

Business
Council of
Australia



Business Council of Australia

**Submission to the
*Australia's Future Tax System Review***

17 October 2008

Table of Contents

The case for tax reform	3
1. Australia's major challenges	4
2. The features of an effective tax system	5
The purpose of the tax system	5
Five features of an effective tax system	6
Reform constraints	8
3. Problems with the current tax system	9
4. Addressing the problems of the current tax system	11

About the Business Council of Australia:

The Business Council of Australia (BCA) is an association of the CEOs of 100 of Australia's leading corporations, with a combined workforce of around one million people. It was established in 1983 as a forum for Australia's business leaders to contribute to public policy debates to build Australia as the best place in which to live, to learn, to work and do business.

BCA contact person:

For further information in relation to this submission, please contact Allesandra Fabro, Director Policy on (03) 8664 2664 or allesandra.fabro@bca.com.au.

The case for tax reform

It is time for Australia to invest in a new reform agenda.

After a decade of exceptional economic performance, significant challenges confront us. The global financial crisis has seen economic activity slow far more sharply than expected. While this has lessened the immediate capacity constraints that have hampered Australia's growth in recent times, it only serves to highlight the importance of positioning our economy to sustain strong growth over the longer term, including through investment in and improvements to productivity. Australia's demographic and environmental constraints will compound the challenges we face.

Focussing on the critical drivers of economic growth – labour, infrastructure and skills – is essential to lifting our productivity and preventing the gains of the last decade from slipping through our fingers. We must continually improve our international competitiveness to ensure that Australia remains an attractive place to invest and do business if we want to prosper, particularly in difficult economic times.

As the financial crisis has reminded us, markets are global. Policy settings must not only reflect this, but position us to take advantage of opportunities that enhance our competitiveness and build economic resilience.

This is as true in taxation as it is in all policy areas. As we develop a new tax architecture for Australia, we must recognise that taxpayers, particularly businesses with global reach, have a range of alternative investment locations available to them. Now, more than ever, Australia must set its policy frameworks with an eye towards long-term strategic growth and flexibility, so that we can benefit from our integration in global markets and economies.

The Business Council of Australia has set an aspirational goal for Australia to be the best place in the world to live, work, learn and do business. As part of this, the BCA believes Australia should aim to achieve a GDP per capita ranking among the top five countries in the world by 2012. In March 2008 similar goals were adopted by the economy stream of the 2020 Summit.

Reform of Australia's tax system is central to achieving these ambitions. The level and structure of taxes imposed fundamentally impact investment, saving and workforce participation – that is the decisions that shape our economic, social and environmental future. The revenues raised by the system can and should 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. Unnecessary taxes and costs should be minimised, and the tax system needs to enable high levels of investment, workforce participation, innovation and global engagement.

In its latest assessment of the Australian economy, the International Monetary Fund (IMF) encouraged Australian governments to use the benefits of recent growth to implement structural economic reforms aimed at lifting productivity and workforce participation – including tax reforms. In considering the case for structural reform of the Australian budget, the IMF also supported reducing the taxation of income over other tax bases. The IMF said

that “a combination of lower labour and capital income taxes, along with increased public investment, will generate the largest economic gains”.¹

The Organisation for Economic Cooperation and Development (OECD) also endorses a shift away from income taxes towards less distortive taxes and improvements to tax design to better support growth.²

These recommendations are consistent with the approach to tax reform outlined by the BCA in June this year in *A Better Tax Return*. 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. The notion of ‘tax and spend’ needs to become ‘tax and invest.’

A Better Tax Return outlines a number of issues relating to Australia’s tax system, and considers them in relation to five priority features. These issues and priorities accord in large part to the initial framing questions set out by the *Australia’s Future Tax System Review* panel (‘the Panel’):

1. What major challenges facing Australia need to be addressed through the tax-transfer system?
2. What features should the system have in order to respond to these challenges?
3. What are the problems with the current system?
4. What reforms do we need to address these problems?

This submission draws upon publically available research and the BCA’s position on tax reform as outlined in *A Better Tax Return* to respond to these questions. A copy of *A Better Tax Return* is attached for the Panel’s reference.

Because of the *Australia’s Future Tax System Review*’s forward-looking agenda, a copy of the BCA’s submission to the Australia 2020 Summit, *Anticipating Success*, is also attached for the Panel’s reference.

1. Australia’s major challenges

The tax system is one of the foundations on which a strong economy is built. Because the tax system is so central to decision making by businesses and individuals, it has a fundamental role to play in addressing Australia’s core economic challenges.

Boosting Australia’s economic and social prosperity means addressing a range of challenges, including:

- declining productivity growth;
- increasing international competition;

¹ International Monetary Fund, Australia – 2008 Article IV Consultation, Concluding Statement, at <http://www.imf.org/external/np/ms/2008/070108.htm>

² OECD, Taxation and Economic Growth, Economics Department Working Paper no. 620, July 2008, p7

- demographic change;
- the risks associated with climate change; and
- more recently, global financial uncertainty.

Successfully tackling these challenges requires a range of reforms in key areas, each of which will need to be complemented by strategic reforms to the taxation system. To achieve the BCA's aspirational goals, Australia will need to sustain growth of rates of around 3-4 per cent over the longer term. This is an ambitious target, but an achievable one – provided we significantly lift productivity, participation, and competitiveness.

The BCA has for some time advocated reforms, in areas such as infrastructure, regulation, workplace flexibility, innovation, and education.³ Sound tax policies can contribute to reform progress in each of these areas.

An additional challenge for Australia lies in the structure of the federal Budget. As highlighted in the BCA's 2008-09 Budget Submission, and acknowledged by the Review's *Architecture of Australia's Tax and Transfer System* paper ('the architecture paper'), Australia has become more sensitive to cyclical fluctuations in the economy due to a growing reliance on income taxes, particularly from companies.⁴ A long term consideration of the structure of the tax system should establish tax bases that will support the objective of fiscal stability over time.

Getting our tax system right will be critical to successfully following a high growth trajectory over the coming years. In contrast, poorly framed tax policy will only add to our challenges and limit our growth. Against this background, the BCA considers that the decisions made as a consequence of the *Australia's Future Tax System Review* will be critical to our future prosperity.

2. The features of an effective tax system

The purpose of the tax system

The fundamental purpose of a taxation system is to support the necessary functions of government.⁵

However, if we are to respond effectively to the challenges Australia faces, we must ensure our taxation system raises these funds in a way that supports economic and social prosperity by driving participation, productivity and international competitiveness.

³ A more detailed description of these reforms can be found at p4 of *A Better Tax Return*. See also the BCA Submission to the Australia 2020 Summit, *Anticipating Success*. The BCA has also produced detailed plans of action in many of these areas: see www.bca.com.au.

⁴ See *Budgeting for Prosperity: BCA Budget Submission 2008-09*, available at www.bca.com.au.

⁵ The BCA notes that supporting the necessary functions of government also implies that attention should be paid to the level of Government expenditure (for a more detailed discussion of this, refer *Budgeting for Prosperity: BCA Budget Submission 2008-09*). Unnecessary or inefficient government expenditure adds to the overall taxation burden and diverts resources away from more productive uses.

As economies and businesses have become more globalised, the competitiveness of tax policy become has become more important and tax setting by governments more dynamic. International research shows that capital investment is highly responsive to relative tax settings across countries and that the competition for skilled labour across countries is increasing, with economic incentive an important factor in an individual's decision on where to live and work.⁶

According to the OECD, in open economies the design of the tax system “will need to consider the design of tax systems in other countries, since countries are increasingly using their tax systems to improve their ability to compete in global markets”.⁷

Just as we are now reviewing our tax system, other governments are also considering how to structure taxes to support economic growth and give the companies and individuals operating within their jurisdictions a competitive edge in global markets. For example, by the time the *Australia's Future Tax System Review* is completed, an estimated ten countries in Europe will have cut their corporate tax rates.⁸ This follows a long term trend in the OECD area where the unweighted average corporate tax rate has dropped from 47 per cent in 1981 to 26.6 per cent in 2008.⁹ This means that the *Australia's Future Tax System Review* must seek to design a tax system that is flexible enough to withstand the challenges of a changing international environment.

Five features of an effective tax system

In *A Better Tax Return*, the BCA has set out five priority features that should be considered when developing an effective tax system for Australia:

1. The tax system must support economic growth and productivity.

The tax system must encourage economic activity and decision making that grows national income in the long term, for example, through its influence over decisions made about:

- 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).

⁶ See, for example, National Bureau of Economic research, “The Effect of Corporate taxes on Investment and Entrepreneurship”, Working Paper 13756, January 2008 and OECD, “The Global Competition for Talent: Mobility of the Highly Skilled”, 2008.

⁷ OECD, *ibid*, p.6

⁸ Piatkowski, M and Jarmuzek, M, “Zero corporate income tax in Moldova: tax competition and its implications for Eastern Europe”, IMF Working paper WP/08/203, August 2008, p4.

⁹ OECD, *ibid*, p.15.

2. The tax system must support social prosperity.

The structure of the tax-transfer system is an integral part of Australia's social prosperity agenda. As Australia's economic prosperity increases, it is important that we find meaningful and sustainable ways to improve the opportunities and circumstances of people experiencing entrenched disadvantage. As part of this, we must take into account how the tax system interacts with transfer payments, the way that progressive taxation scales coupled with targeted welfare affects effective marginal tax rates, and, in particular, how we might be more creative in the delivery of benefits to ensure smoother transitions into the workforce.

3. The tax system must enhance our international competitiveness and engagement in the global economy.

Australia needs a tax system that contributes to its international competitiveness. To compete in a global environment, we need an economy that encourages both inbound and outbound investment.

As *A Better Tax Return* highlights, it is clear that globalisation presents additional challenges for tax systems. Governments are understandably concerned downward pressure on rates will erode revenue raising options. 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.

To prosper, 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.¹⁰

Tax is an important component of a group of factors that determine international competitiveness, along with a skilled workforce, effective infrastructure, efficient government, strong research institutions and an environment that encourages and supports innovation.¹¹ To be most effective, tax must be seen as underpinning a comprehensive reform agenda, integral to all policy areas rather than approached in a stand alone manner.

The BCA considers tax competitiveness, particularly from the perspective of business, as an area warranting further research and in which we intend to provide the review panel with more detailed considerations throughout the review.

¹⁰ For further discussion on enhancing our place in the global economy, see *A Better Tax Return*, pp 16-19

¹¹ The importance of the complete reform 'package' is frequently cited 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.

4. The tax system must be simple and low cost.

We should aspire to being among the best performers on measures related to costs (both broader economic costs and the direct compliance costs on taxpayers) and simplicity. We must also aspire to a tax system that is administered efficiently and with regard for the intent of the law.

Unnecessarily complex taxation systems increase deadweight costs and divert resources away from their most productive use. Complexity and inefficient administration also contribute to investment uncertainty, particularly when the tax impacts of a transaction are difficult to ascertain.

5. The tax system must support fiscal stability.

The tax system must provide fiscal stability in a way that gives governments and others the confidence to undertake long-term planning and decision making. This implies both achieving a sustainable tax mix and, as noted above, rethinking of the role of government spending in the economy, particularly with regard to the effectiveness of some transfer payments.

Reform constraints

Maximum gains in each of these areas would flow from a comprehensive review of the tax system. Unfortunately the potential benefits of reform have been curtailed by limiting the terms of reference, in particular, the explicit exclusion of consideration of the GST.

In *A Better Tax Return*, the BCA argued for the inclusion of the GST on the grounds that it would have allowed for the most comprehensive discussion on the fundamental question how Australia structures its tax system in the most economically efficient way. It would have allowed us to consider the advice of the OECD and other policy experts that emphasise the benefits for economic growth of a shift from income taxes to less distorting taxes such as consumption taxes.¹² It remains the BCA's view that this is a discussion Australia will eventually need to have.

Nevertheless, the BCA understands the political circumstances in which the Review's terms of reference were set. It is the BCA's considered view that opportunity remains for significant and lasting reform to Australia's tax architecture, albeit more challenging to achieve.

¹² OECD, *ibid*, p7

3. Problems with the current tax system

Considering the current tax system in light of the five priority features identified by the BCA serves to highlight a number of concerns. Notwithstanding the structural reforms of the 1980s and late 1990s, further significant improvements could be made under each of the areas described.

BCA considers the following to be among the most important areas for improvement as part of the *Australia's Future Tax System Review*:

- The overall burden of taxation

There has been a steady rise in the tax take over recent decades. Real federal revenue per capita has grown from \$5,123 in 1992-93 to \$12,153 in 2006-07. Federal taxes as a percentage of GDP have grown from around 20 per cent to 25 per cent over the same period.¹³ Because taxation imposes deadweight costs, a tax system should be designed to collect the minimum revenue required to fund necessary government expenditure, not simply by the capacity of taxpayers to pay. As the BCA has previously argued, the overall burden of taxation in Australia must be permanently reduced.

- Over-reliance of taxation on income

The architecture paper notes the total tax burden on capital is around 11 per cent, or the fourth highest in the OECD, compared to 12 per cent on labour (fourth lowest in the OECD) and 9 per cent on consumption (fourth lowest in the OECD). As mentioned earlier, in a competitive international economy, a high tax burden on the returns from capital can detract from a country's international competitiveness. As the Treasury paper points out, a growing body of literature also suggests that, in the longer run, the incidence of high effective corporate tax rates falls unexpectedly heavily on labour through lower productivity and wages. A consideration of the income tax burden must also consider the implications of Australia's personal income tax rates on Australia's attractiveness to skilled workers and incentives to work and to save.

- Declining international competitiveness

It is no surprise that international tax settings are constantly changing. Our level of foreign engagement – in both investment and merchandise trade – has changed dramatically since the last major tax reform processes in 1985 and 1998.¹⁴

As noted above, Australia's international competitiveness results from a range of factors including taxation. To be truly competitive, Australia must develop a tax system that employs the right taxes and rates, relative to the other factors that make it attractive as an investment destination, like infrastructure, education and a culture of innovation. Unfortunately, in many of these areas, Australia has underinvested in reform in recent years.

¹³ BCA Budget Submission 2008-09, p18

¹⁴ See, for example, Table 1 "Australia's changing international circumstances", p17, *A Better Tax Return*.

As *A Better Tax Return* outlines, this underinvestment means Australia cannot afford to be complacent when it comes to the competitiveness of its tax system. On the investment side, for example, international research suggests that low tax rates, particularly corporate and personal tax rates, help alleviate some of the disincentive effects caused by Australia's relatively small domestic economy, geographically dispersed population, and distance from world markets.¹⁵

Yet, as the architecture paper confirms, while Australia's top personal rate is now around the OECD average, the corporate tax rate is increasingly out of step. Since 2001, the unweighted average corporate tax rate for OECD countries has decreased by around 6 percentage points to 26.6 per cent. Australia's company tax rate at 30 per cent is now above the OECD average – and Australia has moved from 9th lowest, to 21st. Such differences contribute to concerns about the international competitiveness of Australia's tax system and in particular, the dampening effect these concerns may have on business investment decisions.

If Australia's tax system is to genuinely enhance our engagement in the international economy, measures that contribute to our international competitiveness should be a key focus of the review, including a reduction in the corporate tax rate.

- Complexity and the costs of administration and compliance

As the architecture paper notes, there are at least 125 taxes paid by Australians – yet ten taxes collect 90 per cent of the revenue. Similarly, the BCA's *Tax Nation* report identified 56 separate taxes borne or collected by business: 21 federal taxes, 33 state taxes and 2 local taxes.¹⁶ The number of taxes raising small amounts of revenue raises legitimate questions about whether they cost more to collect than they raise for the public purse, particularly when taxpayer compliance costs are considered.

The transfer system is also complex, with around 40 cash transfer payments paid by the Australian government to Australians. This level of complexity is unnecessary and imposes additional compliance costs on the Australian economy. The architecture paper notes that 'there are no reliable estimates of the complexity or operating costs of the tax-transfer system but there is a strong sense in the community that they are too high'. It is time that these costs were estimated, reported and monitored and reduced.

- Inefficiency and economic costs

In addition to direct compliance costs, Australia's large number of taxes includes many that are narrowly applied and which impose unnecessary economic (or deadweight) costs. Many state taxes, in particular, fall into this category, and their inefficiency is compounded by the fact that they are applied differently in different states. As the BCA's *Tax Nation* report highlighted, there is considerable scope to rationalise, reduce, or eradicate many of these taxes.

The BCA agrees with the review team's finding that 'the nature of our federation' is intrinsic to this review and that 'coordinated action across governments is imperative'. Removing inefficient, distorting taxes, particularly at the state level, should be a priority for the review.

¹⁵ BCA, *A Better Tax Return*, p 16-19

¹⁶ BCA, *Tax Nation: Business taxes and the Federal-State Divide*, Melbourne, April 2007.

- Tax-welfare churn

As noted in *A Better Tax Return*, approximately half of Australia's welfare spending is returned to the people who paid the tax to fund it in the first place. 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. 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.¹⁷

- Risks to fiscal stability

As identified earlier, the federal Budget has become increasingly subject to the economic cycle. Research conducted for the BCA by Access Economics found that 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.¹⁸

A significant element of this cyclical sensitivity comes from the Budget's growing reliance on income taxes, particularly on the corporate side. 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. Over this time, the share of corporate taxes in overall revenue has increased from 9.6 per cent in 1985 to 24.4 per cent in 2006–07, making it one of the fastest growing sources of revenue for the government.

Providing fiscal stability requires both achieving a sustainable tax mix, and rethinking the role of government spending in the economy.

4. Addressing the problems of the current tax system

The *Australia's Future Tax System Review* 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.

This means we must seek to address the key challenges outlined above.

¹⁷ 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.

¹⁸ BCA, 2008–09 Budget Submission, February 2008, p 21.

Over the next twelve months, the BCA will seek to assist the Review Panel by providing further information in relation to aspects of the five priority features and the challenges the current system presents before they can be achieved.

In particular, the BCA will seek to provide specific additional information on the impacts of the current business taxation system on:

- the hiring and investment decisions of Australian businesses;
- the ability of Australian businesses to expand and compete internationally;
- economic growth and productivity;
- domestic and international competitiveness; and
- Australia's budgetary position.

A Better Tax Return 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.

The BCA considers Australia must seize every opportunity to position itself to deliver sustained economic growth and strong social and environmental outcomes into the future. The *Australia's Future Tax System Review* has a critical role to play in securing the country's future prosperity.