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Business Council of Australia

# Business Council of Australia

# Submission to the Budget Process 2006–07

## December 2005

# TABLE OF CONTENTS

# 1. Executive Summary

The Business Council of Australia (BCA) represents Australia's leading companies, employing nearly one million Australians and accounting for 30 per cent of Australia's exports. The BCA has a strong interest in, and understanding of, the factors that contribute to or detract from the country's economic performance. Australia is well placed to continue to outperform other economies, provided the commitment to economic reform is sustained.

Over the past 12 months, the BCA has articulated reform in four key areas of the economy in order to lock in current levels of prosperity for the long-term, covering: workplace relations; taxation; regulation; and infrastructure renewal. It is the combination of reform in these four areas which will provide significant benefits for Australia's future growth and prosperity.

The BCA welcomes the Government's reforms to workplace relations and recent commitment to address the significant business costs of over regulation. The Federal Government's commitment, in conjunction with States and Territories, to review policy arrangements around Australia's economic infrastructure is also welcomed. It is vital that Australia's infrastructure can meet the increasing demands from continuing economic growth.

The focus of this Budget Submission is taxation reform. The BCA believes that substantial tax reform to remove major impediments to future economic growth is required and that this process must be commenced in the upcoming 2006–07 Federal Budget.

In April 2005, the BCA released the *Taxation Action Plan for Future Prosperity*. The report provided a comprehensive stocktake of Australia's tax regime. The analysis included impediments to achieving a globally competitive tax system, and methods for the Federal and State Governments to address these barriers. This work concluded that in order to progress Australia's competitiveness three broad areas need to be addressed as an immediate priority: personal taxation, corporate taxation and the degree of complexity and uncertainty in the current taxation system.

Australia needs a more competitive personal tax system. Other countries are far better at attracting investment and the best global talent. We need to match their attractive tax systems if we are to stay competitive.

Australia's corporate tax burden is a competitive risk. The amount paid in tax by companies represents over 5 per cent of GDP, substantially above most of our OECD competitors. This financial year, corporate taxation is contributing a record $48 billion to the Federal Government's bottom line. Competitive risks potentially mean lower returns, resulting in a reduced tax take and capacity for the Government to spend on further reform or social measures.

Australia's tax laws and administrative system are in need of significant review and reform. This level of complexity and uncertainty provides a brake on innovation and rapid decision-making, stifling business' ability to be flexible and competitive and adding to the economy's transaction costs.

The BCA's Federal Budget Submission reflects its latest reform thinking in these areas. Australia's taxation system influences economic decision-making and is a key determinant in the competitiveness of Australia's economy. Governments globally are well aware of the importance of a competitive system and are structuring their tax systems to compete for capital and labour. The BCA believes that 'catch-up' policy making and incremental change is no longer appropriate. Australia needs to carefully examine more fundamental reform and reform processes to ensure our tax system remains competitive and to lock in prosperity for the long-term.

# 2. Summary of Recommendations

## *2.1 Immediate Reforms*

***Personal Taxation***

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

   - the initial steps should involve reducing the second highest rate from 42 per cent to 40 per cent, and the highest rate from 47 per cent to 45 per cent as part of the 2006–07 Budget;

   - the top rate could then be reduced to 40 per cent in the 2007–08 Budget.

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

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

   - simplify the taxation law which applies to temporary and permanent migrants;

   - ensure that the ATO is adequately staffed to deal with individual migrant issues through the establishment of a specific ATO Cell. Any generic issues should be referred to a specific area in Treasury so that policy and tax design can be adjusted to ensure that issues such as complexity and administration do not become a block for temporary and permanent migration flows;

   - remove specific taxation barriers for temporary and permanent migrants including reviewing and removing competitive barriers to the attraction of mobile skilled workers in:

     - Australia's superannuation system;

     - the treatment of employee share ownership; and

     - the deemed imposition of capital gains tax applying to temporary workers' world-wide assets.

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

   - although some progress was made in the last Federal Budget, effective marginal tax rates must be further reduced where these unavoidably and significantly weaken workforce participation. The Government should request that the Productivity Commission undertake an analysis of the impacts of high effective marginal tax rates on workforce participation of different groups and possible recommendations flowing from this. The analysis should take into account the economic and social implications of disincentives to work; and

   - the current limited FBT exemption for employer sponsored childcare should be extended so that all employer sponsored childcare is effectively FBT-free.

### *Taxation of Business*

5. A more competitive business taxation system needs to be provided to promote longer-term growth and productivity. The Government should commence an immediate review of the company tax system in time for measures to be included in the 2006–07 Budget to assess and remove pressures against Australia's long-term competitiveness.

    - The best method for reducing the overall burden of company taxation in Australia should be established, including examining options such as reducing the company tax rate or bringing the treatment of business income more into line with our competitors.

    - The review should take into account both international competitive pressures and progress in lowering the top marginal personal taxation rates.

6. The bias against dividends paid from foreign source income should be removed. In 2002–03 the Board of Taxation recommended to the Government that there be reform of this area. The Government indicated at that time that it would be willing to address this issue at a later stage and should do so as part of the 2006–07 Budget.

    - Consistent with the Board of Taxation's recommendation to remove the imputation bias against Australian companies investing offshore, a 20 per cent non-refundable notional franking credit should be introduced to take account of offshore tax paid on offshore profits on behalf of Australian shareholders.

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

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

### *Reduced Uncertainty and Complexity*

8. Tax compliance and administrative tasks must be substantially simplified. The initial steps being undertaken by the Government's Regulation Review Taskforce will be potentially beneficial. However, the Board of Taxation should be charged with preparing a full report on the costs associated with complexity, compliance and administrative burdens, and the scope and possible means of achieving greater simplification in tax systems in Australia. This report should move well beyond the useful but initial steps currently being undertaken by the Board including removing inoperable provisions and reviewing small business taxation issues.

9. A formal program to regularly review new tax laws must be put in place to allow for adjustment and updating of laws as necessary. A formal, regular procedure would allow a recognised mechanism for minor adjustments as well as an opportunity to review major structural changes, like the introduction of the GST, after the first few years of operation. Such reviews and amendments should be recognised as good tax system management.

***Removing Barriers to Reform***

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

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

**Table 1: Measures for Immediate Implementation – Indicative Costing**

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

## *2.2 Longer Term Agenda*

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

However, while these reforms are necessary they will not be sufficient to ensure that the taxation system will improve Australia's competitiveness over the longer term. A more strategic view, backed by substantial reform, will be required in order to ensure that our tax system is sufficiently robust to support the economy through the future challenges of globalisation and demographic change.

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

The BCA recommends that as well as implementing the most urgent reforms (as discussed in 2.1 above) the Government take a longer term view. A longer term program for reform is required for Australia to secure prosperity for future generations rather than piecemeal measures without a longer-term strategy for each Budget cycle.

A package of reforms covering a wide range of interacting public policy areas including taxation needs to be established, with the aim of prividing substantial efficiency gains.

As part of this, a comprehensive review needs to be undertaken with a view to significant taxation reform in order to meet the challenges posed by demographic change and globalisation and to provide for a stronger growth path in the future[1].

[1] The Senate Economics References Committee inquiry into the structure and distributive effects of the Australian taxation system recommended a sequence of tax policy inquiries into a variety of aspects of the taxation system, including effective marginal tax rates, intergenerational issues, and tax expenditures and grants in June 2004. Unfortunately, these recommendations have not as yet been acted upon.

# 3. Economic and Budget Outlook

## *3.1 Economic Outlook*

The underlying strength of Australia's economy is based on three main factors:

- first, the reform successes of the past two decades – including the implementation of National Competition Policy, tax and labour market reform, financial market liberalisation and the floating of the Australian dollar – have seen the living standards of Australians improve significantly;

- second, long-term demographic and social factors – such as the transition of the baby boomer population bulge into the working age bracket and the increasing participation of women in the paid workforce – have resulted in a substantial upswing in the employment to population ratio;

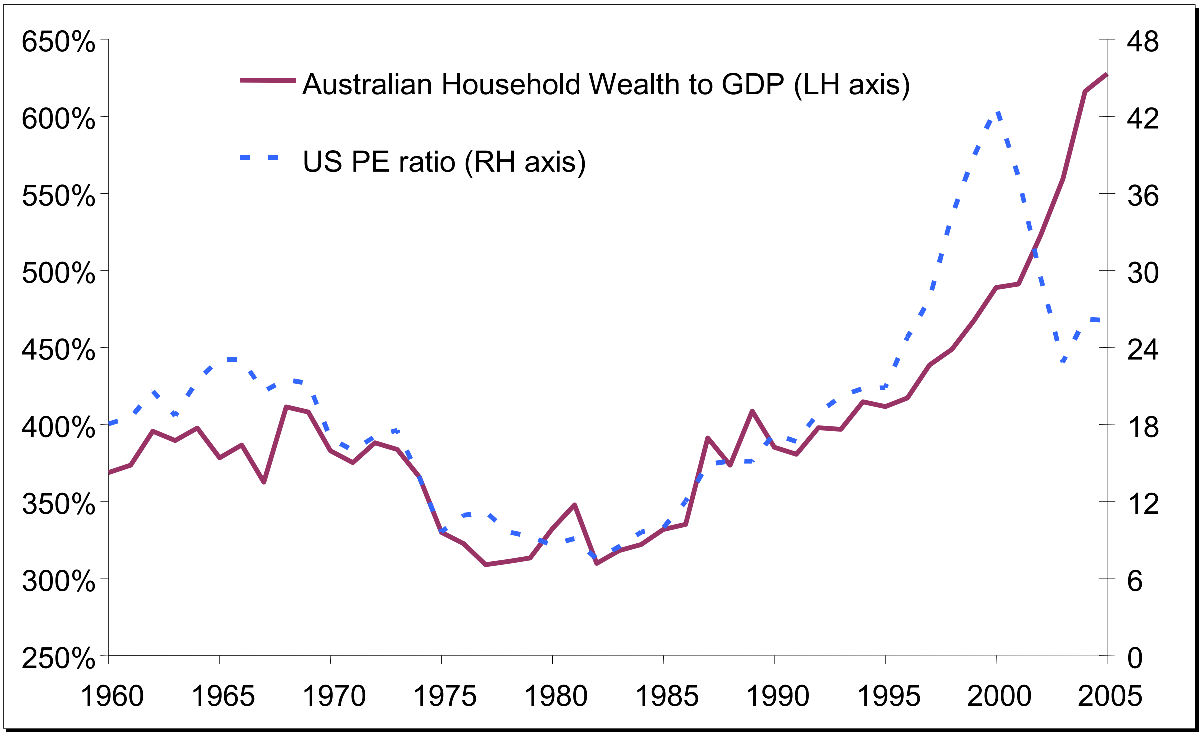
- third, Australia's economic performance in recent years has been boosted by housing and commodity price booms which have provided windfalls of income and wealth to many Australians and have helped to support strong levels of domestic demand.

However there are a number of challenges to ensuring economic prosperity in the future. Section 5 of this document underlines some of the key reforms that Government will need to undertake in order to meet those challenges and ensure the benefits of past reforms are not squandered. A significant focus of this submission is on the specific reforms needed within our taxation system.

In the short-term, the prospects of the Australian economy rely heavily on the timing of dynamics in housing and commodity prices. While housing prices have moderated over the last 18 months, they remain at historically unprecedented levels.

Chart 1 shows we are at a potential tipping point in the asset price cycle in Australia. It is clear that housing prices have risen too far and too fast, leaving housing prices, as a multiple of incomes, very stretched. The dynamics of housing prices over the short-term will have important implications for the economy. A large adjustment in housing prices could significantly impact on consumption and demand by reducing household wealth and dampening consumer sentiment. Weaker consumption and demand could also have serious second-round effects on the housing market and the broader economy as reduced income and increased unemployment impact on households' ability to finance their mortgages.

**Chart 1: Australian and US wealth**




Source: Access Economics
Note: US PE ratio is the price/earnings ratio of the US stock market.
Australian household wealth is significantly influenced by housing prices as most household wealth is composed of housing. A 2004 Melbourne Institute report found that housing assets constituted close to 75 per cent of the assets of the average Australian household.[2]

While real output growth in Australia's economy has slowed since housing prices peaked, the wider economy has emerged remarkably unscathed. This is due in large part to the current global commodity boom which is being driven primarily by China's increasing demand for resources. This boom in commodity prices is pumping $40 billion of extra income into the Australian economy each year[3].

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

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

The prospect of a commodity supercycle is realistic. However, it will likely be in demand rather than prices – and increasingly some of this demand will be met by other countries as supply picks up as noted above. This fact highlights the importance of reducing structural impediments to commodity production and export in Australia, including the addressing of infrastructure constraints.

[2] Headey, Marks and Wooden, 2004, "The Structure and Distribution of Household Wealth in Australia" Melbourne Insitute Working Paper No. 12/04.
[3] Access Economics, Budget Monitor, November 2005.

The above analysis of housing and commodity prices suggests a number of important downside risks to the short to medium-term outlook of the Australian economy. However, if housing prices correct gradually and relatively strong domestic demand and employment growth is sustained in the short term, it also seems reasonable to assume that inflationary pressures will pick up and interest rates could increase.

To this list of risks can be added general risks to the world economy such as high oil prices, the dynamics of the US current account deficit, and rising world interest rates. These factors will require particular attention by Government policy makers to ensure that economic growth is not disrupted over the coming period.

In addition to these short-term risks, the structural factors that have underpinned recent economic prosperity face a number of challenges. Australia's recent productivity performance suggests that the economic benefits of past reform are already starting to wane. In the last year, labour productivity fell by 1.4 per cent, underscoring the worst performance in over 18 years. If productivity growth remains weak, it will significantly affect Australian living standards.

Furthermore, the looming retirement of the baby boomers will undercut the employment to population ratio over the next two decades. This will limit labour supply and hence economic performance over the longer term if not addressed effectively by encouraging continued baby boomer workforce participation, finding alternative sources of labour, and achieving stronger productivity growth.

A number of these issues were also highlighted in the BCA's 2005–06 Budget Submission. The fact that these issues remain, underscores the need for immediate action.

The recent BCA publication *Locking in or Losing Prosperity: Australia's Choice* highlights the long-run economic benefits that could flow from the implementation of a broad-based reform agenda in Australia, compared to a low-growth future if we decide to forego new reforms aimed at lifting levels of productivity and productive capacity.

## 3.2 Budget Outlook

A major indicator of Australia's strong economic performance is the Government's continuing healthy Budget position. The Final Budget Outcome for 2004–05 revealed an underlying cash surplus of $13.6 billion – markedly above the $9.2 billion Treasury had estimated in the 2005–06 Budget (an estimate announced six weeks before the end of 2004–05).

At the same time, the robustness of the Budget over recent years has become increasingly reliant on company tax receipts. There has been a significant and growing contribution from corporate Australia to the Government's coffers with company tax receipts growing from $27.1 billion in 2001–02 to $43.1 billion in 2004–05.

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

Despite the current strength of taxation revenues it should be noted that the positive revenue surprises experienced by the Government in recent years are not guaranteed to continue. As the previous section noted, a number of risks to the economic environment remain in the short and longer-term. These risks need to be addressed by appropriate macroeconomic policy in the immediate term and the implementation of a broad agenda of reform.

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

## *3.3 Long-Term Fiscal Challenges*

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

- a quantity challenge: Australia's ageing population means there will be a big increase in numbers of the aged relative to numbers of workers;

- a price challenge: because of health spending subsidies, for the aged in particular, health care costs to Government will rise relative to other costs.

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

There are good reasons to suggest that the longer term fiscal challenges facing the Commonwealth Government are even larger than those enumerated in the IGR because:

- population estimates released since the IGR have seen a considerable upward revision to the number of the population aged 85 and above in coming decades;

- the simple allowance for ageing may be insufficient to cover future health care liabilities. In particular, future aged groups may contain higher proportions of people who are 'sicker' than their forebears as expectations of health care are higher and in the past many of those who now live with various ailments tended to die;

- there are also likely to be increased non-demographic related spending pressures from areas such as defence and the environment which are not assessed by the IGR; and

- the IGR reported the impact of ageing and relative health cost inflation on Government primary balances – or, in other words, the effect on the Government Budget deficit excluding the interest bill for financing those rising deficits.

The challenges raised by the IGR require significant policy responses. Economic reform is required to raise productivity growth and encourage higher participation so as to boost the size of the economy and address many of the risks associated with slowing growth and rising deficits. Focus also needs to be applied to areas of ageing-related spending pressures which, if left unchecked, will ultimately constrict Budget flexibility, and remove scope for dealing with non-ageing spending pressures such as domestic and regional security, and the environment.

## 4. BCA Reform Agenda and Acknowledgement of the Federal Government's Current Reform Achievements

The Business Council of Australia has a strong interest in decisions that enable Australia to sustain prosperity. Over the past 12 months, the BCA has developed and articulated an integrated reform package centred around four key policy areas: workplace relations, taxation, infrastructure and business regulation. The BCA believes we cannot leave Australia's future prosperity to chance. Warning signs are already emerging that we are starting to slip. Average yearly GDP growth slowed to 3.2 per cent over the five years from 2000–2004 compared with 4.3 per cent in the previous five year period. Vulnerabilities are emerging in our economy that must be addressed now with continual reform to push Australia's competitiveness forward.

The overall message of the BCA reform agenda is that Australia must act now to make further fundamental reforms to lock in current prosperity. Having developed these reform priorities with the help of independent, in-depth research, the BCA is now pushing Governments and decision makers for rapid implementation of a revitalised agenda.

**Workplace Relations**

Making Australia's workplaces more flexible and productive is important if the economy is to continue to grow strongly. Labour market reforms implemented a decade ago have resulted in more jobs, more opportunities and higher incomes.

However, Australia's productivity levels remain lower than those enjoyed by a number of our economic peers. Recently, Australia's productivity growth has begun to slow dramatically as the impacts of those previous reforms start to wear off.

The BCA welcomes the Government's commitment to further workplace relations reform through its WorkChoices legislation.

**Taxation**

The BCA has welcomed the major tax reforms of the past decade. But Australia's taxation system still has major weaknesses.

It is essential that Australia develops a more competitive personal tax system – other countries are far better at attracting investment and the best global talent. We need to match their attractive tax rates if Australia is to stay competitive.

Our overall tax burden on business is nearly double that of our peers – we need a simpler, more competitive company tax system.

Both the tax law and its administration requirements need significant reform, as the current level of uncertainty and complexity acts as a brake on productivity. We need a major overhaul of the tax system to make it easier for businesses to comply with legislation.

**Infrastructure**

The state of our energy, water, transport and urban infrastructure systems, in each case facing significant bottlenecks, will be a key to Australia's future prosperity.

Australia has infrastructure shortfalls of $50 billion for road, rail and water and $40 billion for electricity yet there is no coordinated plan or policy to make sure infrastructure keeps pace with the economy and meets our higher standards of living.

Identifying these problems and revitalising Australia's infrastructure will free up $16 billion in extra economic growth.

**Business Regulation**

The hidden tax on our economy, business regulation, is a rising and uncontrolled tide of red tape. The spiralling cost of compliance is diverting a large amount of Australia's productive resources.

In this decade Federal and State Parliaments will pass 350,000 pages of legislation; in 2003 alone they added 33,000 pages. This is a relatively new phenomenon: half of all legislation passed by the Commonwealth Parliament since Federation has been passed in the last 14 years.

There are better ways to make sure regulation serves business and the community, and not the other way around. Regulation that takes into account the cost to business, is subject to regular review and reduces duplication, will improve the competitiveness of Australia's economy.

**An Integrated Agenda**

The policies outlined above are an integrated agenda and the BCA believes that reform in all four areas is vital to locking in economic prosperity. While the themes and focus of future BCA policy work may vary from year to year, this reform agenda, supported by a public communications program, will remain the organising principle of our work.

The BCA began its advocacy of this reform agenda at the beginning of 2005. Over the past year there have been a number of policy developments undertaken by the Federal and State Governments which address some of the BCA's concerns. These initiatives include:

- the formulation of the WorkChoices legislation;
- the creation of the Fisher Review on Export Infrastructure and the current COAG process concerning infrastructure issues;
- personal income and expatriate taxation reform;
- the creation of the Regulation Taskforce;
- the recent announcement to cut the *Income Tax Assessment Act* by more than 2,000 pages; and
- the current Council of Australian Governments' process reviewing and assessing the future role of National Competition Policy.

The Federal Government should be congratulated for its role in these policy advances, and the BCA supports all measures in the Budget which signal the Government's commitment to such initiatives – such as providing additional resources to the Productivity Commission to undertake its review of Australian Government regulation and additional funding to the Office of Small Business for the further development of its new cost-benefit analysis for Government regulation.

However, many of these processes are still in their initial stages and much more is needed to ensure the prosperity of Australia. This is particularly the case for taxation reform where changes to date have been needed but a more substantial agenda is required. As a consequence of the need for significant and urgent reform in this area, the BCA has focussed this year's Budget Submission on the immediate reforms to Australia's taxation system required to provide a robust framework for future prosperity.

The BCA will continue to monitor current reform efforts and advocate the importance of reform in its four priority areas of taxation, regulation, infrastructure and workplace relations. To this end, in early 2006 the BCA intends to release a state of play document of reforms currently underway. This document will highlight the areas where reform momentum is strong and underline those areas where significant reform effort is still required. This document will provide a basis for prioritising the BCA's reform advocacy in 2006.

# 5. Objectives for Australia's Taxation System

The BCA aspires for Australia to be the best place in the world to live, work, learn, and do business. An integral element in achieving such goals is the creation and maintenance of a dynamic Australian economy.

A dynamic economy provides an environment in which business can flourish. This in turn creates the jobs, career opportunities and standard of living that make Australia an attractive place to live and work. In addition, it provides the incentives for Australians to better themselves through learning and education, and to innovate in the pursuit of entrepreneurial opportunities.

A dynamic economy can be defined by three primary characteristics.

1. *A strong emphasis on investment*
   Investment creates new business operations (offices and factories) which provide employment and increase productive capacity. Investment also improves productivity through capital deepening and facilitating the application of new inventions and innovations.

2. *A fully engaged workforce that is encouraged to participate and improve their skills*
   Strong employment and workforce participation provides more people with incomes to allow a greater standard of living, and creates the demand for goods and services that underpins economic activity. Increasing levels of education and skills in the workforce – ie. greater investment in human capital – improves labour quality which increases productivity and the likelihood of participation in the workforce.

3. *A focus on knowledge and innovation*
   Knowledge is increasingly valued in a modern economy to drive technological development, innovation and increased productivity. Investment in knowledge and knowledge-based innovative activities involves the practical application of knowledge and inventions to create value and wealth. An important element of such investment is the accumulation of human capital through education and training. Not only does education and training, as noted above, improve the skills and quality of labour, it also has strong links to innovation. Higher levels of skills are often required to facilitate the adoption of new technologies. Furthermore, greater skills and knowledge among the workforce are vitally important in the innovation process itself, allowing the creation of new ideas and the productive application of knowledge.

## *5.1 Taxation and a Dynamic Economy*

A dynamic economy is not the product of chance but the result of the capabilities, conditions and incentive structures created by the policy framework of a country. An important element of this policy structure is the taxation system of an economy. This section details the effect that a taxation system can have in creating a dynamic economy, or conversely in hampering the emergence of such an economy. These considerations inform the taxation reform suggestions of this submission.

Before addressing how the taxation system can directly influence incentives to undertake investment, participate in the workforce, accumulate human capital and carry out knowledge-based innovation, it is important to assess how taxation can also affect the dynamism of an economy more generally.

In addition to incentive effects, taxation directly imposes costs on the economy associated with administration, enforcement and compliance. These costs represent a loss of productive output that, if not minimised, will have serious repercussions for the dynamic operation of an economy. These types of costs, particularly those arising from complexity, must be kept to a minimum.

A taxation system should be structured and administered in such a way as to reduce uncertainty within the economy. Uncertainty adversely affects all three key elements of a dynamic economy. Strong investment in physical and human capital, knowledge and innovation require a level of certainty about the future by participants in the economy. The taxation system has the potential to add significantly to the cost of uncertainty. These uncertainty costs for the economy can be reduced through appropriate structures and administration. For example:

- a stable and robust macroeconomic environment is essential to reduce uncertainty in the economy. Large fluctuations in economic conditions affect decisions to invest, employ, participate, innovate and undertake education – this is particularly the case if the decision to undertake these activities is irreversible. The taxation system can help steady the macro-economy through its role as an automatic stabiliser and through ensuring that the tax base is sustainable and reliable through variable economic conditions[4]; and

- uncertainty is influenced by complexity, and a lack of transparency in administration of the tax system. Not being easily able to determine the tax implications of activities that could help to create a dynamic economy, such as investment and innovation, can lead to uncertainty and aversion to undertaking such activities.

### i. Taxation and investment

Taxation on company and private capital income directly affects the level and allocation of investment in the economy by increasing the cost of capital of different assets – ie. increasing the pre-tax rate of return the marginal investment has to earn for a given post-tax rate of return.

The taxation system of an economy can also influence investment by affecting the pool of available domestic savings. The rate of savings in the economy can be influenced by taxation arrangements for personal income and superannuation which impact on incentives to save.

### ii. Taxation and participation and employment

Taxes on labour income drive a wedge between what workers receive and what businesses pay, and can subsequently affect incentives for greater participation in the workforce and higher demand for labour. High marginal taxes on labour income can reduce incentives of workers to supply their labour and participate in the workforce. This is particularly the case for groups of workers for whom participation in the workplace is highly sensitive to income received. Such groups include:

- low-income workers for whom the interaction between tax rates and the welfare system can create high effective marginal rates of taxation;

- working parents, and in particular working mothers, for whom the take-home pay after tax needs to be compared to the increased costs of childcare and other work-family considerations; and

[4] The taxation system operates as an automatic stabiliser to smooth economic cycles by drawing more taxes out of the economy when it is growing quickly – thus reducing demand – and drawing less funds out of the economy when it is stagnating – thus improving demand.

- older workers for whom the considerations of income benefits from working need to be weighed against the leisure and health benefits of retirement.

Beyond such groups, higher marginal personal income taxes are also likely to reduce the incentives of workers to increase their participation in the workforce through increasing their hours of work. Taxation on labour income is also likely to have an influence on the decisions of businesses to employ workers. This is particularly the case if marginal tax increases result in higher wage claims by workers.

**iii. Taxation and skills**

Taxation on labour income can influence the economic impact of skills in the economy. For example, if taxes reduce participation and the supply of labour, the utilisation of the stock of skills in the economy declines.

Taxes on labour income can also influence incentives to upgrade skills through education and training. High and progressive marginal rates of personal taxation income can reduce future returns from human capital investment (the increased income expected from upgrading skills) and thus reduce incentives to undertake education and training.

**iv. Taxation and knowledge-based innovation**

The creation of knowledge-based innovation in an economy is likely to be affected by the taxation effects on investment and human capital formation noted above.

Beyond that it is important to note that such knowledge-based innovation often suffers from non-rivalry and less than full excludability[5]. These factors mean that once knowledge has been created it is often difficult to prevent others from using it at no additional cost. This results in businesses being unable to fully appropriate returns from investment in innovation, and leads to less innovation than is socially optimal. This suggests that not only is it vital that any barriers to knowledge-based innovation within the tax system be removed, but there is also a possible role for taxation incentives to undertake knowledge-based innovation.

## *5.2 Taxation and Globalisation*

The above analysis suggests a number of roles for taxation policy in helping to create and maintain a dynamic economy. The taxation system of an economy needs to:

- reduce administrative, enforcement and compliance costs;
- help minimise uncertainty in the economy; and
- take into account its impact on physical and human capital accumulation, workforce participation and employment, and innovation.

A final consideration that the policy formulation of a taxation system needs to take into account is its role in creating a dynamic economy in an international economic environment characterised by increased globalisation. Globalisation provides both opportunities and challenges in attempting to create and maintain a dynamic economy.

[5] Non-rivalry means the fact that one person consumes a good does not prevent another person from consuming the same good. While non-excludability means that in principle it is not possible to exclude someone from consuming that particular good.

The global integration of capital markets and foreign investment flows can help create a dynamic economy by reducing the need for domestic investment to rely on domestic savings. However, at the same time it provides challenges for an economy which must ensure that it is able to attract the foreign investment and retain the domestic savings which provide the investment base for dynamism.

In addition, the increasing global mobility of highly-skilled highly-paid labour provides the opportunity for an economy to rapidly increase its stock of human capital without necessarily increasing investment in education and training. However, at the same time, this new facet of the global economy also means that economies must compete to attract foreign skilled labour and retain domestically-educated workers.

The opportunities and challenges posed by globalisation increase the importance of the international competitiveness of a country's taxation system – in particular the corporate tax and personal income tax systems. Ensuring that the taxation system of a country creates an internationally attractive economy in which to invest and work is increasingly becoming an essential element in the dynamism of such an economy.

## *5.3 Potential constraints on reform*

Over the past year the BCA has highlighted the importance of timely economic reform to ensure Australia's economic prosperity in the future. Despite the obvious benefits of continued and more substantial tax reform there are a number of potential constraints which reduce the likelihood of reform being undertaken.

### Politics

Tax is a politically sensitive and complex area. It is easy for even the most worthwhile reform measures to be misrepresented by other political groups for short term political gain. In the past significant reform has been achieved when there has been bipartisan support, along with support from groups such as the business community.

There is evidence to suggest that such a conducive reform environment currently exists. The Australian Labor Party indicated that they understand the imperative for a competitive taxation system. The business community has advocated further taxation reform over the last three years and there are a number of other groups and individuals, including backbenchers and academics, putting forward reform ideas. This environment provides the Government with an excellent opportunity to move the debate forward towards real outcomes.

However, a significant political challenge to a renewed tax reform agenda will be the management of issues surrounding the cost of change. Such costs include direct administrative and compliance costs arising from new requirements and the legislative costs associated with delivering change as discussed below.

### Reform Costs

There were a number of costs (real and perceived) in the last tax reform process which need to be learnt from, addressed and managed as part of new reforms. These costs were apparent in the:

- sharp increase in reported business perceptions of tax complexity and workload;

- range of Government responses to modify arrangements to reduce costs and improve taxpayer experience with the tax authority;

- substantial legislation backlog with many measures announced but not legislated (impacting both on Government resources and the certainty of taxpayers); and

- failure of several tax reform proposals that would have had significant transitional costs, to gain support and proceed, including the tax value method, uniform entity taxation and the deferral of fuel taxation reform.

In order to manage these types of issues in the future and ensure that tax reform is not seen as having significant resource and political costs without clear and immediate benefits, any tax reform strategy (and advice) must include consideration of these types of cost issues. Methods for dealing with these broader reform issues should include:

- better understanding at the design stage of the potential costs and benefits including through the implementation phase, in order to minimise any unnecessary costs and ensure that only proposals which are cost reducing are advanced;

- a better explanation for the community prior to implementation of the costs and benefits of reform including building understanding of potential trade-offs;

- ensuring that there are adequate and effective drafting resources available for the implementation of reforms. This could include the use of external drafters to ensure timely drafting. External peer review will assist in ensuring that the original policy principle, as agreed in the Cabinet room, is implemented in the legislation; and

- use of an annual technical amendment bill in order to assist with the effective bedding down of reforms.

**Revenue Costs**

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

Business concerns in relation to this issue have grown over several years[6]. Since the business tax reform program began, a number of legitimate reforms have been delayed or abandoned on the grounds that they are too costly, based on the financial estimates before parliamentary decision makers at the time.

The BCA's concern is that, in the face of what have now become 'regular' record-breaking corporate tax collections, such reforms have been dismissed unnecessarily, even when it becomes apparent that the original forecasts were inadequate.

There are two elements to the costing of tax reforms that combine to create an overly conservative environment for business tax reform:

**i. Conservative Budget forecasts**

Underestimation of corporate and general revenue collections creates a far tighter spending environment than is actually the case, and discourages political decision makers from sensible reform measures where the benefits are not immediately (or politically) tangible.

[6] See, for example, Australian Federal Senate Economics Legislation Committee, Hansard (13 October 2003), p. E2-3.

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

**Table 2: Differences between Budget Forecasts and Final Outcomes – Company Taxation**

| Fiscal year | Original Budget estimate ($m) | Revised estimate at following Budget ($m) | Final Budget Outcome ($m) | Difference between original Budget estimate and final outcome ($m) | Difference between revised estimate and final outcome ($m) | Difference between original Budget estimate and final outcome (%) |
|---|---|---|---|---|---|---|
| 2000-01 | 30,857 | 34,720 | 35,136 | 4,279 | 416 | 13.9 |
| 2001-02 | 27,209 | 27,480 | 27,133 | -76 | -347 | -0.3 |
| 2002-03 | 28,400 | 31,260 | 33,365 | 4,965 | 2,105 | 17.5 |
| 2003-04 | 32,370 | 37,310 | 36,337 | 3,967 | -973 | 12.3 |
| 2004-05 | 39,400 | 40,610 | 43,106 | 3,706 | 2,496 | 9.4 |

Source: Commonwealth Government Budget Papers 2000–01 - 2004–05

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

**Table 3: Differences between Budget Forecasts and Final Outcomes – Underlying Cash Balance**

| Fiscal year | Original Budget estimate ($b) | Revised estimate at following Budget ($b) | Final Budget Outcome ($b) | Difference between original Budget estimate and final outcome ($b) | Difference between revised estimate and final outcome ($b) | Difference between original Budget estimate and final outcome (%) |
|---|---|---|---|---|---|---|
| 2000-01 | 2.8 | 2.3 | 5.6 | 2.8 | 3.3 | 100 |
| 2001-02 | 1.5 | -1.2 | -1.3 | -2.8 | -0.1 | -187 |
| 2002-03 | 2.1 | 3.9 | 7.5 | 5.4 | 3.6 | 257 |
| 2003-04 | 2.2 | 4.6 | 8.0 | 5.8 | 3.4 | 264 |
| 2004-05 | 2.4 | 9.2 | 13.6 | 11.2 | 4.4 | 467 |

Source: Commonwealth Government Budget Papers 2000–01 - 2004–05

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

The BCA understands that the Treasury has made some modifications to its forecasting methodology, particularly as it relates to corporate tax revenues. However, the BCA remains concerned that these changes have not been clearly explained, with little clarification of exactly what adjustments have been made. In addition, we will not be able to judge the accuracy of the changes used in the 2005-06 Budget until the final Budget outcome is released in 2007.

### ii. The selective inclusion of second round effects

Selective incorporation of second round or flow-on effects into reform costings also mean many reforms appear more costly on paper than they actually are. This gives the impression that many reforms are unaffordable, despite the broader boost to the economy that they are likely to provide. Again, this discourages decision makers of all political persuasions from adopting sensible reform.

Measuring the broader economic impacts of specific reform measures is difficult. At the very least a strong attempt at their calculation should be included in the official costing figures. However, where this is not feasible, as a minimum, these second-round and flow on benefits must be documented so that decision makers are aware of the anticipated future benefits of reform action.

The BCA notes that Treasury has stated that it is general policy that second round effects are not included when costing the fiscal impact of proposed tax reform measures[7]. However, it is clear that second round effects have been used in certain circumstances including on major reforms. For example:

- The Review of Business Taxation, while noting the difficulties of accurately forecasting the flow-on economic effects of such a large reform package, estimated a "conservative" growth dividend of up to 0.75 per cent of GDP by 2009–10 ($1.8 billion), and stated:

  *"The collective judgment of the review is that the national dividend will be significantly greater than this but there is no reliable basis that can be drawn upon to unequivocally demonstrate this outcome."*

- The *A New Tax System* package assumed a growth dividend of $1.6 billion accruing to the Federal Government, and $0.9 billion accruing to the States and Territories, over four years.

The following case studies highlight the deleterious effects on reform of conservative revenue forecasting and costing.

[7] See, for example, Australian Federal Senate Economics Legislation Committee, Hansard (13 October 2003), p. E13-15.

**Case Study 1: Taxation of Temporary Residents**

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

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

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

In December 2003 the Treasurer announced that, as the measure had been defeated twice in the Senate, the Federal Government would withdraw it. The failure to implement change has been criticised by international tax commentators as short-sighted and a wasted opportunity to attract skilled workers[8].

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

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

**Case Study 2: Better Treatment for Offshore Earnings**

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

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

The Federal Government decided not to proceed with the measures on cost grounds, noting that the Board only considered its recommendations to be an 'on balance' judgment, and that the move could disadvantage companies wishing to stay domestic-focused[9]. The report gave a preliminary costing of the measures of $520-590 million per annum, although listing several factors which were likely to partly defray this amount[10]. Despite concerns over the cost, in the financial year ended 30 June 2003, corporate tax revenues alone were more than $4.9 billion above the original budget estimates, and more than $2 billion above the revised estimates released during the following Federal Budget.

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[8] 'Few Incentives For Expats', *Australian Financial Review,* (27 February 2004), p.12.
[9] 'Review of International Taxation Arrangements', Federal Treasurer Press Release No. 032, (13 May 2003),
[10] The Board of Taxation, 'International Taxation: A report to the Treasurer', (28 February 2003), p.14.

**Case Study 3: Updating Australia's Tax Treaty with the United States**

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

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

Despite widespread support for the measures, in June 2002, the Joint Standing Committee on Treaties recommended against ratifying the amending protocol, on the grounds that Treasury estimates put the cost of the changes at $190 million per year. These estimates were largely based on the cost of reducing Australia's withholding tax on royalties, with no account taken of the economic benefits flowing to Australia from the reduction in US withholding tax rates.

The committee Chair, Julie Bishop, stated that "no quantitative evidence" of the benefits of the amending protocol had been provided, and as a result, the Treaty could not be justified. It was only resurrected following provision of further information from the Federal Treasury leading to the committee reversing its recommendation two days later.

It was subsequently reported that, largely as a result of the Treaty changes, Australian companies with substantial US investments were repatriating up to $1 billion in additional profits from the US to Australia [11]. Several companies reported that the changes meant decisions to repatriate income were no longer limited by taxation concerns and were made on their business merits. One company reported that the changes had enabled them to lift their Australian dividend payout ratio, directly benefiting their Australian shareholders. The changes resulted in some companies being encouraged to restructure their debt arrangements, resulting in additional Australian corporate tax being paid.

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

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

The BCA acknowledges that a number of tax measures previously rejected have been or are in the process of being re-examined or introduced. However, when compared to the large increase in corporate tax revenues, over and above the original estimated revenue inflows, it is clear that rejection of business tax reforms on cost grounds is in many cases unjustifiable. This is particularly so when second-round effects, albeit difficult to quantify, are likely.

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

# 6. Personal Taxation

**Recommendations:**

1. The two highest steps in the personal tax rate scale should be substantially reduced to no higher than 40 per cent, and preferably lower.

   - The initial steps should involve reducing the second highest rate from 42 per cent to 40 per cent, and the highest rate from 47 per cent to 45 per cent as part of the 2006–2007 Federal Budget.

   - The top rate could then be reduced to 40 per cent in the 2007–2008 Federal Budget.

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

3. Simplify the taxation law which applies to temporary and permanent migrants by either simplifying specific laws in relation to temporary residents or more significantly for Australia's economy, review and reduce the excess complexity that all Australian residents have to face in the current tax system.

   - Ensure that the ATO is adequately staffed to deal with individual migrant issues so that these do not become a barrier to the attraction and retention of skilled migrants through the establishment of a specific ATO Cell. Any common issues should be fed into a specific area in Treasury so that policy and tax design can be adjusted to ensure that issues such as complexity and administration do not become a block for temporary and permanent migration flows.

   - Specific taxation barriers for temporary migrants should be reviewed and removed in order to ensure that they do not disadvantage Australia in competing for the global mobile skilled workforce. Issues to be addressed include:

     - Australia's superannuation system;
     - the treatment of employee share schemes; and
     - the deemed imposition of capital gains tax applying to temporary workers' world-wide assets.

4. Barriers to participation in the workforce should be reviewed and removed:

   - High Effective Marginal Tax Rates need to be reviewed by the Productivity Commission examining the impacts and implications for participation and productivity and measures which could reduce the worst impacts. In addition to this review, measures to address the worst of these rates need to be included in the 2006–07 Budget.

   - The current exemption for employer-sponsored childcare should be broadened to effectively make all employer-sponsored childcare FBT free.

The potential effect of the personal income taxation system on the dynamism of an economy was highlighted in Section 5 above. In particular, the personal taxation system can influence the participation and skills level of the workforce in the economy. Furthermore, it can also affect incentives to save and thus the level of investment within the economy.

This section provides recommendations for reform to the Australian personal taxation system which aim to address these aspects of a dynamic economy.

## *6.1 Savings and Investment*

A key foundation of a dynamic economy is a strong and efficiently allocated investment base. Australia's current personal taxation system provides a number of impediments to the level of investment in the economy and contains biases that prevent the maximisation of productive investment.

Australia's high marginal income tax rates provide disincentives for saving. In a perfectly integrated world capital market this is unlikely to affect the supply and cost of capital in the economy. However, market failure exists in the form of information asymmetry – Australians like to invest in Australian companies and, more importantly, offshore investors have less information to guide investment in Australian companies. These market failures mean that domestic investment is still influenced by domestic savings, and therefore high marginal personal income tax rates are likely to affect investment levels. These disincentives to save are also exacerbated by Australia's system of superannuation taxation which is unique in taxing savings at three points.

The key disincentives to save will be addressed by a reduction in the top two marginal tax rates. It is a rate change and not a threshold change that is needed to improve domestic savings and investment. Raising the threshold is not as effective as a change in the rate in reducing the effective marginal tax rate for as many people as possible – it is the effective marginal tax rate that affects individuals' decisions to undertake additional saving and investment.

The Australian personal taxation system also creates biases against investment in productive assets. The tax system favours lower-risk investment classes, especially when geared, compared with higher-risk business investment. Tax concessions apply for individuals investing in capital growth assets such as property where full nominal interest deductions are allowed. This reduces effective tax rates on geared investments (even if they are not negatively geared). This (together with the full tax exemption for owner-occupied housing) has biased Australian investors in favour of assets of these types. High marginal rates have also encouraged many taxpayers to seek tax shelters, particularly where tax timing benefits can be obtained rather than the most productive investments. Addressing high marginal tax rates is important to help alleviate these issues; further review to reduce such biases will also be required.

## *6.2 Participation, Retention and Skilled Workers*

The active participation of a highly skilled workforce in productive pursuits is a vital element of a dynamic economy.

However, the spectre of an ageing population raises an important challenge to workforce participation levels in the future. As highlighted in publications such as the Inter Generational Report, falling participation rates in the future, due to the structural ageing of the population, will have important economic costs and greatly affect the economy's ability to finance the associated growing demands for Government services.

These adverse participation effects can be addressed in a number of ways:

- increasing domestic birth rates (allowing for an 18 to 25 year lead time);
- increasing the participation rate by encouraging people off social security and into the workforce;
- increasing retention of older workers in the workforce;
- encouraging parents back into the workforce; and
- increasing and retaining migration flows into Australia.

The benefits of increased migration can also be enhanced through a focus on skilled migration, which not only provides more active workforce participants for the economy but can help to improve skill levels as well. However, at the same time as the growth of Australia's local workforce is beginning to decline, the competition for skilled workers worldwide is increasing. The majority of Australia's major competitors are facing similar or more severe demographic changes than Australia and are also looking to fill the gaps through increased skilled migration. This process is accelerating as the Asian and other emerging economies grow rapidly, resulting in higher incomes and increased demand for professional and financial services, thus expanding work opportunities for the highly skilled in those countries.

These trends provide additional challenges for Australia in maintaining a workforce with strong participation rates and high levels of skills. Increasing international competition for skilled labour highlights the importance of providing the right environment not only to attract skilled migrants to Australia, but also to help retain Australia's domestic skilled workforce which will be vitally important to the dynamism of the economy as the economic costs of population ageing begin to manifest.

The role of Australia's personal taxation system in addressing issues concerning workforce participation and skill level in the economy is vital. However, the current structure of the personal taxation system provides a number of constraints to improving Australia's performance in these areas.

## Attracting and Retaining Skilled Labour

### Impact of High Personal Tax Rates

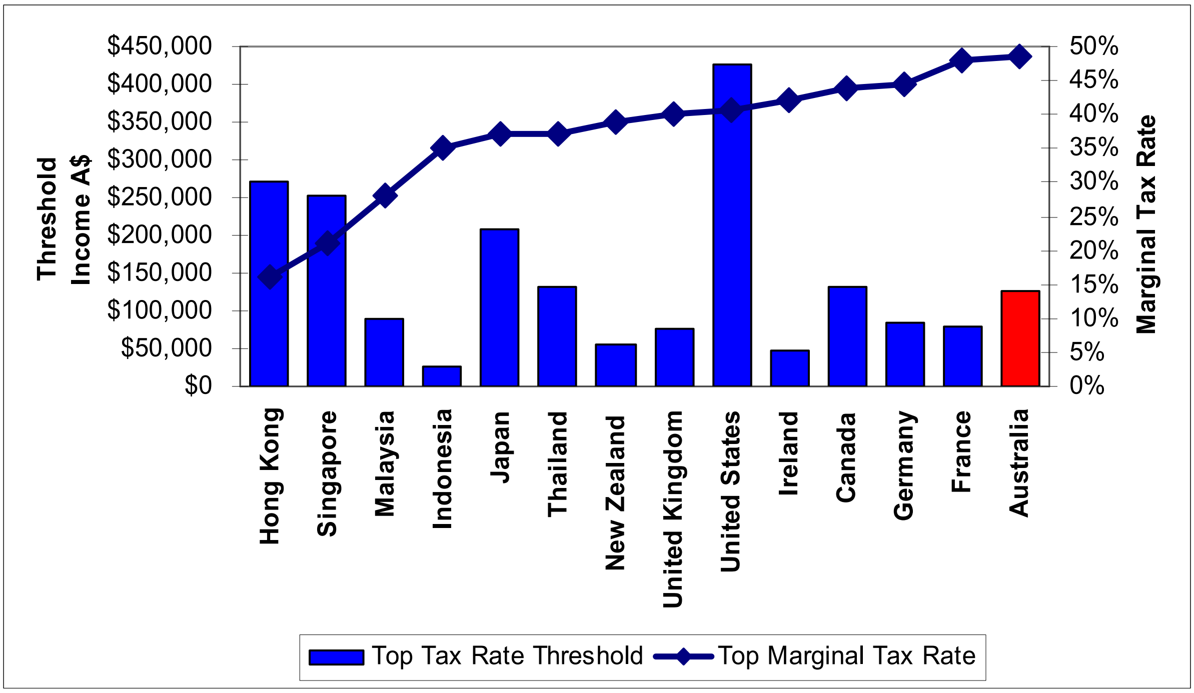
Today around one billion international people movements for all purposes occur each year, of which a significant proportion are work related. Mobility is greatest for the highly skilled. The attractions of international careers including the benefits of career skills, advancement and broader experience are increasing with globalisation as more firms operate internationally. Improved communications and travel services reduce the isolation and other costs often associated with such work, and countries tailor their national laws to particularly accept and encourage skilled entry.

Australia's high marginal tax rates undermine Australia's competitiveness as a location for high-value occupations and activities. Lowering the top two highest marginal tax rates in the personal tax structure will help make Australia a more competitive destination for attracting and retaining skilled employees.

The chart below takes into account the changes announced in the 2004–05 Budget which will be in full operation by 1 July 2006. These changes shifted the threshold tax bracket for the top two thresholds. These changes were warmly welcomed by business at their announcement as significant steps in the right direction towards bringing Australia's personal taxation system more in line with its key competitors.

However, to be competitive a country requires either a very high top marginal threshold such as applicable in the United States, or a low top marginal rate, or preferably both. As can be seen from Chart 2, Australia's top marginal tax rate is higher than 13 of its key competitors (including the US, UK, Ireland, New Zealand and Japan) at 48.5 per cent. In addition, even though its rates are higher, Australia's top threshold is well below key competitor countries such as the United States, Japan, Canada, Singapore, Hong Kong and Thailand.

**Chart 2: Comparison of Marginal Tax Rates and Top Thresholds Expected in 2006**




Sources: 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/faq/taxrates-e.html and http://www.taxadmin.org/fta/rate/tax_stru.html

Income is an important determinant of decisions about where to work and live in an increasingly global labour market. Over one-third of respondents in a recent survey of Australian emigrants cited higher incomes as an important factor influencing their decision to leave Australia[12]. Many skilled employees can earn significantly higher incomes in ($A) terms overseas, and lower taxes can significantly add to the income differential. In addition the difference in how savings and investments are taxed means that the benefits of remaining offshore for longer far outweigh the benefits of returning to Australia.

While the Government's recent threshold changes were substantial and should not be dismissed, it is strongly recommended by the BCA that future changes be made to rates rather than thresholds. Threshold changes should be undertaken as an alternative to marginal rate changes only if highly significant (for example the US top marginal rate is less than Australia's and the threshold is over four times higher than Australia's new top

[12] Hugo, G. Rudd, D. and Harris, K., 'Australia's Diaspora: Its Size, Nature and Policy Implications', *CEDA Information Paper*, No.80 (December 2003).

threshold, commencing at around $430,000 in Australian dollars) or as part of a change in the structure (for example, removing the highest or second highest threshold altogether).

There are a number of reasons why shifting the rate rather than the threshold will have a greater beneficial effect on attracting and retaining skilled labour:

- threshold shifts only change marginal rates for a relatively small number of taxpayers and they do not change the marginal tax rates facing taxpayers with incomes above the new thresholds; and

- the benefits of threshold changes are eroded by inflation over time, and areas that are linked to the rate (such as the fringe benefits tax rate for benefits paid to employees) would not be remedied by a threshold change and would become even more anomalous than they are now.

**Other Taxation Impacts**

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

For non-Australians residing temporarily in Australia, the current tax impacts can be particularly harsh. As well as paying higher marginal and average taxes on personal incomes than they would in many of Australia's competitor countries, a highly skilled worker who chooses to work in Australia rather than in a competitor economy will also have to come to terms with many other complex features of the Australian tax system.

The Government undertook a number of important measures to reduce the capacity of Australia's taxation system to act as an impediment attracting skilled workers. However, these measures were significantly delayed (having being rejected by the Senate twice) and in the meantime, our competitors have moved on. For example, in order to increase their international competitiveness and their ability to attract internationally mobile labour, many countries have or are moving to:

- establish a separate category of 'temporary residents' that are treated differently from both residents and non-residents. For example, the UK has 'resident but not ordinarily resident' and 'residents but not domiciled' classes of taxpayer, Singapore has a 'not ordinarily resident' class of taxpayer and Japan has a non-permanent resident class of taxpayer; and

- exempt certain income of 'temporary residents' from tax (eg. foreign source income not remitted to the individual while they are a temporary resident in the country, or some proportion of their income).

For example:

- UK, Singapore, Thailand and Hong Kong are all operating 'remittance' based systems where temporary residents are exempt from tax on their foreign source income unless they choose to remit that income (bring it into the country);

- Japan taxes those who reside in Japan for up to five years on either their Japanese source income or their total funds remitted into Japan; and

- The Netherlands allows employers to pay eligible expatriate employees (including those with skills that are in short supply) up to 30 per cent of their salary free of tax.

The Government should be commended for achieving passage of its reforms to the taxation of temporary residents previously rejected by the Senate[13]. However, it needs to undertake other reforms aimed at removing barriers to the attraction of the skilled temporary residents, such as:[14]

**i. Complexity and deadweight costs faced by temporary employees and their employers**

There is a high degree of complexity and cost for businesses that attempt to employ temporary residents. To attract workers it is common that the employing business must compensate for the taxes paid. This represents a direct cost that reduces Australia's competitiveness as a location for high-value activities.

**ii. Specific taxation related barriers for expatriates**

In addition the Government needs to address specific taxation related barriers for expatriates such as:

- **Implementing an objective test for inbound residence**
  The current definition of 'resides' in relation to residents for Australian tax purposes does not create certainty in Australia's tax environment. As a result it can be inconsistent and provides different outcomes for people coming to and leaving from Australia on a temporary basis. Consistent with the treatment adopted by our near neighbours and in order to provide greater certainty, an objective test should be developed based on days of physical presence in Australia.

- **Exempting the income that temporary residents derive from foreign workdays**
  A number of countries that are competing with Australia in attracting skilled workers (including Hong Kong, Singapore, Thailand and Malaysia) allow for the income that temporary residents derive from foreign workdays to be exempted from taxation. Australia should consider similar rules.

- **Reform of superannuation for temporary residents**
  Australia still imposes additional non-recoverable costs on employees and/or temporary resident employers as a result of compulsory superannuation requirements. Areas for reform could include:

  – excluding temporary residents from having to make contributions to Australia's compulsory superannuation regime through an extension of the current 'senior executive' exemption to all temporary residents. Temporary residents should be excluded from having to make contributions to Australia's compulsory superannuation charge in the same way that the 'senior executive' exemption operates now[15];

  – ensuring that employers can claim a tax deduction for contributions on behalf of employees to foreign superannuation funds. Contributions to foreign super funds in

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13 Reforms included the insertion of a new definition of 'temporary resident' into s. 995-1 of the *Income Tax Assessment Act 1997*; the extension of the existing four-year exemption from the Foreign Investment Fund rules for temporary residents; and the provision of temporary residents with a four-year exemption from income tax on foreign source income derived from assets, capital gains tax on the disposal of foreign assets and interest withholding tax obligations.

14 A number of these issues were raised in the Ernst and Young, 'Review of International Tax Arrangements', *Submission to the Board of Taxation*, (October 2002), s.8, p. 87-92.

15 This proposal was outlined in recommendation 22 of Business Council of Australia, 'Review of International Tax Arrangements', *Submission to the Board of Taxation* (October 2002).

respect of international employees are a legitimate business cost for which a tax deduction should be allowed to employers.

- **Remuneration such as employee share schemes should receive similar or less severe tax treatment than our competitors.**
  Government should reform areas where Australian businesses are disadvantaged in their capacity to provide a competitive package when trying to attract skilled employees, including:

  – the need to harmonise acquisition rules between share plan and Capital Gains Tax Rules. The current system including the definition of 'deemed to acquire' is unique to Australia and is highly complex;

  – the Fringe Benefits Tax (FBT) and Capital Gains Tax (CGT) exemption should be extended for genuine share plan trusts. An exemption within the FBT and CGT rules for trust activities within employee share plans would bring this treatment into line with overseas treatment;

  – the expansion of the current share plan rules beyond ordinary shares to areas such as listed stapled securities; and

  – bringing the Division 13A treatment into line with international practice through removal of cessation of employment as a taxing event in cases of termination of employment arising from redundancy or retirement[16].

- **Clarify the so-called "deemed disposal" rules to prevent capital gains tax being imposed on foreign employees' world wide assets.**
  Australia imposes CGT on temporary workers by deeming them to have disposed of their world wide assets after they have been resident in Australia for five years, regardless of whether the assets have actually been sold. The BCA notes that the rule effectively results in skilled foreign workers, particularly at executive level, structuring their Australian employment contracts for limited terms of four years, 11 months. In addition, the enforcement of this rule provides an administration burden for the ATO and taxpayers that is unlikely to be matched by the revenue raised.

  The BCA notes that the five year rule was effectively removed for some skilled temporary workers as a result of the recent renegotiation of the US and UK Double Tax Treaties, and will be progressively adressed as subsequent treaties are renegotiated. The BCA also welcomes the announcement in the 2005-06 Federal Budget that the Government intends to reintroduce measures (previously rejected twice in the Senate) to confirm a four-year CGT and foreign source income exemption.

  - the Government should confirm that the pre-existing foreign assets of all temporary resident employees will not be subject to CGT on departure from Australia, regardless of the duration of their Australian employment.

## Participation

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

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[16] A recent Australian Bankers Association submission to the Federal Treasury on this issue demonstrated that 11 of our trading partners do not tax employees on cessation of employment.

**Effective Marginal Tax Rates**

Effective Marginal Tax Rates (EMTR) equals the proportion of an additional dollar of income that is paid in tax or lost through a reduction in (entitlement to) transfer payments. The progressive scale of personal tax interacts with the benefit abatement regimes (means testing) to impose very high EMTRs at low-income paypoints.

High EMTRs create disincentives for those individuals to re-enter the workforce or work additional hours. Because of the significant progressivity of Australia's tax system and the way it interacts with the social security system, EMTRs are difficult to address. Despite a number of recent changes by the Government there are still EMTRs of above 60 per cent on the incomes of some individuals who are moving off benefits and re-entering the workforce. Such high EMTRs impact on individuals' incentives to:

- look for work;
- increase work level or number of hours;
- spend time and money on retraining or on further education in order to obtain additional or higher paid work.

Australia is facing future challenges including an ageing population, and cannot afford to have disincentives on workforce participation. Australia's high marginal tax rates already impact on participation incentive and high effective marginal tax rates exacerbate this problem.

The BCA has previously recommended that the Productivity Commission undertake a review of EMTRs in Australia, their implications of how they impact on participation and productivity and measures which could reduce the worst impacts. We continue to seek this review and measures to address the worst of these rates in the 2006-07 Budget.

**FBT and Childcare**

It is well known that Australia's workforce participation rates are at best average, and well short of the rates in many other OECD countries. Workforce participation rates of women in particular are relatively low.

The lack of availability and rising cost of childcare has become a serious impediment to the workforce participation of Australians with children, particularly women. Thirty-five per cent of employees with caring responsibilities say they would increase their working hours if childcare were more affordable[17].

The BCA believes employers also have an important role to play in working with their employees to develop appropriate work and family policies, and BCA Member companies have reported that good work-family policies produced real benefits for their business, in terms of staff retention, recruitment, staff morale, and higher productivity[18].

However, according to a survey conducted by the BCA in 2005 just 13 per cent of BCA Member companies currently provide employer-sponsored or work based childcare. FBT is one of the most frequently cited reasons for not providing such a service.

The BCA believes that one of the best, and most cost-effective, ways to encourage more businesses to engage in employer-sponsored childcare is to increase the scope of the

[17] Taskforce on Care Costs "Creating choice: Employment and the Cost of Care" (24 February 2005) p 5

[18] Business Council of Australia, 'Submission to the Commonwealth Parliamentary Inquiry into Balancing Work and Family', (18 April 2005).

existing FBT exemption for on-site childcare, effectively making all employer-sponsored childcare FBT free.

Indeed, a number of BCA Member companies have publicly stated (both in the press and in submissions to recent Government enquiries) that the tax impost on childcare is in many cases the determining factor in whether to provide employer-sponsored childcare at all, or expand care to multiple locations[19].

This is partly because of the financial cost of the tax itself, and partly because the onerous requirements that need to be met in order to qualify for the existing limited FBT exemption require employers to take on liabilities and obligations that are impractical and/or too far outside the scope of their business activities.

The BCA firmly believes that encouraging business to provide employer-sponsored childcare will help alleviate the pressures on the childcare system, by:

- **Increasing the number of childcare places available overall.**
  This will not only directly assist the employees of a business that provides employer-sponsored care, it will have flow-on benefits for the rest of the community by freeing up places in the broader childcare system. In some areas parents face waiting lists of up to two years[20].

- **Increasing the number of places available in regional centres**.
  BCA Member companies with Australia-wide operations, that already provide some employer-sponsored care in major cities, report that the tax impost effectively prevents them from offering such programs in regional centres. This is because in order to obtain an FBT exemption under the current tax rules, the childcare centre must be on an employer's premises and effectively available exclusively to its employees[21]. As a result, childcare operations in smaller locations are simply not cost effective.

- **Allowing smaller employers, not just companies with large numbers of employees, to offer childcare.**
  Similar to the problem experienced by employers in regional centres, the current 'exclusive use' requirement means that businesses with smaller staff numbers may not be able to justify an employer-sponsored childcare arrangement.

- **Providing greater competition in childcare generally**
  Allowing companies greater flexibility in the way they provide childcare and the providers they use will help reduce the monopoly currently enjoyed by a few large childcare providers, promoting competition and helping to keep childcare costs in check. The current structure of the limited FBT exemption actually increases pressure on costs, because it forces employers only to consider centres in CBD metropolitan areas, where property rents and on-costs are already high.

- **Providing greater access to 'long day' and 'after hours' childcare.**
  There is a critical shortage of access to childcare outside traditional working hours. Businesses are aware of the working hours required of their employees and can tailor the operating hours of their employer-sponsored childcare centres accordingly, freeing up valuable long daycare places in the broader community.

- **Reducing the substantial cash-economy childcare industry**

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[19] See, for example, 'Childcare: Who cares?', *Business Sunday* (1 May 2005) and 'Employers urge tax friendly childcare', *Australian Financial Review* (13 August 2005).

[20] 'Parents return to work creates a blowout in childcare rebate', *Sydney Morning Herald, (11 August 2005).*

[21] The requirements are explained more fully in the Australian Taxation Office's public taxation ruling TR 2000/4. The inherent uncertainty of the taxation system means many companies also go to the additional expense of seeking a private binding ruling specific to their circumstances.

Increasing the number of places available and lowering the cost of formal childcare will help reduce the current tendency to informal cash-in-hand childcare arrangements. Quite apart from the 'quality of care' implications posed by such arrangements, it is estimated that 53-70 per cent of people who pay for childcare do so on a cash-in-hand basis[22]. Some estimates have put the value of the informal industry as high as $6 billion[23]. Even at a conservative effective tax rate of 16 per cent, almost $1 billion in tax revenue is being lost every year as a result.

Because employer-sponsored childcare falls into the broad category of 'residual benefits' under the FBT law, there is no separate data available on the amount of FBT raised from the provision of employer-sponsored childcare arrangements.

However, the fact that many businesses currently refuse to enter this market because of the tax, and most companies that offer such childcare do so under a structure that avoids the imposition of FBT, it is unlikely that the current revenue raised through this measure alone is particularly large.

But for the availability of childcare, employees have no choice but to withdraw from the workforce, reducing both personal income tax collections and, potentially, productivity.

The BCA believes that any resulting loss of revenue due to an expansion of the FBT exemption would be more than offset by the additional benefits to the economy due to increased workforce participation, as well as the social benefits afforded by relieving current pressures on the childcare industry. Government modelling on its existing programs suggests that every dollar the Government spends on childcare returns total economic benefits of $8.11, including $1.86 to the Budget bottom line in terms of increased taxation and reduced benefit outlays[24]. There is no reason to suggest that similar economic benefits would not be obtained by broadening the FBT exemption. Any reductions in the cash-economy childcare industry would also help offset any revenue cost.

While a broader exemption may be likely to increase the number of employees who choose to salary sacrifice their childcare arrangements, the resulting revenue implications (which can be reasonably assumed to be less than the revenue implications of employees withdrawing from the workforce altogether) would be partially offset by the reduction in Government Childcare Benefit, which is not payable to employees on salary sacrifice arrangements.

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[22] Taskforce on Care Costs 'Creating Choice: Employment and the Cost of Care', (24 February 2005), p.6.

[23] '$6bn black market in nannies', *Sun-Herald* (30 October 2005).

[24] 'More than just play dough - a preliminary assessment of the contribution of childcare to the Australian economy', FACS, (2004).

# 7. Company Taxation

**Recommendations:**

5. A more competitive business taxation system must be provided to promote longer-term growth and productivity. Government should commence an immediate review of the company tax system in time for measures to be included in the 2006–07 Budget to assess and remove barriers to Australia's long-term competitiveness.

    - The best method for reducing the overall burden of company taxation in Australia should be established including examining options such as reducing the company tax rate or bringing the treatment of business income more into line with the practice undertaken by Australia's competitors.

    - The review should take into account both international competitive pressures and the top marginal personal taxation rates.

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

    - In 2002–03 the Board of Taxation recommended to the Government that there be reform in this area. The Government indicated at that time that it would be willing to address this issue at a later stage; ideally it should do so as part of the 2006–07 Budget.

    - Consistent with the Board of Taxation's recommendation to remove the imputation bias against Australian companies investing offshore, a 20 per cent non-refundable national franking credit should be introduced to take account of offshore tax paid on offshore profits on behalf of Australian shareholders.

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

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

A robust and efficiently allocated investment base is vital to the dynamism of any economy. Investment increases productive capacity, provides employment opportunities and improves productivity. The taxation of companies is an important public policy framework for influencing investment in the economy. Company taxes affect the cost of capital in the economy – and thus the level of investment – and create incentive structures for the allocation for such investment.

Furthermore, the growing integration of global capital markets has greatly increased the sensitivity of foreign investment flows to the relative competitiveness of the company taxation environment provided in different countries. This process highlights the increasing importance of maintaining an internationally competitive company taxation regime in order to attract and retain foreign investment flows that are vital for improved employment, productivity and economic dynamism.

This section provides recommendations for reform of the Australian company taxation system which attempt to address current barriers to productive investment in the economy.

## *7.1 High Corporate Taxation Burden*

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

The survey compares the headline corporate tax rate and corporate tax burden in Australia with similar measures in a range of comparable economies. These economies were selected on the basis of their likely competitive relationship with Australia, now and in the future, including the OECD, EU, selected Asia-Pacific economies and Australia’s major trading and investment partners.

In comparison, Australia’s corporate tax rate of 30 per cent compares favourably with the averages for the selected groups. Only in comparison to the highly competitive EU countries is Australia’s corporate tax rate substantially higher than the average of 25.3 per cent. However, when looking at a more complete measurement of the system’s competitiveness, Australia’s corporate tax burden (measured as the company tax to GDP ratio) is considerably higher than the averages of all competitor groups. Disregarding Norway and Luxembourg due to features peculiar to those economies, Australia has the highest corporate tax burden across every relevant global comparison (see Chart 3 below).

Australia clearly has a very high tax take from business income (tax to GDP). Moreover, Australia’s relative competitive position is getting steadily worse. Even if factors such as increased company profitability are considered significant contributors to the more recent rises in corporate tax take, it is clear that Australia’s taxation of companies remains at least as unfavourable as prior to the 2001 Ralph Review of Business Taxation reforms. On the other hand, most of Australia’s competitors are actively providing more favourable environments either through changes to the treatment of business income or through changes to the statutory rate.

For example, more than one-third of the OECD member states and more than one-third of the European Union member states have reduced their statutory corporate tax rates in the last 12 months. When the business tax reforms came into effect in 2001, Australia’s statutory corporate tax rate was below the OECD and EU averages, in 2005 it is now above both of these averages.

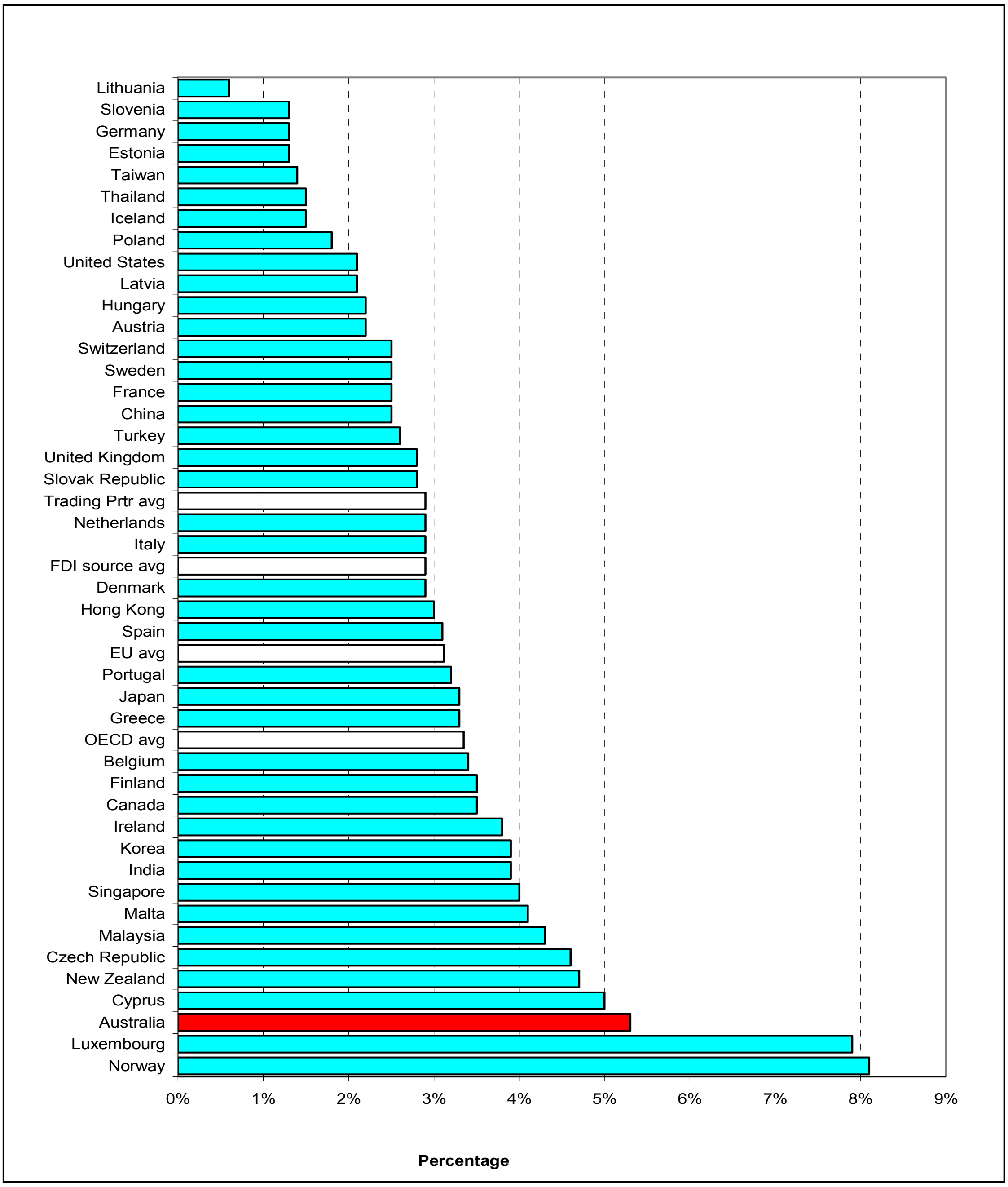
While the company tax rate was reduced from 36 per cent to 30 per cent in 2001 as part of a wider package that the BCA supported, the tax burden on companies remains uncompetitively high. This is largely because while Australia’s statutory rate is broadly comparable with its competitors, the Australian company tax base is one of the broadest in the world. The reasons for this include the following:

- no write-offs for goodwill acquisitions (tax deductible write-offs are available in many countries, including the US and UK);

- depreciation that is close to effective life. In many other countries, capital write-offs for investment in plant and equipment are simplified and accelerated;

- full capital gains tax on companies without discounts or inflation relief; and
- relatively few tax concessions combined with complex specific and general anti-avoidance provisions apply to a wide range of activities including foreign source income, infrastructure investment and capital management transactions.

**Chart 3: OECD, EU, selected Asia-Pacific, trading partner & FDI source economies corporate tax / GDP comparison**




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 & Singapore (2005).

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

Case Study 4 below provides a comparison of company taxation treatment in the United States, a country with a relatively high statutory corporate taxation rate but a low, and therefore highly competitive, company taxation burden.

**Case Study 4: United States of America – High corporate tax rate – low corporate tax burden**

The United States, despite having a higher corporate tax rate than Australia, has a significantly lower corporate tax burden, one of the lowest in the OECD. This is because the effective tax rate paid by companies is considerably lower than the federal statutory tax rate of 35 percent (companies may also be subject to state taxes). A recent study of 275 top American companies that were all profitable for each of the years 2001–2003 found that the average effective tax rate paid by those companies was 21.4 percent in 2001 and 17.2 percent in 2002–2003, resulting in an effective rate of 18.4 percent over the three year period[25]. The following factors contribute to the low effective tax rate:

- accelerated depreciation – the tax laws generally allow companies to write off their capital investments considerably faster than the assets actually wear out. While this is technically a tax deferral, the deferral tends to be indefinite as long as the company continues to invest;

- stock options – companies get a tax deduction for the difference between what employees pay for stock through the exercise of options given by the company and what the stock is worth. This is usually the practical outcome in Australia but is not expressly provided for and requires a reasonably arguable position as to deductibility. Therefore, stock options are not utilised as extensively as in America;

- tax credits – the federal tax code provides substantial tax credits for companies that engage in certain activities such as research (in addition to immediate deductibility of research investments), oil drilling, exporting, hiring low-wage workers, affordable housing and investments in alternative fuel. As credits, these directly reduce a company's taxes. In addition, companies can purchase tax credits from other companies that are unable to utilise them. For example, Bank of America cut its taxes by $580 million over the 2001–2003 period by purchasing affordable-housing credits;

- tax incentives – in addition to general tax credits, the Government also provides large tax subsidies to specific companies and industries. These incentives are extremely specific and depend on the company and industry. For example, aerospace and defence companies had the lowest effective tax rate over the period 2001-2003 due to industry specific incentives. The aerospace company Boeing enjoyed additional tax incentives resulting in a three-year effective tax rate of 18.8 percent;

- carry-back excess tax incentives – companies are able to carry-back excess tax credits in a particular year to earlier years and reduce a previous year's tax liability;

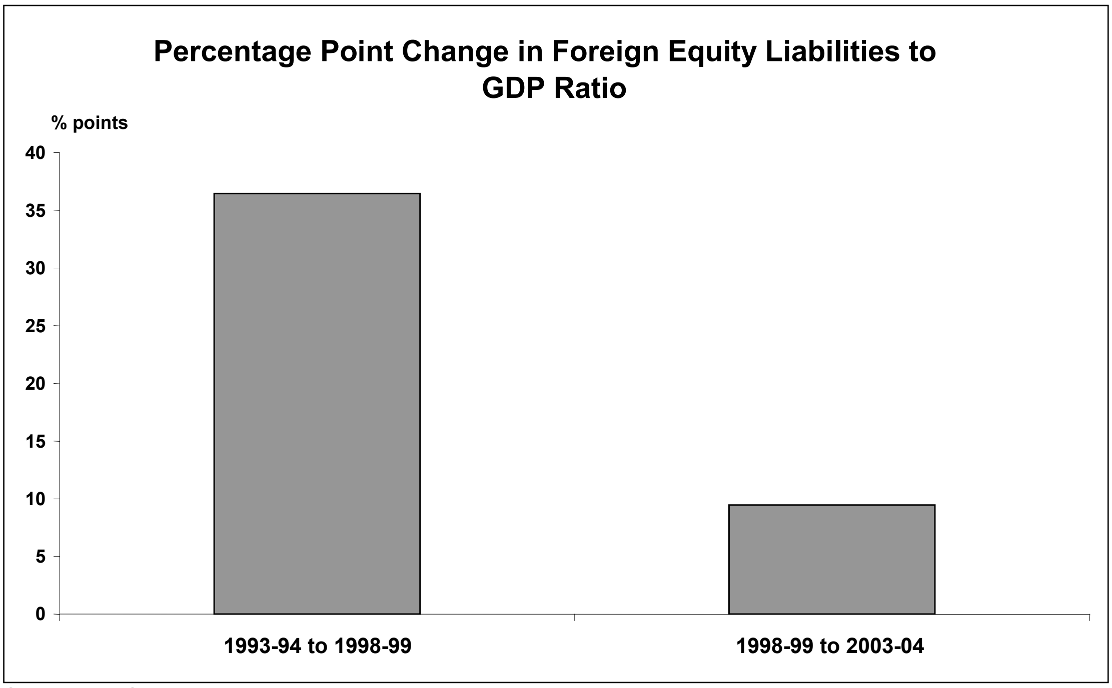
- carry-back of tax losses – companies are able to carry-back tax losses to earlier years and obtain a refund of tax paid. (This approach may be more useful than Australia's carry-forward system because if a company suffers losses for a number of years it may have difficulty utilising those losses when it finally has taxable income due to the loss recoupment tests);

- favourable treatment of foreign income – the US uses a general foreign tax credit regime similar to Australia but provides taxpayers with more flexibility by providing a foreign tax credit that is equal to the average tax paid on active foreign source income. As such, taxpayers can invest in countries with low as well as high effective rates and the average foreign income tax paid may be within the rates recognised in the USA. In addition, active foreign income that stays abroad is not subject to taxation in the United States, regardless of whether or not it is taxed in the source jurisdiction.

[25] MacIntyre, R. and Nguyen, T., 'Corporate Income Taxes in the Bush Years', (September 2004).

There is evidence to suggest that Australia's increasingly uncompetitive company taxation system is beginning to adversely affect its ability to attract foreign investment. Chart 4 below, taken from the BCA's *Corporate Taxation: an International Comparison*, shows the percentage change in the ratio of the level of foreign equity investment to GDP in Australia over the two five year periods 1993–94 to 1998–99 and 1998–99 to 2003–04. Foreign equity investment is the major component of foreign direct investment. The changes in these ratios reflect real foreign investment transactions, that is the data removes the impact of swings in the value of equity due to factors such as price or exchange rate changes. The figure shows that investment inflow growth has declined substantially since the end of the 1990s. From 1998–99 to 2003–04, foreign equity investment in Australia increased by just 10 percentage points of GDP. In contrast, in the preceding five year period to 1998–99, foreign equity investment increased by 37 percentage points of GDP[26].

**Chart 4: Percentage Point Change in Foreign Equity Liabilities to GDP Ratio**




Source: ABS 5302

Australia cannot afford to ignore significant barriers to our competitiveness, and our uniquely high company tax burden compared with every potential trading partner or competitor clearly falls into this category. This should be addressed by either lowering the statutory rate further or looking to ensure that the business taxation system is as competitive as possible. In April 2005 the BCA strongly recommended that the Government review the company tax system (both the treatment of business income and the statutory rates) within the context of the global environment to assess and remove barriers to Australia's competitiveness.

[26] Data for 2004–05 is not included in Chart 4 because of the large but offsetting transactions associated with only one company, the change by News Corporation from being an Australian to a United States domiciled company.

## 7.2 Franking Credit Tax Bias

An overall bias continues to exist at both the shareholder and company level against Australian companies investing offshore. Australia's imputation regime only provides a credit for Australian company tax paid on income that has an Australian source. This creates a bias in favour of direct investment offshore rather than investment offshore via an Australian company with offshore investments. Individuals who invest directly offshore receive a credit for foreign taxes levied on their income.

The Board of Taxation recognised that this bias was not in Australia's longer-term interest and recommended that this bias be removed. The bias provides a disincentive to Australian companies who rely on the investment of Australian shareholders to grow globally at a time when we should be supporting, not hindering, the offshore growth of our companies and their capacity to compete globally.

While not proceeding with these recommendations immediately (largely on revenue grounds), the Government left the door open to consider these reforms in the future. As recommended by the Board of Taxation, a 20% non-refundable notional franking credit for offshore profits paid to resident shareholders as unfranked dividends should be introduced.

## 7.3 State Taxes

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

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

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

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

The removal of these taxes will promote the economic growth and long-term investment performance of each State and Territory. To do less than remove these nine taxes in the immediate future would go against the spirit of the original reform agreement.

Federal, State and Territory Governments all have an important role to play in reducing the tax burden facing companies and encouraging the continuation of Australia's economic prosperity.

# 8. Simplification of the Taxation System

**Recommendations:**

8. Tax compliance and administrative tasks must be simplified. While the current work of the Government's Regulation Taskforce may be beneficial, a more comprehensive review of taxation specific issues must be undertaken.

   - To that end, the Board of Taxation should be charged with preparing a full report on the costs associated with complexity, compliance and administrative burdens, and the scope and possible means of achieving greater simplification of tax systems in Australia. This report should move well beyond the useful but initial steps of reviewing and removing inoperable provisions and small business taxation issues currently being undertaken by the Board.

9. A formal program to regularly review new tax laws must be put in place to allow for adjustment and updating of laws as necessary. A formal, regular procedure would allow a recognised mechanism for minor adjustments as well as an opportunity to review major structural changes, like the introduction of the GST, after the first few years of operation. Such reviews and amendments should be recognised as good tax system management.

The impact of the Australian taxation system and the cost it imposes on business is not only the result of current policy intent, but the legacy of past decisions and half-implemented reforms developed over the last 70 years.

It comes as no surprise that Australia's taxation system is overly complex, contradictory and prescriptive. The compliance burdens of the tax law arise in many ways – unclear law, excessive choice, concepts and timing of valuation unrelated to ordinary business practice, frequency of payment, complexity and opacity of language, unreasonable approaches to record keeping and many more.

Even well-qualified members of the community struggle, and for those who are not well-qualified the task is overwhelming. The fact that complexity arises in so many everyday areas like property sales or retirement incomes suggests that this is a system requiring much more than fine tuning.

Adding to this burden is the current self-assessment approach to Australia's taxation system. This principle confers responsibility on taxpayers for applying the tax law to their own circumstances. Failure to correctly self-assess can result in substantial penalties and, in some cases, prosecution.

While the BCA supports the self-assessment regime, it is worth noting that it was introduced just as the tax laws were reformed in ways that made them vastly more complicated and burdensome to understand. The tax authorities sought to offset this extra burden with education and other forms of taxpayer assistance, but this seems to have only provoked Governments to believe that even greater complexity could be accommodated.

The result has been a taxpayer community that has almost no faith in its own ability to self-assess, even with ATO assistance, so the vast majority seek professional assistance. Repeated subjective surveys and studies show that taxpayers find the system burdensome and risky.

Recent experiences like the Australian Taxation Office's crackdown on mass-marketed tax effective investment schemes have led many individuals to fear Australia's taxation regime, rather than respect it for the role it plays in providing the community with resources.

At the corporate end, recent moves by the ATO to attack what appear to be long-standing accepted taxation practices such as the use of in-house finance companies, coupled with the extraordinary levels of penalties imposed, continue to encourage an adversarial relationship between business and the revenue authority.

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

Legislation by press release, where laws become effective from the date of announcement, is still a common occurrence. Combined with the lack of tax drafting resources which delays the preparation of tax bills, Australian taxpayers are often forced to operate in an environment where the law is not only uncertain, it is unwritten. In November 2005, for example, there were almost 100 announced tax law changes yet to be legislated. Many were technically in effect, though no law had been written.[27]

Unwritten law has a variety of effects. In some cases, announced measures, like the entity taxation regime, were later cancelled, leaving companies exposed to unnecessarily incurred preparation costs.[28]

In other cases, like the blackhole expenditure regime which applies from 1 July 2003, and the share-capital tainting rules which are intended to apply from 1 July 2002, new rules are theoretically functioning although the law is either unwritten or still in the confidential draft stage, which means companies are required to operate in a vacuum.

The BCA welcomes the recent moves by Government to examine ways to reduce red tape and regulation for business. However, the BCA also believes that much more ambitious goals for tax simplification should be set, based particularly on the policy reforms necessary to reduce tax workload. 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.

A high priority should be given to developing and implementing a comprehensive research program into the administrative, compliance and decision-making costs of the tax system and the drivers of those costs, as a basis for long-term reform of tax policy and tax administration to deliver simplification and reduce costs.

In addition, a formal program of regular review must be put in place to allow for adjustment and updating of existing laws as necessary. No tax change, no matter how thorough the consultation process, can foresee all permutations and/or implications.

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

Such reviews and amendments should be recognised as good tax system management, and a formal, regular process would not only allow updating and fine-tuning, it would reduce the opportunistic politicisation of sensible changes by opposition parties quick to brand existing laws as failures every time an amendment is made.

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[27] Thomson ATP Federal and State "Legislation by Press Release" announcement scorecard as at 25 November 2005.

[28] 'Tax Backdown Leaves Companies Exposed', *Australian Financial Review (*24 March 2001), p.5.

# 9. Conclusion

Australia is a prosperous nation, but it has the potential to be more. It has the potential to become the best nation in the world in which to live, work, learn and do business.

That potential must be harnessed if Australia is to advance to the next stage in its evolution as one of the world's most dynamic economies.

The prosperity Australians have come to enjoy has been built on the substantial reforms of the past. However, given the range of challenges the nation faces, including increased global competition and fundamental demographic change, Australia cannot rest. It is essential that the remaining barriers to our competitiveness and economic strength be removed.

Australia has been able to benefit from increased globalisation, by taking advantage of greater market opportunities. But the international forces that have assisted Australia's recent growth also bring greater sensitivity to changes around the world. This sensitivity means any key weaknesses in the Australian economy will soon be exposed.

The taxation system fundamentally impacts many aspects of Australia's growth potential, from workforce participation to the cost of capital for Australian business. It should be one of the economy's most efficient areas, yet the system as it stands acts as a brake on future growth.

Growth is hampered at the personal tax level by our high marginal tax rates, which deter skilled Australians from returning home after working abroad, and reduce our capacity to attract the best in global talent. While the Government has undertaken a number of reforms to remove disincentives for older workers, the system continues to deter workforce participation by other segments of the population, particularly women with children. The current personal tax rates, particularly when combined with the withdrawal of Government benefits, continue to discourage employees from increasing their working hours. While recent adjustments to Australia's personal tax scales have temporarily alleviated some of the burden, the system continues to penalise taxpayers on higher incomes, who are responsible for the bulk of individual savings and investment.

Such outcomes are inconsistent with the Government's policy of increasing domestic population growth and encouraging greater skilled participation in the workforce, and encouraging strength in the domestic economy.

But personal taxes are only part of the equation. Growth is also hampered by our current corporate tax structure, and the overall burden it places on Australian business. The corporate tax burden, despite our competitive headline rate, is far higher than it should be due to Australia's very broad corporate tax base. Although continued business investment is critical to maintaining a robust and progressive economy, the current tax system is adversely impacting on the cost of capital needed to maintain investment levels.

Add to those restrictions the continued uncertainties, complexities, and anomalies in the tax law and the way it is administered, and it is clear that Australia's tax reform journey is far from over.

Today Australia enjoys a significant Budget surplus supported by the strong foundations of past economic reform and beneficial global economic conditions. But we should not be lulled into a false sense of security. Global conditions will not always be so advantageous, and there are already signs that key sectors of Australia's domestic economy are beginning to slow. Australia must act now if it is to harness its full potential, and secure its future prosperity.