribute to productivity growth over the longer term.

EXHIBIT 3
THE INTERNATIONAL GROWTH OF AUSTRALIAN BUSINESS

Australian businesses earn increasing amounts offshore. In the 2007 financial year, the offshore earnings of Australia's 100 most globalised companies (companies with the most foreign revenue) hit $218.9 billion – an increase of more than 15 per cent.

Although recent turmoil on global financial markets may slow growth in some sectors, it is clear that Australia's small domestic market means the internationalisation of business can only continue.

Sector	Foreign Revenues $b
Mining	92.3
Services, other	45.1
Manufacturing	40.9
Services, financial	36.0
Agribusiness	4.4

'Overseas trade is a necessity. Australia is the fifteenth largest economy in the world, but accounts for only 1.6 per cent of world GDP. As such, foreign markets offer Australian firms huge growth potential (and the Australian consumer access to the best products). Although Australia has experienced significant globalisation more needs to be done. With only 21 million geographically dispersed people, Australia cannot match world's best practice in the production of every good and service that the market demands. It must trade. Countries of a similar structure tend to export at least 25 per cent of GDP.'

Source: *The Diplomat*, May/June 2008.

An internationally competitive economy is also better able to manage the risks associated with imbalances in the economy, such as future fiscal pressures, a shortfall in national savings, or excessive reliance by any sector on debt.

Building stronger domestic foundations, including through a world-leading tax system, will better position Australian businesses to compete in global markets.

The tax system also improves incentives for Australians to save and invest in Australia and contributes to the drive to grow the population, by increasing Australia's attractiveness to internationally mobile skilled labour.

Simplicity and low cost

Simplicity is regularly identified as a goal of taxation but all too rarely achieved. Complex regimes reduce voluntary compliance, increase taxpayer (and government) error, increase taxpayer perceptions that the system is unfair, and increase the economic drag of the system, diverting resources away from their most productive uses.[9]

One of the chief contributors of complexity in a tax system is the lack of a guiding plan with clearly articulated objectives. The absence of a plan leads to piecemeal changes and uncoordinated reforms, increasing the risk of unintended consequences. It also makes it more difficult for governments to resist calls for special concessions that simply do not fit longer-term priorities.

Complexity also results from the sheer number of taxes, many of which raise relatively little revenue.

As the BCA's *Tax Nation* report identified, there were 56 separate taxes borne or collected by business in 2006.

Significantly, of the $27.5 billion in tax borne by the businesses in the survey, 66 per cent ($18.1 billion) was income tax. It took 50 other taxes to raise the remaining 34 per cent ($9.4 billion). The number of taxes raising small amounts of revenue raises legitimate questions about whether they cost more to collect then they raise for the public purse.

The 'deadweight costs' of taxation are now well known.[10] Taxes impose direct and indirect administrative, compliance and other decision-making costs on the economy. These transaction costs reduce the share of the income available for investment and consumption. A tax system must be economically efficient both in terms of compliance costs for taxpayers and government collection costs.

A key priority for the reform should be to reduce the number of taxes currently levied.

Providing fiscal stability

The tax system must be capable of providing a reliable source of funds to enable the appropriate level of government activity, for the benefit of all Australians.

In recent years, both the stability and size of the revenue base have become growing sources of concern. Unfortunately, scope for reform in both of these areas has already been constrained through the review terms of reference – by removing elements of the tax base from consideration (the goods and services tax, tax-free superannuation), and by assuming a constant, rather than reduced, level of government spending.

Stability and sustainability

The stability and sustainability of budget revenues is a key consideration for fiscal policy. Table 2 provides a snapshot of federal government revenues at the time of each of the two most recent major tax reviews. Real federal revenue per capita has grown from $7,166 to $12,153 over that period.

While revenue levels are increasing, research shows that the federal Budget has become increasingly subject to the economic cycle. Virtually all of the revenue side of the Budget is now sensitive to the economy, whereas little more than one in every $25 on the spending side is similarly sensitive.[11]

This means that when growth slows, the federal Budget will deteriorate markedly and quickly, unless offsetting decisions are made to curtail spending or raise taxes. As the BCA submission to the 2008–09 Budget highlighted, given the political difficulties of cutting spending, the likely fallbacks are higher taxes (which in turn would weigh against competitiveness and longer-term growth prospects), or larger fiscal deficits.

A significant element of this cyclical sensitivity comes from the Budget's growing reliance on income taxes, particularly on the corporate side (see Table 2). The substantial increase in total tax revenue over the last decade has been underpinned by a sharp rise in corporate income tax: from $27 billion in 2000, to a projected $73.5 billion in 2008–09.[12]

Over this time, the share of corporate taxes in overall revenue has increased from 9.6 per cent in 1985 at the time of the Review of the Australian Tax System reforms, to 24.4 per cent in 2006–07, making it one of the fastest growing sources of revenue for the government.[13]

This level of reliance is not common. According to the OECD, Australia has the second highest reliance on corporate taxation as a percentage of total tax revenue. In 2004, the unweighted average across the OECD was just 9.1 per cent.[14]

In the context of an ageing population (see Exhibit 4), and the future reductions in Australia's working-age population, our reliance on personal income tax is also a significant concern.

A stable revenue supply is one that relies on a range of taxes, raised from a varying and broad base. If Australia is serious about long-term reform, we need to consider the entire tax mix, including the GST.

Alongside this heightened instability are questions of the sustainability of the total tax take. All taxes carry an economic cost, and while higher taxes might meet immediate adequacy goals, they may also reduce future adequacy by damaging growth prospects. The review should explicitly consider how a sustained reduction in the total tax burden can be achieved.

TABLE 2: REVENUE TRENDS

	1985 Review of the Australian Tax System	1998 A New Tax System/Review of Business Taxation	2007
Total federal revenue (original)	$58b	$133b	$278b
Reliance of federal budget on corporate taxes (companies, superannuation and PRRT)	9.6%	17.6%	24.4%
Federal revenue to GDP ratio (including GST)	22%	23%	25% (2005–06)
Federal revenue per person (in today's dollars)	$7,166	$8,828	$12,153

Source: ABS Catalogue No. 5302.0, *Balance of Payments and International Investment Position*, Australia, December 2007 and BCA 2008–09 Budget Submission.

EXHIBIT 4
TAX IMPLICATIONS OF AN AGEING AUSTRALIA

The fiscal implications of population ageing have been well articulated in the federal government's Intergenerational Report and more recently by the Productivity Commission.

This work confirms that population ageing will result in a significant fiscal burden or gap emerging in coming decades. This reflects the adverse impact of slower economic growth on revenues and increasing expenditures associated with health, aged care and pensions.

In particular, the Productivity Commission noted the following:

- While taxation revenue will largely track GDP growth, government expenditure is likely to rise more rapidly, placing budgets under considerable pressure.
- Although education and some welfare payments are projected to increase more slowly than GDP, government spending on health, aged care and pensions will grow at a faster rate.
- The major source of budgetary pressure is health care costs, which are projected to rise by about 4.5 percentage points of GDP by 2044–45, with ageing accounting for nearly one-half of this.
- In the absence of policy responses, the aggregate fiscal gap will be around 6.4 percentage points of GDP by 2044–45, with an accumulated value over the forty years of around $2200 billion in 2002–03 prices.
- On past trends, much of this could be expected to be borne by the federal government, but there are also significant potential burdens faced by state and territory governments.

These conclusions point to growing tensions between state and federal governments in regard to revenue and spending responsibilities, and draw into question the ability to effectively sustain current revenue-sharing arrangements. These tensions could be exacerbated by a reduction in GST revenues as a result of increased spending on GST-exempt items (namely health).

The analysis concludes that 'the shift towards consumption of tax-exempt items that accompanies ageing is most likely to reduce long-run GST revenues lightly as a share of GDP.' While its current estimates are for a modest reduction of GST revenues, against the backdrop of increased spending demands, even modest shifts are likely to cause friction in current revenue-sharing arrangements.

Based on past experience, there is concern that the most likely 'default' outcome will be a reliance on higher taxes. This will weigh on growth and make it harder to meet spending obligations.

Source: Productivity Commission, *Economic Implications of an Ageing Australia*, Research Report, Canberra, 2005.

The role of government

'A reduction in today's tax burden without addressing spending is at the expense of future taxpayers who must service or repay the debt. This is a particularly inequitable strategy in the context of the higher tax burdens on those taxpayers already likely to result from the increasing age dependency ratio.'

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

The role of a taxation system is to support the necessary functions of government. Tax and spending decisions should be driven by clearly stated and assessed needs and objectives, not simply by a 'capacity to pay' as revenues increase. The welfare system, in particular, should not be expanded for its own sake or for the sake of political expediency.[15]

Unfortunately, over recent years government expenditure has continued to grow with little apparent regard for whether this intervention contributes meaningfully to prosperity. This has seen a rapid increase in assorted benefits and payments, even as concerns are raised about future pressures on the Budget as a result of Australia's ageing population.

All areas of spending – including business support programs – should be regularly reviewed to determine their effectiveness and net benefit. The BCA has also proposed a Charter of Budget Quality to promote greater transparency and accountability for new spending programs.[16]

The reluctance to discuss the appropriate levels of government expenditure has put constraints on past tax reforms, as governments insist on maintaining current revenues in the immediate term at the expense of what could be wider-reaching reforms that bring greater benefits in future years. At a time when reforms to federal–state relations are also firmly on the agenda, there is no better opportunity to address the size – and efficiency – of government.

If we are serious about lifting Australia's long-term productivity, we should seek to reduce Australia's tax to GDP take, and maintain it at a reduced level.

Tax and intergovernmental relations

There is currently broad support for efforts to modernise the Australian federation, to improve accountability and service delivery across the board, and reduce the economic and social costs that arise from the current level of duplication and overlap in regulatory regimes.

The tax system is a necessary part of reforms to improve the operation of our federation. When taxes are imposed by all layers of government, the overall competitiveness of a tax environment hinges on an effective interrelationship between the tax systems of often competing jurisdictions.

As noted earlier, the BCA's *Tax Nation* report found that businesses operating across state borders bear or collect up to 56 separate taxes. This results in a system that is overly complex, opaque, and costly for both business and government to administer. These costs weigh on the competitiveness of the business sector – and other parts of the community.

It is clear that reforming the tax system will raise important questions about revenue-raising and sharing arrangements.

As the BCA highlighted in *Budgeting for Prosperity*, a significant part of the fiscal tensions that exist across state and federal jurisdictions stem from the imbalance between spending responsibilities and the capacity to raise revenue.

Clarifying roles and responsibilities in service delivery and fixing fiscal arrangements are fundamental steps to any improvement in the federal system. As fiscal pressures associated with population ageing mount, there will be an impetus for governments at all levels to seek greater revenues, and the complexity of the current system both increases opportunities for, and decreases the transparency of, revenue raising initiatives.

The introduction of the GST made the first serious attempt in many years to reform some of the unnecessary complexities and inefficiencies in state taxation. The outcome in reality involved political compromises and repeated delays in the removal of state taxes under the Intergovernmental Agreement. As a result, business has been left frustrated and disillusioned by the lack of progress in reducing the number of taxes and genuinely addressing complexity and compliance costs.

This is despite the fact that these so-called 'deadweight' costs have been repeatedly shown to reduce business investment levels and discourage employment.

An in-depth understanding of the strengths and weaknesses of the state and territory tax systems, how they impact on costs, and how they might be reformed to maintain a competitive business sector and improve long-term revenue security, will be integral to better federal–state relations.

Tax implications of emissions trading

The introduction of an emissions trading scheme has the potential to deliver significant revenue to the government. The size and predictability of this revenue stream in the near term and over time, and how it should be used and allocated, will have a very important bearing on future growth and prosperity and is a crucial area of consideration for the review. Obviously these considerations and the design of other changes to the tax system should take into account the overriding objective of an emissions trading scheme, which is to reduce greenhouse gas emissions at least cost. It is critical that other policy measures – be they tax, spending or regulatory in nature – do not work against this.

CONCLUSION

Taxes play a fundamental role in economic and social prosperity. Because the tax system influences almost every aspect of economic decision making, tax reform must be treated as an integral part of Australia's broader reform agenda, working in concert with other key reforms.

The Australia's Future Tax System review presents an opportunity for a fundamental change in mindset about tax. Rather than seeing tax as a necessary burden, we must see it as an enhancer of a more prosperous future – a way to underpin national reform in key areas such as federal–state relations, infrastructure, education, workplace flexibility, trade and innovation.

A comprehensive review of the taxation system is as ambitious and complex as it is essential. We know Australia is likely to reap substantial benefits by reforming the broader structures of the tax framework. Consideration must be given to the impacts of tax across the economy and community, and to how those impacts relate to future risks and challenges. If we are to use the tax system to promote economic growth and productivity, support social prosperity, enhance our engagement in the global economy, and underpin fiscal stability, we must be confident that unnecessary costs are minimised, and that the incentives (or disincentives) created by taxation enable the outcomes needed to achieve our ambitions.

Fundamental reform is not easy. Getting the balance right, in terms of the amount of tax collected and the types of taxes imposed, will be a challenge for policymakers. If we are to be confident the review will be successful in laying long-term foundations for growth and prosperity, we must be confident that it is conducted with a long-term vision for Australia's prosperity.

This paper argues that the overarching aim of reforms should be to enable Australia to move into the top-five band of countries with the world's highest living standards by 2012, and ultimately become the best place in the world in which to live and work. But such aims will not be achieved in the absence of real change, or without seeing those changes through to implementation.

We must seize every opportunity to position Australia to deliver sustained economic growth and strong social and environmental outcomes into the future. Reform of Australia's tax system has a critical role to play in securing the country's future prosperity.

NOTES

1 Department of Prime Minister and Cabinet, *Australia 2020 Summit*, Final Report, Canberra, 2008, p. 38.

2 BCA, *Tax Nation: Business Taxes and the Federal–State Divide*, Melbourne, April 2007.

3 *Anticipating Success: BCA Submission to the Australia 2020 Summit,* Business Council of Australia, April 2008, p. 12.

4 There has been much discussion of the issues around the tax/welfare churn and its resulting costs; see for example P. Saunders (ed.), *Taxploitation: The Case for Income Tax Reform*, Centre for Independent Studies, 2006; and the BCA submission to the 2008–09 Budget, *Budgeting for Prosperity*, February 2008.

5 These concerns are discussed in the OECD 2007 publication, *Fundamental Reform of Corporate Income Tax* (p. 76).

6 There is a large body of international tax research to suggest that low tax rates, particularly corporate tax rates, have a significant 'head-turning' effect and encourage greater levels of foreign investment.

7 The importance of the complete reform 'package' is discussed time and time again in the literature on international competitiveness; see for example M. Porter, *The Microeconomic Foundations of Prosperity: Findings from the Business Competitiveness Index*, in the Global Competitiveness Report 2007–08, World Economic Forum.

8 ibid., p. 59.

9 See for example American Institute of Certified Public Accountants, *Guiding Principles for Tax Simplification*, New York, 2002.

10 For a thorough discussion see the BCA *Taxation Action Plan for Future Prosperity*, April 2005, p.11.

11 See p. 21 and Paper 2 of the BCA *Budgeting for Prosperity* submission.

12 Australian Government, Commonwealth Budget Paper No. 1.

13 Corporate taxes include company tax, superannuation taxes and resource rent taxes.

14 OECD, *Fundamental Reform of Income Tax*, Tax Policy Studies No. 16, 2007, p. 31.

15 For a discussion of the need to better assess the size and priorities of Australia's welfare system, see P. Saunders, *Australia's Welfare Habit and How to Kick It*, Duffey & Snellgrove, 2004; and P. Saunders and B. Maley, 'Tax Reform to Make Work Pay' in P. Saunders (ed.), *Taxploitation: The Case for Income Tax Reform*, Centre for Independent Studies, 2006.

16 For an examination of the need to reconsider Australia's spending priorities and the size of government intervention, see the BCA submission to the 2008–09 Budget, *Budgeting for Prosperity*.

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