Taxation Action Plan

FOR FUTURE PROSPERITY

Business Council of Australia

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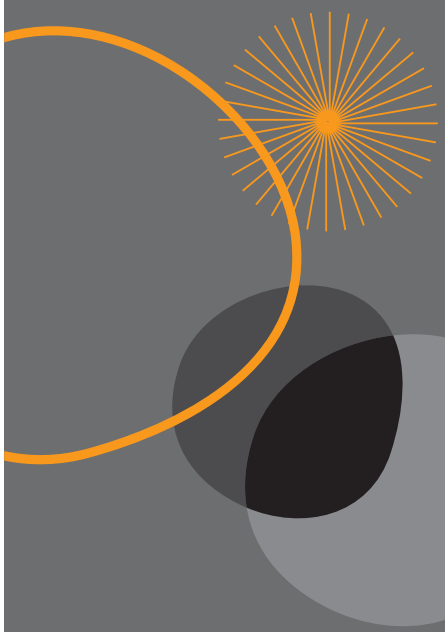
Glossary

ABS	Australian Bureau of Statistics
ATO	Australian Taxation Office
BAD	Bank Accounts Debits Tax
DWT	Dividend Withholding Tax
EMTR	Effective Marginal Tax Rate
FBT	Fringe Benefits Tax
GDP	Gross Domestic Product
GST	Goods and Services Tax
IGR	Intergenerational Report 2002–03 (Commonwealth Government)
OECD	Organisation for Economic Co-operation and Development
PC	Productivity Commission
TNTS	The New Tax System
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
VFI	Vertical Fiscal Imbalance

Executive Summary



Australia is experiencing one of its most prosperous periods for several decades. This has delivered economic wellbeing and higher standards of living to more and more Australians, and reflects the benefits of past reforms.

However, cracks have begun to emerge in our economic performance. Australia has a large current account deficit, high levels of household indebtedness and growing signs of capacity constraints. These increase Australia's susceptibility to slower growth here or abroad, and to other potential shocks. In addition, we face longer-term challenges associated with population ageing and ever-increasing competition in global markets.

Australia needs to respond to these challenges now to ensure that we not only lock in the benefits of past reform, but also build on them to sustain strong growth and prosperity over the long term. The alternative is that current policies and economic structures become obstacles to future prosperity.

The Business Council of Australia (BCA) represents the Chief Executives of 100 of Australia's leading companies. The BCA develops and advocates, on behalf of its Members, public policy reform that positions Australia as a strong and vibrant economy and society. The companies that its Members represent are among Australia's largest employers and taxpayers, and represent a substantial share of Australia's domestic and export activity. They have a significant interest in the prosperity of Australia and therefore the scope and direction of economic reform.

Within this context, the BCA considers that a revitalised economic reform agenda must be aimed at increasing competitiveness through high productivity and raising workforce participation. These two factors will determine Australia's capacity to sustain strong economic and income growth and to deliver the standard of living to which Australians have become accustomed.

Taxation reform must play a key role in a revitalised reform agenda.

Important areas of taxation have been addressed, including lowering Capital Gains Tax (CGT), preserving the integrity of franking credits, replacing the highly inefficient Wholesales Sales Tax (WST) with the Goods and Services Tax (GST) and adjusting income tax thresholds. However, significant weaknesses remain even in those areas that have been improved. For example, changes to income tax thresholds have not kept pace with inflation and even with modest inflation the CGT imposes a wealth tax on capital.

More broadly, the size and scope of Australia's taxation system means that it impacts on virtually every area of the economy and economic decision-making. The tax system affects decisions related to consumption, workforce participation, investment, business structures, business operations and locations. It therefore has significant bearing on productivity, workforce participation and Australia's growth prospects.

Like all public policy, taxation policy has a range of goals and aims. Each of these goals is important, and prioritising them is not always easy. The firm starting point for the BCA is that achieving virtually all of the goals of taxation policy in the long run depends on continued strong economic growth. More specifically, sustaining the revenues to support the provision of Government services is dependent on economic and income growth, as is our capacity to achieve equity objectives through the welfare transfer system. This means that the economic efficiency of the tax system and the extent to which the tax system supports competitiveness, productivity and participation must be the key policy goal because without that Australia will not be able to meet its other policy objectives over the long term.

Taxes impose a net cost on individuals and economic activity. The magnitude of these costs and net impacts will depend on the efficiency of the tax as well as any services provided in return. The costs of taxation are borne by households and individuals; some directly and some through higher costs of production and therefore prices. In the traded sector, where costs cannot be passed on because prices are determined in global markets, the costs are borne in terms of a loss of competitiveness. Wherever possible, Australia should be looking to enhance the economic efficiency of the tax system by minimising the tax burden and operating costs and by providing greater simplicity and transparency.

It has been said that Australia is a relatively low-taxing country. Depending on which OECD statistics are used this may appear to be the case. However, this does not mean that Australia can afford to be complacent. Australia's tax burden is increasing. Australia needs to be wary of the current trend of becoming more heavily taxed than its most important OECD trading partners. Australia has a particularly high tax burden on business income and on income taxation in general. It also has very high effective marginal taxes and high marginal tax rates where other countries have worked hard to reduce these.

The BCA's tax reform priorities are therefore firmly focused on improving the economic efficiency of the Australian tax system in the context of both current and future challenges. Global demographic trends and increasing competition for skilled labour and capital in the global market place generally are the background against which tax reform needs to be considered. These factors mean that Australia will face stronger competition, including tax competition from other countries seeking to gain competitive advantage in attracting skills and investment. The assessments contained in this paper show that the case for tax reform is pressing and that further reform can help to secure stronger future growth.

The BCA's recommended tax reform priorities are framed around ensuring Australia has the capacity to:

- **continue to attract skilled labour;**
- **support workforce participation; and**
- **sustain strong levels of business activity and investment.**

The immediate reform priorities are comprehensive, but this paper recognises the long-term challenges, which means that this is not the final word on reform.

The BCA's taxation reform priorities

Reducing the Australian tax system's largest cost

The BCA considers the highest personal taxation rates to be one of the largest sources of existing adverse taxation costs in the economy. Australia's top marginal rates are amongst the most aggressive in the OCED and the most aggressive in the ASEAN region. Australia's heavy reliance on income tax, particularly taxes on the most mobile parts of the population, is a competitive disadvantage for Australia.

The two highest marginal tax rates in the personal tax structure should be lowered, to make Australia more competitive by:

- **reducing barriers to attracting highly skilled workers;**
- **reducing disincentives for saving;**
- **reducing distortions between alternative investments by reducing the tax benefits for highly geared investments and tax avoidance strategies; and**
- **reducing the cost of capital impacting on investment.**

The two highest steps in the personal tax rate scale should be reduced to 30 per cent in the longer term.

- **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 Federal Budget.**
- **The top rate should then be reduced to 40 per cent in the 2007–08 Federal Budget.**

Reducing tax on temporary residents

Features of the tax system that specifically disadvantage Australia as a work location for temporary residents should be removed.

Temporary residents working in Australia should not be subject to Australian tax on foreign source investment income.

- **The Government should reintroduce its proposed reforms to the taxation of temporary residents that were previously rejected by the Senate; and**
- **additional reforms for temporary residents should be undertaken. This should include exempting the income that temporary residents derive from foreign workdays and reforming the tax treatment of superannuation for temporary residents.**

Making Australia a more attractive base for international business investment

A key priority is to remove the bias in the imputation system against foreign source income. This issue was extensively covered by the BCA in its report 'Removing Tax Barriers to International Growth'.

The Board of Taxation considered this issue in 2002–03 making a positive recommendation to the Government, which indicated that it is willing to return to it at a later stage. It should do so now.

Making Australia a more attractive location for business investment

Competitive weaknesses within Australia's company taxation system in terms of company rates the company tax base and biases favouring lower return investments within Australia should be addressed.

Australia's company tax rate is, at best, average compared to its international trading partners and the Australian treatment of business income such as Australia's capital allowance regime compares unfavourably with many of its competitors.

A more competitive business taxation system should be provided to promote longer-term growth and productivity. The Government should:

- **commence an immediate review of the company tax system to assess and remove pressures against Australia's competitiveness. The review should focus on options for reducing the effective rates of tax on income from capital, covering areas such as the capital allowance regime and options for ensuring that the effective life regime does not discourage investment, particularly in long-term infrastructure. The review should be completed prior to the 2006–07 Federal Budget; and**
- **review the company taxation rate with a view to lowering it, taking into account both international competitive pressures and progression in lowering the top marginal personal taxation rates.**

Additional strategies to improve competitiveness and workforce participation

- **The remaining most highly inefficient taxes, particularly taxes on financial and insurance instruments, should be abolished.**
- **In addition, four areas of risk for Australia's economy need immediate consideration by appropriate bodies of review. These reviews must be effectively resourced in order that the Government can consider recommendations and provide a package of reforms as part of the 2006–07 Budget. The four areas are:**

  a. effective marginal tax rates must be reduced where these significantly weaken workforce participation;

  b. tax uncertainty and compliance must be reduced and administrative tasks substantially simplified, removing significant and unnecessary costs on productivity;

  c. biases and distortions against saving should be reduced; and

  d. the efficiency and transparency of Commonwealth–State spending and revenue raising responsibilities must be improved with an aim to reduce the overall tax burden.

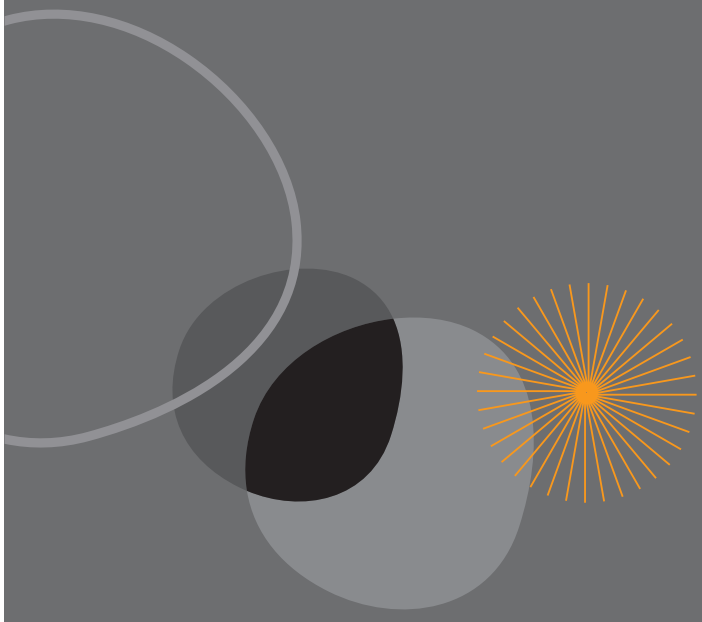
This paper discusses the Australian tax system in two parts.

Part One considers the tax system from the perspective of the most important policy reform issue in Australia today: the competitiveness of the Australian economy. It considers the nature of the competitiveness challenge, the effects of the tax system on competitiveness and possible directions for further tax policy reform that would improve competitiveness. It then discusses the longer-term implications of structural changes impacting the economy – notably population ageing – and possible tax policy responses. A summary of reform priorities and indicative costings completes Part One.

Part Two provides a 'state of play' of Australia's tax system. It includes a survey of the main features of the current tax system, and provides an assessment of its overall performance. Part Two should be considered as background to the analysis and conclusions of Part One.

Chapter 1

Introduction



Australia is experiencing one of its most prosperous periods for several decades. This has delivered economic wellbeing and higher standards of living to more and more Australians and reflects the benefits of past economic reforms. Nevertheless, behind this robust performance lie a number of vulnerabilities. Constraints and imbalances are emerging that, in the absence of reform, are already slowing growth and limiting future opportunities. The composition of growth is based on drivers that are unsustainable in the long run. Domestic demand has consistently outpaced domestic production. The large current account deficit, low levels of household saving, or conversely high levels of household debt, have increased the economy's vulnerability to weaker growth here or abroad and to any unexpected shocks. Business is concerned that high levels of debt have not funded investment in productive assets, such as infrastructure, that enhance Australia's long-term growth potential. In addition, Australia, like many other countries, faces longer-term challenges associated with an ageing population, slowing population growth and increasing competition from global markets.

In order to respond to these challenges effectively, the BCA considers that the Government must embark on a revitalised program of economic reform. This is necessary if we are to lock in the prosperity that we have achieved over the past decade and to build on it to enable Australia to support higher standards of living in the decades ahead.

In broad terms the BCA considers that a revitalised reform agenda must be aimed at ensuring that Australia's long-term prosperity will be achieved by raising competitiveness through higher levels of productivity, sustained productivity growth, raising workforce participation and more efficient resource allocation. These factors will ultimately determine Australia's capacity to sustain strong economic and income growth.[1]

Taxation reform must be incorporated as a key element of this broader economic reform agenda.

1.1 The case for tax reform

The tax system in Australia impacts on almost every area of the economy and economic decision-making (see 'Impacts of the Tax System on Day-to-Day Decision Making, page 8). The Australian tax system collects the equivalent of around one-third of annual national income. The system has very wide coverage taxing incomes, expenditures, capital transactions and some aspects of wealth. In addition, the specific design intention of some taxes is to directly change economic outcomes. Taxes are used to discourage some activities (such as gambling and smoking) or to encourage others (such as making provision for retirement savings). The service industry that has developed to deliver tax outcomes, including tax compliance and administration, has also reached a large scale and directly consumes substantial national resources.

As a result of these features, the tax system affects consumption decisions, workforce participation, saving and investment decisions, business structures and business operations. It therefore has significant bearing on productivity and participation and prospects for growth and prosperity.

Impacts of the Tax System on Day-to-Day Decision-Making

Consumers

- **To consume today or tomorrow? (savings)**
- **To consume good X or good Y?**
- **To rent or buy?**
- **Buy Australian or imported goods?**
- **Cash or barter?**

Suppliers of labour

- **To work or to take leisure (and/or stay on welfare)? (labour supply decision)**
- **To work longer hours?**
- **To accept a job where the returns are non-financial rather than financial?**
- **To enter into home production or to engage in market production?**
- **To retire from the workforce or not?**

Investors

- **To invest in one asset rather than another?**
- **To make an investment now or later? (e.g. tax effective timing of an action)**
- **To leave an inheritance or not?**

Demographics

- **To marry or not to marry?**
- **To have children or not to have children? (including how many and when)**

Business structures

- **To vertically integrate the business or not? (i.e. effect of tax cascading)**
- **What legal structure?**

Business operation

- **Which industry?**
- **Which location?**
- **Human capital or IT?**
- **Cash economy or not?**
- **Insource or outsource?**
- **Import or produce?**

Business investment

- **How much capital and how much labour?**
- **Debt or equity?**
- **Where to locate the investment – domestically, internationally?**

1.2 Assessing Australia's tax system and the priorities for reform

Like most public policy, taxation policy has a range of objectives and aims. Understanding each of these key objectives and aims, as well as the role and effectiveness of Australia's tax policies in delivering against them, is necessary if an effective assessment of Australia's tax system is to be undertaken.

Before addressing tax policy aims, it is important to understand that all taxes impose a net cost on individuals and on economic activity (see 'The Theory on the Economic Costs of Taxation', page 11). Simply put, taxes influence choices by introducing a 'wedge' in transactions and between actions and outcomes. Who bears the ultimate cost of tax depends on the nature of the tax and the activities and entities to which it applies; but there is always a cost.

'Deadweight costs' of the tax system (costs that produce no benefit) arise from changes in activities induced by taxation, which are typically higher the higher the tax rate. A further source of deadweight costs is that of administration and compliance. These costs are borne partly by households – some are borne directly while others enter into the costs of production and hence higher prices for households.

In the traded sector, however, where prices are set by international market forces, the costs are business costs that cannot be transferred to customers. They directly affect the competitiveness of Australian suppliers and the returns to investors.

Wherever possible, we should be looking to minimise both the tax burden and the operating costs of the tax system. The 'net' impact of taxes should be assessed by comparing tax costs with the benefits of the ends to which tax revenues are applied. If we are to minimise tax burdens, we need to ensure spending programs are as effective as possible. Although tax and spending are closely linked, the fact that nearly all tax revenues are raised for the general purposes of Government (and not hypothecated to specific purposes) means alternative tax policies can be meaningfully compared separately from the programs that they fund.

Tax policy goals

The key purpose of the tax system is to raise revenues to fund Government spending at the Commonwealth, State and Local level. In terms of determining how this revenue is raised, a range of additional goals apply. Different assessments of the tax system use different criteria or goals. However, in general terms, the key tax goals are taken to include: economic efficiency; simplicity; equity; and transparency – with the revenue raising aspect referred to in terms of the 'adequacy' of the system. While additional goals may be identified, these general objectives remain fairly consistent with those identified by Adam Smith more than 200 years ago.

The goal of **economic efficiency** for the tax system relates directly to the competitiveness of the economy and the extent to which tax structures enhance or impede competitiveness. More specifically, the goal of an 'efficient' tax system usually refers to two dimensions:

- **allocative efficiency – the tax system should not inhibit the economy's capacity to allocate resources to their most productive/valued use at any point in time; and**
- **dynamic efficiency – the tax system should not inhibit the economy's capacity to maintain an efficient allocation of resources over time; and the tax system should not inhibit investment in new ideas and technology and innovation to enhance productivity and to develop new and better products and services.**

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

Achieving greater economic efficiency through improved tax neutrality can however compromise other goals:

- **base broadening can reduce simplicity and increase compliance costs; and**
- **greater uniformity of tax rates can adversely impact on the equity of the tax system.**

In a world of increasingly free flows of capital, labour, goods and services the economic efficiency of Australia's tax system becomes even more important in the face of international tax competition. Increasingly, this means that the decisions and behaviours impacted by our tax system extend beyond our borders. Consideration must be given to the structure of the Australian tax system and how it is performing relative to current and potential competitors.

The **adequacy** of the tax system refers to whether or not the system is producing revenues capable of meeting spending requirements. Spending decisions are ultimately a function of available revenues. Governments tend to want to spend what they receive (one way or another) and like to have the flexibility of the option to spend more. Put simply, the adequacy challenge is ultimately determined by the size of Government. This means assessing adequacy is not straightforward, and consideration must be given to the costs associated with raising revenue in the first place.

Adequacy should be assessed not only in terms of the current fiscal position, but importantly in terms of the sustainability of the system. Assessment of adequacy must reflect not only the adequacy of the revenue generated in terms of the spending initiatives funded, but also the associated costs, as these could reduce the future revenue-raising capacity of the taxation system. Therefore close links exist between the adequacy and dynamic efficiency effect of tax choices. Higher taxes might better meet current adequacy goals but carry the cost of reducing future adequacy by damaging growth prospects in the future.

The **equity** or fairness of the system is usually assessed against the 'capacity to pay' principle. There are two dimensions:

- **horizontal equity – the idea that everyone with the same capacity to pay should bear the same taxation burden; and**
- **vertical equity – the idea that those with a higher capacity to pay should pay more tax. Taxes that are proportional achieve this, but so do progressive tax scales (those with a higher capacity to pay face higher rates of taxation).**

How to assess these broad dimensions poses additional challenges. Should such an assessment be based on individual or family capacity to pay? What should be taken into account in assessing capacity (income, assets, spending needs, etc.)? How progressive should the system be?

The Theory on the Economic Costs of Taxation

Taxes are transfers. They reflect a political decision that value produced in one area should be transferred to another – for example, from a worker's wages to public health services.

If the transfer is all that happens, taxation could be thought merely to redistribute rather than change the level of aggregate value. Unfortunately, this is not possible as taxation also impacts on the aggregate level and pattern of economic activity. It is then a matter of degree to which these changes reduce overall value in the economy. An inefficient tax system imposes a higher 'deadweight cost' than a more efficient system.

The main deadweight costs of concern in this paper are those that reduce economic growth by reducing the competitiveness of the Australian economy. These arise in two main ways.

Firstly, taxes impose direct and indirect administrative, compliance and other decision-making costs on the economy. These transaction costs (like those arising from other regulations) reduce the share of the income available for investment and consumption.

Secondly, and probably more importantly, taxes may change behaviour in a way that reduces economic growth and hence the future size of the economy. This may arise to the extent that taxes raise the cost or reduce the supply of capital, investment, or labour or distort the pattern of savings or investment.

For example, if a worker reduces hours worked due to the imposition of taxes, the whole economy loses that part of production. Similarly, if a firm shifts its high-value functions from Australia to an office abroad because its high-value workers thereby pay less tax, Australia's level of economic activity and average productivity will both fall.

In practice, it is difficult to conclusively demonstrate the precise behavioural effects of taxation, as many complex factors can be involved. The incentive to participate in the workforce, for example, is affected by both a substitution effect (where taxes on one activity favour substitution of alternatives, in this case work for leisure) and an income effect (where activities are encouraged to offset taxes imposed on them, in this case by working more to sustain after-tax income). Most studies suggest that taxes have deadweight costs that reduce economic growth and output at least to some degree.

The impacts depend on circumstances. In theory, the deadweight costs of raising tax revenue from a particular source tend to be greater:

- **the greater the total amount of tax revenue raised from that particular source (the greater the total amount of economic activity affected by that particular type of tax);**
- **the higher the effective marginal rates of tax on the activity. In economic theory, the costs of taxation increase more than proportionally with increases in the tax rate. This is the main rationale for lower rates of taxation;**
- **the greater the disparities between rates of tax applying to that activity and alternative, substitutable activities. This is the main rationale for more uniform rates of tax across different forms of income. This is not just a domestic issue, for instance differences in tax rates between countries competing for skilled labour are critical, where workers are increasingly choosing between alternative locations for working in their profession; and**
- **the more sensitive taxpayers' economic decisions are to those differences in effective marginal tax rates. A primary breadwinner on median wages meeting the basic needs of a family, for example, may be less likely to withdraw labour as a result of taxes than someone whose choices relate to earning income for discretionary expenditure purposes.**

Simplicity of the tax system is a goal that too often is given the least amount of focus. The key to understanding simplicity and its importance is to focus on how easy it is to understand tax laws and rules and how much work they create relative to the outcomes achieved (ultimately the revenue raised). In doing so we need to focus on the 'system in use', not as intended or theorised, but how it is actually adopted by all concerned. This means looking at the policies and how they are implemented, interpreted and administered. If tax laws and policies are complex and poorly understood, people are less inclined and less able to adhere to them. Complex policies clearly add to administrative and compliance costs, and a complex tax system creates uncertainty, raises the cost and difficulty associated with decision-making and can contribute to poor decisions.

Simple policies are often more transparent, but transparency as a tax policy goal goes further than this. **Transparency** relates more broadly to the understanding people have about taxes and how they operate. For example, do people understand at what point a tax applies? Which level of Government is collecting it and for what purpose? The underlying question that needs to be addressed in the context of transparency is whether tax policies can or should be designed in a way that enhances public understanding (and political accountability) about the tax system and the broader choices of public policy that relate to the taxes being raised.

While these tax policy goals may appear relatively straightforward, assessing tax systems against them is not, for a number of reasons.

One problem is that individual tax goals can be in conflict with one another. For example, a measure designed to be more equitable may be less simple. More broadly, in order to assess a system against these goals there must be some prioritisation or ranking assigned to each of the goals. This in turn can be complicated by the fact that some of the goals are closely interconnected. The outcome of this is that there is no common measure or benchmark of the performance of the tax system that encompasses all of these goals in a consistent way.

This paper proposes a prioritisation of tax policy goals for Australia based on the BCA's key objective of sustaining strong productivity and therefore economic growth, high levels of workforce participation and improved prosperity. From this will flow a prioritisation of proposed tax reforms.

1.3 How does the Australian tax system perform against key policy goals?

Economic efficiency

The economic efficiency of the Australian tax system has been improved by past tax reforms. The main sources of these gains have been reductions in the top marginal tax rates, a lower company tax rate, reduced economic distortions between alternative business investments and, through the GST and other elements of The New Tax System, a more neutral and efficient system of indirect taxation.

Despite these gains, the economic efficiency of the tax system is declining due to increasingly adverse effects of its features on the competitiveness of the Australian economy. The main competitive weaknesses emerging in the tax system are as follows:

- **Tax rates – marginal and average – facing highly skilled, high-value workers are too high compared with key competitor economies.**
- **High marginal tax rates on personal income – distorting investment and savings decisions and adding to the cost of capital.**
- **The tax treatment of workers engaged temporarily in Australia is unnecessarily unfavourable.**
- **The business tax system is increasingly uncompetitive compared with competitor economies – most have much more favourable capital allowance arrangements and, particularly in key high-income centres within the Asian region, appreciably lower company tax rates.**
- **There is a tax bias against investing offshore through Australian multinational companies.**
- **Business investment in Australia bears appreciably higher effective tax rates than low-risk and geared investment alternatives.**
- **The interaction of Australia's progressive personal tax rates and the social welfare benefit abatement regimes (i.e. means testing) imposes high effective marginal tax rates on the incomes of individuals re-entering the workforce.**
- **Some remaining State taxes on financial and insurance instruments are highly inefficient.**
- **The tax system maintains a considerable bias against saving.**
  - The system remains heavily weighted to income rather than consumption taxes.
  - Income tax is especially heavy on business and interest income.
  - The encouragement to saving from the income tax concessions for superannuation fund contributions and earnings is eroded by high effective marginal tax rates on superannuation benefits arising from the pension means tests and income tax arrangements for retirees.
  - Taxes on superannuation at the saving stage directly reduce the private savings pool.

The high administration, compliance and decision costs of the Australian tax system impose deadweight costs for the Australian economy and directly reduce international competitiveness.

Adequacy

It could be argued that the Australian tax system is currently adequate and meets Australia's fiscal demands. The Federal Budget remains in surplus and there is broad commitment from both sides of politics to maintain fiscal responsibility – generally taken to be maintaining a balanced budget over the economic cycle (running surpluses when times are good – as they have been) at the Federal level.

Looked at from a longer-term perspective, however, as articulated in the *Intergenerational Report (IGR),*[2] it could also be argued that the current system is not at all adequate or sustainable. The IGR projections clearly show that spending pressures will outpace revenue collection on a 'no-policy-change' basis and by a significant margin (see 'Future Challenges for Australia's Economy: Australia's Ageing Population,' page 15).

As noted above, taxes impose a cost on individuals and economic activity. The BCA considers that adequacy must be assessed in that context and hence with a view to minimising taxes wherever possible. In that regard, the steady rise in the total tax burden in Australia is another mark against the adequacy of the system. Australia will not be able to sustain this trend indefinitely because it damages future growth potential.

Equity

In broad terms, the overall progressivity of fiscal policies, including the tax system, has been fully preserved or even increased over the past 25 years or so of policy reform. As some economic and social trends have worked to increase inequality in the distribution of market incomes, reforms to the tax and transfer systems have generally worked to offset most or all of that impact. Many social transfers have increased considerably. An exception to this overall result arises from the disproportionate impact of higher complexity and compliance costs on some low-income earners and small business.

In Australia, there seems to have been a zealous incorporation of vertical equity features into specific tax and transfer rules. It is not clear whether this reflects clear intentions or a confusion of vertical and horizontal objectives. For example, the means testing of family transfers has the appearance of a vertical equity feature (means tests) superimposed on a horizontal equity provision (recognition that dependent children affect capacity to pay). Whatever the source of this unusual result,[3] it produces costs both of administrative difficulty and higher effective marginal tax rates.

A range of features of the tax system that operate against the economic efficiency axiom also operate against the horizontal equity axiom, including biases in the treatment of different classes of investment. These biases, combined with excessive marginal tax rates on some income, not only create unequal treatment of different classes of income but also encourage tax minimisation which undermines the vertical equity goal.

Future Challenges for Australia's Economy: Australia's Ageing Population

There has been an increasing focus on the impact on Australia of an ageing population since the Treasurer released the *Intergenerational Report* in 2002. More recently, the Productivity Commission (PC) released its draft report into the *Economic Implications of an Ageing Australia.*[4]

Over the next 40 years, the age structure will change such that a higher proportion of the population will be older, driven by factors such as lower fertility rates, longer life expectancy and the ageing of the 'baby boomers'. This has implications for labour force participation, economic growth, Government expenditure and the capacity of Governments to raise revenue from existing sources.

Around one in eight Australians are currently aged 65 or over. According to the PC projections, in 40 years time, this will double to more than one in four people. Those aged over 85 will increase more than four fold. This change in age structure also brings with it a fall in labour force participation, with an expectation that labour force growth will slow to a trickle over the next 15 years. With this, the potential rate of economic growth will fall.

At the same time, under current policies large increases will occur in age-related Government expenditure, particularly on health and aged care. Further increases in health expenditure will be driven by real increases in the cost of health care, due to advances in medical technology and rising age-related demand for (essentially publicly funded) health care.

The PC projections estimate that, on a 'no policy change' basis, the combination of lower growth and higher spending will lead to a fiscal pressure 'gap' (growth of Government expenditure over revenue) of around 7 percentage points of GDP by 2044–45, even after allowing for some offsetting reduction in expenditure in areas such as education and family payments. These results, affecting both Commonwealth and State Governments, are shown below.

PRODUCTIVITY COMMISSION NATIONAL FISCAL PRESSURE PROJECTIONS

Age-related Government spending to GDP ratios			
	2002–03 Percentage points	2044–45 Percentage points	Difference Percentage points
All Government summary			
Health	5.7	10.7	5.0
Aged care & carers	1.0	2.3	1.3
Education	4.8	3.7	-1.1
Social safety net	6.5	8.1	1.6
Total	18.1	24.9	6.8

SOURCE: Productivity Commission 2004, Economic Implications of an Ageing Australia, Draft Research Report, Productivity Commission, Canberra (Table 1, page XL).

Simplicity

The Australian tax system is complex and costly and tax reforms to date have tended to increase rather than reduce this problem.

So many features of the system cause high operational costs that it can only be concluded that simplicity has been given very little attention in the design of arrangements. Some examples of the causes of complexity include the following:

- **Rules are elaborate when something simpler may well do. For example, the exemption from capital gains tax for owner occupied housing is labyrinthine because it confuses so many tax system principles.**
- **Many income (and expense) calculations involve costly compliance tasks ultimately for little or no revenue. For example, rental housing often produces little or no tax revenue overall but often tasks such as complex valuation or record keeping to determine the eligible component of capital expenditures are required. There are many other examples around the general treatment of small amounts in the tax system, including interest on transaction accounts and the expensing rule for small depreciable items.**
- **System coverage is often very high with low thresholds (or caps). Examples include the low-income tax threshold, the GST registration threshold, low-expensing caps for equipment investments, and low thresholds for higher frequency of tax calculations and payments.**
- **There are many examples of double (or more) handling. For example, superannuation and company income distributed as dividends are taxed more than once, the value-added design of the GST involves repeated tax and credit calculations, and income taxes and social assistance means tests co-apply to many forms of income.**
- **The choice between individual and family tax units is confused. Both treatments now apply simultaneously for different features of the system – including the means testing of hitherto universal horizontal equity provisions (family assistance).**
- **Tax laws are often uncertain due to a lack of clarity of underlying purpose or due to difficulties in practical application. Moreover, uncertainty in the application of the general anti-avoidance rule has risen significantly in recent years.**

Transparency and public understanding

The transparency of the tax system has experienced mixed fortunes. The GST is more transparent than the Wholesale Sales Tax that it replaced. On the other hand, the greater complexity of tax laws has made them effectively more opaque. The income tax rate scale is an increasingly misleading representation of actual tax rates, the Medicare levy is a misleading misnomer because the high and increasing public costs of the health system bear no relation to the revenues raised by the levy and some taxes, like payroll tax, continue to be largely hidden from the view of those (employees) most adversely affected by them.

Vertical Fiscal Imbalance, the de-linking of state taxing and expenditure decisions, creates a substantial source of misinformation for taxpayers and voters, and so distorts political incentives. Program responsibilities are confused and the funding of programs is politically de-linked from their delivery. It is difficult to estimate the extent to which this is contributing to policy reform inertia or misdirection in many areas of the public sector, but the costs are likely to be considerable.

The Australian tax system differs from that in other countries most conspicuously in the absence of a separate social security tax and system. This may also reduce its informational value – ironically in relation to one of the main areas of public expenditure most likely to increase over the long term.

Conclusion

The above is not a full and complete assessment of the tax system. What it does, however, is highlight the fact that there are many areas that can and should be improved upon in the Australian tax system. The challenge flowing from this is to prioritise these issues and to develop a better understanding of the current and future challenges and therefore the nature of reforms to be implemented.

1.4 Prioritisation of tax goals in Australia

As noted above, individual tax goals are often interconnected and can conflict with one another. How then should Australia prioritise tax policy goals and reforms?

> The firm starting point for the BCA is that achieving virtually all of the goals of taxation policy in the long run depends on continued economic growth.

More specifically, sustaining the adequacy of the system rests firmly on sustained economic growth, which in turn depends on an economically efficient tax system – that is one that supports Australia's competitiveness. This point has been clearly and repeatedly made by the Treasury. In the context of handling the fiscal implications of population ageing, the conclusions drawn include: 'The best approach is to look for ways to increase the size of the economy so that we all have higher incomes and are better able to meet the costs associated with our ageing population;'[5] and this option is clearly better than increasing the average tax burden on the working population. Not only does it directly reduce living standards, but it also would work against increasing the 'size of the pie' by reducing returns from additional work and investment.'[6]

Sustaining efficiency and competitiveness may require tax reductions, but ultimately this will sustain a higher degree of adequacy than a system that does not support competitiveness and growth.

Our capacity to achieve equity objectives, including through the welfare system, is determined by the adequacy of the system and therefore economic growth.

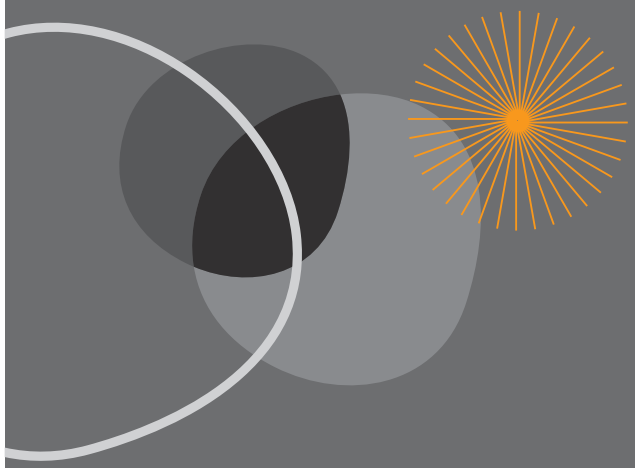
These interdependencies illustrate the vital importance of ensuring the tax system contributes as fully as possible to economic growth – in part so that the tax system can contribute as fully as possible over the longer term to other policy goals.

Greater simplicity and transparency are essential ingredients to improving the economic efficiency of the tax system. Unnecessary complexity and opaque policies are quite simply deadweight costs – both undermine the efficiency of the system and people's preparedness to support and adhere to the system. In the BCA's view, enhanced simplicity and transparency should be pursued in conjunction with other reforms aimed at enhancing the efficiency of the tax system.

The BCA's priorities are clearly focused on improving the economic efficiency (competitiveness) of the Australian tax system and enhancing simplicity and transparency. The following chapters address the issues and challenges for competitiveness and tax policies for Australia and the reform implications.

Chapter 2

Australia's International Competitiveness



2.1 The meaning of competitiveness

Australia is an internationally open society, keen to reap the benefits of full engagement in the world. As part of this, we have an open economy. This means that financial capital, investment expertise, and to an increasing extent skilled labour can flow relatively freely in and out of the economy.

Open engagement with the world brings higher economic growth stemming from the advantages of specialisation and trade, the achievement of economies of scale, deeper financial markets, greater innovation, and the rapid exchange of new ideas and skills. Greater global engagement, however, also means that domestic producers of goods and services are exposed to competition both in local and overseas markets.

Our ability to sustain and advance the economy in this environment essentially defines our competitiveness.

Competitiveness is ultimately determined and best measured by the level and rate of growth of productivity. However, the word 'competitiveness' rather than 'growth' or 'productivity' is used here to capture the idea that this growth must occur in the context of open engagement with the world.

'Competitiveness' may refer to individual enterprises (or industries) or to the aggregate economy. In each case, greater competitiveness means the ability to produce goods and services of greater value.

At the enterprise and industry level, greater value can be achieved either by commanding higher prices, by producing at lower costs or by producing more. The relative importance of these varies from one product or service to another.

These sources of higher value are produced mainly by the combination of high-technology physical capital and highly skilled labour.

For individual businesses, increasing competitiveness relies on increasing the capital, scale and skills that can be engaged by the firm.

For the economy as a whole, competitiveness also means:

- **the ability to attract and promote activities (industries and occupations) that have higher value relative to others. This depends on factors including the cost and availability of capital, the quality of social and economic infrastructure, and regulatory and tax burdens; and**
- **ensuring that available resources, particularly people, are as fully employed as possible.**

For an economy it is not enough to create capital, entrepreneurs or creative and highly skilled workers – because capital, enterprises and talented people can and often will shift to other locations if they are able to operate more competitively (that is produce and retain higher value) abroad.

Other economies are also continually striving to improve their competitiveness, attracting capital, investment and expertise. The task for all countries (as it is for all enterprises) is one of continuous improvement of the environment in which these key factors can be produced, retained and engaged.

For an economy to sustain its competitiveness it must embrace change and continually respond to global developments. It is vital to understand clearly what this does and does not mean.

It does mean providing the conditions for continually increasing and employing capabilities – by saving, investing, learning, creating, discovering and making Australia an attractive place for all of these things to occur in the highest-value activities. It also means fully utilising available resources, particularly people.

Securing higher competitiveness does not mean:

- having a lower exchange rate. A lower exchange rate benefits the market performance of many industries but only at the expense of consumers and others in the economy in the long run. The exchange rate changes the distribution of value but does not determine the overall ability of the economy to create value. A more competitive economy generally will sustain a higher exchange rate giving Australians greater purchasing power in the world economy, while a lower exchange rate (sustained over time) reflects a poor international assessment of Australia's relative productivity, competitiveness of the business sector and capacity to sustain strong economic performance;
- lower wage rates. Lower wages may reduce costs for specific industries, but a more competitive economy produces higher value, which supports the capacity to pay higher wages; or
- only pursuing comparative advantage. All countries, even the least developed, can benefit by specialisation and trade based on comparative advantage (for example an abundant supply of low-skilled, low-wage workers). This is important, and produces one-off benefits, but subsequently there may be little further advance. Increasing competitiveness requires more – increasing the value of what is profitably produced.

Evolving Competitive Advantage: Singapore's Experience

Singapore is a small country with a small population and few natural resources, yet it has established a formidable track record of strong economic growth over the past four decades.[7] This has been achieved through an agenda of economic reforms aimed at supporting Singapore's competitive advantages.

In the early 1960s Singapore's economy was focused on small industry related to retail trade. Manufacturing accounted for 12 per cent of GDP. Economic performance was poor, unemployment high, and the workforce small and poorly educated.

From the mid-1960s to the late 1970s, Singapore embarked on a strategy of comprehensive reform aimed at supporting export led growth and development. The economy was opened to foreign investment, as Singapore sought to leverage the experience and technology of multinational corporations.

This success created new challenges. Labour shortages emerged, labour costs rose and Singapore lost its competitive edge relative to its more heavily populated neighbours.

Economic reform was then refocused away from labour intensive industries towards capital-driven higher-value-added activities. Higher-value-added manufactures grew, as did the services sector.

In the late 1990s and since, economic policy in Singapore has aimed to support a further shift up the production value chain focusing on competitiveness in the services sector. The financial services sector has been deregulated and opened up to greater international competition, as has the telecommunications sector.

Singapore has transformed itself from an economy relying on low-skilled, low-wage labour, to one increasingly focused on created competitive advantages based on skills and technology. This has been achieved by opening the economy to competition and responding to competitive pressures through the development of a policy environment supportive of investment, skills and innovation. The result: Singapore has averaged real per capita GDP growth of more than 5 per cent a year since 1960.[8]

2.2 Why competitiveness matters

The reward for higher competitiveness is higher income. All of the higher income economies, including Australia, have achieved their position through sustaining high levels of competitiveness. Whether, and to what degree, they continue to do so depends on continually making the changes necessary to maintain competitiveness.

Competitiveness is not guaranteed for developed economies. There are many examples in history of countries moving down as well as up in their relative income positions – indeed, Australia's relative position moved down considerably over much of the 1900s. Performance improved over the last decade on the back of economic reforms that were begun in the 1980s. We should be proud of our improved position – but recognise that the 80 years in between were wasted.

These observations point to the broad importance of competitiveness. Competitiveness sustains the standard of living.

Weaker competitiveness means lower wages. It also means a lower tax base, and so a lower capacity to provide public services and income transfers. Weaker competitiveness reduces our capacity to meet our social, cultural, environmental and security aspirations.

If the exchange rate is lower, reflecting our lack of competitiveness in the long run, it means all Australians pay more for traded goods and services, lowering their purchasing power.

We must ensure that competitiveness and value creation is nurtured and sustained as strongly as possible. This is the challenge that faces any country that wants to fully benefit from engagement with the world. This is the competitive world in which we live – it is not a matter of choice or a partisan position. Australia is not unique in its aspirations in this regard.

2.3 The basis of Australia's competitiveness

Australia is endowed with a range of natural assets including land, mineral resources and tourist attractions that provide the foundations for its competitive advantages in key areas. These continue to contribute considerably to wealth and wellbeing. They form one element in Australia's competitiveness.

However, competitiveness is mostly a created capacity. It is produced mainly by people. A supply of labour therefore is clearly a key ingredient. The keys to producing the much higher value outputs of modern sophisticated economies are the building of capital and skill. For this Australia has the disadvantage of a relatively small population[9] and as a result, a small pool of available savings to finance investment. Even the successful conversion of natural assets into economic value requires huge investments of skill and infrastructure. The Australian economy has now grown to the point where services and manufactures represent as large a share of exports and a much larger share of total production, as those based on natural resources (see Figure 2.1).

This underscores the fact that elements of competitiveness are often highly integrated. Skills, finance, capital equipment and infrastructure combine to support one another. For example, investment in new equipment often brings new methods and skills that further enhance productivity.

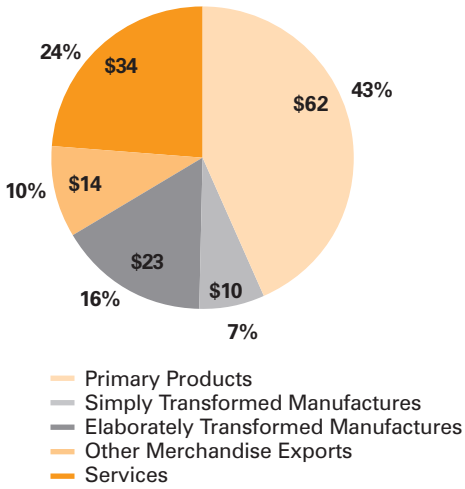
The competitiveness of the Australian economy in all of these areas depends importantly on the social and economic policy framework provided by Governments.

Policies must simultaneously support all of these ingredients essential to growing competitiveness, facilitate risk-taking and reward endeavour.

2.4 Is Australia sustaining its competitiveness?

If Australia allows itself to fall behind, providing a less competitive setting than other countries, growth will falter and opportunities will be lost. This has happened before. Considerable concern emerged in the 1970s and 1980s that the Australian economy was falling well short of its potential. Productivity in Australia had fallen short of that of many other advanced economies, including the US and leading European economies. Equally, the economy struggled to respond to changes and shocks so that inflation and unemployment emerged as seemingly intractable features.

FIGURE 2.1
AUSTRALIA'S EXPORTS ($A BILLIONS)

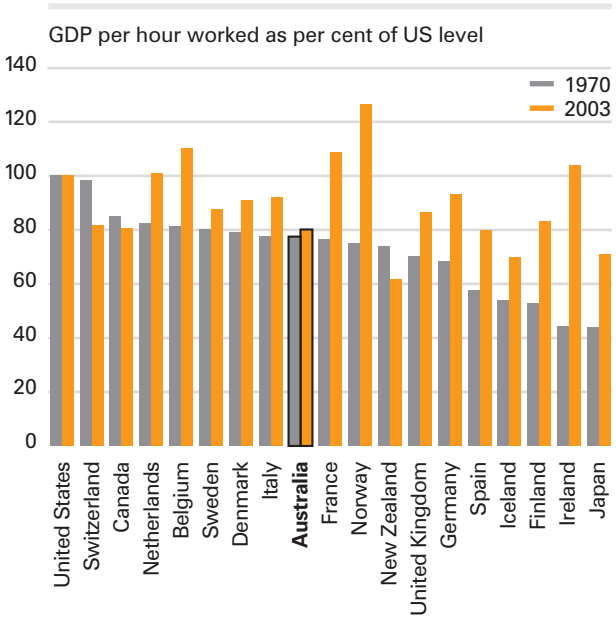


Source: Adapted from data in DFAT 2004, Composition of Trade Australia 2003–04 (figures rounded).

The economic policies that had developed since Federation, including high industry protection, fixed or managed exchange rates, centralised wage fixing, high tax rates on narrow bases, and public ownership or regulation of many key industry sectors including the financial system, inhibited the competitiveness of the economy.

The global environment of the late 20th century differed greatly from that of earlier times, with new international competitors, new technologies and rapidly changing demographic patterns.[10] To produce a more dynamic, competitive and robust economy in the face of these changes, major reforms swept away much of the earlier policy framework.

FIGURE 2.2
AUSTRALIA'S RELATIVE PRODUCTIVITY



Source: OECD (2004).

The new policy framework reduced and refocused economic regulation and allowed a stronger role for market processes in deciding prices and resource allocation. Many of the policy impediments to Australia's competitiveness were reduced or removed.

In response, Australia's economic performance has improved considerably, with a long period of sustained growth, strong investment, low inflation, higher incomes and falling unemployment since the early 1990s. As other economies have also advanced, the productivity gap between Australia and the leading economies has persisted, but Australia has at least kept up (see Figure 2.2).

However, this does not mean that the current policy framework is in all respects operating to fully sustain Australia's competitiveness and to ensure the economy remains on a sustainable high-growth path.

Australia's recent strong performance certainly owes a great deal to improved policy settings, but is now also being assisted by some propitious global developments.

- **The recent economic resurgence of some large Asian economies has increased prices for resource exports while technology, exchange rate developments and global production shifts have lowered prices for many imports. As a result, Australia has been enjoying unusually strong gains in its terms of trade (export prices rising faster than import prices).**
- **The economic slowdown that affected much of the developed world after the bursting of the technology bubble has led to a period of unusually low global inflation, interest rates, and cost of capital.**

These trends represent an unusual combination and have contributed to strong investment, employment and economic growth in Australia. As part of this, although Australia has among the largest current account deficits in the world – currently around 7 per cent of GDP, reflecting in part very weak export performance – we are still finding it relatively easy at this stage to fund the deficit and maintain investment with capital inflow. But this will not always be so.

These factors point to potential vulnerabilities. Recent trends in the terms of trade and interest rates are unlikely to persist indefinitely. Certainly we are unlikely to benefit again from the structural decline in interest rates that has accompanied the decline in inflation rates around the world.

Looking beyond the recent strong performance it is possible to see a range of underlying trends and issues, many already evident, that may work to reduce Australia's competitiveness. These could adversely affect economic performance quite quickly, especially if the current propitious global circumstances should turn.

- **Australia's workforce participation rates are at best average, and well-short of the rates in many other OECD countries.**
- **Skill shortages are emerging.**
- **Household savings have steadily turned negative and Australia's reliance on inflows of foreign capital has again reached record levels.**
- **Earlier gains in the growth of export volumes appear to have stalled across many sectors including in elaborately transformed manufactures and some high-value services.**
- **The pace of policy reforms in those markets where competition and efficiency has continued to lag has slowed considerably in recent years. These include some areas of the labour market, professional service industries, a range of public services and utilities, and some others.**
- **Concerns are growing at emerging shortfalls in physical infrastructure.**

2.5 Will competitive pressures intensify?

While these developments are emerging in Australia, the competitiveness of other countries in the world economy continues to build. The world's developed economies have long been locked into competition for investment and increasingly for skilled workers.

New competitors are also emerging and many are rapidly advancing the restructuring of their economies into more sophisticated services and more advanced areas of manufacturing. For example: India has been building its services sector utilising a vast pool of skilled, English language workers; financial markets in several major Asian centres continue to grow strongly; and China and several other countries are moving increasingly into more advanced areas of manufacturing.

The underlying trend is that more and more of the world's key resources are becoming mobile. This is occurring for several reasons.

- **Key resources are increasingly embodied as skills and talents in people, who can readily move.**
- **The activities that enter into the value chain are increasingly being broken up. This often makes them more mobile. For example, more professional and creative services (e.g. style, design, research, engineering, architecture, marketing, information and financial management) can be undertaken separately from physical production and from delivery to customers.**
- **With economic development the range of desirable locations to live and work is rapidly increasing, and Governments are increasingly seeking to attract high-value activities and workers.**
- **The costs of travel are falling.**
- **The costs of communications are falling.**
- **Financial markets are also increasingly global, especially as information costs fall. Markets for capital and investment have long been internationalising, although most of the investment has continued to concentrate on the most advanced countries. The globalisation of these markets is continuing to intensify, with new information technologies and as new economies converge on those of the developed world.**

The effect of these trends is to persistently raise the cost of poor policy or other weaknesses in the competitiveness of the Australian economy.

Effective policy responses have long development and lead times. If we add to that a long recognition time, we will be in a weaker position to respond. Most of the social and economic trends now emerging seem certain to accelerate over coming years. We need to make policy changes now to strengthen Australia's future competitive position.

The following sections provide observations on trends affecting the key factors of production.

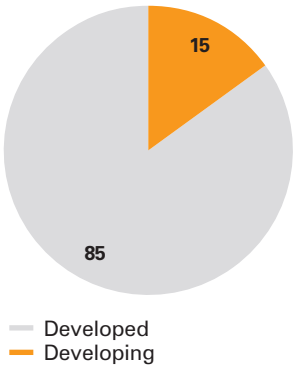
Competition for capital

The competition for foreign direct investment and other capital flows will intensify in the future for two key reasons.

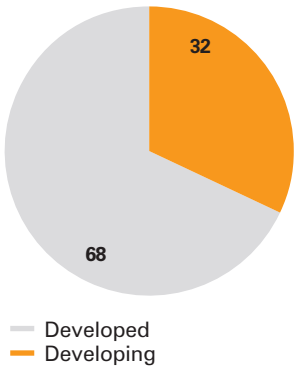
First, the overall global balance of supply and demand is set to change. Demand is likely to increase due to the rapid emergence of large economies like China and India. Meanwhile the supply of savings in the developed (and many developing) countries is likely to continue to weaken with increasing fiscal pressures and ageing populations.

Second, and potentially more powerfully, there could be further major changes in the relative attractions of different countries as destinations for global capital (see Figure 2.3). Again, the emergence of new economies and in particular the growing sophistication of their financial systems is likely to increase competitive pressures on this count as well.

FIGURE 2.3
FOREIGN DIRECT INVESTMENT INFLOWS 1980 (%)



FOREIGN DIRECT INVESTMENT INFLOWS 2003 (%)



Source: UNCTAD FDI database (figures rounded).

While Australia may be well placed to supply certain goods and services to these new economies and may attract capital for that purpose, it will at the same time face strong new competition across large areas of its economy. This will follow particularly rapid advances in the scale and performance of Asian capital markets.

There has been a short hiatus in these trends in recent years. The global cost of capital fell substantially due to the economic slowdown following the end of the technology stock bubble and Asian financial systems suffered a crisis in the late 1990s. However, these are short-term developments. The longer term looks most likely to be decidedly different and Australia will need to ensure that it meets these challenges and remains competitive.

Competition for labour

Global labour market pressures are also likely to intensify through:

- **increased international mobility and competition for skilled labour; and**
- **the effects on workforce growth around the world of low and declining birth rates.**

Today around 1 billion international people movements for all purposes occur each year. More and more of these are work related. In particular, mobility is greatest for the highly skilled largely because national laws more often accept or encourage skilled entry (see Table 2.1). For Australia, a rapid increase has occurred in the numbers of people leaving on a long-term or permanent basis, although net inflow continues to provide much of our population growth. We have become more dependent on highly skilled workers coming either short-term or as immigrants.

TABLE 2.1
SKILLED MIGRATION TRENDS

Skilled immigrants in selected countries – share of all immigrants who are skilled (%)

	1991	1999	2001*
Australia	37	42	60
Canada	18	47	55
New Zealand	na	47	68
United States	18	22	17
Sweden	6	8	10
United Kingdom	7	33	32

*Data refers to 2002 for US.

Temporary workers admitted under skill-based categories (000s)

	1992	1997	2000
Australia	41	82	116
Canada	70	75	94
New Zealand	na	27	48
United States	143	na	505
France	5	5	8
United Kingdom	54	80	124

Source: UN World Economic and Social Survey 2004.

Added to this trend more recently has been the rapid globalisation of skilled services and occupations. More firms operate in many countries and can more easily locate high-value services separately from physical production (whether in-house or through outsourcing). Lower travel costs and the rapid emergence of new information and communications technologies have reduced the costs of these choices. The growing sophistication of many new economies as well as the continued trend to integration of the developed economies has created a global marketplace for the highly skilled occupations.

Well-educated Australians, with the advantage of English as their first language, are highly competitive in this global marketplace. As noted above, over the past ten years, a rapid increase has occurred in the numbers of highly skilled Australians leaving for work in other countries. The numbers of Australians living overseas on a long-term basis is rapidly approaching one million, and these are very disproportionately the high-skill, high-value workers.

Of course, Australia also attracts immigrants, including skilled immigrants. But the balance has been closing. In 2001–02, more than 80,000 specialist managers and selected professionals came to Australia on a permanent or long-term basis. But almost 50,000 left.[11] There are many benefits as well as costs in these movements, and the balance of them perhaps does not yet suggest that Australia has a severe problem. However, they point to the growing internationalisation of the skilled labour market and the rapidly increasing importance for Australia to maintain its competitiveness in that market.

Mobility of the highly skilled is likely to continue to increase for several reasons:

- **The rapid growth of the Asian and other developing economies will result in higher incomes for a dramatically increasing share of the world's population and therefore increase the demand for professional and financial services. This will greatly expand work opportunities for the highly skilled in those countries. At the same time, the pressures of ageing populations in other developed economies, often more severe than projected for Australia, will create further demand in the global labour market (see case study on China, and Figures 2.4 and 2.5 in the pages that follow).**
- **If labour demands of an increasingly specialised Australian economy do not fully match the pattern of qualifications produced by the education system, skill mismatches could see more skilled Australians going offshore for job opportunities and Australia relying more on skilled migrants to fill skill gaps here.**[12]
- **The attractions of international careers are increasing, particularly as more firms operate internationally. Improved communications and travel services reduce the isolation and other costs often associated with such work. At the same time, career skills and advancement often benefit from experiences gained in postings abroad.**[13]
- **Another factor may be the fiscal effects of ageing populations. If these costs are reflected in higher taxes on highly skilled workers, and if those impacts differ appreciably between countries (especially developed versus developing), they may well increasingly impact decisions on where to live and work.**

China and the Growing Demand for Skilled Labour

China's strong economic expansion has captured global attention, particularly in terms of China's demand for commodities.

China's demographic outlook and the implications, including the potential demand for skilled labour and the implications for global competition for skilled labour, is an issue that attracts less attention.

Reflecting the impact of its one-child policy, China's population growth is projected to slow dramatically. Population growth averaged 1.2 per cent over the period 1980–2002. The rate of growth is projected to halve, to average just 0.6 per cent per annum over the period from 2002–15.[14] Labour force growth is already less than 1 per cent and China's working age population will decline from 2020. Consistent with these trends, China's population is set to age significantly with the average age increasing from 27 years to 40 years from 1995 to 2025.[15]

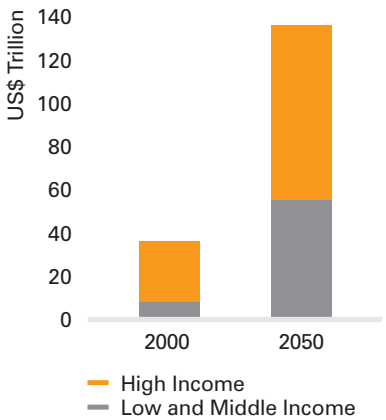
China is set to face the same demographic pressures (and the same adverse implications for economic growth) as the developed economies, but from a very different starting point in terms of economic development. If China is to sustain strong economic growth it will need to address the same labour supply issues as countries like Australia.

Further compounding this challenge, China is aiming to lift the value-add of its economic activities, which will heighten the demand for skilled labour in particular. Here, too, China faces significant challenges given that the average number of years of schooling in China is just over six years, on average only 3–5 per cent of China's prime working age population have tertiary qualifications, and only 13 per cent of under 25-year-olds are currently enrolled in tertiary education.[16] These aggregate figures are distorted by the substantial differences in rural and urban educational outcomes. Addressing this imbalance is the issue, given that it is workers currently in the rural sector and state-owned enterprises that will increasingly be needed to meet the demand for labour in urban centres and in more advanced economic activities over time.

What this means is that China is likely to become an increasingly important competitor for skilled labour in the global labour market at a time when most developed countries will also be facing slower growth in labour supply and most global population growth will be occuring in the least developed economies. Australia, which already relies on a relatively large intake of skilled migrants, and should do so even more, will face increasing competition in attracting and retaining skilled workers on both a temporary and permanent basis. The number of Australian-born Australian residents emigrating to China on a permanent or long-term basis increased nearly 120 per cent from 1998–2002.[17]

It seems reasonable to conclude that income levels and therefore taxation arrangements will feature to a greater extent in efforts to attract and retain skilled labour, as is becoming evident by the measures already being adopted by other OECD countries. As one example, the provincial Government in Quebec, Canada, has introduced five-year income tax holidays for some highly skilled workers.[18]

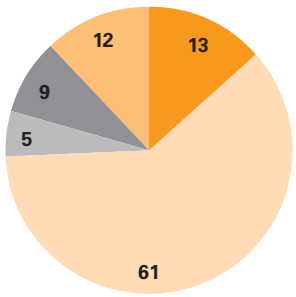
FIGURE 2.4
SHIFTS IN GLOBAL INCOME



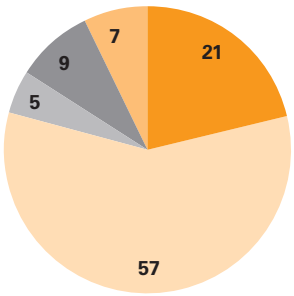
Source: World Bank News Release 2005/108/ESSD

FIGURE 2.5
GLOBAL POPULATION TRENDS

World Population 2000 – % Shares



World Population 2050 – % Shares



Source: UN Population Database (medium variant).
Charts exclude Oceania.

The increase in labour mobility comes at a time when the rate of growth of overall workforce numbers is about to slow dramatically for demographic reasons. In Australia, the first of the baby boom generation are reaching the age range (over 55) where retirement rates increase. At the other end of the age range, the numbers of young people entering the workforce will fall as a result of low birth rates.

As a result, on current trends, the rate of workforce exit is expected to rapidly approach the rate of workforce entry in Australia over the next 20 years, even with current net immigration rates, so that workforce growth will largely cease.

These changes combine to make it more urgent that workforce participation rates increase and that Australia's relative attractiveness particularly for internationally mobile skilled workers is maintained.

Australia needs to reform its policies and practices in three main areas:

- **participation rates of women;**
- **participation rates of mature-aged individuals; and**
- **attraction and retention of skilled internationally mobile workers, which also requires a competitive business sector capable of generating challenging, high-paying jobs.**

Other competitive pressures

Capital, labour and natural resources are the traditional factors of production. In modern knowledge-intense economies the creation of value also needs to encompass human capital, the skills and knowledge held by individuals. But there is much more than this as well.

Key additional factors determining the competitiveness of firms and of the economies in which they operate include a range of intangible 'capitals':

- **entrepreneurship;**
- **invention and innovation;**
- **internal organisation and culture;**
- **social capital (the level of trust, particularly in markets);**
- **brand and customer capital; and**
- **external relationships, networks and clusters.**

While most of these are not recognised or measured as assets by the accounting standards, and are little studied in economics, together with human capital they represent most of the investment and wealth in modern economies, including Australia.

One illustration of this is that most companies have share values that are several times greater than their book value. Share values at least in part reflect all of the expected sources of value of companies including the unmeasured intangibles. Book values reflect only the narrower set of mostly physical assets (some intellectual property and purchased goodwill may also be recognised in part).

Investment in intangibles is critical to competitiveness, but carries many risks. Unlike the traditional factors of production, intangible capital most often has no alternative use if it is unsuccessful in the firm that creates it. But if a country wants a competitive modern economy it must provide a policy framework that nurtures this high-risk investment.

The strength of this imperative is increasing as a result of the continuing and rapid emergence of new competition from developing countries at the level of consumer goods, intermediate technologies and services. Industry-by-industry, sector-by-sector, new competitive pressures are destroying value in the developed and developing economies by producing cheaper products. Goods and services that a few years ago held significant values are increasingly becoming inexpensive commodities and these are most efficiently produced by the emerging economies. The recent announcement that IBM is selling its personal computer business to a Chinese company (and that China already accounts for 40 per cent of IBM's Personal Computer workforce) illustrates this trend.

The only way to successfully respond to this in advanced economies is not a so-called race to the bottom; rather it is to continue the process of restructuring to higher value production and to focus only on the highest value components of the production chain (for IBM this currently is consulting, software and high-end business systems). This requires the right policy framework. For many advanced economies this is a clear challenge. To keep growing they must continually build their knowledge intensity and creativity so that they increasingly produce sophisticated and better solutions that are as yet unavailable from competitors. Investment for this transition must focus on the knowledge base; education; other processes for building human capital; superior organisational and financial management skills; research and development; and design.

For Australia this is not quite so straightforward. We retain large land and resource based assets. We share the need for increasing knowledge intensity but, compared to many other advanced countries, some of our best applications will be weighted to production process and resource management innovations in these industries rather than new products and services. But we cannot rely on these sources of advantage alone. Other sectors will also have to contribute.

The imperative is for each country to develop unique applications linked to its economic structure and potential.

2.6 Conclusions

After more than three decades of trade liberalisation and market deregulation both in Australia and overseas, Australian businesses now have unprecedented access to international markets for the goods and services they produce as well as the inputs of raw materials, intermediate inputs, skilled labour, and the financial and physical capital needed for their development. However, it has also brought unprecedented competition.

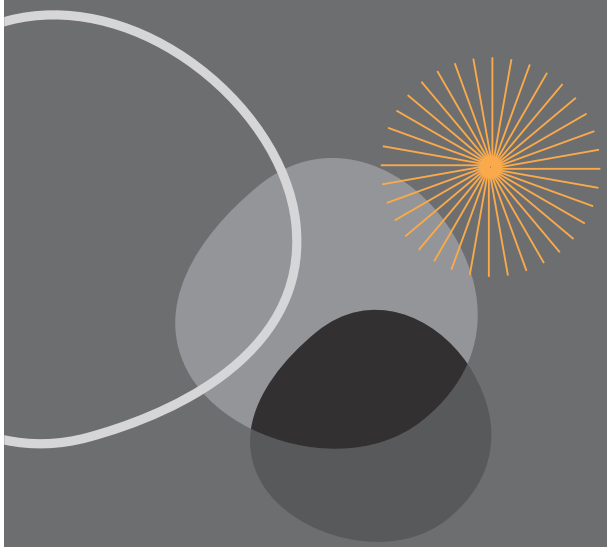
In coming years, Australia faces sharply increased demands on Government (and the community) for higher spending, at the same time as a reduced capacity to expand its economy as the population of workforce age ceases to grow. This creates a very strong policy imperative for finding new ways to expand the economy.

Australia's prospects for increased economic growth and employment are heavily dependent on its ability to attract the financial, physical and human capital needed for the development of businesses in Australia. That is, growth depends on increasing the competitiveness of the Australian economy.

International competition for financial capital, high-value investment and skilled labour is intensifying and likely to accelerate. Early policy responses are needed to position Australia to maintain its competitiveness in attracting these activities and resources.

Chapter 3

Competitiveness and the tax system



The developments discussed in Chapter 2 demonstrate the need to regularly adapt Australia's economic policy framework to ensure it continues to support competitiveness.

Is the tax system again emerging as a high-priority area in this context? The answer to this question depends on:

- **the significance of the tax system to competitiveness;**
- **the role the tax system can play in supporting or improving our competitiveness; and**
- **whether other countries are using tax policies to gain competitive advantages.**[19]

As discussed earlier, the tax system has become very pervasive in terms of its size and breadth. Taxes influence most activities and economic decision-making either directly or indirectly. As such, tax policy is a significant factor impacting Australia's competitiveness.

3.1 Taxes and emerging competitive pressures

Tax arrangements will be important, particularly in the following areas:

- **the attractiveness of Australia as a location for investment;**
- **the cost of capital for business investment in Australia;**
- **the level and efficiency of investment within Australia, whether in housing, physical business assets, infrastructure, human capital or the other intangible assets that play the major role in a modern knowledge-intense economy;**
- **incentives for Australians to save and invest in Australia;**
- **Australia's attractiveness to internationally mobile skilled labour;**
- **workforce participation rates (including hours worked);**
- **managing the risks associated with imbalances in the economy (such as future fiscal pressures, a shortfall in national savings, or excessive reliance by any sector on debt); and**
- **the direct effects on competitiveness arising from the reporting, transaction and other compliance and decision-making costs of the system.**

If the Australian tax system works against productivity, workforce participation, the attraction of skills, savings or innovation, economic and productivity growth will suffer and the economy will be more vulnerable to competition, external shocks and internal pressures such as an ageing population. Other countries will be quick to take any opportunities missed here. How other countries are pursuing the use of tax policy to improve their competitiveness is an important additional issue to be taken into account in considering appropriate tax policies for Australia.

3.2 International trends in tax policy

At present, Australia is attracting significant net capital inflow and Australia is seen as a relatively attractive location for skilled migrants. We offer political stability, relatively strong growth and opportunities, a high quality of life, clean and safe cities, wonderful beaches, etc.

As competition for capital and skilled labour intensifies, we will need to do more to attract and maintain both. Other settings, including the availability of challenging well-paid jobs, tax considerations and broader policy settings will be important. Tax arrangements in Australia will be even more important for competitiveness if the countries with which we compete actively use tax policy to gain competitive advantage.

If this is the case, it is likely that the deadweight costs of Australian taxes will increase, since the availability of more attractive locations overseas will increase the tax sensitivity of activities in Australia.

Australia's competitors include many countries offering similar investment and occupational opportunities to those offered here. They also include the countries of residence of businesses competing internationally with Australian companies.

Australia's broad economic structure means that this is a wide range of competitors. Australia is an advanced economy with important service and manufacturing industries directly competing with those of other more advanced economies. Australia also has large agricultural and resource capabilities often competing with such activities in both advanced and developing economies.

International business investment decisions are made with tax issues firmly in mind. As noted above, tax issues impact on the cost of capital and the availability of labour. Tax systems remain critical points of competitive advantage or disadvantage. It is therefore necessary to take trends in international tax settings fully into account in designing systems in Australia.

Competition from the main developed economies

It is perhaps fortunate that most of the developed economies design their tax systems in the face of broadly similar fiscal challenges. For example:

- **The absolute per capita size of general Government spending (excluding transfer payments) is remarkably similar across the advanced countries (about $US5,000 per person when adjusted for purchasing power – estimated using *The OECD in figures, 2003, Supplement 1)*.**
- **Longer-term pressures from rising health costs and demographic change are being faced by all countries (some more so and sooner than Australia).**

Despite these common pressures considerable differences in tax as a share of national income arise due to two main factors.

- **Differences in the composition of Government expenditure, especially on social security and other transfers. These transfers are higher in virtually all other developed countries than in Australia, but are largely or wholly funded by separate social security taxes levied at flat rates and often subject to a cap. This can mean that tax systems abroad are less progressive at high incomes than in Australia because in Australia specific social security taxes are generally not levied, with social services funded out of general revenue.**
- **Differences in per capita GDP. For the same level of absolute public spending, lower tax rates are possible in those countries with larger tax bases due to higher per capita incomes, particularly the US, which has a per capita income level (in purchasing power terms) around 20–30 per cent larger than most other OECD countries including Australia.**

It is important to acknowledge that an accurate cross-country comparison of tax to GDP ratios is difficult.

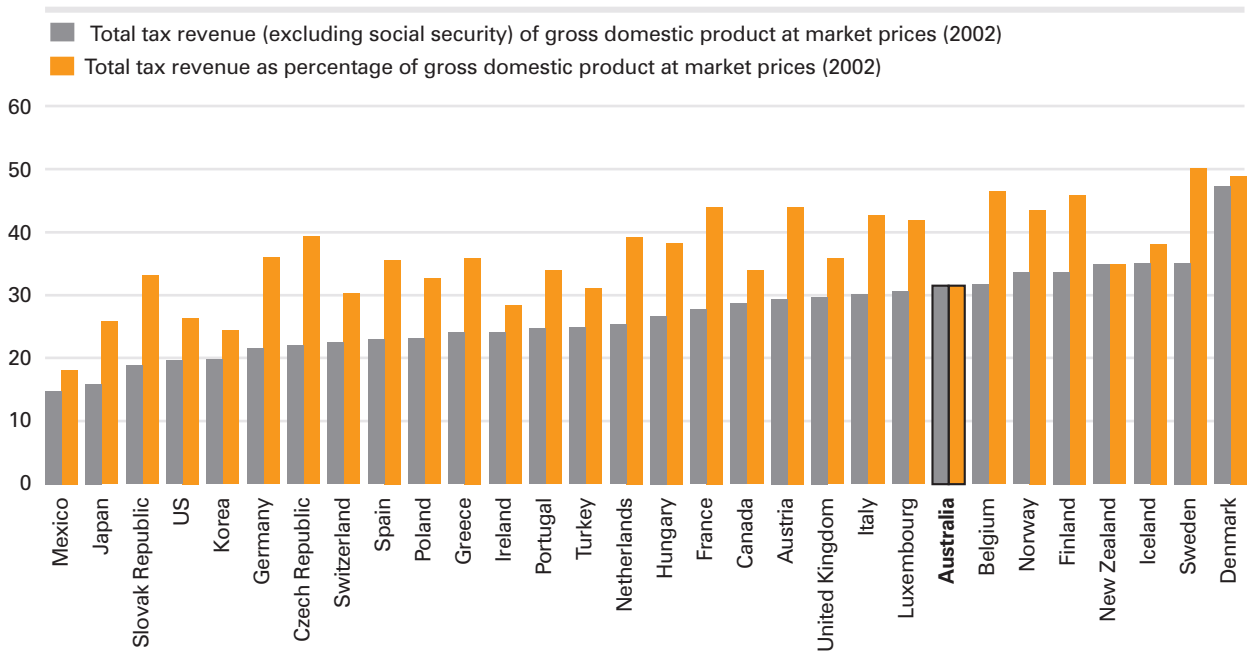
A key complication is whether to measure Australia's taxation burden against countries including social security taxes which are part of most OECD systems.

If we compare Australia's tax burden against countries including their social security taxes, for an accurate comparison we should also consider adding Australia's Superannuation Guarantee and the compulsory workers compensation schemes to the calculation of Australia's tax burden. These imposts are similar to social security taxes. Figure 3.1 includes a comparison of countries, (measured both with and without social security taxes) against Australia, which in both measurements does not include the Superannuation Guarantee or workers compensation.

If social security taxes are not included in the measurement (arguably for a more even comparison) then Australia's overall burden is higher than in most European countries, the US and Japan. When social security taxes are included, Australia's tax burden is lower than in most European countries and only a little higher then the US and Japan.

Recent work by Peter Burn (How Highly Taxed are We?, CIS Policy Monograph 67, 2004, page 8), using the more conservative measure (including the social security taxes levied in most other OECD countries but not including Australia's Superannuation Guarantee or workers compensation premiums) concludes that the level of Australian taxation is broadly comparable with the weighted average level of tax in all OECD countries but still concludes that Australia is more heavily taxed than its most important OECD trading partners.

FIGURE 3.1
TOTAL TAX RECEIPTS 2002 (% OF GDP)



Source: OECD, Revenue Statistics, 1965–2003 (2004)

It is possible for countries to structure their tax systems to ensure that their economies remain relatively attractive for the most internationally mobile people and activities, and to favour those factors most important for international economic competitiveness.

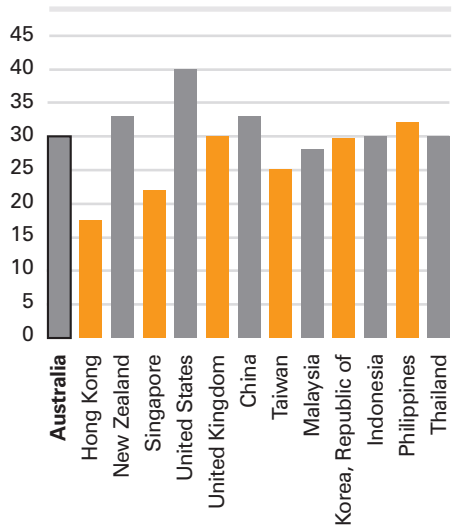
Some countries have sought to gain advantage through policies that include favourable tax arrangements:

- **Ireland is the best known example, where the company tax rate for example is 12.5 per cent (assisted by European Union grants).**
- **Switzerland, in ways largely restricted to the financial sector, has pursued a different version of this strategy for many years.**

For the most part, these exceptions have not yet presented a major competitive threat to Australia, as they relate to relatively small economies.

More challenging, particularly as they operate within our time zone and region, are the city States of Hong Kong and Singapore (see Figure 3.2). Both have maintained favourable tax regimes for capital income and Hong Kong has a very low tax structure across the board. Both attract large and increasing numbers of highly skilled Australian workers each year. New Zealand has also undertaken considerable tax reform but maintains a broadly similar tax regime to that in Australia in many respects. It has a relatively low top marginal tax rate and favourable treatment of capital gains. Countries such as China will need to be watched.

FIGURE 3.2
COMPARISONS OF INTERNATIONAL COMPANY TAX RATES (2004)



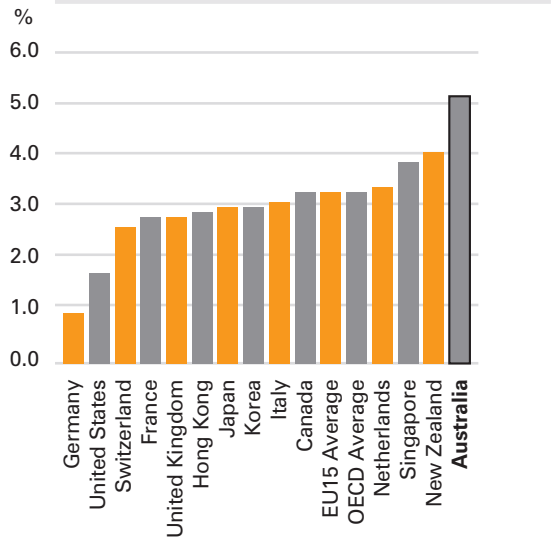
Note: These headline rates include State taxes on average, (e.g. the US Federal rate is 35 per cent, plus an average State rate of 5 per cent), and any surtaxes or surcharges on top, (e.g. in Germany and Korea).

Source: KPMG, Corporate Tax Rates Survey, January 2004; presentation by David Stevens, KPMG, to the Business Coalition for Tax Reform, November 2004.

Among the larger developed countries, the most significant competitors for Australia are clearly the US and UK (for many reasons including our common language). These countries have large financial markets, are significant sources and destinations of direct investment capital, and are the two largest destinations for highly skilled Australian workers moving overseas. However, it is not only the statutory rate but the overall burden on business income that Australia needs to consider, as can be seen in Figure 3.3.

How do the tax systems of these larger economies deal with the most important drivers of competitiveness?

FIGURE 3.3
CORPORATE INCOME TAX BURDEN (% GDP) 2002



Source: KPMG, data is for 2002 from the OECD Revenue Statistics 1965–2003 (published 2004) and Singapore and Hong Kong Budgets (2003 data).

Note: The above list is of key OECD competitors and Hong Kong and Singapore for additional comparison. Using the OECD measurement, there are only two countries in the OECD that have a higher corporate income tax burden: Norway and Luxembourg. The OECD data appropriately includes superannuation contributions tax (but not the surcharge for higher income earners which is counted as a payroll tax) and taxes on superannuation fund income. Company tax is by far the largest sub category; however, a range of other taxes on corporate income is also included in Australia's data such as the Petroleum Resource Rent Tax. Even without these measurement complications, Australia is still well above the OECD average when these additional taxes are taken out.

Australia's company tax revenue has been growing very strongly and is at a record high. In the 2004–2005 Mid-year Economic and Fiscal Outlook the projected company tax revenue was $41 billion. Company tax receipts have been the fastest growing area of tax revenue over recent years. The share of company tax receipts in total receipts has risen from 15 per cent in 1999–00 to around 20 per cent in 2004–2005, while personal income tax has remained steady relative to the total receipts take (around 51 per cent).

Taxation of capital and business investment

The company tax rate in the US is 35 per cent at the Federal level and typically a further 5 per cent at the State level (see Figure 3.2). The UK has a standard company tax rate of 30 per cent (lower for small companies).

The US and UK and most other countries provide a much more favourable capital allowance regime than does Australia, contributing to lower corporate income tax burdens. The regimes are usually much simpler than Australia's elaborate 'effective life' system and provide more rapid write-off of most capital expenditures. These provisions bring four main competitive advantages:

- **Simpler compliance and administration tasks.**
- **Reduced bias intrinsic to income taxes against saving and investment.**
- **Reduced bias against higher risk and return business investment.**
- **Providing a favourable investment tax climate for critically important investments in production capacity relative to competitors, given that such arrangements are globally applicable.**

Taxation of higher skilled (and income) workers

The US and UK, along with most other advanced economies impose both social security taxes and personal income taxes. The analysis of these taxes is complicated and difficult. For instance, income taxes are levied at different rates and thresholds in different US States and some cities. Different thresholds and offsets apply for different family structures. Social security taxes may be either or both payroll taxes or personal taxes and different effective rates may apply to the self-employed relative to employees and in other special cases. The social security taxes may have a lesser impact on economic behaviour than the general revenue income tax because they carry entitlements.

The net effect of all of these features is that the three tax systems (the US, UK and Australia) broadly collect similar revenues but there is one clear difference. The marginal tax rates applying to higher incomes in the US and UK are below those in Australia. This arises mainly because in the US and UK social security tax is capped at a certain income level, reflecting the idea that while social security programs in those countries are income related they provide only a minimum safety net.

The cap means that effective marginal tax rates above that level fall. This can operate to ensure that marginal tax rates on highly skilled workers are lower than otherwise. In the UK, the effective personal tax rate on workers earning over about $A75,000 is 41 per cent (including an uncapped social security tax of one per cent). In the US, the rate varies by State and city. Because the cap on the non-Medicare component of social security is set at $US90,000 (for 2005) marginal rates may reach above 40 per cent up to that level but can fall below that rate (until the highest rate steps apply). Rates in the high 30s to low 40s are typical beyond that level. This includes the uncapped Medicare component of the social security tax, which is struck at 1.45 per cent on employees.

In both countries then higher income workers typically have marginal tax rates of around 40 per cent while in Australia the rate is 48.5 per cent.

Other emerging developments in developed economies

Another emerging international pressure may arise from the increasing integration of the European economies. This has generated something of an agenda for tax harmonisation, although it is one being pursued with characteristic European caution among the main countries.

More significant responses have been witnessed among some smaller States, such as the countries of Scandinavia, which have reformed taxes on companies and investment income and have kept these taxes at a much lower level than taxes on labour income. There are signs of some shift towards favouring withholding taxes rather than income tax on interest income and, to a much lesser extent, to favouring simpler taxes on dividends (rather than the imputation system).[20] The US, which has a classical system, has also reformed its tax treatment of dividends, opting for a schedular-type system where dividends are taxed at the lower rates of either 5 or 15 per cent depending on tax bracket of the shareholder.

There remain large differences in the detail of tax levels and systems between countries. However, if countries move towards convergence, this will place further pressure on Australia. If a large number of countries have common tax arrangements, one of the cost advantages for a company choosing to expand activities in those countries is that it does not have to learn new tax rules and develop unique tax compliance systems.

The tax systems of many countries have moved away to some degree from comprehensive income taxation towards schedular arrangements, which tax different income classes on their own basis, often at flat rates. This has long been a feature of the UK system. This approach often provides a much simpler system and one that in practice can impose fewer distortions than comprehensive systems. For example, the uniform treatment of dividends avoids the bias against foreign source income that is a feature of imputation systems such as that in Australia. In the US, the dividend rate is also broadly aligned with that for capital gains (resulting in common treatment of retained and distributed company income).

Schedular arrangements also allow the tax treatment of capital income to be struck at more competitive rates than applies to labour income. This has been attributed as a key advantage of the Scandinavian systems, allowing those countries to maintain generous welfare states without unduly damaging their economic competitiveness.[21]

Tax competition from developing economies

Developing countries are characterised by the low relative size of their public sectors – typically one-third to one-half that of the developed countries. This reflects a range of factors, some of which (such as poor legal and physical infrastructure and minimal if any social welfare system) can act detrimentally to their competitiveness. But it does mean that they typically have low aggregate tax burdens when expressed as a share of GDP.

As developing economies grow, the tendency is to move towards developed country public expenditure and tax levels. Nonetheless, in this growth phase, some of these countries can in the meantime provide considerable tax competition for specific industry sectors (e.g. resource processing industries).

3.3 Conclusions

It is clear that the tax system is an important policy lever influencing the competitiveness of economies and is used specifically by some countries to gain a competitive advantage.

In assessing the performance and efficiency of the Australian tax system, account must be taken of tax arrangements and policy developments in key competitor economies – developed and developing.

The above analysis also highlights the following key issues:

- **There are important differences between countries in terms of the corporate tax income burden.**
- **Company tax rates do vary significantly, with many of Australia's nearest neighbours and competitors having very competitive rates. Lower revenue collections may reflect lower levels of Government spending and service provision, but lower company tax rates are an important issue in influencing business investment and expansion decisions.**
- **Many developed economies have simpler tax regimes covering business investment and company income.**
- **There are also important differences in the taxation of personal income and, in particular, tax rates applying to higher income earners.**

These issues and their implications for Australia are discussed in greater detail in Chapter 4.

Chapter 4

Competitive performance of the Australian Tax System

Australia's capacity to compete in increasingly globalised markets must be supported by a tax system that supports the key elements of economy-wide competitiveness including high levels of productivity, strong productivity growth and high rates of workforce participation and investment growth.

In order to achieve these broad objectives, the tax system must support Australia's ability to attract capital and skilled workers, sustain high investment particularly in the business sector, support risk-taking and entrepreneurship, high-value activities, innovation, the application of skills and new ideas, skill formation and the development of human capital. It also needs to ensure that workforce participation is encouraged. Moreover, the tax system should seek to impose the lowest possible deadweight costs on the economy, including administrative, compliance and decision-making costs.

This chapter reviews in more detail those elements of the Australian tax system that are most likely to directly impact on Australia's current and future competitiveness and economic performance relative to other countries. In doing so, it builds on the brief assessment of the Australian tax system outlined in Chapter 1 and conclusions reached in Chapter 3.

4.1 Taxes and highly skilled workers

Tax rates

The rate structure of the personal tax system (including the Medicare levy) can be characterised as having the following three elements:

- **A basic rate of 31.5 per cent (this marginal rate applies to median and average earnings and over half of all taxpayers).**
- **A low rate structure for low incomes, including a tax-free threshold of $6,000, a first step of 17 per cent, a higher threshold for the Medicare levy and low-income rebates, including a larger one for those of retirement age. The low rate structure is effectively supplemented also by means-tested family payments.**
- **Two higher tax brackets, effectively surtaxes, applying to incomes from about 1.2 times average wages.**

The progressivity of the low rate structure is the main instrument for achieving progressivity in the tax system.

In 2001–02 (the latest year for which the Australian Taxation Office's Taxation Statistics have been published), this structure meant that only three per cent of the personal income tax paid in Australia was paid by those on incomes below $20,000. The low rate structure has the effect of lowering the average tax rate for all taxpayers. For example, the average tax rate for a taxable income of $50,000 (an average wage) is just under 24 per cent.

The higher rate 'surtax' structure also makes a contribution to progressivity. The total additional tax collected by the higher rates (including on the fringe benefits tax) compared with the basic rate is approximately $10 billion, which is about four per cent of the total tax revenue collected in Australia.

The full-time earnings of most of Australia's highly skilled workforce exceed the average wage (currently about $52,000 per annum). Australia imposes higher average and marginal tax rates on these incomes than do its key competitors.

It also imposes its two highest marginal tax rates on virtually everyone in these skilled income ranges. The marginal tax rate for the income bracket between $58,000 and $70,000 is currently 43.5 per cent, and it increases to 48.5 per cent beyond this level. These thresholds are being adjusted to $63,000 and $80,000 from 2005–06.

In 2001–02, only 21 per cent of taxpayers reported taxable incomes over $50,000 but these taxpayers paid over 58 per cent of all income taxes. If company income tax and fringe benefits tax attributable to individuals is added, this percentage would be higher again.

Even if the surtaxes were removed from this group altogether, so that the basic tax rate of 30 per cent also became the top tax rate, they would still pay the largest share of total income taxes. Average tax rates would continue to rise with income for this group, albeit less steeply than now. As it is, the effect of the surtaxes is to raise average tax rates quite steeply. For a taxpayer with a taxable income of $150,000 for example, the 2004–05 tax scale imposes an **average** tax rate of almost 39 per cent, and this approaches 43 per cent at an income of $250,000.

As noted earlier, the main economies competing with Australia for highly skilled workers typically have **marginal** tax rates at these income levels of around 40 per cent (taking account of national and sub-national taxes) with much lower average tax rates. This means that as incomes rise in those countries into the levels typically paid for highly skilled workers, lower, more competitive marginal rates and less steeply rising average rates apply than in Australia.

High marginal tax rates undermine Australia's competitiveness as a location for high-value occupations and activities. In thinking about the importance of taxes on highly skilled workers, consideration needs to be given both to Australia's capacity to attract skilled migrants but also to retain skilled workers in the Australian economy. Income and earnings are an important determinant influencing decisions about where to work and live in increasingly global labour markets. Over one-third of respondents in a recent survey of Australian emigrants cited higher incomes as an important factor influencing their decisions to leave Australia.[22] The reality is that many can earn significantly higher incomes in $A terms overseas, and lower taxes make these incomes all the more attractive. While the cost of living may be higher in some cases, the value of any accrued saving for those intending to return to Australia at some point can be an added bonus.

Other tax effects in choosing to work in Australia

If a person is a resident of Australia for tax purposes, all of the Australian tax laws apply. That is, they are taxable on the income they earn from both Australian and foreign sources. Even if the person is a non-resident, Australian tax laws apply to income from Australian sources.

For non-Australians residing temporarily in Australia, the tax impacts are particularly harsh. As well as paying somewhat higher marginal and average taxes on personal incomes, a highly skilled worker who chooses to work in Australia, or whose employer decides to locate him or her in Australia, rather than in a competitor economy, will also have to come to terms with many other features of the Australian tax system.

This can create a considerably greater set of disadvantages than applies merely through higher rates of tax. These disadvantages also reduce Australia's competitiveness as a location for highly skilled, high-value activity.

Among these issues are the following:

- **Australian laws mean that even a temporary resident will become subject to Australian tax on foreign source income. By temporarily working in Australia, for example, overseas assets become subject to capital gains tax and savings funds become subject to Australian accruals tax rules. Australia taxes the incomes of temporary residents of Australia as if they were migrating to Australia to take up permanent residence, even though they are required to return to their home countries when their visas expire. These arrangements are discussed in further detail in Part Two.**
- **From an employer point of view, wages paid to an employee usually attract both payroll tax (typically about 6 per cent) and a compulsory superannuation contribution obligation (the 'Superannuation Guarantee') of 9 per cent. It is not straightforward to compare the Superannuation Guarantee with social security; overseas superannuation payments directly benefit employees and are not formally regarded as a tax. This issue aside, while payroll based taxes also apply in the US and UK as part of social security arrangements, once again a key difference arises in that the taxes overseas are largely capped. Much lower rates therefore apply to most highly skilled workers.**
- **Australia's fringe benefits tax also applies, sometimes in circumstances that would not create tax obligations in most other jurisdictions. For example, Australia's tax treatment of employer-provided motor vehicles, car-parking places and meals entertainment often has no counterpart overseas.**
- **For income tax and for these other taxes, the relatively complex Australian tax rules need to be understood and applied.**

  These arrangements are often complex and very costly for businesses that employ temporary residents, many of whom bring key skills. To attract the workers it is common that the employing business must compensate for the taxes paid.[23] The tax, being incident on business rather than the employee, is thus highly inefficient.

  Like high marginal tax rates, these issues are undermining Australia's competitiveness as a location for high-value occupations and activities.

  Attempts by the Commonwealth Government were recently made to remove the worst of these tax effects but these have been withdrawn following rejection in the Senate.

4.2 Taxes and workforce participation

Apart from the effects of the high marginal tax rate structure applying to the highly skilled sector of the workforce, Australia's tax system combined with its means-tested social security arrangements, also results in high effective marginal tax rates at lower incomes. These arrangements are discussed in greater detail in Part Two.

From the point of view of Australia's competitiveness high effective marginal tax rates at lower incomes are mainly of concern to the extent that they reduce workforce participation and so reduce the potential size of the economy.

The extent of this effect is difficult to gauge. It is possible that tax responsiveness is lower at lower levels of earnings. International movements of people are not a significant issue at this level, and decisions to work will be more sensitive to average than marginal tax rates for many workers. Important exceptions may be second earners and sole parents, most often women, who may face not only high effective marginal tax rates but also childcare and other costs that contribute to making the decision to work a marginal one.

Another difficulty is that means testing of family and other benefits reduces the overall cost of these programs, which means that overall tax burdens are lower than otherwise. If means tests are made less stringent, the cost is likely to be reflected in higher tax burdens somewhere else in the economy. The net effect on competitiveness is unclear.

Economic theory suggests, however, that the deadweight costs of a tax increase with the square of the tax rate (double the rate causes four times the cost). If tax responsiveness is similar at all points of the tax system this means that deadweight costs are minimised the more uniform the rates of tax (uniformity implies the lowest possible rate on the broadest possible base). At the very least this means that net benefits are likely to arise if any examples of very high effective marginal tax rates are addressed. It may be that these rates can be higher than those at the top of the tax scale due to lower tax responsiveness, but still there will be benefits in not allowing these rates to reach the very high levels currently observed.

As Part Two illustrates, there remain many examples of effective marginal tax rates in Australia exceeding 50 per cent, and some are much higher. It is likely then that there would be economic benefits in continuing to seek ways of reducing the highest of the effective marginal tax rates.

4.3 Distortions to savings, investment and the cost of capital

The Australian tax system continues to bias decisions away from saving and investment choices. Many of these may be difficult to overcome, but changes in Australia's strategic environment are working to increase their costs. The main concern is that tax arrangements adversely affect incentives for investment in the business areas that are most important to our growth potential. The adverse features include:

- **Income from capital is subject to relatively high effective tax rates due to the significant broadening of the tax base over the last two decades. In particular, investment in plant and equipment is taxed more heavily relative to competitors as a result of the absence of accelerated depreciation.**
- **The imputation system retains a bias against overseas investment by Australian corporations: shareholders receive no relief for foreign tax paid on income paid to them as dividends.[24] This reduces Australia's attractiveness as a location for international activities.**
- **The tax system favours lower-risk investment classes, especially when geared, compared with higher-risk business investment. These biases are amplified by some parallel provisions in the social security means tests and by the high marginal tax rates in the personal tax system. The lack of loss carry-back provisions also favours low-risk investments.**
- **To some extent high marginal rates have also encouraged many taxpayers to seek other tax shelters as well – in areas such as exotic agribusiness ventures where tax timing benefits can be obtained.**

Some of these biases are also present in foreign tax systems. However, in general there are two main differences – there is less opportunity in most other countries to obtain full tax benefits from highly geared investment and business investment in plant and equipment obtains more favourable tax treatment.

A competitive personal tax system

The impacts of the high marginal and effective marginal tax rates on workforce participation are fairly well understood and covered in public debate. Less well understood is the significant impact high personal tax rates have on the cost of capital, investment and savings.

Australia is a small economy operating in an open international capital market. If international capital markets were perfectly competitive, the rates of personal income tax that Australia imposes on its residents would have no impact on the cost of capital in Australia. However, there is significant literature and evidence to show that capital markets are not perfect and 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. In addition, the size of the Australian market can limit larger overseas investments because of the difficulties associated with entering/exiting positions without having a significant impact on the market. As a result, although there is an open international capital market, the marginal investor in Australian companies, including large Australian multinational companies, may often be an Australian resident. Given that the return on a project needs to compensate for the post-tax return by providing a better pre-tax return, the rates of personal income tax that Australia imposes on its residents is likely to influence the cost of capital for those Australian companies that still rely heavily on Australian residents as their main source of additional capital. Clearly in the case of private companies the Australian cost of capital and therefore personal taxation rates is even more of an issue.

Since the introduction of the dividend imputation regime in Australia, the company tax regime operates in effect as a withholding tax on shareholder income. As discussed in more detail below, the rate of company tax is a final withholding tax on the income of foreign investors. This means that reductions in the rate of company tax can reduce the cost of capital for Australian companies that raise their additional capital from foreign shareholders.

By contrast, the rate of company tax is only an interim withholding tax for Australian shareholders who face statutory marginal tax rates in excess of the company tax rate. For those shareholders, reductions in the company tax rate do not reduce the statutory marginal tax rate imposed on their dividend income. Rather, those reductions are simply offset by the additional personal income tax they have to pay on their dividend income to 'top up' the tax rate to their higher personal income tax rates. As a result, in order to reduce the cost of capital for Australian companies who raise their additional capital from Australian shareholders, it is necessary to focus on reducing Australia's high top rates of personal income tax.

Australia's system of superannuation taxation is also unique in taxing savings at three points unlike any other developed country in the world. Coupled with the heavy reliance on income taxation these features are likely to adversely impact saving behaviour.

A competitive business income system

Along with the provision of a skilled workforce, the availability and cost of capital including through the level of domestic savings and investment are vital in ensuring Australia's sustained productivity growth. Australia is currently not short of capital inflows and has maintained a high investment and growth rate. This has reflected in large part the increasing competitiveness of Australia as an investment location for other reasons, together with the low returns (cost) of capital in many other countries. Instead the recent focus has been on labour capacity and supply. The current capital supply conditions cannot be expected to hold indefinitely and given the challenges discussed in Chapter 2, Australia needs to boost domestic investment and savings. If, as expected, the competition for equity capital intensifies in years to come, the uncompetitive features of the company tax base are likely to prove increasingly costly for Australia.

It should be noted that the company tax rate was reduced from 36 per cent to 30 per cent in 1999 as part of a wider package that the BCA supported.[25] This move was important for supporting competitiveness. However, the new rate is by no means at the lower end of the spectrum in terms of international comparisons and is higher than in neighbouring nations. Australia depends relatively heavily on company tax revenues, which was 4.4 per cent of GDP (measured as Federal Government Company tax revenue) in 2003–4; this ratio is more commonly 2.5 to 3.5 per cent in other OECD countries. In addition, the measures that were traded off – specifically depreciation allowances – have proven to be more costly than envisaged in terms of distorting long-life investment. The Commissioner's review of effective lives of assets has had much larger impacts than business expected (for a number of industries this has been a significant double hit: loss of accelerated depreciation and then effective lives significantly revised upwards).[26]

Both Australia's statutory company tax rate and effective company tax rates impact on foreign investment levels and hence the domestic cost of capital. As a small economy, Australia has virtually no capacity to influence the international price of capital, particularly for debt capital, which makes up the greater part of foreign investment in Australia. Any tax imposed on non-resident suppliers of capital will either prevent the supply of that capital to Australia or be passed on as an additional cost to the resident borrower, unless the non-resident lender is able to fully offset any Australian tax paid against their local taxes.

The Australian company tax base is one of the broadest in the world. The reasons for this include the following:

- **absence of tax loss carry-back provisions and under recent changes the total foregoing of carry-forward tax losses in the event of a majority change of ownership;**
- **depreciation that is close to effective life. In many other countries, capital write-offs for investment in plant and equipment are simplified and accelerated;**
- **no write-offs for goodwill acquisitions (tax deductible write-offs are available in countries such as US and UK);**
- **full capital gains tax on companies without discounts or inflation relief; and**
- **relatively few tax shelters and concessions, while complex specific and general anti-avoidance provisions apply to a wide range of activities including foreign source income, infrastructure investment and capital management transactions.**

Since the Australian company tax base is so broad, Australia needs to reduce its statutory company tax rate to a level below those of our competitors, including our near Asian neighbours, in order to reduce the effective rates of Australian tax on the income of non-resident investors to competitive levels.

Reductions in the effective rate of company tax would lessen barriers to investment, assisting Australia's productivity and longer-term prosperity. This could be addressed through lowering the statutory company tax rate (thereby promoting investment particularly from offshore) or by ensuring that the business taxation system is as competitive as possible (particularly promoting domestic business investment). The apparent loss of revenue on lowering the effective corporate rate on non-residents will in part be reversed on the ultimate disposal of the investment where it relates to undistributed business value.

A wide range of uncertainties, complexities and anomalies in the business tax base (such as deduction black holes, non- deductibility of purchased goodwill, treatment of losses and uncertainty surrounding the general anti-avoidance provisions) combine with a relatively unfavourable treatment of tangible investment to continue to reduce Australia's competitiveness.

Compared to many foreign competitors Australia's tax system is not sufficiently favourable to higher-risk business investment. Given the importance of investment for productivity, particularly in areas such as long-term infrastructure or high-risk projects, measures that both improve the competitiveness of the business taxation system and remove current barriers and distortions to investment should be considered.

Investment is highly sensitive to taxation arrangements in Australia. From 1999 the capital allowance regime used the economic effective life estimation to calculate the depreciation rate of an asset rather than the previous accelerated depreciation method. While this appeared to be good economics and therefore good policy at the time, looking at the business investment environment in a wider context reveals that it had several key failings. The move to effective life depreciation did not take the following into account:

- **The international context. Australia's key competitors have more favourable regimes in order to promote investment.**
- **The business investment impacts of the sudden removal of what was in some cases a tax subsidy. This impact is amplified in the context of the more favourable tax treatment of some alternative areas of non-business investment.**
- **Where accelerated depreciation had addressed market failures such as the propensity to only invest in projects with quick and more certain returns (because of the time value of money and short-termism in capital markets).**
- **That existing distortions created by inflation are heightened when dealing with smaller depreciation amounts.**
- **Longer depreciation periods encourage maintenance of older infrastructure rather than purchasing new infrastructure because maintenance receives an immediate write-off.**

The Government's lack of attention to the issues of market failure in relation to both long-term and more risky investment is of particular concern. The BCA is currently undertaking work that demonstrates the impacts of incorrect signals including market failure and pricing long-term investment. This is against a background of underinvestment in almost every significant infrastructure area. The BCA highlights the adequacy and capacity of our economic infrastructure as a significant area of risk for the economy. Given these issues, a review and adoption of measures to support rather than prevent investment, particularly in longer-term assets, need to be considered a priority for Government. This should include consideration of a more favourable capital allowance regime, loss-flow through measures and measures to address capital gains tax biases such as a participation exemption.

The direct costs of the tax system

The Australian tax system is more complex and imposes heavier administrative, compliance and decision-making costs than previously and in comparison with most other countries. This problem pervades nearly all areas of the tax system, and reduces the competitiveness of the Australian economy.

Some of the sources of this complexity were noted in the discussion above. Others are discussed in Part Two.

The high costs of operation of the tax system (and the other decision costs that it imposes) generate deadweight losses that directly reduce the competitiveness of the Australian economy. OECD figures (in US dollars for 2002) show that Australia spends $1.19 on tax administration per 100 dollars of tax collected. There are higher cost countries. But in Sweden the figure is 42 cents, the US 53 cents and Ireland 95 cents.

Other risks to competitiveness

While all taxes have some adverse efficiency effects, some are much more damaging than others, and tax reforms usually target their reduction or removal. Despite past reforms, some highly inefficient taxes remain in the Australian tax system. Most of these reduce competitiveness directly by imposing direct costs on business conducted in Australia. Some significantly distort economic incentives. Particularly inefficient taxes include the:

- **remaining State/Territory taxes on financial instruments and transactions;**
- **State/Territory taxes on insurance, including fire service levies.**

It is possible also that the tax system is contributing to Australia's shortfall in national savings. In particular, high taxes involving marginal rates exceeding 50 per cent apply to the returns to financial savings and investments of retirees over substantial income ranges. Australia also provides less favourable treatment of superannuation savings generally than afforded in most other countries. Taxes on superannuation contributions and earnings may improve public finances but at the expense of private saving. The 15 per cent Superannuation Surcharge was introduced in the 1996–97 Federal Budget as a temporary measure to help deal with the significant Budget deficit ($10.3 billion). Taxing savings in this way was poor policy then and remains so, even though the Budget position has been strong for many years.

However, the effects of taxes on aggregate saving behaviour are not fully understood. The system displays clear biases against saving but whether that actually leads to significantly lower aggregate saving is uncertain. The main concern is that prolonged heavy reliance on foreign savings represents a risk factor that could result in damage to the Australian economy if some form of crisis or other unexpected new pressures emerge in the world economy.

4.4 Conclusions

Australia's competitiveness in increasingly globalising markets for highly skilled workers is adversely affected by the relatively higher marginal tax rates applying in its high rate structure. It is also adversely affected by a range of other taxes and design complexities that apply to, or in respect of, employment income in Australia.

The Australian tax system is likely to be adversely affecting workforce participation through areas of very high effective marginal tax rates (often exceeding 50 per cent) arising from the interaction of the tax system and means tests for family and social security payments.

Australia's high personal tax rates impact on the cost of capital, investment and savings.

The reduction in the statutory company tax rate in Australia to 30 per cent means that Australia currently has a broadly comparable statutory company tax rate with many of its current largest competitors but not its nearest neighbours and given the broad-based distortions referred to earlier, it is a misleading rate by which to measure competitiveness.

Australia has a very high tax take from business income (tax to GDP). Australia's productivity and long-term prosperity would be assisted by less revenue reliance on business income. This could be addressed through lowering the statutory rate still further and/or as an interim step looking to ensure that the business taxation system is as competitive as possible in other ways.

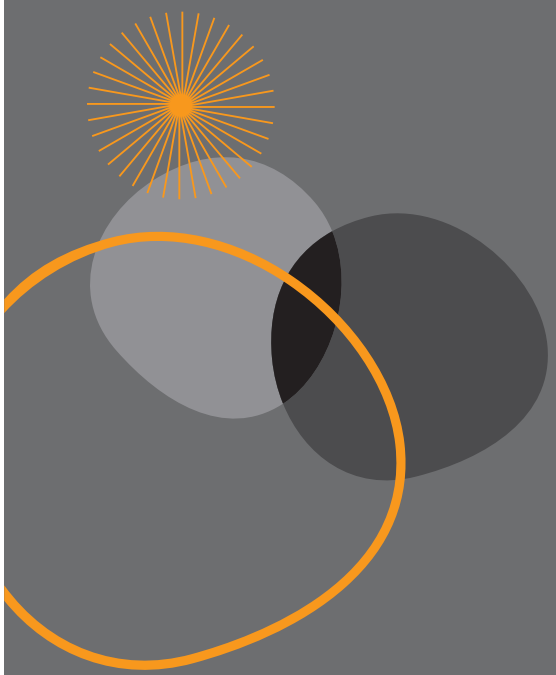
The Australian company tax base is uncompetitive relative to other countries particularly in its treatment of new investment in plant and equipment. The favourable tax treatment of some other forms of investment, particularly geared passive and low-risk investment creates a further source of bias against higher risk and reward business investment – including long-term investments.

Other threats to competitiveness include:

- **the high level of tax law uncertainty, administrative and decision-making costs of the system;**
- **the continuation of distortionary costs to business such as a range of inefficient State transaction taxes and the 3 per cent tariff which applies under the Tariff Concession Scheme to business inputs where there is no domestic producer; and**
- **the risks to future growth, if future conditions are less favourable for attracting foreign savings, arising from Australia's chronic domestic savings shortfalls due in part to the considerable biases in the tax system against saving.**

Chapter 5

A Longer-Term Agenda for Tax Reform



The issues outlined so far point to the continuing importance of tax policy for sustaining productivity and competitiveness.

There are two broad types of response that can be made to this challenge. The first is an orthodox strategy of continuing incremental adjustments to the existing tax system while remaining within the context of the current policy framework (specific recommendations are outlined in Chapter 6). This represents a relatively straightforward, more readily attainable and quickly achievable task and the BCA advocates taking this approach as far as possible. The immediate reform priorities are comprehensive, but this paper also recognises the long-term challenges, which means that these immediate priorities are not the final word on reform.

Looking further ahead, sustaining the goals of competitiveness, adequacy, and equity (including intergenerational equity) will become increasingly challenging as a result of population ageing and continuing global economic developments in particular.

Against this background, it is important to consider whether more fundamental change may be required over a longer time frame to underpin competitiveness and sustained growth in Australia. There is likely to be substantial benefit in reforming the broad structures of the tax framework itself. This was attempted in part with the introduction of the GST.[27] However, in practice the compromises struck to ensure parliamentary support for the GST limited the scope for change and ultimately the benefits stemming from that reform.

The main objective of this chapter is to identify some elements of a possible second, or more fundamental, reform strategy as a starting point for more comprehensive discussion and change. It is only intended as a beginning. The development of a comprehensive reform agenda has many elements and, because the tax system is part of a broader fabric of public policy, broader tax policy changes may need to await progress on other fronts before they can be tackled. Of course the ground-work also needs to be laid for more comprehensive change, and there must be public debate about what is possible and desirable.

The objective here is to identify some of the main elements of a possible reform agenda as a starting point for more comprehensive discussion and reform. In the interim, there is substantial benefit to be gained in enhancing the efficiency of the existing framework through relatively orthodox measures that, provided it does not result in reform fatigue, should also lay the foundations for more fundamental change.

5.1 Linking tax and other policy agendas

The tax system is just one part of the broader fabric of public policy. Ideally, tax policy should be assessed together with the programs that it funds. More fundamental reform therefore requires a vision of the role and structure of Government itself or at least some of its main elements.

The roles of the different tiers of Government in Australia and the financial relations between them deserve increasing attention. One reason is that the major shared program responsibilities of the Commonwealth and the States, in particular the health system, the education system and infrastructure provision, are in varying states of disrepair. These issues threaten social and community goals and risk undermining Australia's economic competitiveness, particularly if the response of Governments is simply additional inefficient spending and higher taxes to fund that expenditure.

The tax system could play an important part in pursuing comprehensive reform in these areas. The allocation of taxing powers between the Commonwealth and the States is likely to require adjustment over time. More significantly, reform in these areas could involve the development of new tax and non-tax funding instruments, or improved tax provisions for private funding of some of these activities.

5.2 The scope for a lower tax burden

From time to time, reforms are advocated for Australia's tax system on the basis that it will provide a reduction, sometimes major, in the overall tax burden.

However, there are few reasons to believe that the overall scale of Government will be reduced significantly without radical new approaches to the role and conduct of Government:

- **No such sustained reduction has occurred in Australia to date.**
- **Forward projections, based on current policy settings, all point to increased spending.**
- **Achieving long-run fiscal improvements through policies to improve workforce capability, participation and infrastructure, require additional public investments in the first instance.**

While there is considerable potential for greater program efficiency, without more fundamental change, it is likely this will merely limit the rate of spending growth rather than provide significant scope for tax cuts.[28] The only sure source of funds for net tax cuts is the illusory one generated by bracket creep.

There is also limited scope for funding tax cuts from a reduction in the fiscal balance. While there is little reason to continue budget surpluses every year, and every reason to prefer lower taxes, Australia cannot return to sustained fiscal deficits without risking its macroeconomic stability. In any event, a reduction in today's tax burden without addressing spending is at the expense of future taxpayers who must service or repay the debt. This is a particularly inequitable strategy in the context of the higher tax burdens on those taxpayers already likely to result from the increasing age dependency ratio.

More radical approaches to the reform of Government could facilitate substantial tax cuts. Some possible elements of this option are discussed below. Without substantial expenditure reductions the main alternative would be to obtain greater revenues from the least economically inefficient of the tax bases (mainly higher consumption taxes). This approach brings obvious political challenges in the context of Commonwealth–State financial relationships in Australia.

5.3 Piecing the elements together

To allow a wide range of alternative approaches to reform, tax and spending arrangements need to be seriously addressed.

In the past, the success of reform has often depended on the creation of broad packages that provide some assurance that changes are comprehensive and fair. Substantial reform built on a comprehensive vision often has better prospects for securing public support than incremental or piecemeal adjustments. Critical for future reform success will be ensuring that comprehensiveness does not overload the community with change, or that trade-offs do not limit the eventual benefits that flow from change (as noted earlier, a criticism that could be directed at the eventual GST package).

Comprehensive reform will require careful assessment of the costs and benefits (both immediate and over the longer term), but also needs creativity in thinking about what is possible.

A significant challenge to any renewed tax reform agenda is the cost of change. The costs of change include direct administrative and compliance costs arising from new requirements (including learning tasks) and the legislative costs associated with delivering change. The latter can apply even when, in the end, reform does not get up for any number of reasons, including as a result of fatigue.

Clear evidence that tax reform had run up against these constraints in the early part of the current decade included the following:

- **A sharp increase in reported business perceptions of tax complexity and workload.**
- **A range of Government responses to modify arrangements to reduce costs and improve taxpayer experience with the tax authority.**
- **The substantial legislation backlog that had developed by 2001–02, with many measures announced but not legislated (in part ameliorated only by the deferral of commencement dates).**

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

The costs of change must therefore provide an important input to the design of any new reform proposals. New proposals should be cost–reducing overall. Given that any change has costs, this means that some elements of the reforms must make compliance easier for taxpayers.

Before considering options for Australia some overseas experiences are examined to see whether these offer insights for possible new approaches that could be considered in the Australian context.

5.4 Ideas from overseas tax systems

Tax systems must be tailored to the circumstances of each country and so the idea of international best practice is not always helpful in forming a view about tax reform. Because every country has had to make compromises it can be very easy for those reluctant to change to find undesirable elements to match attractive ones. Singapore, for example, has highly competitive income taxes – but it also has estate duties (generally 5 per cent) and a 110 per cent tax on new cars, each of which might prove unpopular in Australia.

The fact that other countries make their own compromises does not mean that nothing can be learnt from overseas experience and practice. Some overseas provisions are examined simply for the purpose of finding illustrative examples of what is possible and to see how tax goals have influenced other objectives.

Here, in no particular order, is a listing of some interesting tax rules overseas – all of which have been taken from countries with relatively high incomes (like Australia).

- **The tax rate on capital income does not have to reflect commitments to a welfare state. In Sweden, where public outlays are 57 per cent of GDP (2004), the company tax rate is 28 per cent. Ireland's general Government outlays are almost the same relative size as Australia's, but its company tax rate is 12.5 per cent. In Singapore, where Government outlays are only one-sixth of GDP, the company tax rate is 20 per cent.**
- **Capital allowances on plant and equipment investment are simplified and accelerated in many countries including the US and UK. In the UK, a flat 25 per cent declining balance deduction is allowed each year, with first-year deductions of 50 per cent for small business and 40 per cent for medium-sized business. For small business, annual expenditure on equipment up to $100,000 is fully expensed.**
- **Personal income tax in Switzerland can be very simple for the elderly. People who have been retired for at least 10 years can elect to cease calculating and paying income taxes altogether by instead paying an annual lump sum tax (the 'forfait fiscal'), linked only to the rental value of their home.**

- **In the UK, very few people can succeed in claims for work-related expenses. The tax system is sufficiently simple that most individuals do not lodge an annual tax return.**
- **Norway, Finland, Denmark, Italy and Austria use 'dual' income tax regimes to tax the income of individuals at different rates depending on its source. Income from labour continues to be taxed at the progressive statutory marginal rates of personal income tax, whereas income from capital is taxed at a flat rate, which is usually set at a lower rate of tax applicable to labour income.**
- **The highest marginal tax rates on personal incomes are typically reduced by caps on social security taxes (or their equivalent). Examples of caps after which there is no tax on higher earnings (on payrolls or on employment income) are the US ($120,000), UK ($80,000) and Singapore ($50,000) using approximate $A values.**
- **The highest marginal tax rates (sometimes including social security taxes) on personal incomes lie close to 40 per cent in the US, UK, Ireland and New Zealand.**
- **In some countries, net rental income is taxed without allowing losses to offset tax on other income. In Singapore, income tax is very low and so relatively unimportant for rental income. However, the main tax on rental property is very simple: a 10 per cent tax imposed on gross rather than net rent. For this tax gearing has no tax benefits at all.**
- **The complexity of calculating net rental income is avoided completely in the UK for most of those who let rooms in their homes. Rents up to about $200 per week are tax exempt.**
- **Some countries avoid the complexity of taxing distributed company income twice. Singapore has replaced dividend imputation with a 'one-tier' tax system – dividends are simply exempt from tax, as are capital gains and almost all income from foreign sources.**
- **In the US, most capital gains and qualifying dividends received by individuals are subject to federal tax at rates of up to 15 per cent.**[29]
- **OECD figures (in US dollars for 2002) show that Australia spends $1.19 on tax administration per 100 dollars of tax collected. There are higher cost countries. But in Sweden the figure is 42 cents, the US 53 cents and Ireland 95 cents.**
- **The registration threshold for GST varies considerably around the world, including some countries with no threshold. Compared with Australia's $50,000 level, it is higher in a number of OECD countries including in France (about $120,000), Japan ($130,000) and UK ($135,000) measured in Australian dollars. The US system is much simpler still: a single stage sales tax is imposed in most States but only on final retail sales.**

This is a limited selection of taxation features in a range of countries but several key features stand out.

- **Simplicity has been emphasised, especially for small business and individuals.**
- **It has not been considered essential to tax all income at the same rates or on a comprehensive basis. Separate arrangements have facilitated simplicity and introduced partial expenditure tax elements into the income tax systems.**
- **Effective tax rates on savings and investment have been kept well below the higher personal taxes, largely irrespective of the scale of social transfers, because such activity is sensitive to tax rates.**
- **The design of social security taxes has helped keep down marginal tax rates on labour incomes.**

5.5 Strategic choices for designing further tax reform

It is not the intention here to define a preferred long-term tax reform package for Australia, or to describe all possibilities. Rather, two broad approaches are presented in general terms to illustrate and contrast strategic choices and to stimulate consideration and debate:

- **One approach is to pursue only those priorities critical to ensuring that Australia broadly maintains its present level of economic competitiveness in the face of emerging trends and challenges, while building the capacity for longer-term incremental change.**
- **An alternative and significantly more ambitious approach would be to transform the tax system in concert with other major public policy reforms to open up the possibility of shifting Australia onto a higher economic growth path.**

The first approach does not preclude the second, but if the second is desirable, the first changes should be developed with a view to more comprehensive reform and as part of a broader public reform discussion.

Approach 1: Securing immediate competitiveness and incrementally improving future tax design

To secure the economic competitiveness of the Australian economy for the short and medium term in the face of emerging competitive pressures, and to commence a long-term program for incrementally improving the economic efficiency of the tax system, would essentially require two main responses.

First, the main package of reforms set out in Chapter 6 would need to be implemented in the immediate term. The key elements of this package are as follows:

- **Reductions on the top personal tax rates to about 40 per cent or less.**
- **Improving the competitiveness of the business tax system, considering areas such as the introduction of a more competitive capital allowance regime, assessing the benefits of further reducing the company tax rate or an immediate loss-offset as a fundamental part of a good income tax system.**
- **Exempting temporary residents from Australian tax on foreign source income.**
- **Removing the tax bias against dividends paid from foreign source income by extending the dividend system.**
- **Eliminating the remaining highly inefficient State taxes on financial and insurance instruments.**

Second, work should commence on building a much better understanding of:

- **the sources of and remedies for the high administrative, compliance and decision costs of the Australian tax system;**
- **the workforce participation effects of high effective marginal tax rates for those in receipt of social and family assistance; and**
- **the effects of the tax system on national savings.**

The Government should commit to adjust tax policy in the light of findings and recommendations on these issues.

The second and third of these require mainly technical analysis and may best be undertaken by the Productivity Commission (with suitably broad and unrestricted terms of reference).

The Board of Taxation[30] is probably best placed to oversee the first of these projects on tax simplification. The associated empirical research would require supplementary resources. To be meaningful, the terms of reference should not restrict consideration of options (for example on revenue grounds) but rather should provide a comprehensive basis for future policy judgements.

The scope for tax simplification potentially has multiple dimensions, encompassing thresholds, exemptions, legal forms, timing of payments, and many other policy and administrative issues. The first task would be to obtain evidence on what aspects of the current system generate the greatest cost. Then options for change could be developed without restriction and their priority considered.

Approach 2: Integrated tax and public policy reform

Approach 1 is based on an acceptance of the current public policy orthodoxy that has prevailed in Australia over many years. This accepts the need for periodic adaptive change for the public sector only within the constraints of existing institutions. It can be contrasted with the more dramatic shifts in conditions that face much of private industry from time to time as global conditions shift.

A more radical, fundamental shift in policy has the potential to lift Australia beyond its current growth trajectory. While the scale of reform delivered by the first approach could work to secure that trajectory against already emerging threats, it is likely to prove to be insufficient over time.

The aim of a more radical approach would be to secure a much more ambitiously competitive taxation framework for Australia. While the immediate tax measures proposed in Approach 1 should be adopted also under Approach 2 as an initial instalment of reforms, the second approach would aim to achieve much more, for example:

- **Reducing the reliance on income tax, thereby reducing the weight of taxation on savings and investment.**
- **Removing the higher rate structure in the personal income tax. This would mean that (apart from the threshold and lower rate structure supplemented by family assistance) income tax could be imposed predominantly at a low standard rate on entities and individuals.**
- **Radical income tax simplification, possibly through introducing innovations such as schedular taxes, taxes on gross rather than net measures of income, and one-tier taxation of the income of entities including superannuation funds and companies.**
- **Radical reform of State taxes, abolishing all or most of the existing highly inefficient State tax bases, and replacing them with new approaches to State access to revenues.**

This much more substantial tax reform would almost certainly require a fundamental review and reform of the wider public policy framework, incorporating the tax system as just one part. The additional scope of this review could include the following:

- **The allocation of taxing powers between the Commonwealth and the States/Territories. It is not clear that the current allocation of GST revenues and inefficient own-tax bases to the States is desirable or sustainable. About half of the State tax base is highly inefficient and should be abolished.**
- **The allocation and/or coordination of program responsibilities between three levels of Government. The reform of taxing powers, and the reform of the main public expenditure programs in Australia, cannot proceed satisfactorily until the allocation (and coordination) of program responsibilities is overhauled and made more transparent.**

- **The design and funding of the insurance functions of the public sector and their role relative to that of the private sector. These include arrangements for funding mainstream health, unemployment, and retirement income purposes, often dealt with very differently by the tax and public program systems of other countries. The possibilities include taking these out of the general tax system altogether by creating hypothecated social insurance levies or by substantial privatisation. Decisions on these possibilities are needed before intergovernmental funding and program arrangements can be satisfactorily reformed; and**
- **The planning, coordination and funding of social and economic infrastructure development in Australia. There is considerable scope for a greater private (including non-profit sector) role in the provision of social and economic infrastructure and possibly associated services.**

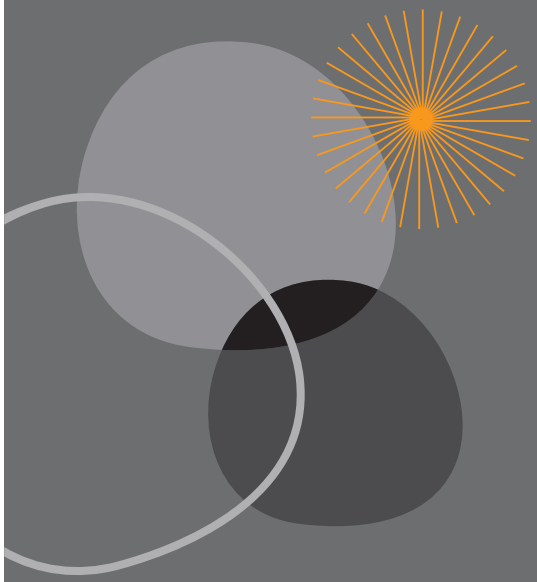
  The development of new approaches to all of these areas (and probably others) could considerably change the environment in which tax policy is developed. In particular, if a private (but perhaps compulsory) model replaced public provision in all or most of the areas of social insurance and infrastructure provision, and if Commonwealth–State financial relations were overhauled and streamlined, appreciable reductions in the aggregate role of the tax system could facilitate a more fundamental tax restructuring than is possible under Approach 1.

These elements of an integrated reform of the public programs of Australia are illustrative and could well be modified or supplemented following further consideration. The potential scope and promise of this approach would need to be explored by a process of strategic review focused on building enhanced competitiveness – clearly not a job for an interdepartmental committee seeking to accommodate multiple interests.

While this approach would take more time to develop and even more time to implement, its advantages could be considerable. The newly competitive economies in the Asian region are seeking to build far more competitive public policies than have evolved in Europe and other advanced countries until now. It is likely that a strategy of periodic catch-up will fail to give Australia the new growth impetus that it needs to confidently grow its economy into the new century. Approach 2 (however modified from the suggestions raised here) requires considerable energy and ambition, but offers considerably more promise for Australia's long-term future.

Chapter 6

Reform Priorities



The need for tax reform is pressing. This paper highlights increasing challenges to the competitiveness of the Australian economy that are exposing weaknesses in the tax system, and the increasing structural challenges associated with population ageing.

If left unattended, these weaknesses mean that Australia will experience lower economic growth and a smaller future tax base just as pressures from an ageing population and other sources are generating new expenditure demands on Government. The case for tax reform therefore, has firm economic roots and important social consequences.

The creditable economic growth of the Australian economy over most of the past 15 years may, for some, temporarily obscure the case for reform. Strong performance aside, the status quo in public policy always has its supporters because many have adapted to it and have career and other interests in its continuation. Now is the time to change as the competitive pressures underpinning the case for reform are rapidly strengthening. A forward-looking view and a proactive response are essential to give Australia its best chance for continued, long-term economic and social success without serious risks or disruptions.

The assessment in the previous chapters of the competitiveness of the Australian tax system suggests that there is considerable room for further renovation and rebalancing to improve the economic performance of the system.

Further reform would remove inhibitors of competitiveness and help secure a stronger future growth path. The main priority at this stage is to bring the Australian tax system into a more competitive position in a number of ways where major competitors currently have an edge.

There are other long-term issues facing the Australian tax system that are not immediately critical to competitiveness, or that need to be linked to other areas of policy reform, for example issues arising from the financial relationships between the Commonwealth and the States. Solutions to these challenges are likely to involve less 'orthodox' responses such as discussed in Chapter 5 and will involve the consideration and assessment of a far wider range of issues. The challenge here is to begin such assessment and public debate now to ensure that Australia is well placed to make the changes needed to sustain growth and respond effectively to population ageing and other demands highlighted earlier in this paper.

6.1 Reducing the Australian tax system's largest cost

The BCA considers the top two personal taxation rates to be one of the largest existing deadweight cost of taxation in the economy. The two highest marginal tax rates in the personal tax structure should be lowered, ideally to 30 per cent, to make Australia more competitive by reducing:

- **barriers to attracting highly skilled workers;**
- **disincentives for saving;**
- **distortions between alternative investments by reducing the tax benefits for highly geared investments and tax avoidance strategies;**
- **the impact of investment and the cost of capital.**

While previous reforms in this area, including the 2004–05 Budget announcements that moved the middle and middle upper thresholds[31] for the 30 per cent and 42 per cent rates, have improved incentives for work and saving, these middle and lower threshold changes are not sufficient to make a substantial difference where the majority of savings and investment occurs.

Threshold changes are attractive to Government because they have significantly less cost than rate changes. However, these changes do not provide the benefits the economy needs. It is a change in the marginal rate that impacts on the marginal investor, the marginal decision to save, and the decision to work and for how long (in terms of number of hours and to what age).Threshold changes only change marginal rates for a relatively small number of taxpayers. They do not change the marginal tax rates facing taxpayers with incomes above the new thresholds.

In addition, 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.

Ideally the top two rates would be dropped to 30 per cent, bringing them in line with the company taxation rate, thereby removing the complex and distorting tax-planning opportunities that currently are encouraged because of the difference between the rates. In terms of practical steps, reducing the top rates of tax could be achieved in a number of ways and to varying degrees.

A straightforward option is to replace the existing two steps with a lower single step, say 40 per cent rate (plus Medicare levy). This would broadly match the UK and (in 'typical' States) the US systems. The revenue cost of this option would be about one-third of the current yield of the higher rate structure and would partly be offset by the revenue effects of efficiency, growth and compliance gains.

A more substantial reduction, say to 35 per cent or ideally the current basic rate of 30 per cent (plus Medicare levy) would give Australia a competitive advantage over many countries with which we compete and the benefits of neutrality with the company rate.

A third and less orthodox approach would be to replicate the effects of capping that applies to the major part of overseas social security taxes. For example, a greater part of the income tax could be ascribed to the Medicare levy and total payments under this levy capped. Ideally, the payroll tax base (and the superannuation guarantee) could be similarly capped. These approaches could mean that the marginal tax rates fall only at substantially higher income levels, but would have significantly lower implications for revenue costs.

6.2 Reducing tax on temporary residents

Features of the tax system that specifically disadvantage Australia as a work location for temporary residents should be removed. The Government should reintroduce its proposed reforms to the taxation of temporary residents that were previously rejected by the Senate. These reforms included:

- **The insertion of a new definition of 'temporary resident' into s. 995-1 of the *Income Tax Assessment Act 1997*;**
- **Extension of the existing four-year exemption from the Foreign Investment Fund rules for temporary residents; and**
- **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.**

In addition, it is important that Government consider other reforms aimed at attracting the skilled temporary resident, for example (as discussed further in Part Two):

- **Exempting the income that temporary residents derive from foreign workdays; and**
- **Reforming the tax treatment of superannuation for temporary residents either by:**
  - 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; or
  - recognising contributions to foreign social security systems as being equivalent to Australian superannuation for the purposes of companies meeting their minimum support obligations and allowing Australian employers to claim deductions for contributions to foreign superannuation plans on account of temporary residents.

6.3 Making Australia a more attractive base for international business investment

While many features of Australia's international tax regime have been improved by recent reforms, some features remain that disadvantage overseas expansion by Australian companies. This threatens the growth of high-value activities in Australia associated with corporate headquarters and financial market development.

A key priority is to remove the bias in the imputation system against foreign source income. This issue was extensively covered by the BCA in its report *Removing Tax Barriers to International Growth.*[32] The Board of Taxation considered this issue in 2002–03 making a positive recommendation to the Government, which indicated that it is willing to return to it at a later stage. It should do so now.

6.4 Making Australia a more attractive location for business investment

Business investment is vital for competitiveness and brings new technology and skills. The competitive weaknesses of the tax system in this area compared with other countries and the biases favouring lower-return investments within Australia should be addressed.

Given the challenges that Australia faces in underinvestment in infrastructure, the introduction of a more competitive (and simpler) capital allowance regime should also be considered to support investment and in particular to address the market failure issues of investment in long-term infrastructure.

Clearly this area needs comprehensive review, but a more competitive system would need to address 'black holes'[33] and intangibles such as the write-off of goodwill and could include capping the effective lives of assets on a more consistent basis or ensuring that each change to an asset's effective life is reviewed for its impacts on investment particularly for investment in long-term infrastructure. This could be considered in conjunction with or as an alternative to a loss-offset measure and the treatment of losses generally.

We must also aim for lower company taxes, given that:

- **Australia's tax rate is, at best, average compared to its international trading partners and even less competitive when the base broadening distortions referred to earlier are taken into account.**
- **Even though the imputation system operates as a partial withholding tax for personal tax, company taxes impact directly on funds retained within the firm and not delivered as dividends.**
- **It is the company tax rate that impacts on the investment decisions of offshore investors.**

6.5 Other strategies to improve competitiveness

The areas discussed above deal with the most critical issues for further adjusting the tax system to strengthen the competitiveness of the economy. A number of strategies could also make important contributions. These include:

- **Addressing instances of very high effective marginal tax rates where it is clear these have adverse effects on workforce participation and where other ways of addressing incentive effects are unavailable. Policies should continue to ensure in particular that the workforce participation of women and mature-aged workers is supported.**
- **Removing or reducing the remaining highly inefficient taxes – particularly State taxes on financial transactions and instruments and insurance. Consideration should also be given to reducing the payroll tax burden, by rate reductions or employee income caps.**
- **Simplifying and reducing uncertainty in the tax system across the board, seeking to largely remove compliance tasks for many in the community and reducing business costs as much as possible.**
- **Biases against saving in the Australian tax (and social security) system will develop greater importance for Australia's competitiveness if international conditions change. This is a risk factor that at least deserves investigation and monitoring.**

6.6 Summary of BCA reform priorities

1. The two highest steps in the personal tax rate scale should be substantially reduced to 30 per cent in the longer term and no higher than 40 per cent in the immediate term.
    - 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 Federal Budget.
    - the top rate should then be reduced to 40 per cent in the 2007–08 Federal Budget.
2. Temporary residents working in Australia should not be subject to Australian tax on foreign source investment income.
    - legislation reforming the taxation of temporary residents which was previously rejected by the Senate should be reintroduced into Parliament immediately.
    - additional reforms for temporary residents should be undertaken. This could include exempting the income that temporary residents derive from foreign workdays and reforming the tax treatment of superannuation for temporary residents.
3. The bias against dividends paid from foreign source income should be removed.
    - the Board of Taxation considered this issue in 2002–03 making a positive recommendation to the Government, which indicated that it would be willing to return to it at a later stage. The Government should do so as part of the 2006–07 Budget.
4. A more competitive business taxation system should be provided to promote longer-term growth and productivity. The Government should:
    - commence an immediate review of the company tax system to assess and remove pressures against Australia's competitiveness. The review should focus on options for reducing the effective rates of tax on income from capital covering areas such as the capital allowance regime and options for ensuring that the effective life regime does not discourage investment particularly in long-term infrastructure for completion prior to the 2006–07 Federal Budget; and
    - review the company taxation rate, taking into account both international competitive pressures and progress in lowering the top marginal personal taxation rates.
5. The remaining most highly inefficient State taxes, particularly taxes on financial and insurance instruments, should be abolished.
6. In addition, four areas of risk for Australia's economy need immediate consideration by appropriate bodies of review. These reviews must be effectively resourced in order that the Government can consider recommendations and provide a package of reforms as part of the 2006–07 Federal Budget.
    - Effective marginal tax rates must be 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 disincentives to work.

- Tax uncertainty and compliance must be reduced and administrative tasks substantially simplified removing significant and unnecessary costs on productivity. The Board of Taxation should be charged with preparing a 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.
- Biases and distortions against saving should be reduced. A robust and transparent review of tax-related distortions against savings should be undertaken by Treasury immediately.
- 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 recent Productivity Commission report, *The Economic Implications of an Ageing Australia*.

Table 6.1 provides a guide to indicative costing of key measures. The BCA acknowledges that these costings are by no means as thorough or comprehensive as those prepared by the Departments of Treasury and Finance. Nonetheless, they provide an indication of the revenue impacts of these key measures. These costs have been prepared using Treasury's conservative method which does not acknowledge the second-round behavioural response impacts which these tax changes would bring. These estimates are likely to be higher than would actually be the case were these measures implemented.

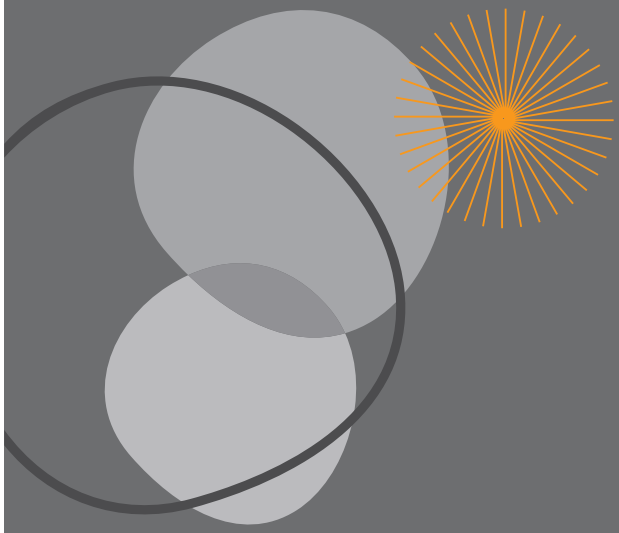
The main aim of the measures proposed is to increase the supply potential of the Australian economy (this would lessen potential inflationary pressures). The measures would also stimulate demand (more so in later years) but this impact would be relatively small.

TABLE 6.1
MEASURES FOR IMMEDIATE IMPLEMENTATION: INDICATIVE COSTING

Measure *Start year.	**Broad Revenue Estimates ($b)**			
	2005–06	**2006–07**	**2007–08**	**2008–09**
Two initiatives that are outstanding from the previous Review of Business Tax and the Government's international taxation work				
Reintroduce legislation on previous measures to reform the taxation of temporary residents.	0.05*	0.05	0.05	0.05
Implement Board of Taxation recommendation to remove bias against Australian companies investing offshore (20 per cent tax credit).		0.40*	0.40	0.40
The BCA's highest priority – to remove the largest deadweight taxation costs for the economy				
Move the 63,001–80,000 threshold rate from 42 per cent to 40 per cent and the 80,000+ threshold rate from 47 per cent to 45 per cent.		1.45*	1.62	1.81
Undertake the next steps towards a more competitive personal tax system, taking the 80,000+ threshold rate from 45 per cent to 40 per cent.			3.06*	3.35
Total $b (of broad costing estimates) of key measures	**0.05**	**1.90**	**5.13**	**5.61**
Budget Forecasts Current (04–05) Mid-year Economic and Fiscal Outlook estimates (underlying cash balance) $b	4.50	5.70	7.60	

Chapter 7

Overview of the Tax System: State of Play



This chapter provides a description of the broad features of the Australian tax system, and explains the main changes brought about by reforms over the past 20 or so years.

7.1 Major elements of the system

The Australian tax system has the following main elements:

1. Taxes on personal incomes

- Individual income (including capital gains) tax
- Medicare levy
- Family benefits and other offsetting transfers (either in the form of positive budget outlays or negative taxes)
- Fringe benefits tax
- Tax on superannuation fund contributions and earnings
- Payroll tax
- Superannuation guarantee (a quasi tax)

2. Taxes on business income (including full capital gains)

- Company tax
- Individual income tax applied to dividends, trust and partnerships distributions, and the business income of individuals
- Petroleum resource rent tax

3. Taxes on international income

- Income tax on the foreign source income of residents
- Taxes on the Australian income of non-residents
- Rules for deciding the source of income, in particular transfer pricing provisions.

4. Taxes on consumption, other indirect taxes and wealth taxes

- Goods and services tax
- Excises, special taxes, and resource taxes
- Customs duties
- State taxes on transactions, instruments and insurance
- Property-based taxes

5. The administrative, compliance and policy making systems

Each of these five subjects is dealt with in more detail in the following chapters.

7.2 Major features of the system

The Australian tax system collects revenues equivalent to almost one-third of gross national income. The Commonwealth Government collects the largest part of tax revenues, although a considerable share of this revenue is transferred to the States and Territories. After deducting administration costs, all GST revenue is distributed among the States and Territories, according to the Commonwealth Grants Commission process.

Income taxes are the main source of revenue, including payroll and fringe benefit taxes imposed on employers, they represent about two-thirds of total tax revenues. Taxes imposed on goods, services and property provide the remaining third. This is broadly similar to the average ratio for advanced countries, although there is considerable variation between countries.

Most countries impose a general tax on goods and services and specific taxes such as excises. In Australia, the GST provides a little under half of indirect tax revenues and about 13 per cent of all tax revenues.

By far the most significant structural difference between the tax system in Australia and elsewhere is the absence, in general, of social security taxes in Australia.[34] This difference complicates comparisons between Australia and other countries. For example, most comparisons combine some or all of the social security taxes with income taxes (typically resulting in a larger tax total than the Australian income tax) while some compare only the general income taxes (in which case Australia's tax appears among the heaviest).[35] Further issues are noted in 'Social Security and its Alternatives: A Conundrum for Tax Analysis', page 73.

In other respects, the Australian tax system broadly conforms to what could be described as the 'standard model' found in most developed countries.

The main features include:

- **Progressivity. The average rate of tax rises with capacity to pay. This is delivered by the personal income tax rate scale applying to wage and salary income and associated means - tested social transfers (which operate like negative income taxes).**
- **Transaction or 'realisation' basis. Most measures of the tax base are determined at the time of a transaction. This can distort the tax system in favour of some forms of income over others (essentially any gains that generate deferred realisations bear less tax in a present value sense).**
- **Nominal or 'money', rather than inflation-adjusted or 'real', basis of valuation. This can exacerbate the economic distortions caused by inflation, particularly when inflation is high and sustained.**
- **Dual tax bases. Taxes are imposed both when income is derived and when it is spent on consumption. This allows tax rates to be lower than if the whole burden was imposed on one base. It also provides a compromise between the efficiency benefits of consumption taxes (which do not penalise savings) and the vertical equity goals of income taxes (because lower income earners consume more of their income and therefore pay a higher relative share of their income in consumption tax).**
- **Lower taxes on most forms of capital income compared with the highest rates imposed on labour and other personal incomes. Almost all countries provide lower effective tax rates on owner-occupied housing, capital gains and retirement savings arrangements such as superannuation, and most set the company tax rate below the top personal rate. One key effect is to reduce the penalty that income taxes otherwise impose on income that is saved.**
- **Avoiding international double taxation. Trade and investment flows between countries raise the risk of double taxation (tax in two locations) that is dealt with by a range of conventions. The Australian system broadly conforms to these international norms, both for income and consumption taxes. These do, however, involve some compromises in the ways that taxing rights are shared between source and destination countries.**

Social Security and its Alternatives: A Conundrum for Tax Analysis

Nearly all developed countries provide age pension entitlements and often some other benefits (such as unemployment and medical insurance) funded from social security taxes. These benefits are of a kind also provided by private saving and insurance arrangements and in general, public and private systems coexist.

Social security taxes usually are levied on the individual incomes of the self-employed and split between taxes on personal incomes and payroll taxes for employees. While the payment of these taxes typically brings entitlement to scheme benefits, entitlements are not usually linked only to accrued contributions. Most schemes include some redistributive element.

Australia does not have universal social insurance or its associated taxes. It provides a safety net means-tested age pension (and other benefits) funded from general revenues (mainly the income tax). Australia also has a compulsory superannuation system for most employees (but not the self-employed). This system is privately run and contributions to it are not regarded as taxes, although being compulsory, they are similar to payroll taxes in practice.

Australia also has a general purpose payroll tax, levied by the States and Territories although not on all employees. Most other countries do not have this form of general taxation. For those few who do, it is generally a much smaller tax than in Australia (although payroll based taxes are widespread as a part of the social security tax system).

These considerable differences between the Australian and overseas tax and social security systems pose difficulties in attempting comparisons between them. It is likely that the economic effects of superannuation contributions, payroll taxes, social security taxes and income taxes vary, because they have different incidence and associated benefits and purposes.

The dual 'tax and entitlement' character of social security means that it operates in part as a form of remuneration, just as employer contributions to private superannuation or employer payments for employee health insurance are fringe benefits forming a part of remuneration. This is likely to reduce the negative impact on workforce participation motives relative to general taxes of the same rate. At the same time, because there usually is only a partial relationship between the levels of tax and entitlement in social security systems, social security also operates partly like any other tax. It can be expected to have greater behavioural effects than compulsory superannuation arrangements that result in fully requited benefits.

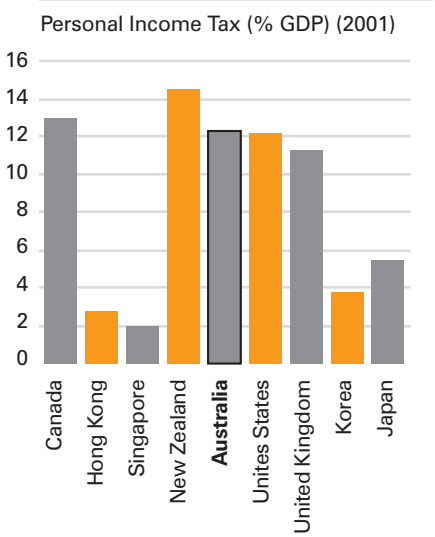
The difference between public and private arrangements can be unclear. For example, Singapore provides for a compulsory provident fund operated separately from public accounts, allows withdrawals from this into privately managed funds, and allows the use of accumulated savings for diverse purposes (including housing and education). The US is currently considering proposals to allow social security funds to be transferred to private accounts. Australia, of course, has compulsory private retirement saving for many. All of these involve different mixes of public and private arrangements.

These considerations make it difficult to decide what to include or exclude when seeking to compare tax and fiscal systems of different countries. Comparisons restricted to general purpose income taxes probably exaggerate the adverse picture for Australia. On the other hand, comparisons that combine income and social security taxes probably overstate the relative burden in other countries compared with Australia.

It may be thought that the broad conformity of the Australian tax system with this 'standard model' indicates consistency with a collective wisdom about tax design, perhaps suggesting that Australia is not far removed from best practice. However, the standard model is not uniformly adopted, with most countries (including Australia) having developed a range of distinct additional features. To the extent that the standard model represents an 'averaging' of practices, it disguises considerable variation at important levels of detail.

There are also considerable differences in the overall level of taxation between countries. Australia is similar to the US and Japan, and depending on how measured is lower than most of Europe where general Government spending and social transfers are relatively high, and notably higher than our Asian neighbours. Figure 7.1 shows personal income tax burdens in a range of countries.

FIGURE 7.1
PERSONAL INCOME TAX BURDENS
IN AUSTRALIA'S TRADING PARTNERS



Source: David Stevens, KPMG, presentation to the Business Coalition for Tax Reform November 2004; data from the OECD Revenue Statistics 1965–2002 (published 2003) and Singapore and Hong Kong Budgets 2003.

The main areas of difference between the Australian tax system and most comparable countries include:

- **The absence of taxes dedicated to social insurance (principally national pension systems) although the superannuation guarantee is a partial and hybrid alternative and workers' compensation could also qualify.**
- **Near full dividend imputation. Most countries provide some form of relief from the double taxation of distributed company income but few provide a system like Australia's very effective imputation system.**
- **One of the highest levels of vertical fiscal imbalance between the levels of Government in the world.**
- **The imposition in Australia of tax on retirement saving funds (superannuation) at the savings stages (contributions and fund earnings) rather than exclusively at the time benefits are paid.**

In addition to these differences, there are numerous other differences of detail between countries, and substantial variations arise in the effects of different tax systems.

7.3 The burden of the Australian tax system: an illustration

The burden of taxes is often described by their aggregate revenues as a share of GDP. Another approach is to consider what individual Australians typically pay. The lack of transparency of much of the Australian tax system means that many Australians have little understanding of this burden.

The following example assesses the possible burden of a range of taxes (each legally payable by different entities) for an Australian individual full-time worker who has wage income and spending patterns that are close to statistical averages. This is a simplified hypothetical example – for example housing ownership, superannuation and debt are ignored – but it illustrates reasonably accurately how the Australian tax system typically works for individuals.

For this illustration, we assume that this individual:

- **Earns an annual wage of $50,000 (which is about the average full time wage).**
- **Has no partner or children or entitlements to tax offsets or deductions. This means that on 2004–05 tax rates, personal income tax paid will be $11,922 (almost 24 per cent).**
- **Works for an employer who pays 6 per cent payroll tax (that is, $3,000). In this illustration, the 9 per cent superannuation guarantee on employers is not included, as it is not formally a tax.**
- **Spends all disposable income on consumption, saving nothing. This is quite realistic in average terms as the aggregate household savings rate in Australia is now close to zero (in fact slightly negative). For this individual, spending in economic terms will be equal to after tax wages ($38,078).**

Assume also that the spending pattern of this individual matches the pattern of consumption in the aggregate Australian economy – this is a very average sort of person! Taxes on goods and services in Australia (including the GST, excises and State indirect taxes) are equivalent to about 15 per cent of final consumption expenditure (excluding imputed rents) – at this average rate the individual would bear taxes of $5,712 within the overall prices paid for goods and services.

In addition, assume (reasonably) that payroll tax, personal income tax and all consumption taxes are incident on the individual.

On these assumptions, the economic income of this individual (and the total paid by the employer in respect of the employment) is $53,000, comprising a wage of $50,000 and payroll tax of $3,000. The total tax paid is:

- **Payroll tax of $3,000**
- **Personal income tax of $11,922**
- **Consumption taxes of $5,712**

Total taxes paid are thus $20,634, which is approximately 39 per cent of economic income. It is likely that some additional charges would reflect the passing on to this individual of the administrative and compliance costs of the tax system, bringing the total impact above 40 per cent.

This illustration shows how consumption taxes potentially reward savings compared with income (including payroll) taxes – the total tax on economic income that is saved in this example would be 28 per cent instead of 39 per cent.

7.4 Commonwealth–State financial relations

Each of the three levels of Government (Commonwealth, State and Local Government) has its own revenue raising powers and expenditure responsibilities. However, there are significant imbalances, with the Commonwealth raising more revenue than it directly uses and conversely the States and Local Governments raising considerably less than they require with the gap met by payments from the Commonwealth. This imbalance is referred to as 'vertical fiscal imbalance' (VFI).[36]

This situation arises mainly from the decision taken by the States to surrender income taxation to the Commonwealth, and has been exacerbated by the encroachment of Commonwealth policy initiatives into many of the functional responsibilities of the States.[37]

Table 7.1 (treating the GST as a Commonwealth tax) compares the proportion of taxes collected at the different levels of Government and each level's proportion of tax-funded[38] own-purpose[39] expenses, for 2002–03.

Table 7.1 shows that:

- **the Commonwealth's own-source revenues exceed its own-purpose expenses by nearly 40 per cent;**
- **the States' own-purpose expenses substantially exceed their own-source taxation revenues (by nearly 60 per cent); and**
- **Local Governments' own-purpose expenses exceed their own-source tax revenues by around 35 per cent.**

Tax collection by the three levels of Government in Australia is very poorly linked to the pattern of responsibilities and expenditures of each level and the tax role has increasingly been concentrated on the Commonwealth. The Commonwealth collects over 80 per cent of tax revenues but transfers almost 30 per cent of this to the States for general or specific (tied) purposes.

The main change in Commonwealth–State financial relations in recent years has been the replacement of the discretionary pool of general purpose grants (paid by the Commonwealth to the States) with a pool comprising the revenues from the GST. This pool is growing more quickly than the arrangements that it replaced, providing the States with a greater level of funding than would otherwise have occurred.

TABLE 7.1
TAXES RAISED AND SPENT BY LEVEL OF GOVERNMENT, 2002–03

	% of total taxation raised	% of total tax-funded own-purpose expenses	Degree of VFI (=A/B)
	(A)	(B)	(= A/B)
Commonwealth	81.7%	58.6%	1.39
State	15.3%	37.3%	0.41
Local	3.0%	4.1%	0.74
Total	**100.0%**	**100.0%**	

Source: Access Economics State Budget Monitor No. 62, 2004; ABS 5506.0 and 5512.0.

VFI has advantages and disadvantages.

The main advantage is that it facilitates more uniform (and probably more efficiently collected) taxes across Australia, which also has some administrative and compliance benefits. There are, however, considerable disadvantages. Most obviously, the separation of spending and taxing between two levels of Government sends a highly confused message to the electorate and accountability for overall public policy outcomes is fractured.

VFI is not confined to Australia, but is much more pronounced here than in other major federations, such as Germany, Canada and the United States.

VFI is also part of Australia's history as Table 7.2 shows.

7.5 Commonwealth taxes

The Commonwealth Government is heavily reliant on income tax as its main source of revenue (see Table 7.3). Including income tax paid by companies, income tax in 2004–05 is estimated at over $150 billion, or around 69 per cent of total Commonwealth tax revenue including the GST (treated in this paper as a Commonwealth tax although its net revenues are transferred to the States and Territories after deducting administration costs).

Income tax revenues are paid mainly by ordinary wage and salary earners. Although taxpayers derive income from a range of sources, including dividends and rental properties, wage and salary income accounts for around three quarters of personal taxpayer income.[40] Fringe Benefits Tax of around $3 billion is collected from employers, effectively taxing non-salary benefits provided to employees at 48.5 per cent, to foster greater neutrality between cash wages and non-cash-wage income.

TABLE 7.2
TAXATION BY LEVEL OF GOVERNMENT

% of total taxes collected by:	1901–02	1929–30	1948–49	1964–65	1974–75	1985–86	1993–94	2002–03
Commonwealth	63.6	54.2	88.2	82.2	80.4	79.9	74.4	81.7
State	18.4	31.5	7.9	11.8	15.7	16.3	21.4	15.3
Local	17.9	14.3	3.9	6.0	3.9	3.8	4.2	3.0

Source: ABS, 5512.0, April 2004.

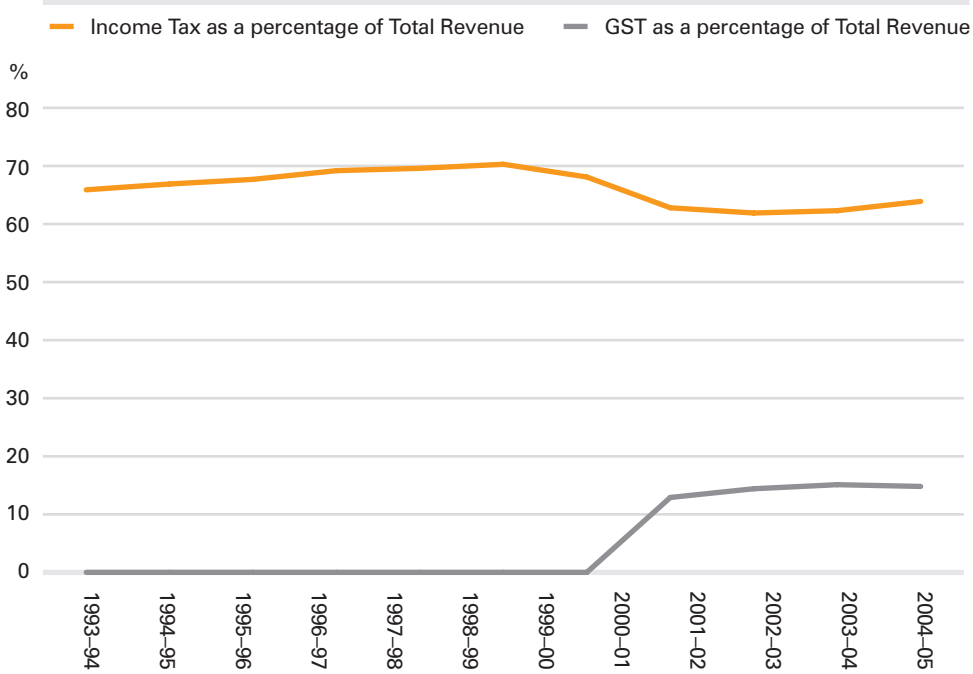
TABLE 7.3
MAIN SOURCES OF COMMONWEALTH GOVERNMENT REVENUE, 1993–94 TO 2003–04

Source of revenue	1993–94 $m	1998–99 $m	2003–04 $m
GST	0	0	32,050
Income tax	66,416	103,017	138,890
Other taxes	27,608	38,087	31,654
Total taxes	94,024	141,104	202,594
Other revenue	6,722	5,341	14,671
Total revenue	100,746	146,445	217,265
GST as a % of total revenue	0.0%	0.0%	14.8%
Income tax as a % of total revenue	65.9%	70.3%	63.9%

Source: Ernst & Young, adapted from Budget 2004–5, Budget Paper No. 1, Statement 5: Revenue, Appendix F: Cash revenue statistics and history.

In respect of Australian residents, company tax is essentially an income withholding tax. Under the 'classical' system of company taxation used in some countries (and in Australia until the mid-1980s), income is taxed twice – once at the corporate level and then again at the individual level when distributed as dividends. However, Australia's imputation system recognises Australian tax paid at the company level on the distribution of dividends to Australian residents. Company tax also applies to Australian source income earned by non-residents through Australian companies (or Australian branches).

FIGURE 7.2
TRENDS IN COMMONWEALTH GOVERNMENT REVENUE SOURCES 1993–94 TO 2003–04



Source: Ernst & Young, adapted from Budget 2004–05, Budget Paper No. 1, Statement 5: Revenue, Appendix F: Cash revenue statistics and history.

Prior to the introduction of GST, the proportion of total Commonwealth Government revenue raised from income tax increased steadily from around 65 per cent in 1993–94 to around 70 per cent in 1998–99. Although the introduction of GST has taken some of the pressure off income tax as a source of revenue to meet increases in Government spending, the Commonwealth Government still raises only a slightly lower proportion of its total revenue from income tax (see Figure 7.2).

The Goods and Services Tax (GST) was introduced in 2000. It is levied at a single rate of 10 per cent on a broad base. The GST replaced a multi-rate wholesale sales tax (imposed on some goods) and a number of State taxes. All GST revenues (net of administration costs) are paid to the States and Territories, replacing former arrangements for general purpose grants.

The main items that are zero rated are:

- **exports (excluding tourism and other exports consumed in Australia) and international travel;**
- **tourism and other imports consumed overseas;**
- **health and medical care;**
- **education and child care; and**
- **most food for home use.**

Financial supplies, housing resales and rental housing are generally input-taxed.

Almost as important to Commonwealth revenues as the GST are other indirect taxes, mainly excises.

Excise duty is levied on petroleum, alcohol and tobacco products. The relatively high taxation of excisable products reflects a range of policy objectives (see Chapter 11).

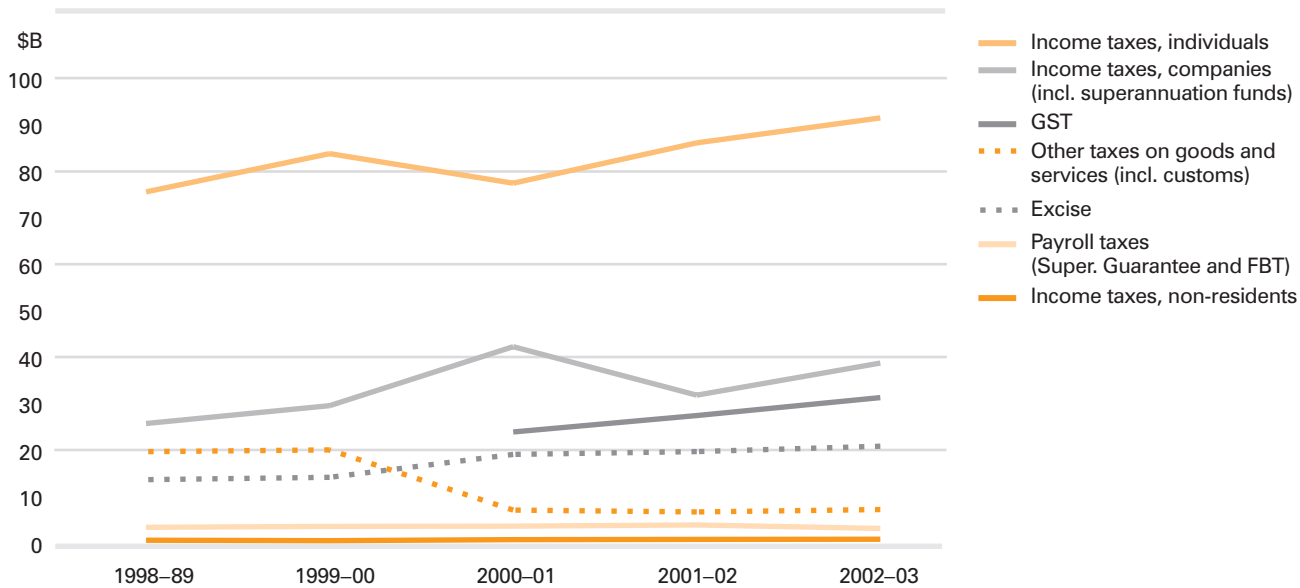
Despite the narrow base, high effective tax rates on excisable products make a significant contribution to Commonwealth revenue. Domestic excise on these three categories of goods raises over $21 billion per annum,[41] or the equivalent of around 60 per cent of the total revenue collected by the GST, a tax applying across a broad base of consumption but at a much lower average rate of 10 per cent.

Figures 7.3 and 7.4 show movements in dollar terms and as a proportion of total Commonwealth taxation revenue over time, based on ABS revenue statistics and definitions.

Notable movements in Commonwealth revenue over the period 1998–99 to 2002–03 include:

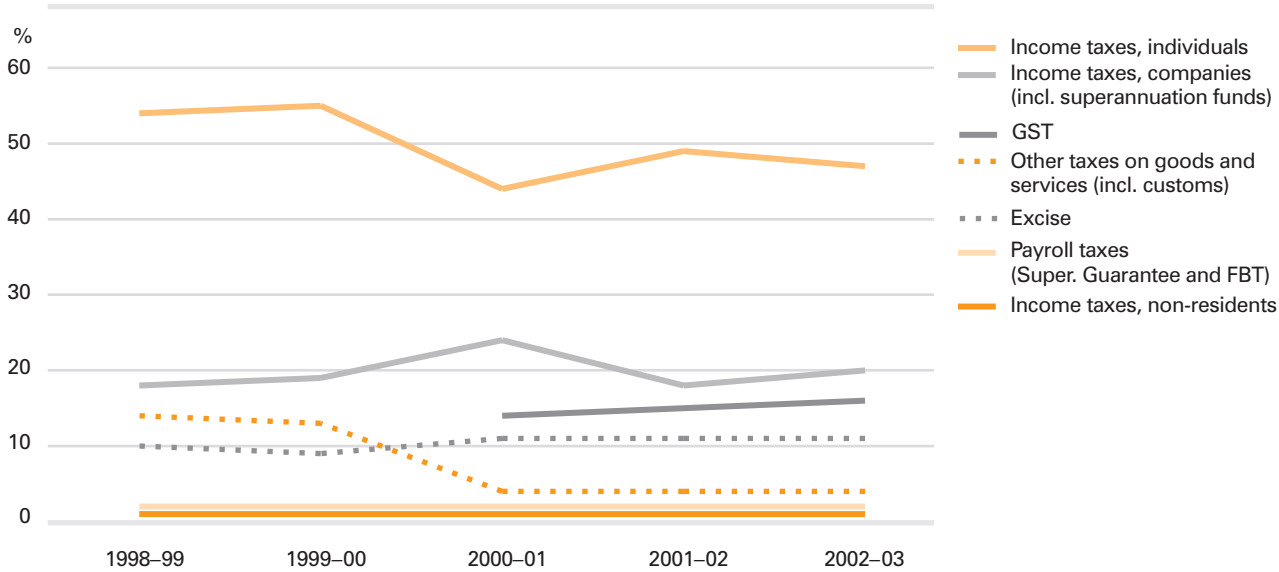
- **Strong income tax collections (despite tax cuts) reflecting strong wages growth and associated 'bracket creep'. Reductions in income tax rates had an impact in reducing revenue in 2000–01, partly financed by, and coinciding with, the introduction of the GST as part of The New Tax System (TNTS).**
- **Solid growth in GST collections, reflecting strength in private consumption.**
- **A large fall in other taxes on goods and services, mainly reflecting the abolition of the wholesale sales tax under TNTS.**
- **Strong company tax collections, underpinned by strong corporate profits. The one-off spike in collections in 2000–01 reflects the bring-forward in the timing of company tax collections under TNTS arrangements.**
- **Relatively stable excise collections after the one-off increases in 2000–01 associated with TNTS. The contribution of excise to Commonwealth revenue can be expected to decline in future years, especially given the 2001 policy decisions to remove indexation of petroleum products, and reduce beer excise.**

FIGURE 7.3
COMMONWEALTH TAX REVENUE, 1998–99 TO 2002–03



Note: ABS definition of Commonwealth tax revenue.
Source: ABS 5506.0 Taxation Revenue 2002–03

FIGURE 7.4
PERCENTAGE SHARE OF COMMONWEALTH TAX REVENUE 1998–99 TO 2002–03



Note: ABS definition of Commonwealth tax revenue.
Source: Adapted by Access Economics from ABS 5506.0 Taxation Revenue 2002–03

7.6 State, Territory and Local Government taxes

The States' powers to raise own-source taxation revenue are limited by a constitutional bar on raising duties of customs or excises. The States also exchanged their income taxes for grants from the Commonwealth during the Second World War and have not since re-entered the income tax field.

With access to neither general sales nor income taxes, the States have resorted to a range of lesser taxes while also remaining highly dependent on fiscal transfers from the Commonwealth.

The Commonwealth payroll tax was transferred to the States in 1971 and is now the largest single State tax at almost 30 per cent of total State own-tax revenue (see Table 7.4). Land is also a major tax base, with land tax, stamp duty on conveyances and other taxes on property collectively raising around 40 per cent of State tax revenue.

There is little uniformity in tax rates and bases across the States including major revenue sources such as land tax and payroll tax. As well as distorting location and other economic decisions, such disparities impose significant compliance costs on firms operating across jurisdictions.

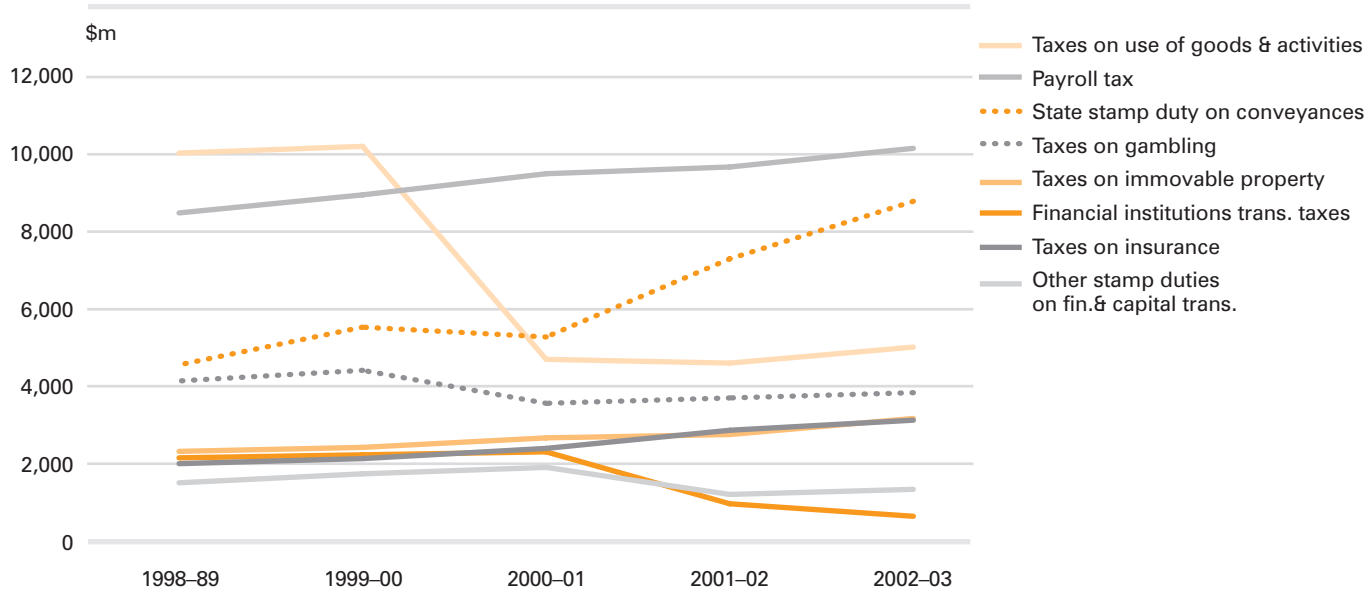
TABLE 7.4
STATE TAX REVENUES

State Government Taxation Revenue (2004–05 Budgets)

	2004–05 $m	% of total revenue (rounded)
Payroll taxes	**11,460**	**29%**
Taxes on property		
Land taxes	3,435	
Financial institutions' transactions taxes	626	
Stamp duties on financial transactions	10,579	
Other	662	
Total taxes on property	**15,302**	**38%**
Taxes on provision of goods and services		
Excises and levies	182	
Taxes on gambling	4,280	
Taxes on insurance	3,372	
Total taxes on provision of goods and services	**7,834**	**19%**
Taxes on use of goods and performance of activities		
Motor vehicle taxes	5,288	
Franchise taxes	14	
Other	367	
Total taxes on use of goods and performance of activities	**5,669**	**14%**
Taxation revenue	**40,265**	**100%**

Source: State Budget Papers

FIGURE 7.5
STATE TAX TRENDS



Source: ABS 5506.0 Taxation Revenue 2002–03.
Figures 7.5 and 7.6 show movements in dollar terms and as a proportion of total State taxation revenue sources over time, based on revenue statistics collated by the ABS.

A number of inefficient, narrowly based taxes remain at the State level, such as stamp duties on non-residential conveyances, stamp duty on financial transactions and very high taxes on general insurance.

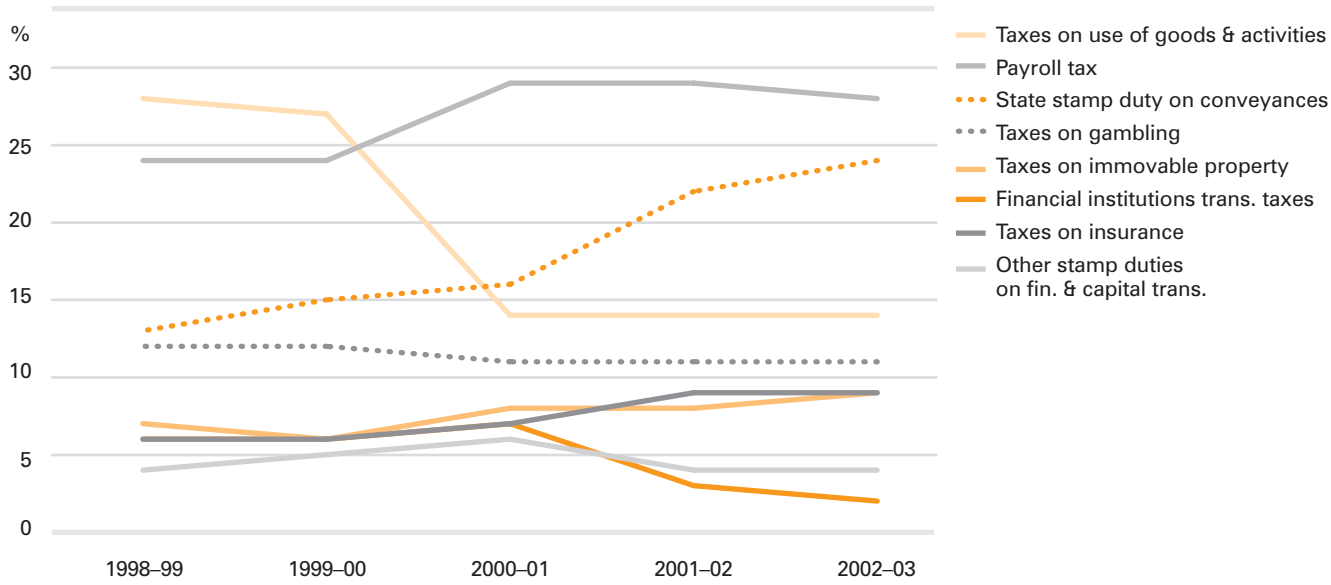
Partly reflecting its status as a 'sin' tax, State Governments also raise a significant level of revenue from gambling.[42]

Local Governments in Australia collect only about 3 per cent of total tax revenues. The main source of tax revenue for Local Governments is the property rate (raising about $8 billion).

Notable movements in State revenue over the period 1998–99 to 2002–03 (see Figures 7.5 and 7.6) include:

- **The large increase in stamp duty on conveyances, driven by the residential property boom over this period. Taxes on immovable property (such as land tax) have also benefited from the strength of the property market.**
- **Ongoing growth in payroll tax, reflecting strong employment and wages growth.**
- **From 2000–01, 'taxes on use of goods and activities' primarily consists of motor vehicle taxes (such as stamp duty on registration). The large decrease from 2000–01 largely reflects the loss of revenue associated with the abolition of State business franchise fees.**

FIGURE 7.6
PERCENTAGE OF STATE TAX REVENUE



Source: ABS 5506.0 Taxation Revenue 2002–03.

- **The decline in 'financial institutions transactions' taxes from 2001–02 which reflects the abolition by all the States of Financial Institutions Duty (FID) from 1 July 2001. This tax was abolished under an agreement between the Commonwealth and States/Territories as part of The New Tax System. States and Territories have agreed also to abolish debits tax (imposed on withdrawals from certain bank accounts) by 1 July 2005 (NSW has already abolished this tax).**

7.7 Twenty-five years of tax reform in Australia

With the advent of much larger public sectors over the last century and increasing international competitive pressures in more recent decades, most countries have changed tax policies to minimise the potentially adverse economic effects of higher taxes.

Australia has been slow to adapt, relying instead on increasing income tax burdens imposed on a narrow base, and some ad hoc indirect tax imposts. Reform eventually came in the latter part of the century (particularly from the mid-1980s onwards) bringing innovations often adopted much earlier in other countries and some hybrid innovations of its own.

As a result, the Australian tax system today exhibits some strength for today's conditions. It fully funds the current and capital cost of Government, unlike many other systems at present. It has a relatively neutral indirect tax base. The statutory company tax rate is not out of line with many of our competitors although it is not at the competitive end, and while there is very strong growth and profitability and a recovering global economy, it does not appear to constrain healthy aggregate investment levels. The dividend imputation system contributes to the neutrality of the treatment of entities and alleviates the tax bias against investments in equities.

However, the Australian tax system has significant weaknesses. It has high operating costs. In combination with the social transfer systems, it discourages workforce participation and may be working against desirable levels of savings and retirement income provision. At the same time, policy innovation abroad carries the very real risk that Australia will again lag tax design innovation to its disadvantage.

There has been little change in the overall level of taxation in Australia over the past 25 years. The main changes in tax arrangements have been driven by the idea of applying tax to a wider base, thereby allowing lower tax rates to improce efficiency. The key elements of these tax reforms have been:

- **broadening the income tax base to include more capital gains, fringe benefits, superannuation funds and lump-sum benefits, previously exempt income including from gold-mining, and foreign source income, and by reducing some deductions such as accelerated depreciation;**
- **reductions in the rate of income tax. The top personal rate of tax has been reduced from 60 per cent to 47 per cent. Rates have fallen in other income ranges, although inflation has often eroded these effects. The main company tax rate has been reduced from 46 to 30 per cent, and the double taxation of distributed company income was removed by dividend imputation; and**
- **replacement of the multi-rate wholesale sales tax and some other transaction taxes with the more broadly based GST at the lower flat rate of 10 per cent (this also involved a minor shift in the balance of taxation from income to indirect taxation, although other trends have worked in the reverse direction over the period).**

The main changes to the systems for tax collection arose from the progressive introduction of the self-assessment system and the strengthening of penalties and other mechanisms for reducing tax evasion and avoidance. Beyond these, the tax reforms have increased the operational costs of the tax system. In general, the broadening of the tax base raises appreciably the number of transactions and taxpayers subject to tax. The efficiency and equity gains sought by the reforms have come at the expense of a considerably less simple tax system.

Twenty-Five-Year Chronology of Major Australian Tax Reforms

Late 1970s to early 1980s: Encouragement for investment in plant and equipment – accelerated depreciation and the investment allowance were introduced for this purpose. Experiments with the indexation of the tax scales were begun but soon abandoned.

Mid-late 1980s: The income tax base was broadened. Investment incentives (except for business R & D) were abandoned (but partly restored in early 1990s).[43] New taxes included petroleum resource rent tax (replacing excises), fringe benefits tax, inflation-indexed capital gains tax, gold-mining income and superannuation lump sum taxes. Tax rates were reduced by rate cuts and dividend imputation. The top personal tax rate was reduced from 60 to 49 per cent, and the company tax rate (after an initial increase) from 46 to 39 per cent.

1998–2002: The New Tax System and New Business Tax Systems. GST replaced wholesale sales tax and some other indirect taxes, particularly at the State level. Reductions in income tax rates were made at the lower end of the scale but not the top rate (apart from a limited adjustment to its threshold). Family payments were increased and reformed. Company tax was reduced to 30 per cent but the business tax base again broadened including removing the partly accelerated depreciation arrangements and removing indexation of capital gains tax for companies. Indexation of capital gains for individuals was also removed but replaced by excluding 50 per cent of gains from the tax base. Some tax base concessions were introduced for small business. The Board of Taxation was established in 2000 to advise the Government, providing a business and broader community perspective on the development and implementation of taxation legislation as well as the ongoing operation of the tax system.

2002–04: Some limited improvements to international tax arrangements were introduced. Two major tax simplification reform proposals from the Ralph review of business taxation were rejected: a single entity tax regime (for trusts and companies) and the 'tax value method' for the measurement of business income. The Government commenced to focus more on tax administration: a Minister for Revenue was appointed, the Office of the Inspector-General of Taxation was established, responsibility for legislative design shifted from the Tax Office to Treasury, and a review of self-assessment undertaken.

The trend since the early 1970s has also been towards strengthening tax compliance and measures against tax avoidance and evasion.

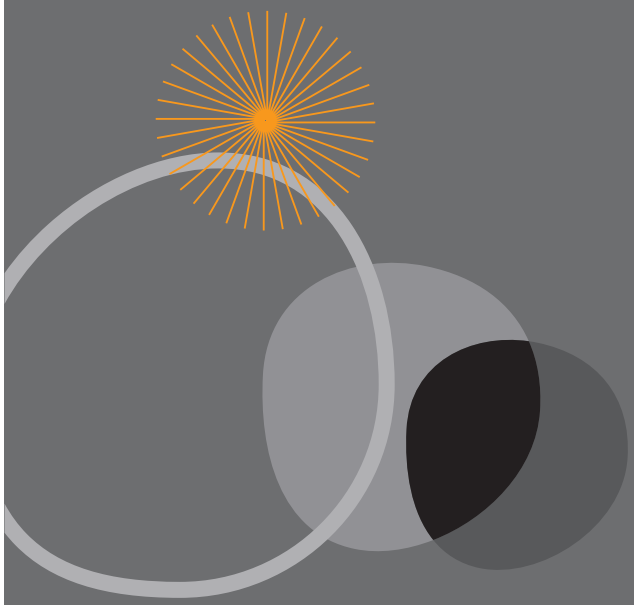
Taken together, the measures have had the following broad results:

- **greater neutrality, implying greater horizontal equity and allocative efficiency – bases were broadened and rates reduced;**
- **a more robust tax base, in anti-avoidance features and in the face of possible changes in economic structure or factor incomes;**
- **increased complexity and costs of administration and compliance; and**
- **overall, there has been an increase in the aggregate tax burden (relative to GDP) and vertical fiscal imbalance, and little change to vertical equity, or the balance between income taxation versus consumption taxation.**

The economic performance of Australia has improved considerably over most of this period, particularly the past decade. It cannot be said specifically the role tax factors have played in that result, but there is very likely to have been important benefits from several of the elements, particularly reductions in personal and company tax rates. However, given the challenges that Australia faces, more work needs to be undertaken in order to further lift Australia's performance. Further taxation reform will be an important component in ensuring Australia's future prosperity.

Chapter 8

Personal Income Tax



Personal income taxes include taxes directly paid by individuals, and other taxes relating to personal income that are paid by other parties. The main taxes on personal incomes are:

- **income tax on individuals, including tax on capital gains;**
- **Medicare levy;**
- **fringe benefits tax, paid by employers;**
- **payroll tax, levied by the States on employers; and**
- **superannuation taxes.**

There are also family payments delivered through the tax system, the interaction of which with personal tax rates is one of the reasons Australia has higher effective marginal tax rates for many taxpayers.

8.1 Overview of taxes on personal income

The individual income tax, which is by far the largest tax, is imposed on a highly progressive rate scale. The rate scale is effectively modified by the means tests applying to associated transfer payments and by a number of tax offsets. The individual income tax base is fairly comprehensive, including labour income, business income, pensions and other personal benefit payments, investment income and capital gains. The main exclusion is imputed rent and capital gains associated with owner-occupied housing.

Contributions to superannuation funds broadly have a two-step scale (with a shading-in range between the 15 per cent and 30 per cent rates). Fringe benefits tax, income tax on superannuation fund earnings, and payroll taxes are applied at flat rates. The payroll tax has a threshold based on the aggregate wage payments of employers rather than the individual income levels of employees.

8.2 Individual income tax

Key features

The individual income tax is the main instrument in the tax system for the delivery of vertical equity objectives (imposing tax on a progressive scale so that those with higher capacity to pay incur proportionately higher tax obligations). It is assessed annually, on an individual (not family) basis. Most tax is paid in advance of assessment through pay-as-you-go and withholding systems.

In the 1980s, concerns arose that very high tax rates were leading to tax evasion and avoidance. The system had become too progressive so that in practice it was no longer achieving the underlying equity objective. These concerns focused on three main features:

- **the highest tax rate step was 60 per cent and applied from as low as 1.6 times average male earnings;**
- **the rate applying at average earnings had moved from around the mid-30s, which was considered acceptable, to the mid-40s, which was not; and**
- **company incomes distributed as dividends were subject to double taxation, an effective tax rate of up to 78 per cent.**

As a result, marginal tax rates were reduced, thresholds were adjusted and double taxation of company income was removed by dividend imputation. These changes were accompanied by broadening the tax base, particularly by introducing fringe benefits and capital gains taxes, to preserve the revenue and more appropriately tax income, regardless of the source.

Over the past 20 years, these broad goals have been retained, requiring periodic adjustments as inflation has produced 'bracket creep'. The New Tax System, in particular the GST introduced in 2000, facilitated a larger than usual adjustment with significant reductions in most marginal tax rates. These have subsequently been further supplemented by some adjustments to tax bracket thresholds. However, the main structural features of the rate scale have remained intact. Currently:

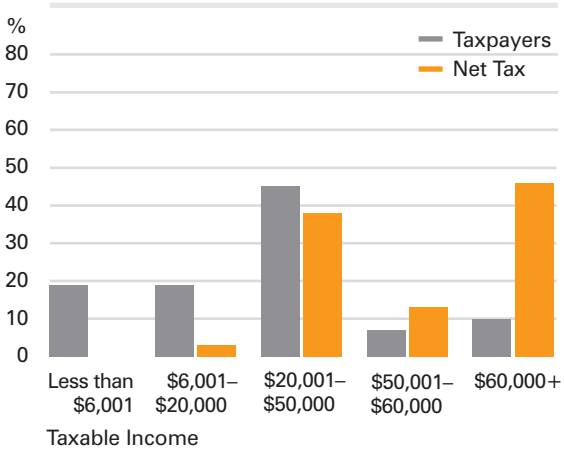
- **The highest personal rate step is 48.5 per cent and applies at around 1.5 times average earnings.**
- **The rate step applying at median and average earnings is 31.5 per cent.**
- **A tax threshold of $6,000, low-income rebates, and a lower rate first step of 17 per cent (18.5 per cent when the Medicare levy applies) deliver the largest contributions to progressivity of the system.**

Imputation continues to prevent double taxation of dividends.[44] The capital gains tax has been reduced (albeit with the removal of price indexation of the base and averaging) by providing a 50 per cent discount in the calculation of net gains where assets are held for more than 12 months.

Who pays income tax?

The personal income tax system shows a very high degree of progressivity across a relatively low, and compressing, taxable income range. As shown in Figure 8.1, in 2001–02 the 10 per cent of taxpayers (including those with zero tax payable) with taxable income over $60,000 (subject to the top marginal tax rate in 2001–02) paid 46 per cent of tax.[45]

FIGURE 8.1
PERCENTAGE OF TAXPAYERS AND TAX PAID, 2001–02



Note: figures rounded.

Source: Australian Taxation Office, Taxation Statistics 2001–02

As income tax scales are not formally indexed to inflation or real wages, nominal wage growth results in 'bracket creep' – as a higher percentage of an individual's income is subject to higher marginal tax rates, average tax rates increase as wages grow.[46] This results in a larger number of people moving into higher tax brackets. It also means that a higher proportion of their income is taxed at higher rates. As noted above, periodically some of this bracket creep has been returned by Governments as income tax cuts.

Figure 8.2 shows how the percentage of taxable taxpayers whose taxable incomes reach the top marginal tax bracket has changed since 1980. In 1980–81, 1.3 per cent of taxable taxpayers were subject to the top rate. In 2001–02, the figure was 12.7 per cent.

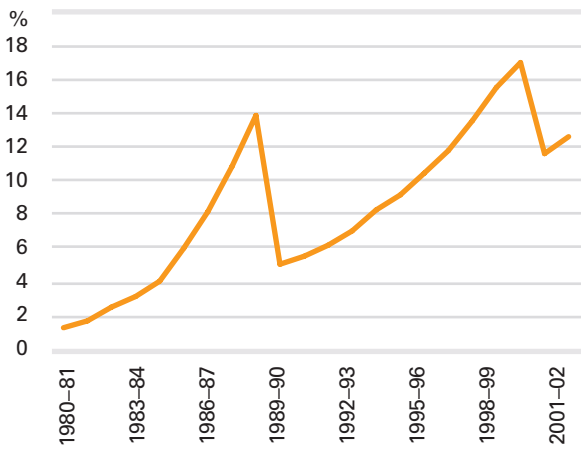
The trend rise in the proportion of taxpayers on the top rate occurs due to bracket creep and real wage growth. However, it is also influenced in some cases by simplification of the tax scales impacting on the coverage of the top tax bracket.

Income tax cuts, usually including increases in the income thresholds where the rate applies rather than rate reductions, temporarily mitigate against the rising trend. For example, the fall in the proportion of taxpayers in this bracket in 1989–90 reflects the large rise in the top rate threshold from $35,000 to $50,000. Similarly, the decline in 2000–01 reflects the further rise in the threshold to $60,000.

The threshold rose to $70,000 in 2004–05 and is to rise to $80,000 in 2005–06. However, bracket creep continues to erode these changes so the proportion of taxpayers with incomes reaching the top bracket is likely to remain around 12 per cent and resume its growth again.

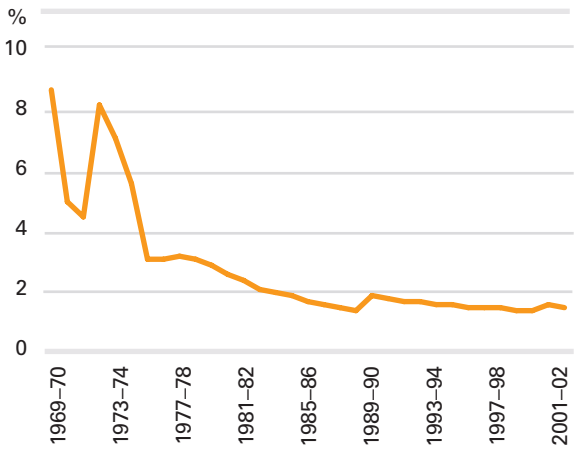
Figure 8.3 shows the decrease in the income threshold of the top marginal rate as a multiple of male total average weekly earnings (MTAWE). In 1969–70, an individual would have needed to earn 8.6 times MTAWE to be subject to the top marginal rate. By 2001–02, an individual earning only 1.4 times MTAWE paid the highest marginal rate of tax; this ratio is broadly the same now.

FIGURE 8.2
PROPORTION OF TAXPAYERS AT THE TOP MARGINAL TAX RATE



Source: Derived from Barber, S., Parliamentary Library Services Research Note No. 47, Taxpayers in the top tax bracket and ATO Taxation Statistics 2001–02.

FIGURE 8.3
TOP TAX THRESHOLD AS MULTIPLE OF AVERAGE WEEKLY EARNINGS



Source: Derived from Barber, S., Parliamentary Library Services Research Note No. 47, Taxpayers in the top tax bracket and ATO Taxation Statistics 2001–02.

8.3 Attracting investment: why personal tax rates are so important

Reductions in the company tax rate have reduced rates of tax on non-resident investors.[47]

Since 1993, the company tax rate has been reduced from 39 per cent to its current level of 30 per cent:

- **in 1993–94 it was decreased from 39 per cent to 33 per cent;**
- **in 1995–96 it was increased from 33 per cent to 36 per cent;**
- **in 2000–01 it was reduced to 34 per cent (accelerated depreciation was also abolished and replaced with effective life depreciation); and**
- **in 2001–02 it was decreased to 30 per cent.**

Reductions in the company tax rate have:

- **reduced the rate of tax that Australia imposes on the income of non-resident investors, since one of the important functions of the company tax regime is to impose, in effect, a final withholding tax on the Australian source income that foreign investors earn through Australian companies or the Australian branches of foreign companies; and**
- **reduced the cost of capital for those Australian companies that raise their equity primarily from foreign investors (where the marginal investor is a non-resident).**

Although recent reductions in the company tax rate have reduced the disincentive for non-residents to invest in Australia, it is has done less to reduce the disincentive for resident individuals to save and invest.

Following the introduction of the dividend imputation regime, the company tax system acts in effect as both:

- **a final withholding tax on the Australian source income that foreign investors earn through an Australian company or the Australian branch of a foreign company; and**
- **a withholding tax on the income that Australian residents earn on their investments through Australian resident companies including the labour income of incorporated self-employed individuals or contractors. In particular, it imposes:**
  - an interim withholding tax on the dividend income residents receive from Australian companies. Individuals receive imputation credits for the amount of company tax already levied on their income and must pay additional tax if their marginal tax rate exceeds the company tax. By contrast, individuals (and superannuation funds) facing marginal tax rates below the rate of company tax are able to obtain a refund for any excess imputation credits; and
  - a final withholding tax on the income that is retained by the company.

As a result, reducing the company tax rate reduces the effective tax rate that:

- **non-resident shareholders are legally liable to pay on their Australian investment income; and**
- **resident shareholders pay on the income that is retained by the company.**

However, reducing the company tax rate does nothing to reduce the effective marginal tax rate imposed on income distributed to resident shareholders, including those individuals who face a higher statutory rate of personal tax than the company tax rate. Under the dividend imputation regime, any reduction in the amount of tax payable by the company is offset by an increase in the amount of additional personal tax payable by those individuals.

Since 1993–94 there have also been changes to both statutory marginal rates of tax and the thresholds at which those rates cut in, in order to improve both the equity and efficiency of the tax system. However, the changes in the personal tax rates to date have had little effect on the effective marginal tax rates that Australia imposes on the incomes of those resident individuals who are responsible for the bulk of saving and investment undertaken directly by individuals.

As indicated in Tables 8.1 and 8.2, which draw from ATO 2001–02 data, a very large part of individual saving and investment is undertaken by individuals who face statutory marginal tax rates on their income of at least 42 per cent. In particular, individuals earning over $58,000:

- **derive over 51 per cent of investment income plus the 1.5 per cent Medicare levy; and**
- **face a statutory marginal tax rate of at least 42 per cent on their income.**

Although the personal income tax thresholds will be changed again from 1 July 2005 (to $63,000 and $80,000), such changes will do little to reduce the statutory marginal tax rates facing those individuals who undertake the bulk of saving and investment. Specifically, the new thresholds will (see Table 8.2 and 8.3):

- **reduce the statutory marginal tax rate applying to individuals with incomes between $58,000 and $63,000 from 42 per cent to 30 per cent;**
- **reduce the statutory marginal tax rate applying to individuals with incomes between $70,001 and $80,000 from 47 per cent to 42 per cent; and**
- **not alter the statutory marginal tax rate applying to individuals with incomes of more than $80,000 who represent Australia's most significant investors. Although these individuals will pay a lower average rate of tax as a result of the threshold changes outlined above, this will not change the marginal rate of tax they face when making new savings and investment decisions. It is mainly the marginal rate of tax that affects savings and investment decisions, not the average tax rate.**

TABLE 8.1
INCOME EARNED BY INDIVIDUALS IN EACH TAX BRACKET, 2001–02

Tax bracket	Wage or salary income		Investment income	
	$m	%	$m	%
Below $6,000	52	0	2,091	10
$6,001 to $20,000	19,533	7	1,294	6
$20,001 to $50,000	132,573	50	5,676	27
$50,001 to $60,000	35,268	13	1,485	7
Above $60,000	76,199	28	10,764	51
Total	267,596	100%	21,311	100%

Note: figures are rounded.

Source: Ernst & Young, adapted from ATO 'Taxation Statistics 2001–02: A summary of taxation, superannuation and industry benchmark statistics 2001–02 and 2002–03'.

TABLE 8.2
INCOME EARNED ABOVE SELECTED INCOME THRESHOLDS, 2001–02

Tax bracket	Wage or salary income		Gross interest income		Dividend income		Assessable foreign source income	
	$m	%	$m	%	$m	%	$m	%
Above $50,000	111,467	42%	1,777	33%	5,507	68%	783	47%
Above $60,000	76,199	28%	1,388	26%	4,913	60%	667	40%
Above $70,000	59,089	22%	1,172	22%	4,492	55%	610	37%
Above $80,000	41,979	16%	957	18%	4,072	50%	552	33%
Above $100,000	27,245	10%	739	14%	3,525	43%	475	29%

8.4 The economic impact of the high top two rates

The costs of the top marginal tax rates are significant for the economy. Reducing the top marginal tax rate would reduce the:

- **disincentive to save and invest;**
  - for instance, by reducing the effective marginal tax rate applying to individuals earning over $80,000. For example, reducing the top marginal tax rate to 43.5 per cent (from 47 to 42 per cent plus the Medicare levy of 1.5 per cent) would reduce the effective rates of Australian tax imposed on the investment income of those individuals with income over $80,000. Those individuals with income over $80,000 earn 35 per cent of individual investment income from interest, dividends, assessable foreign source income, net capital gains, and distributions from partnerships and trusts. In so doing, the cost of capital for Australian companies reliant on Australian resident investors would also fall.
- **disparities in the effective marginal tax rates applying to different forms of income from capital earned through different entities, thereby improving the overall quality of investment. Reducing the top marginal tax rate would also reduce the differences in the effective rates of Australian tax applying to income from different sources;**
- **current bias that the imputation regime provides against investment offshore indirectly through Australian multinational companies without distorting the effective rates of Australian tax imposed on the Australian source income of resident investors;**
- **extent to which the current tax system reduces the ability of Australian businesses to attract and retain skilled labour by reducing the effective marginal tax rates imposed on the incomes of those individuals;**
- **incentive for high-income individuals to devote resources to tax planning in order to reduce their tax liabilities;**
- **incentive for companies to retain their earnings rather than redistribute those earnings in the form of dividends, since there would be a smaller difference between the company tax rate and the top marginal tax rate; and**
- **complexity of the tax system, particularly if the top marginal tax rate was aligned with the company tax rate, thereby reducing administrative and compliance costs.**

Net capital gain		Distributions from partnerships and trusts		Taxable income	
$m	%	$m	%	$m	%
4,211	69%	12,999	49%	147,396	43%
3,796	62%	10,612	40%	107,286	31%
3,498	57%	9,353	35%	87,231	25%
3,200	52%	8,094	31%	67,176	20%
2,817	46%	6,697	25%	48,705	14%

Note: The percentages represent the proportion of taxpayers earning above the selected income threshold. The percentages therefore decrease proportionately as the thresholds increase.

Source: Ernst & Young, adapted from ATO 'Taxation Statistics 2001–02: A summary of taxation, superannuation and industry benchmark statistics 2001–02 and 2002–03'.

A rate change is needed, not a threshold change. Raising the threshold at which the top marginal tax rate cuts in would reduce the average rate of tax paid by these individuals and increase their after-tax income. However, it would not alter the marginal tax rate that these individuals face when they are deciding to undertake additional saving and investment.

8.5 Effective marginal tax rates

The income tax rate scale is not a complete guide to the effects of fiscal arrangements on disposable incomes. Other features of fiscal and tax arrangements effectively increase tax rates.

- **Australia provides age pensions and other social benefit payments subject to means tests. The means test operates to reduce transfer payments as other income increases, much like the tax system.**
- **Payments are made to families with dependent children. In earlier times these were universally provided by tax rebates but now they are means tested.**
- **Several tax features also operate to change the effective tax rates. Special tax offsets for those on low incomes and those aged over 65 increase the effective tax threshold but are withdrawn as incomes rise beyond specified levels.**

  The progressive scale of personal tax interacts with the benefit abatement regimes (means testing) to impose very high effective marginal tax rates (EMTRs), that is, the proportion of an additional dollar of income that is paid in tax or lost through a reduction in entitlement to transfer payments. Some individuals who are moving off benefits and re-entering the workforce can face EMTRs in excess of 60 per cent.

  In Australia, for significant numbers of people, effective marginal tax rates exceed those implied by the tax scales by a large margin.
- **For those aged over 65 EMTRs of 40 per cent or more apply for much of the income range beyond the pension free area. For example, a single pensioner faces EMTRs between 40 and 66 per cent on non-pension income from $3,180 to $34,603, and this range extends higher for couples (see www.centrelink.gov.au – A guide to Australian Government Payments p 20).**

TABLE 8.3
MARGINAL RATES OF TAX ON PERSONAL INCOME AND THRESHOLDS, 1993–94 TO 2005–06

1993-94		1994-95		2000-01	
Tax bracket	Rate	Tax bracket	Rate	Tax bracket	Rate
0 to 5,400	0%	0 to 5,400	0%	0 to 6,000	0%
5,401 to 20,700	20%	5,401 to 20,700	20%	6,001 to 20,000	17%
20,701 to 36,000	35.5%	20,701 to 38,000	34%	20,001 to 50,000	30%
36,001 to 38,000	38.5%	38,001 to 50,000	43%		
38,001 to 50,000	44.125%				
50,001 and over	47%	50,001 and over	47%	50,001 to 60,000	42%
				60,001 and over	47%

Note: These rates exclude the Medicare levy, generally imposed at the rate of 1.5 per cent.
Source: Provided by Ernst & Young from ATO tax data for various years.

- **Over the income ranges where family payments are reduced by means tests (which vary with the number of children), EMTRs increase by 20 or 30 per cent, taking total rates above 50 per cent. This can particularly affect work incentives for second earners in a family, most often women.**
- **The withdrawal of the low-income tax offset over the income range $21,600 to $27,475 raises the EMTR in that range to 35.5 per cent (see www.ato.gov.au – Low income tax offset calculation).**
- **By comparison under the current tax rate scale, the highest tax rate is 48.5 per cent[48] applying to incomes over $70,000. The rate is 43.5 per cent for the income range $58,000 to $70,000.**

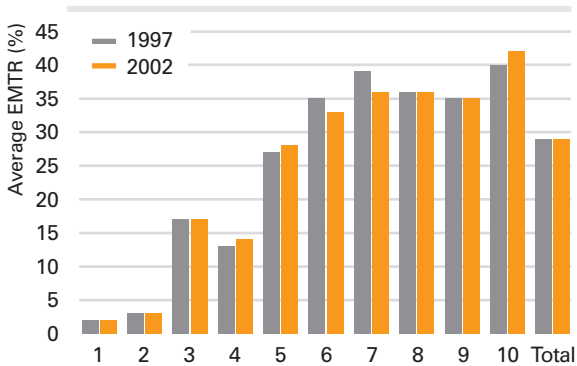
High EMTRs reduce economic efficiency by providing disincentives for those individuals to re-enter the workforce or work additional hours.

The introduction of The New Tax System has had little impact on those high EMTRs. In particular, research suggests:[49]

- **The proportion of individuals in the lower half of the income distribution (deciles 1 to 5) facing high EMTRs in 2002 is generally either the same as or slightly higher than the proportion in 1997. As illustrated in Figure 8.5, 19 per cent of those individuals in the bottom half of the income distribution faced high EMTRs in 1997, whereas 22 per cent of those individuals faced high EMTRs in 2002.**
- **In 2002, a much higher proportion of those with higher incomes face EMTRs over 60 per cent. As indicated in Figure 8.5, four and six per cent of those in deciles 9 and 10 respectively faced high EMTRs, whereas in 1997 a negligible proportion of those individuals faced high EMTRs.**

2003-04		2004-05		2005-06	
Tax bracket	Rate	Tax bracket	Rate	Tax bracket	Rate
0 to 6,000	0%	0 to 6,000	0%	0 to 6,000	0%
6,001 to 21, 600	17%	6,001 to 21,600	17%	6,001 to 21,600	17%
21,601 to 52,000	30%	21,601 to 58,000	30%	21,601 to 63,000	30%
52,001 to 62,500	42%				
62,501 and over	47%	58,001 to 70,000	42%	63,001 to 80,000	42%
		70,001 and over	47%		
				80,001 and over	47%

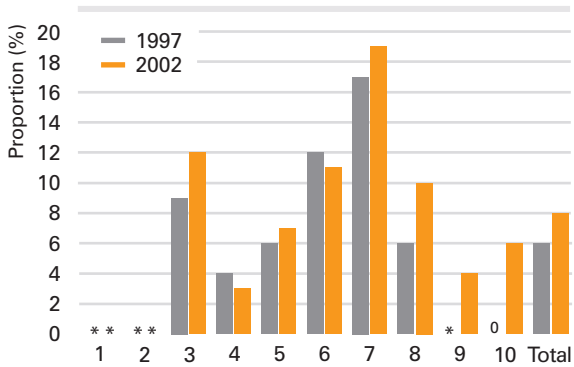
FIGURE 8.4
ESTIMATED AVERAGE EFFECTIVE MARGINAL TAX RATES FOR INDIVIDUALS, 1997 AND 2002



Note: By decile of gross family income.

Source: Beer, G. 2002, 'Work Incentives under a New Tax System: The Distribution of Effective Marginal Tax Rates', Economic Record, vol. 79, Special Issue, pp. S14–S25.

FIGURE 8.5
ESTIMATED PROPORTION OF ALL INDIVIDUALS FACING EFFECTIVE MARGINAL TAX RATES IN EXCESS OF 60%, 1997 AND 2002



* Estimate statistically unreliable.

Notes: Estimated proportion of all individuals facing effective marginal tax rates in excess of 60 per cent by decile of gross family income. Some columns may not add to 100 per cent due to rounding.

Source: Beer, G. 2002, 'Work Incentives under a New Tax System: The Distribution of Effective Marginal Tax Rates', Economic Record, vol. 79, Special Issue, pp. S14–S25.

- **The average EMTRs faced by individuals in each decile have not changed significantly over the five years since 1997. As indicated in Figure 8.4, the average EMTR all individuals faced in both years was 29 per cent.**

Some high EMTRs have been reduced in more recent reforms, but high rates persist.

Fringe benefits tax

An unusual feature of the Australian income tax system is the imposition of taxes on fringe benefits on employers rather than employees. The fringe benefits tax (FBT) is imposed at the top personal tax rate irrespective of the personal tax rate of the employee to whom the benefit is paid.

The imposition of this tax on employers was originally justified as a simplification initiative (to avoid the need to allocate fringe benefit values to employees). This rationale has been lost as most fringe benefit values are now allocated to employees for the calculation of income support and other entitlements.

The FBT has high administrative costs and is a particular nuisance tax for internationally mobile workers temporarily engaged in Australia, despite several attempts to simplify its operation.

8.6 Taxes on retirement saving

Australia has a very unusual and complex tax regime for retirement savings.

There are two main elements to this unique approach. First, Australia does not provide a universal public social security system, but rather provides a means-tested 'safety net' age pension. The pension is supplemented by what are in effect compulsory private savings for retirement. This is achieved by the Superannuation Guarantee, which is a compulsory social-security-like instrument applied if superannuation support has not been provided. However, unlike social security systems, the Superannuation Guarantee applies only to employees and not to the self-employed.

The second unique feature is the tax treatment of saving for retirement.

Most countries tax retirement saving on a version of the 'expenditure tax' principle, which has two elements:

- **Tax on savings is deferred. Income that is contributed to retirement funds is excluded from the tax base at the time it is derived and subjected instead to tax at the time it is taken as a retirement benefit. Given progressivity of the tax scale, this often means that the tax rate is lower, as retirement incomes usually are lower than incomes during working years.**
- **The investment earnings on such savings are tax exempt. This means that tax does not reduce its spending power over time, avoiding the double tax bias against savings associated with income taxes.**

The Australian treatment used to conform with this approach before 1988 but now only partly conforms to this principle. It does so in a unique and complex way, and with gaps and inconsistencies.

- **Tax deferral is only partial. Most contributions by employees and some by the self-employed obtain no deferral. Employer and some other contributions obtain partial deferral with a tax of 15 per cent imposed on contributions (higher if the surcharge applies) and then a like tax reduction provided when benefits are taken.**
- **Recently, high-income earners have also paid an additional 15 per cent tax on contributions without relief at the benefit stage. This introduces a (compressed) progressive income (rather than expenditure) tax feature entirely unique to Australia.**
- **Super fund investment earnings are subject to tax at 15 per cent (10 per cent for capital gains) but unlike most such funds abroad obtain an offsetting benefit in full dividend imputation credits (if any). How closely this results in effective tax exemption equivalent to the expenditure tax benchmark[50] depends on the investment strategy of the fund. There is a clear bias against strategies that do not generate imputation credits (such as most capital-certain strategies, often sensibly pursued close to retirement age).**
- **Compared with overseas arrangements another unique, and perverse, feature of Australian arrangements arises from the very high EMTRs on retirees due to means tests and tax arrangements. This means that income taken as a retirement benefit can bear a higher tax rate than would apply when it was originally derived. For example, the marginal tax rate applying to typical production workers is 31.5 per cent. However, where tax is deferred through a deductible superannuation contribution, it typically will bear tax at EMTRs of 40 to 66 per cent, from a low threshold. This reverses the tax rate advantage more common overseas.**

The single motivation for most of these unusual features is itself probably perverse. Their goal is to increase current tax revenues relative to the more usual treatment. This is perverse because although the fiscal benefit could be said to add to national savings, the funds involved are directly taken from the pool of private saving. The actual effect on national savings is unclear as it depends on the resulting behavioural effects on both Government and private savers, which cannot be reliably assessed. In all likelihood the net benefits for national savings are negligible at best.

For all these strange features, the tax treatment of superannuation remains concessional compared with full income taxation of equivalent savings. This is not to say that it is the most concessional option, or that its benefits can be understood. The treatment of some alternative investments is discussed below.

8.7 Taxation of alternative non-business investments

The main non-business investment alternatives available to individuals and their tax treatments are as follows:

- **Interest-bearing investments – full income taxation.**
- **Owner-occupied housing – exempt from income tax on implicit rent and capital gains thereby achieving the expenditure tax benchmark, although State and Local Government property and financial taxes partly offset this result.**
- **Rental housing – full taxation on net rent (with a complex allowance for capital works depreciation), half taxation of capital gains, and full deductibility of nominal interest deductions. A similar treatment applies to commercial property but higher rental risks and returns in this sector may dampen tax effects.**

- **Shares – dividends taxed with imputation credits only for Australian tax paid, creating effective biases against income benefiting from tax preferences and from overseas. Half capital gains tax. Full gearing deductions allowed (as for real estate), although underlying risk profiles are usually quite different and may dampen tax effects.**
- **Managed investments (usually trusts) – the tax treatment of underlying income (but not net losses) flows through to unit holders.**

As can be seen, very different tax consequences continue to apply for different classes of investment and the more concessional treatments are not afforded to the most productive assets. The concessions for owner-occupied housing are greatly compounded by further concessions in the means testing (including asset testing) rules for social security payments. Gearing concessions (in practice) tend to most favour lower-risk investments in capital growth assets.

The capital gains tax was changed from an inflation indexed model to the much simpler half-inclusion approach in 1999 (applying only to individual taxpayers – there is no discount for companies). The effects of this change are mixed. One key benefit is to reduce the 'lock-in' effect of capital gains taxes, by reducing the tax penalty for selling assets. This is likely to have improved the liquidity and efficiency of asset markets. The change also substantially simplified the calculation of taxes and is more consistent with trends overseas.

While the change favoured real capital gains, the removal of indexation of the base can result in higher taxation for assets that appreciate broadly in line with, or a little more than, inflation.

Because interest deductions are allowed in full (even where interest rates reflect an inflation premium), the capital gains discount increases an existing bias in favour of investments funded by borrowings where capital growth represents a large part of total returns on an asset. On the other hand, capital gains tax is double taxation where capital growth on company shares reflects retentions of already taxed income. The discount in this case reduces this tax bias against investment.

8.8 Conclusions

The current rates of personal income tax provide unacceptably high economic distortions and therefore deadweight cost on the economy.

The top two highest personal tax rates remain as a significant point of competitive disadvantage for Australia:

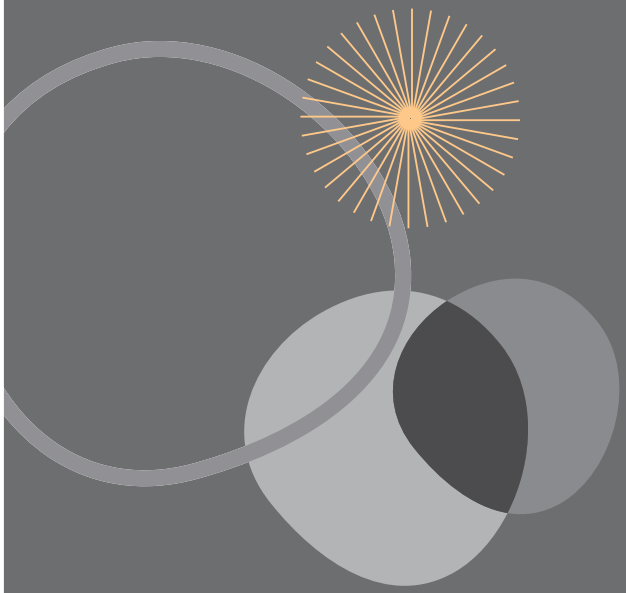
- discouraging higher-skilled internationally mobile workers;
- providing disincentives for saving;
- exacerbating distortions between alternative investments by maintaining the tax benefits for highly-geared investments and tax avoidance strategies; and
- increasing the cost of capital, thereby impacting on investment.

In addition:

- The personal tax system is unreasonably complex.
- Effective marginal tax rates for many of those receiving family allowances and other transfers continue to present significant disincentives for workforce participation.
- The Medicare levy is a misnomer and misleads Australians about the real cost of public health programs. Other countries achieve information benefits by breaking taxes on income into more clearly defined purposes (including social insurance, Medicare and State or local purposes).
- Australia's hybrid arrangements for the taxation of superannuation savings, the means testing of age pensions and like transfers, and the taxation of the income of persons aged over 65 combine to produce extraordinary complexity and extremely high marginal tax rates on savings.

Chapter 9

Business Income Tax



This chapter describes the main features of taxation arrangements for business income.

Business income is subject to the general income tax in Australia. A resource rent tax also applies to petroleum production but this is a secondary profit tax levied as a return to the community from the use of scarce natural resources, and is not considered here.

The business tax contains a vast array of special features, too numerous to consider here. The discussion is limited to some broad features.

9.1 General features

The business income of individuals, including shares of partnership income or trust distributions, is taxed to individuals in the same way as other sources of income.

The taxable income of companies is subject to tax at a rate of 30 per cent. Two exceptions apply: income from offshore banking is taxed at 10 per cent and the income of pooled development funds (venture capital investors) is taxed at 15 or 25 per cent depending on its source.

The general rate of company tax has been reduced substantially from 46 per cent during successive tax reforms since the mid-1980s. However, company tax revenues have remained very robust as a range of reforms increased the tax base. These include base broadening measures such as the removal of exemptions (principally gold-mining), removal of accelerated depreciation and investment allowances, and the taxing of capital gains (at full nominal rates) and foreign source income.

The company tax rate is now broadly comparable with the statutory rates applying in most competitor countries. However, it is much higher than the rates that apply in some of our nearest competitors and, while comparison measurements are difficult, it appears that Australia's effective company tax rates are not competitive with either our largest competitors or our neighbours (see Figures 3.2 and 3.3 in Chapter 3).

Company income distributed as dividends carries a full, refundable imputation credit for Australian company tax paid. For this income, the company tax operates effectively as a withholding tax and the ultimate tax rate is that applying to the shareholder, ranging from 0 to 48.5 per cent for individuals and 15 per cent for superannuation funds. The 30 per cent rate applies to retained earnings and to income distributed to non-resident shareholders (international tax arrangements are discussed in Chapter 10).

The business tax base is calculated under specific rules in the tax law, and so often varies from general accounting measures of profit. Company groups may elect to be taxed as a consolidated entity. Losses may be carried forward indefinitely for deduction against future taxable income. Capital losses are quarantined and may be offset only against capital gains. Table 9.1 demonstrates the range of taxation rates on different types of entities.

TABLE 9.1
MARGINAL RATES OF COMPANY TAX BY TYPE OF COMPANY

Type of company	Statutory tax rate
Private companies	30%
Public companies	30%
Retirement savings account providers	
Standard component of taxable income	30%
RSA component of taxable income	15%
Life Insurance companies	
Ordinary class	30%
Complying superannuation class	15%
Registered organisations (including Friendly Societies)	
Ordinary class	30%
Complying superannuation class	15%
Non-profit companies	
First $416 of taxable income	0%
Shade-in above $416 to $914	55%
Taxable income above shade-in range	30%
Pooled development funds (PDFs)	
Companies that are PDFs throughout the year:	
on small to medium-sized enterprise income component	15%
on unregulated investment component	25%
Companies that become PDFs and are PDFs at the end of the income year:	
on small to medium-sized enterprise income component	15%
on unregulated investment component	25%
on taxable income that exceeds the PDF component	30%
Credit unions	
Interest received by:	
Small credit unions (with a notional taxable income of less than $50,000)	30%
Medium credit unions (with a notional taxable income of $50,000-$149,999) on the taxable income that exceeds $49,999	45%
Large credit unions (with a notional taxable income of $150,000 or more)	30%

Source: Provided by Ernst & Young, from Table 4.1, Company Tax Rates, 2001– 02 income year, ATO 'Taxation Statistics 2001–02: A summary of taxation, superannuation and industry benchmark statistics 2001–02 and 2002–03'.

9.2 Business tax and investment

Perhaps the most important issues arising in the taxation of the business income base relate to the treatment of different classes of investment.

The business tax base, like the accounting system for business profits, is rooted in 19th century, industrial age concepts. As a result, there are marked differences in the tax treatment of different types of investment, tangible and intangible.

Tangible assets

Physical (tangible) capital is recognised as an asset, and so expenditures on its purchase or creation are not ordinarily deductible. Amortisation deductions generally are allowed to reflect declining value where assets have a limited economic life.

Over the past 30 years, the amortisation arrangements have changed several times. In the early 1980s, highly accelerated depreciation and investment allowances were introduced. These were removed in the mid-to-late 1980s. A lesser degree of acceleration was reintroduced in the early 1990s, but removed again in 1999 (except for a special provision for small business) when the company tax rate was reduced from 36 to 30 per cent. The current stock of business assets carries all of the histories of these changing rules according to their vintage.

Separate rules also apply for buildings (where rates of allowance have also varied from time to time).

A wide range of capital expenditures by companies are neither deductible nor subject to amortisation. Some of these were provided with a five-year write-off in 2001, but many others remain as 'black holes'.

Intangible assets

It is now widely recognised that, in the modern economy, investment in intangible assets substantially exceeds that in physical assets. However, relatively few of these assets are recognised by accounting standards or tax laws. This largely explains the vast gap that has opened over recent decades between the values recorded on company balance sheets and the market value of company shares. Book values simply miss most of the assets that generate the value of a business.

In the economy as a whole, a significant part of national intangible investment is in the education, training and experience that produce human capital; the skills and knowledge embodied within people. For businesses, a wide range of other investments create intangible assets, including investments in proprietary knowledge or know-how, brands, customer relationships, supplier networks, and organisational leadership and culture.

The importance of intangible investments for competitiveness was discussed in Part One.

The tax system recognises some intangibles, mainly patents, copyrights and design. These are afforded capital allowance deductions over estimated effective lives.

Some classes of investment have special provisions. Mineral and petroleum exploration is deductible. Most investments in Australian film copyrights are afforded either immediate or two-year write-offs. Further concessions are provided to business research and development, subject to a threshold and numerous special rules – a 125 per cent deduction on most expenditures.

Most other expenditures that create business intangible assets are expensed under the tax law just as they are under the general accounting standards, provided they are incurred in the course of business operations. However, some exceptions apply as 'black holes' in the tax law. In addition, the value of intangibles included within the purchase price of an existing business will generally be treated as purchased goodwill and not allowed any amortisation deductions.

Investment and risk: treatment of intangible assets

Despite there being a number of significant 'black holes', overall, the provisions for current expenditures on intangibles are favourable relative to investment in physical assets. Immediate deduction is rare for physical assets.

However, there are sound reasons for this treatment of intangibles:

- **the investments play a critical role in a modern economy. Favourable tax treatment recognises their importance for dynamic efficiency. Some of the benefits produced are externalities, providing broader economic advantage than can be captured by the firm undertaking the expenditures;**
- **immediate deduction is the usual treatment in all countries. To provide otherwise would seriously damage competitiveness;**
- **at a practical level, it is often difficult to allocate expenditures between intangible asset creation and current expense; and**
- **most intangible investments are high-risk and generate volatile values. Assigning effective lives is difficult. Given broader tax system biases against risk (associated particularly with restrictions on access to the tax benefits of losses – see 9.3), expensing provides some offset to this bias.**

However, the value of intangibles enters the tax system in other ways, and these vary appreciably between countries. In particular, capital gains taxes capture intangible values when shares or whole businesses are sold. Capital gains taxes thus operate to withdraw some of the benefits of expensing under the ordinary income tax provisions.

Removing disincentives to investment in infrastructure

Australia's income tax system does not allow full and immediate claiming of losses incurred in generating assessable income unless and until there is other taxable income against which such losses can be set. Loss refunds generally are not permitted. Accordingly, in the early years of an infrastructure project typically with very large up-front capital and financing costs, income tax losses are incurred that cannot be set against other taxable income. Loss crystallisation is deferred, possibly for many years and at declining present value levels.

The most direct method of addressing this distortion in the income tax system would be to provide a loss offset measure. The most appropriate type of measure would need to be considered in more detail. Two possible options that are direct and provide simplicity and transparency could involve allowing full and immediate claiming of income losses via refunds, or a voucher system, set at the level of the approved maximum cost to taxation revenue, with funds paid direct to the eligible infrastructure borrower.[51]

9.3 Taxes on entities and their distributions

Partnerships, trusts and companies

Where income is derived by legal entities other than individuals, tax may be imposed on the entity rather than, or in addition to, its beneficial owners. The tax system provides a range of quite different tax treatments for different entities. The main differences relate to whether:

- **tax is levied on the taxable income of the entity. In Australia, this applies to companies and in special circumstances certain trusts, but not to most trusts or partnerships;**
- **tax preferences can pass through to beneficial owners. In Australia, this is possible for partnerships (including joint ventures) and most trusts (other than the few directly paying tax), but not companies. Any income that has not borne tax at the company level due to a tax preference will be taxed at the shareholder level if paid as a dividend, effectively cancelling the concession; and**
- **tax losses can pass through to offset the taxable income of beneficial owners, or must be carried forward by the entity to offset future entity income. In Australia, partnerships pass through their losses but not trusts or companies which must carry them forward within the entity.**

As this listing shows, tax preferences and tax losses are trapped inside companies, but tax preferences flow through in trust distributions and both losses and preferences flow through in allocations of partnership income.

Where preferences or losses are trapped at the entity level, they must be carried forward in the hope that they can be offset against entity taxable income in future years. Since the resulting tax benefit is deferred (and may be lost if the entity fails to generate sufficient future net income or undergoes a mojority ownership change) it loses value. The result is higher tax revenue but higher effective tax rates for those affected. This creates a bias against riskier and long-term investment where losses are more likely in earlier years and breaches both horizontal equity and economic efficiency principles.[52]

It is sometimes argued in response that these features offset other weaknesses in tax rules. This is a very weak argument since the effect of restricting access to preferences and losses varies between taxpayers depending on their circumstances. Many taxpayers can fully utilise the losses and preferences denied or deferred for others. The only real case for current arrangements is thus revenue-based.

Some of the impact of the restrictive company treatment has been alleviated by the 'tax consolidation' arrangements – these effectively allow a free flow of preferences and losses among companies within a group, but still none may pass to shareholders.

These differences in treatment often provoke attempts to circumvent them:

- **Some financial products, mainly leasing and its equivalents, can effectively allow tax preference to be used by third parties.**

- **Some businesses, particularly those prone to generate early year tax losses, have sought to establish themselves as trusts or partnerships rather than companies.**
- **Some industries have sought specific tax concessions to allow preferences or losses to be passed from companies to their shareholders, for example oil exploration companies.**

These various attempts complicate the operation of tax laws and many have provoked complex anti-avoidance provisions. For example, some trusts and partnerships have been subject to company treatment and some financial arrangements subject to burdensome risk tests.

An attempt was made in recent times to reduce the differences in tax treatment by treating most trusts in the same way as companies. This would not have dealt with the main breaches of tax principles associated with the different treatments of entities, and the proposal was not proceeded with.

Dividends and imputation

Because companies pay tax at the entity level, the issue arises as to what tax consequences should arise when dividends are paid to shareholders.

In theory there are several options:

- **Dividends could be tax-free (or taxed at a low rate, perhaps on a final withholding basis). This would be very simple and would clearly encourage investment but would remove company income from participation in the progressive tax system.**
- **Dividends could be fully taxed to shareholders without any relief for company tax paid. This is the 'classical' system, which means that company income distributed to shareholders bears tax twice (usually at a high combined rate).**
- **Dividends could be taxed to shareholders but credits provided for some or all tax already paid at the company level. This is the imputation system. The result is that, for resident companies and shareholders, distributed company income is taxed at shareholder tax rates, whether or not it was taxable income in the hands of the company.**
- **Dividend payments could be tax deductible for companies in the same way that interest payments are deductible. This system treats debt and equity similarly and has a similar effect on tax rates as dividend imputation for resident shareholders. It has not been adopted internationally as the effect for foreign owned companies is to transfer the main taxing point from source to residence (that is, Australia would lose company tax but due to existing tax treaties would recover little of it in dividend withholding tax).**
- **Companies could be taxed like trusts or partnerships, so that all company income is allocated to shareholders for taxation. This has not been adopted anywhere (except for some small companies). It conflicts with the strategies of most companies to retain rather than distribute at least some income. It is probably complex. It also conflicts too fundamentally with the existing web of international tax treaties.**

Australia and many other countries originally adopted the classical system (which in much earlier times caused little difficulty as all income tax rates were very low). As tax rates increased, the unsustainability of double taxation eventually led Australia in 1987 to follow the imputation model already common in Europe. Unlike most European systems, Australia (and New Zealand) adopted full imputation, giving 100 per cent rather than partial credit for company tax paid.

The United States was long a stand-out exception in maintaining the classical system. This led to major innovation in United States company distributions, which more often took the form of share buybacks and capital returns, to avoid the resulting double tax on dividends. Very recently the US has adopted a variant of the first option listed above – a lower rate of tax on dividends. Some developing countries have also adopted this approach (including full exemption).

The world now stands divided between the imputation and low (or no) dividend taxation options. The fundamental differences between these are:

- **Simplicity versus equity – the low tax option is much simpler but results in less progressive taxation of distributed income than the imputation system.**
- **Overall tax rate – for distributions of taxable company income, imputation provides more tax relief than even a low-rate double tax.**
- **Treatment of tax preferences and foreign source income – domestic tax imputation taxes this income at a higher rate than does the low-rate option. As a result, the low-tax rate dividend option has a lower bias against tax preferred and foreign sourced (and taxed) income than the imputation system. It is possible, of course, to modify either system to alleviate this result if desired including simply extending the current imputation system to include foreign source income.**

The choice between these options is a choice between the competing tax objectives. How that choice is to be made may depend in part on tax principles, but also importantly on the extent of tax competition being driven by systems abroad.

A key issue is the neutrality of treatment of income that is taxed at the company level by foreign jurisdictions.

Capital gains and imputation

Capital gains tax and dividend imputation were introduced in Australia at much the same time (in the mid-1980s). The interaction between these two arrangements affects the incentives for companies to either pay dividends or retain earnings.

Where taxable company income is distributed, full imputation works to apply the shareholder income tax rate to it. This rate could be zero for a shareholder with total income below the tax threshold, 15 per cent for superannuation funds, or the relevant marginal tax rate for other individual shareholders.

TABLE 9.2
TAXATION OF CAPITAL GAINS: SOME INTERNATIONAL COMPARISONS

	Capital gains tax liability	
Jurisdiction	**Individuals**	**Corporates**
Canada	50% general exemption Top federal income tax rate is 29% in 2004	50% general exemption Top federal income tax rate is 22% with surtax in 2004
France	16% tax rate for assets held for 2 years or more	Currently 19% but moving to general exemption (by 2007) for participating shareholding (15% or more)
Germany	EUR 512 annual exemption 50% exemption from tax for shares General exemption for immovable property held for 10 years or more Top income tax is 45% in 2004	Generally a 95% exemption for most shares Top federal income tax rate is 26% including surcharge in 2004
Ireland	EUR 1,270 annual gain is tax-free 20% rate on ordinary gains	Substantial shareholding (10% or more and EUR 50m or 5% or more and EUR 5m) are exempt (EU and DTA countries) 20% rate on ordinary gains
Netherlands	Generally exempt	Substantial shareholding (5% or more) is exempt
United Kingdom	GBP 8,000 annual gain is tax-free Only portion of gain in business is taxable (ranging from 0 years 100% to 2 years 25%). For non-business assets the range is 0 years 100% to 6 years 80%) Top rate is 40% in 2004	Substantial shareholding (10% or more) for trading companies is exempt (including offshore assets) Corporate rate is 30% in 2004
United States	Where assets held for 12 months or more tax rate is 15% Where individual in the 10% and 15% income tax bracket, maximum capital gains tax is 5% (and 0% in the future)	Substantial shareholding (80% or more) for incorporation, liquidation and reorganisation transactions is exempt (deferred) until the time that the stock or assets received in the transaction is disposed of

Note: each jurisdiction has special rules/exemptions for primary residence and small business shareholdings. Each jurisdiction also offers 'roll-over' relief, and preferred capital gains tax treatment for collective investment vehicles and regulated saving schemes. NZ, Singapore and Hong Kong have no capital gains tax on either individuals or corporates.

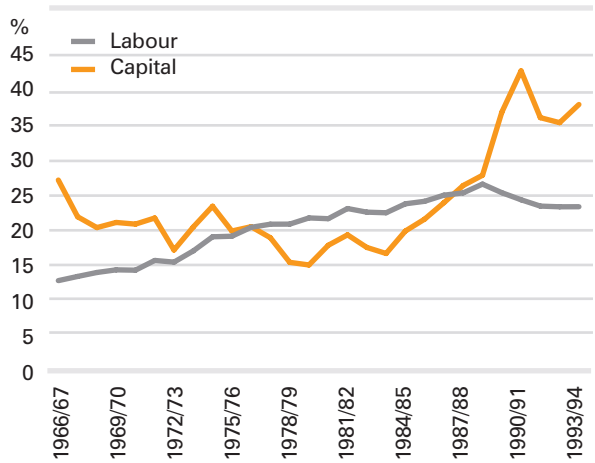
Source: KPMG, adapted from KPMG European Tax Handbook, International Bureau of Fiscal Documentation (2004).

Where company income is retained, it is taxed in the first instance at the company tax rate. In addition, the retained earnings increase the net assets of the company and (subject to many other variables affecting share prices) reflect in the value of the company's shares. If the shareholder sells these shares, the original capital gains tax would effectively apply the shareholder marginal tax rate to the gain without credit for the underlying company tax already paid. Ironically then, the mid-1980s tax reforms removed the double taxation of distributed company income but introduced double taxation of retained company income. This double tax, of course, applied only when shares were sold.

Following the Review of Business Taxation in 1999, the capital gains tax was halved for individuals and reduced from 15 to 10 per cent for superannuation funds. It is interesting to reflect that this effectively applies to company retained earnings the 'low-tax rate' approach to taxing company income in the hands of shareholders.

As a result, Australia now uses two approaches to deal with the double tax problem arising from taxing both companies and their shareholders. It has a European-style imputation system for distributed company income and a US-style tax rate concession for retained income.

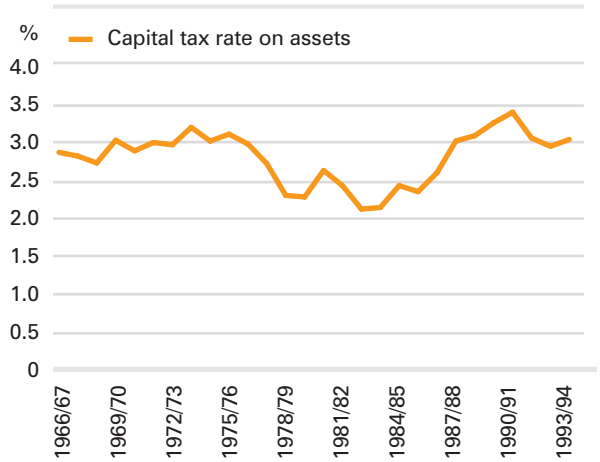
FIGURE 9.1
LABOUR AND CAPITAL TAX RATES, 1967–94



Source: Adapted from data provided by Diewert, W.E. and Lawrence, D.A., and figure in their report, 'The Deadweight Costs of Capital Taxation in Australia', Discussion Paper No: 98–01, Department of Economics, University of British Columbia, Canada, Figure 3 (1998).

As capital is a vital ingredient in production, how it is taxed relative to Australia's competitors is important. In Australia, capital gains derived by companies are taxed in full. For individuals, half of the gain is assessable. Overseas, there is a great diversity of treatments but very few countries tax capital gains in full and many provide substantial exemptions or highly concessional rates, see Table 9.2.

FIGURE 9.2
CAPITAL TAX RATES ON ASSETS, 1967–94



Source: Adapted from data provided by Diewert, W.E. and Lawrence, D.A., and figure in their report 'The Deadweight Costs of Capital Taxation in Australia', Discussion Paper No: 98–01, Department of Economics, University of British Columbia, Canada, Figure 4, (1998).

Despite changes in detail, the rates of tax on capital and on labour have changed little in Australia over the past decade. It is important to recognise, however, that these levels of taxation have undergone a long period of trend increase over previous decades.

Research by Diewert and Lawrence (1998) on the deadweight costs of taxing income from capital in Australia indicates that the rates of tax that Australia applied to both income from labour and capital increased over the period 1967 to 1994 (see Figure 9.1).

In order to obtain a more accurate estimate of the tax rates on capital, Diewert and Lawrence estimated capital tax payments relative to the value of assets since it is this tax rate that drives investment decisions. Once again, this increased steadily from 1983 to 1994 (see Figure 9.2).

As noted by Diewert and Lawrence, changes to the Australian tax system between the mid-1980s and mid-1990s fell relatively heavily on capital, establishing the higher base that persists today. In the decade to 1994:

- **the capital tax rate on assets increased sharply to around 3 per cent per annum; and**
- **this increase in the overall rate of capital tax can be attributed to the introduction of capital gains taxes, increasing reliance on transactions taxes and the progressive tightening of exemptions from the tax base.**

Despite reductions in the statutory marginal tax rate applying to income from capital gains, the effective rate of tax imposed on capital gains is still high, particularly for individuals, and differs depending on the entity through which those capital gains are earned.[53]

9.4 Conclusions

The reduction in the statutory company tax rate in Australia to 30 per cent means that Australia currently has a broadly comparable company tax rate with many of its current largest competitors but Australia's company tax rate is significantly higher than the rate in some regional competitor nations.

Australia has a very high tax take from business income (tax to GDP). Australia's productivity and long-term prosperity would be assisted by less revenue reliance on business income. This could be addressed through lowering the statutory rate still further or as an interim step looking to ensure that the business taxation system is as competitive as possible.

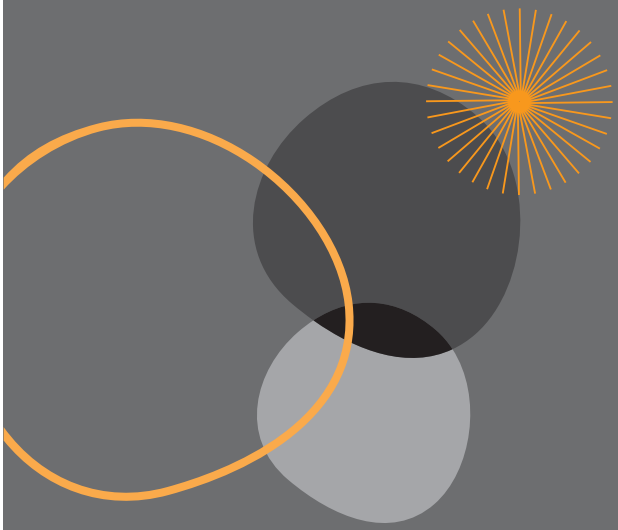
Given the importance of investment for productivity, particularly in areas such as long-term infrastructure or high-risk projects, measures that both improve the competitiveness of the business taxation system and remove current barriers and distortions to investment should be considered.

Compared to many foreign competitors and in the context of highly favourable treatment of some low-risk and geared investment classes, Australia's tax system is not sufficiently favourable to higher-risk business investment. More favourable treatment of capital expenditures and further capital gains tax relief would reduce this bias.

A wide range of uncertainties, complexities and anomalies (such as deduction black holes) in the business tax base combine with a relatively unfavourable treatment of tangible investment to continue to reduce Australia's competitiveness.

Chapter 10

International Taxation Arrangements



This chapter provides a discussion of the main features of Australia's international tax arrangements. International arrangements are increasingly important as the Australian economy is increasingly engaged in the international economy. In particular, these arrangements can considerably affect Australia's attractiveness as a base for foreign investment, as a destination for foreign investment and as a location for internationally mobile highly skilled workers.

10.1 Overview of the international tax system

Australia levies tax both on the foreign-sourced income of its own residents and on the Australian-sourced income of non-residents. This approach is common to many though not all other countries. The result of these systems is that any income of the resident of one country that is sourced in another country may be taxed twice.

Some relief from the burden of this double taxation (though often not from the double compliance and administration burdens) is often contained within the tax law, as it is in Australia. It is also common for countries to enter into bilateral tax treaties to mutually agree to provide further relief, and Australia also has a considerable network of these.

It is perhaps something of a mystery that there has been no serious attempt to develop a multilateral international tax treaty, akin to the World Trade Agreement, that might simplify and expedite these processes. The best that has been managed is the production of 'model' bilateral treaties, although there is more than one of these and they are inconsistent. As it is, bilateral tax treaties are often out of date; slow and costly to renegotiate; differ considerably from one case to another; and so multiply the costs and complexities of international business considerably. However, they are usually better than no treaty.

Recently, Australia has begun to make more concerted efforts to negotiate more and better tax treaties, and such efforts have improved things to some degree.

Generally, the overall scheme of these arrangements is to attempt to prevent tax biases favouring or penalising international dealings. The taxing rights of source countries are usually accepted and residence countries provide credits for source tax payments (or sometimes full exemption) to prevent double taxation.

If these arrangements to relieve international double taxation worked well, they would present resident investors with a tax-neutral choice between local or foreign investment. The same tax would be paid whether the investment is made at home or abroad. However, in practice, the tax paid on an investment in a country varies depending on the residence of the investor. Two identical investments in a foreign country can bear different total taxes. If the investors are competitors (say, each seeking to establish a business in the foreign country), one will be disadvantaged relative to the other. Tax neutrality in the country of residence (investment source) can come at the expense of tax non-neutrality in the country of investment destination.

The fact that, in practice, tax systems breach these general principles anyway imposes a further impediment to the international flow of investment.

The following sections provide further discussion separately for the arrangements for foreign and domestic investors, and income taxes on non-residents.

Some countries have sought competitive advantage by offering themselves as tax havens. Many countries including Australia seek to address this threat in their own laws. However, if tax haven status is combined with secrecy laws it can be very difficult to apply domestic laws effectively. Australia has been participating in an OECD initiative attempting to overcome this problem.

Over the past 20 years, Australia has introduced much more comprehensive and complex international tax arrangements. It has been among the relatively few countries to develop complex provisions in its primary tax laws designed to tax investments that benefit from major tax concessions in foreign jurisdictions. These rules generally apply to passive rather than active businesses, but can impose considerable compliance costs on both forms of investment.

10.2 Taxes on foreign source income

A simple approach to the taxation of foreign source income is to exempt it if it bears tax in the foreign country. This system broadly applied in Australia until the mid-1980s and still applies in many countries abroad.

Now, however, Australia seeks to reduce the scope for international double taxation of income through a complex foreign tax credit system. In addition, Australia has sought to reinforce the integrity of its tax system through the introduction of an accruals tax regime that applies Australian tax to certain income accruing in overseas entities where it has not been subject to tax comparable with that in Australia. This regime is comprehensive, applying detailed rules to controlled foreign corporations, overseas passive income funds and overseas trusts holding assets from a resident transferor.

These arrangements are very complex and a detailed exposition is well beyond the scope of this paper. The fundamental issue that arises is that Australia has one of the more complicated and comprehensive tax arrangements for foreign source income and simpler arrangements in many other countries make those competitors more attractive places to base international investment. Given that headquarter activities are among the highest value activities in the international economy, it is to Australia's advantage to provide an attractive tax environment for such investment.

A Review of International Taxation was undertaken by the Board of Taxation and Treasury in 2002 and 2003. This has led to some useful simplifications and improvements in the tax arrangements applying to foreign source income, particularly in the accruals regime.

Despite these reforms, however, Australian shareholders still face high and disparate effective rates of Australian tax and total tax (i.e. Australian tax plus foreign tax) on the dividend income they earn from their offshore investments as a result of the complex interaction of Australia's dividend imputation and foreign tax credit regimes with the tax regimes of other jurisdictions.

In particular, as outlined in Table 10.1:

- **There is currently a tax bias against offshore income. The range of effective total worldwide tax rates for Australian resident investors in a number of key investment countries ranges from 57.5 per cent (Hong Kong) to 66.5 per cent (United States). This is a very high tax cost for typically high-risk business income.**

- **There is currently a tax bias against investment offshore through Australian multinational companies with offshore investments. Individuals and superannuation funds can face higher effective tax rates on their dividend income if they invest offshore through Australian multinational companies, than if they invest offshore directly. That is, Australia's dividend imputation and foreign tax credit regimes create an unintended tax bias against investing in Australian multinational companies.**
- **There is currently a tax bias in favour of investment through Australian superannuation funds. Individuals who invest in Australian or foreign companies directly face higher effective tax rates than if they invest in those companies through a superannuation fund. This bias is intended to reduce the disincentive to save and invest for retirement. In so doing, however, it also unintentionally distorts the pattern of investment and the choice of entity through which to make that investment.**

In the short term, the Government needs to assign a high priority to reducing these investment distortions by:

- **reducing the top personal tax rates; and**
- **implementing the Board of Taxation's recommendation to provide a 20 per cent tax credit to shareholders on unfranked dividends paid out of foreign source income.**

Once these high-priority reforms have been implemented, the Government also needs to consider conducting a much more comprehensive review and reform of the manner in which Australia taxes the foreign source income of its residents in order to significantly simplify the current regime.

TABLE 10.1
EFFECTIVE TAX RATES FOR INVESTMENT IN SELECTED COUNTRIES

Type of investment and investor	Effective tax rates on dividend income from investments in:								
	Australia	US	UK	NZ	HK	Singapore	Japan	Netherlands	France
Direct investment by:									
Individuals:									
- effective rate of total tax	48.5%	66.5%	64.0%	65.5%	57.5%	59.8%	64.0%	66.3%	65.6%
- effective rate of Australian tax	48.5%	28.3%	34.0%	22.4%	40.0%	37.8%	23.5%	21.9%	22.3%
Super funds:									
- effective rate of total tax	15.0%	44.8%	40.5%	43.1%	29.9%	33.7%	40.5%	44.3%	43.3%
- effective rate of Australian tax	15.0%	6.5%	10.5%	0.0%	12.4%	11.7%	0.0%	0.0%	0.0%
Indirect investment through and Australian company by:									
Individuals:									
- effective rate of total tax	48.5%	68.2%	64.0%	65.5%	57.5%	59.8%	69.4%	71.3%	70.8%
- effective rate of Australian tax	48.5%	29.9%	34.0%	32.5%	40.0%	37.8%	28.9%	27.0%	27.5%
Super funds:									
- effective rate of total tax	15.0%	47.5%	40.5%	43.1%	29.9%	33.7%	49.4%	52.7%	51.8%
- effective rate of Australian tax	15.0%	9.3%	10.5%	10.1%	12.4%	11.7%	8.9%	8.4%	8.5%

Note: It is assumed for the purposes of Table 10.1 that:
- individual shareholders are subject to the top rate of personal tax;
- income from investments in the US through an Australian company is subject to foreign dividend withholding tax at a rate of 5% (i.e. the Australian company is assumed to have more than 10 per cent of voting power, but less than 80 per cent); and
- income from investments in New Zealand (NZ) through an Australian company is subject to the NZ Foreign Investor Tax Credit regime, which reduces the combined NZ company tax and foreign dividend withholding tax payable to 33 per cent.

Source: Ernst & Young.

10.3 Income taxes on non-residents

Australia asserts taxing rights over the income of non-residents that is sourced in Australia. This is consistent with the practices of most other countries.

International tax treaties generally accept this. The usual approach is that home (or income 'destination') countries also tax the foreign source income of their residents but give credit (or other relief) for taxes imposed by the source country. The purpose of international tax treaties is largely to negotiate how the overall tax burden is to be shared between source and destination countries (while ensuring that overall double taxation is avoided).

However, the implications of taxing non-residents depend on the economic incidence of those taxes, and in turn economic incidence depends on the way international markets and foreign tax jurisdictions operate. Few if any issues would arise if every country had a similar tax system, but this is not the case.

Taxes on non-residents can affect the flow of capital to Australia. Evidence in many overseas studies shows that international investment flows respond strongly to tax wedges.

Australian taxes would have virtually no impact on after-tax returns to non-resident investors if those taxes could be fully credited by the non-resident investor against their home country tax liabilities. If, however, Australian taxes increase the overall tax payable on income from capital by the non-resident investor, it is highly likely that the economic incidence of that tax will shift from the non-resident investor back to Australia.

The operation of the global market for capital was outlined in Chapter 2. Australia is a small economy relative to the global markets in which foreign capital is supplied. It is likely therefore that it cannot influence the fundamental drivers of the international price of that capital.

For Australia, which has historically relied very heavily on a large and regular flow of foreign capital, and still does, the meaning of this is reasonably clear. Any additional tax imposed on foreign capital (that is, tax that is not offset by credits or other relief abroad) will be borne in Australia instead of abroad. The incidence of the tax will shift to the factors of production in Australia. The only exceptions to this will arise to the limited extent that Australia can establish itself as a premium location for foreign investment relative to other competing countries.

Some further detail is now provided on the taxes currently applying to non-residents on the main types of capital income.

Interest

Most of the foreign capital invested in Australia takes the form of debt, and most of that is intermediated by the banking system. Net foreign debt exceeds $400 billion. Most of the interest payable on that debt is exempt from Australian tax under a range of provisions.

Unless exempted, interest paid to non-residents is subject to interest withholding tax – set at 30 per cent in the tax law but usually reduced to 10 per cent or less in Australia's network of bilateral tax treaties. But total interest withholding tax revenue is usually less than $1 billion per annum.

Since Australia is a small country relative to international financial markets, it has no influence on the international price of captial. Accordingly, Australian borrowers must bear the cost of any additional tax imposed on interest paid to non-resident lenders (through higher interest rates). Any such tax increases the cost of capital in Australia, and so at the margin reduces investment.

This explains why so much interest paid to non-residents is exempt from tax. The goal of policy is to impose interest withholding tax only when it results in no increase in tax paid by foreign lenders, a result that arises only when Australian tax is offset by tax credits granted by foreign jurisdictions. In those cases, the Australian tax is not an additional tax on foreign lenders but instead represents a sharing of tax revenues with a foreign tax authority.

For many years Australia has successfully accessed foreign debt markets. Exemptions from interest withholding tax have been extended when evidence emerged that it was affecting the cost of borrowing in particular markets – for example exemption was extended to the US public market in the mid-1980s to match the position already granted to the European bearer market.

All that is required is that market developments continue to be monitored to ensure that exemptions are extended whenever circumstances arise making the Australian tax non-creditable abroad.

Dividends

Foreign investors hold approximately one-third by value of all the shares issued by companies incorporated in Australia (including Australian subsidiaries of foreign companies). Dividends paid by Australian companies to those non-residents are subject to dividend withholding tax (DWT) of 30 per cent, but international treaties typically reduce this substantially. However, DWT is zero for any dividend franked under the imputation system (that is, dividends paid from company income that has been fully taxed in Australia) and for dividends paid from income sourced in a foreign jurisdiction. As a result the DWT collects only a few hundred million dollars annually.

Since DWT is often granted a tax credit in home countries, it has not represented a significant impediment to foreign investment in Australia. While it may seem little more than a nuisance given its minor yield, it has the secondary purpose of representing a point of negotiation in international tax treaty discussions.

Payments for intellectual property

The tax considerations applying to interest are similar to those applying to withholding taxes on royalties for intellectual property. The incidence of the tax will depend on the availability of credits. The recent renegotiation of tax treaties with the US and UK, two important sources of intellectual property, has updated arrangements for this income class.

10.4 Labour income: international experience

As outlined in Part One, globally there has been extensive reform which has reduced barriers to international trade in goods and services, removed constraints on foreign investment and relaxed immigration controls. This has resulted not only in an unprecedented increase in the international mobility of not only goods and services, financial and physical capital, but also human capital.

As a result, many countries have been focusing on redesigning their tax systems so that they are able to take advantage of the emergence of a global employment market and the increasing supply of internationally mobile, highly skilled labour.

In the past, most foreigners who entered a country did so either to:

- **spend a short time either on business or holiday; or**
- **take up permanent residence.**

This helps explain the reason why the tax regimes of most countries tended to treat:

- **individuals entering the country for relatively short periods of time as non-residents for tax purposes; and**
- **individuals entering the county for longer periods of time as residents for tax purposes. It was reasonable to assume that those individuals were taking up permanent residence, and should be treated for tax purposes in the same manner as other residents.**

More recently, however, an increasing number of individuals have been working in other countries for much longer periods of time – periods long enough for them to be considered to be residents for tax purposes. As a result, temporary residents have found themselves being treated for tax purposes in the same way as permanent residents, even though they have no intention of taking up residence, and their visas require them to leave the country.

Many countries have recognised this problem and have been amending their tax systems in an attempt to reduce the tax bias against temporary residents.

Typically, these amendments involve two main types of changes.

First, a distinction has been drawn between permanent residents, who have entered the country with the intention of taking up permanent residence, and temporary residents, who have entered the country with the intention of subsequently leaving at a later date.

Second, temporary residents have been given an exemption from tax on certain forms of income. The type of income that is exempt from tax tends to vary across countries. For example, some countries:

- **exempt all of the foreign source income of temporary residents from tax. That is, they continue to treat the temporary resident as a non-resident for tax purposes by exempting from tax any income arising from their offshore activities (e.g. Belgium);**
- **exempt the foreign source income of temporary residents from tax as long as it is not remitted to them while they are working in the country (e.g. UK, Hong Kong and Singapore. Similarly, Japan limits the taxation of its temporary residents to the greater of their Japanese source income or the total income remitted to Japan); and**
- **exempt a specified proportion of the income of temporary residents from tax (e.g. Sweden, the Netherlands and France).**

10.5 Labour income: Australian experience

Unlike the countries outlined above which have introduced special tax concessions for temporary residents, Australia continues to tax its temporary residents as if they were permanent residents. That is, temporary residents of Australia are taxable not only on the income they earn in Australia, but they are also taxable on the income they earn from their foreign investments while they are in Australia.

As a result, individuals who come to work temporarily in Australia for extended periods of time can face quite high and different effective rates of Australian tax. They must pay Australian tax not only on the wages they earn from their employment in Australia, but also on any income they earn from their foreign investments in Australia. The amount of additional tax they pay therefore increases as their income from offshore investments increases.

This taxation of the foreign source income of temporary residents tends to reduce the after-tax income that these individuals derive from their employment in Australia. In other words, it increases the effective tax rate that Australia imposes on their Australian employment income.

This tends to:

- **deter individuals from coming to work in Australia for extended periods. In particular, it discourages highly skilled individuals who have significant foreign investments from coming to work in Australia for periods of time in excess of six months;**
- **distort the types of individuals who come to work in Australia for extended periods. In particular, it tends to discourage older, more highly skilled individuals, who have accumulated significant foreign investments, in favour of younger, less experienced, individuals who have little of no foreign source income; and**
- **distort the type of work that is done in Australia by temporary residents. In particular, it creates a tax bias against projects that require the skills of older, more experienced individuals who have to spend significant amounts of time in Australia working on the project.**

This current tax treatment of temporary residents imposes significant costs on businesses that employ such workers, many of whom bring key skills that are currently in short supply in Australia. In order to attract such individuals, it is common that the employing business must compensate those individuals for the additional Australian tax levied on their income. The tax, being incident on business rather than the employee, is thus highly inefficient.

Attempts by the Commonwealth Government were recently made to remove the worst of these tax effects but these have been withdrawn following rejection in the Senate.

Although reducing the top marginal tax rate would reduce the effective rates of tax Australia currently imposes on the employment income of temporary residents, it would also be desirable for the Government to reintroduce its proposed reforms to the taxation of temporary residents that were previously rejected on several occasions by the Senate. These reforms remain a key priority for promoting Australia's long-term competitiveness and include:

- **the insertion of a new definition of 'temporary resident' into s. 995-1 of the *Income Tax Assessment Act 1997*;**
- **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;
  - interest withholding tax obligations; and
- **extension of the existing four-year exemption from the Foreign Investment Fund rules for temporary residents.**

The foreign income exemption for temporary residents measure is specifically designed to attract internationally skilled mobile labour to Australia and assist in the promotion of Australia as a business location, by reducing the costs to Australian business of bringing skilled expatriates to work here. In addition, consideration should also be given to a range of additional reforms to ensure that Australia remains an attractive place for temporary residents. These could include measures as discussed in the Review of International Tax Arrangements: Submission to the Board of Taxation, Ernst & Young October 2002 (section 8 pp 87-92):

- **implementing an objective test for inbound residents;**
- **exempting the income that temporary residents derive from foreign workdays; and**
- **reforming the tax treatment of superannuation for temporary residents either by:**
  - 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; or
  - recognising contributions to foreign social security systems as being equivalent to Australian superannuation for the purposes of companies meeting their minimum support obligations and allowing Australian employers to claim deductions for contributions to foreign superannuation plans on account of temporary residents.

Implementing an objective test for inbound residence

The current definition of 'resides' in relation to residents for Australian tax purposes is out of step with Australia's desire to provide a more definitive tax environment. It is inconsistent, providing different outcomes for people coming to and leaving Australia on a temporary basis. Basing a person's tax residency on where their mail is delivered and where they keep their goods is unlikely to be relevant to the type of expatriate that Australia is trying to encourage to come to Australia today. An objective test should be developed based on days of physical presence in Australia. Such a system would be consistent with the treatment adopted by our near neighbours and would provide greater certainty.

Exempting the income that temporary residents derive from foreign workdays

Exempting the income that temporary residents derive from foreign workdays aims to increase Australia's international attractiveness as a home of regional head offices. The current Australian tax rules are out of step with our neighbours such as Hong Kong, Singapore, Thailand and Malaysia, who offer this type of exemption.

Reforming the tax treatment of superannuation for temporary residents

Australia still imposes additional non-recoverable costs on employers and/or temporary resident employers as a result of compulsory superannuation requirements, in terms of:

- **the 30 per cent Australian tax payable on contributions to the fund and the 30 per cent payable on withdrawal of the balance;**
- **the time value of money that may be recovered by agreement from the temporary resident following departure from Australia;**
- **the administrative cost of having the temporary resident join the Australian fund, while maintaining their home country superannuation fund, with the employer seeking to recover the contributions from the employee.**

These issues result from the double coverage of employees under home and host country social security systems.

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. This proposal was outlined in recommendation 22 of the BCA's 'Review of International Tax Arrangements: Submission to the Board of Taxation', October 2002. If a full exemption cannot be achieved, then an alternative is to:

- **recognise contributions to foreign social security systems as being equivalent to Australian superannuation for the purposes of companies meeting their minimum support obligations; and**
- **allow Australian employers to claim deductions for contributions to foreign superannuation plans on account of temporary residents.**

10.6 Trade

International trade presents issues for both indirect taxes and income taxes.

Indirect tax systems can affect relative prices and so adversely affect competitiveness in trade. If indirect taxes are imposed on exports as well as imports, trade is subject to double taxation. The incidence of such taxes depends on market conditions. The GST and other value-added taxes worldwide exempt exports, preventing these effects. However, other indirect taxes add to export costs and can therefore adversely affect trade.

An income tax difficulty arises in deciding where income is derived in international transactions, and hence where it should be taxed. This difficulty is compounded when trade occurs between associated entities so that the price struck may not be at arms length – it may be affected by a desire to minimise tax in one of the jurisdictions. This is known as transfer pricing. It is essential that tax authorities provide fair and timely advance assessments in these circumstances (and mostly do in Australia).

10.7 Conclusions

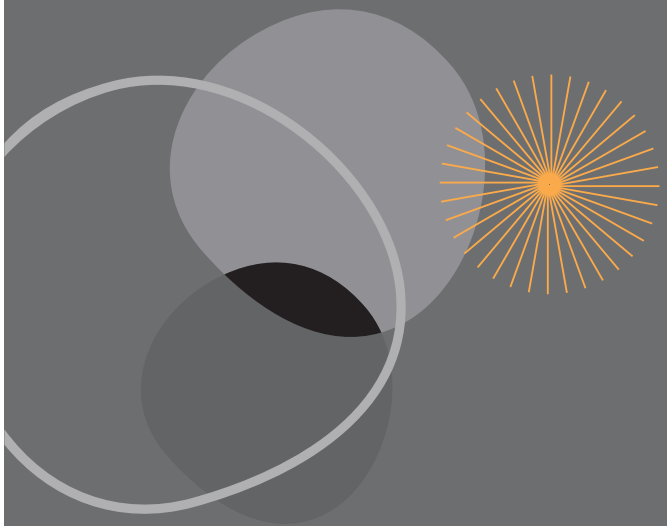
Although recent reforms have brought significant relief, Australia still retains one of the most complex and administratively burdensome tax regimes for foreign source income, damaging Australia's competitiveness as a location for corporate headquarters and capacity for Australian companies to expand offshore.

The taxation of the foreign source income of temporary residents working in Australia is generally incident on employers and represents a direct cost that reduces Australia's competitiveness as location for high-value activities. A range of other features of the tax law applying to temporary non-residents also substantially diminish Australia's competitiveness as a location for such workers, and require reform.

There is currently a bias within the (otherwise effective) dividend imputation system that works against foreign investment by Australian shareholders in Australian companies and hence against the competitiveness of Australian companies.

Chapter 11

Consumption and Other Taxes



11.1 General taxes on consumption

The most important tax reform in recent decades was the introduction in July 2000 of the Goods and Services Tax (GST). The tax was built on the value-added model. This approach eliminates the cascade effect of single stage sales taxes, and hence price distortions, since the GST paid on any business purchase is credited against the GST liability of that business. The disadvantage of the value-added tax is its much higher compliance cost (including the cascading effect of these) as many more transactions are subject to tax and most of the tax levied is allowed as a credit.

In Australia, these costs were increased by setting the GST registration threshold at $50,000 of annual total sales, well below the level in many other countries.

The value-added approach was taken notwithstanding the relatively low tax rate of 10 per cent. For all the controversy caused by tax reform on this scale, the GST collects only about 13 per cent of Australia's nationwide tax revenues.

Exemptions from the tax base were initially based mainly on pragmatic considerations (such as the difficulty in taxing financial margins and services such as health and education supplied largely free of charge). However, political compromises imposed by the Senate resulted in some further narrowing of the base, in particular excluding many food items. This further complicated the tax for little gain in vertical equity.

The GST principally replaced other indirect taxes, notably the wholesale sales tax and financial institutions duty. The net increase in indirect taxation was marginal and as a result little changed the overall income tax burden in Australia. The small net effect was offset by income tax cuts and compensatory increases in pensions and other benefit payments. For political reasons, several of the transfer payments exceeded the required compensation.

The main benefits of the new arrangements were twofold:

- **the tax is economically more efficient than the arrangements it replaced (involving less distortion of relative prices); and**
- **the base is more robust to changes in the pattern of consumption than its alternatives.**

Against these benefits, the GST has considerably higher collection and compliance costs than the previous narrower tax bases.

The GST revenues are now linked to the funding of the general-purpose grants for the States, replacing the previous grants program. The main benefit of this innovation was the negotiation of the abolition of some economically inefficient State transaction taxes. The main disadvantage arises in the effect on incentives for the States to reform their public programs. Since the GST pool is providing larger transfers than the arrangements that it replaced, in effect it may relieve reform pressures on the States.

The Commonwealth Government has made a commitment that the 10 per cent tax rate is not to change. However, while this commitment has direct benefits it also carries a potential cost. With the GST administration and compliance structure established, and with the value-added model eliminating price distortions, any increase in the rate represents an opportunity to raise revenues with negligible economic and compliance costs. On the other hand, many other tax arrangements with high social, economic or compliance costs have been retained. Overturning the rate limit presents at least a potential opportunity for future reforms that could bring economic gains.

Three other directions for GST reform may also be possible.

First, future improvements in Commonwealth–State financial arrangements may require a change in the basis for general-purpose funding of the States.

Second, it may be possible to revisit the GST tax base in some areas. Although some technical problems would need to be solved, the financial system is subject to hybrid arrangements that may be capable of improvement. In addition, the concessional exemptions in the tax base could be reconsidered in the context of wider reforms.

Finally, there is likely to be scope to reduce the administrative and compliance costs of the GST. The GST is a relatively expensive tax to collect. In 2003–04, it accounted for 25 per cent of the total recurrent costs of the ATO but only about 16 per cent of ATO revenue collections. The overall compliance cost for business is not known but is likely also to be relatively high. One reason for this is that the value-added concept generates multiple tax reporting and payment transactions through the production chain. Most of the gross tax liability is subsequently credited or even refunded. Net tax revenue is only a small fraction of the total assessed liability. In effect, each dollar ultimately collected has been subject to several rounds of compliance work.

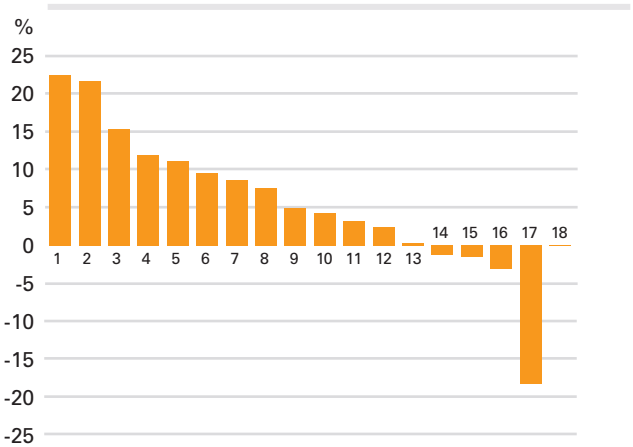
This multiple handling has been justified on the basis of compliance benefits, but the philosophy underlying this approach was developed many decades ago in an era before computers were readily available. With advanced electronic record-keeping and communications, there may be scope to significantly reduce costs in a range of ways. The following represent illustrative examples:

- **Consideration could be given to payment and reporting exemptions for business-to-business transactions for those taxpayers or transactions meeting required standards of record keeping and tax compliance (a precedent for this type of exemption was included in the former prescribed payments system).**
- **A substantially higher GST registration threshold may be possible, without revenue cost, for small entities engaged wholly in business-to-business transactions. Many thousands of small entities engage in the GST system exclusively as contractors to businesses and exempt entities. While some of these may want to register for GST to obtain credits on purchases, many more have only minor purchases, and GST compliance costs could well exceed the value of credits.**

Net GST collections by industry are shown in Figure 11.1 below. Since the introduction of the GST, around 60 per cent of GST collections have been derived from the wholesale, property and business services, and manufacturing industries.[54] Negative collections in industry groups such as Government administration and health and education reflect their GST-free status. That is, entities in these groups are likely to be in a 'net refund' position, with input tax credits (GST on inputs) greater than GST collected (GST on outputs).

GST revenue accruing to the States has increased considerably since 2000–01, and significantly above expectations. From 2004–05, all States and Territories are better off under the new financial arrangements than they would have been if previous arrangements had continued. The figures released by the Commonwealth Treasurer following the 2004 Pre-Election Economic and Fiscal Outlook suggest average annual growth in GST revenue of around 10 per cent per year, with GST revenue to the States as a whole 45 per cent higher than the amount in 2000–01 (providing a cumulative GST 'windfall' of $11.8 billion). Tables 11.1 to 11.3 show the growth in GST revenue, distribution among States, and the size of the GST 'windfall' over previous arrangements.

FIGURE 11.1
NET GST COLLECTIONS BY INDUSTRY, 2002–03



1 Property & business services
2 Wholesale
3 Manufacturing
4 Finance & insurance
5 Retail
6 Construction
7 Communication
8 Personal & other services
9 Accom., cafes & restaurants
10 Transport & storage
11 Cultural & rec. services
12 Electricity, gas & water supply
13 Agriculture, forestry & fishing
14 Education
15 Health & community services
16 Mining
17 Govt. admin. & defence
18 Other

Source: Australian Taxation Office, Taxation Statistics 2001–02 (published 2004).

TABLE 11.1
GST REVENUE TO THE STATES (CASH) (ESTIMATED)

	2000-01	2001-02	2002-03	2003-04	2004-05 (est)	Increase from 2000-01 to 2004-05	Increase	Average annual increase
	$m	$m	$m	$m	$m	$m	%	%
NSW	7,258	8,132	9,080	9,691	9,870	2,613	36%	8%
Vic	5,099	5,593	6,365	6,974	7,321	2,222	44%	10%
QLD	4,658	5,019	5,888	6,575	7,314	2,656	57%	12%
WA	2,375	2,518	2,910	3,160	3,613	1,239	52%	11%
SA	2,279	2,477	2,859	3,154	3,282	1,003	44%	10%
Tas	988	1,060	1,247	1,399	1,434	446	45%	10%
ACT	473	544	616	661	677	204	43%	9%
NT	1,226	1,290	1,515	1,684	1,712	486	40%	9%
Total	**24,355**	**26,632**	**30,479**	**33,297**	**35,223**	**10,868**	**45%**	**10%**

Source: Commonwealth Treasury, quoted in Access Economics, 2004, 'Axing the Alcabala: A Program for a 21st Century State Tax System', report by Access Economics for the Business Coalition for Tax Reform November 2004, p.23.

TABLE 11.2
GST REVENUE 'WINDFALL' TO THE STATES OVER PREVIOUS ENTITLEMENTS (ESTIMATED) ($m)

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	Cumulative gain to 2007–08
NSW			270	244	541	908	1,963
Vic		127	360	291	505	794	2,077
QLD	76	504	797	590	787	1,035	3,792
WA		157	286	228	319	458	1,448
SA		99	183	160	234	319	995
Tas		70	107	94	124	150	545
ACT		39	57	52	66	89	303
NT	0	112	139	131	142	150	682
Total	86	1,106	2,199	1,790	2,718	3,904	11,802

Note: Totals may not add due to rounding.
Source: Commonwealth Treasury and Treasurer's press release 2004/083

11.2 Specific taxes on goods and services

The major specific taxes on goods and services in Australia are set out in Table 11.3.

TABLE 11.3
INDIRECT TAXES COLLECTED BY THE COMMONWEALTH GOVERNMENT
Australian Government Revenue (2004-05 MYEFO)

	estimate **2004-05**	
	$m	**% of total revenue**
Taxation revenue		
Income Tax		
Total individuals and other withholding tax	105,060	
Companies (including PRRT)	42,430	
Superannuation funds	6,710	
Fringe benefits tax	3,020	
Total income tax	**157,220**	**70**
Indirect tax		
Excise duty		
Petroleum and other fuel products	13,400	
Other excise	8,250	
Customs duty	5,714	
GST[55]	36,040	
Other indirect tax revenue	1,140	
Total indirect tax	**64,544**	**29**
Agricultural and other taxes	1,898	
Total tax revenue	**223,662**	**100**

Source: Adapted from 2004–05 Mid-Year Economic and Fiscal Outlook.

Specific indirect taxes result in higher tax rates on some goods and services relative to a broadly based consumption tax and are levied in virtually all countries. They may be justified on a number of grounds.

As well as raising revenue, specific indirect taxes may:

- **ensure the social costs arising from consumption or use of a product are borne (or paid for) by those using that product – this rationale is often applied to excises on tobacco, alcohol, fuel and gambling taxes all of which involve activities with social costs;**
- **attempt to change consumer behaviour in a way that reduces the use of the product causing the social cost (for example the tobacco tax is now very high and seeks to discourage use);**
- **in some other cases, the higher rate of tax may be applied because the use of the good or service is inelastic (relatively unresponsive to tax rates). This has sometimes been argued for fuel taxes (ironically in earlier times this rationale was also used to support tobacco taxation whereas responsiveness to the tax is now an explicit aim); and**
- **in rare cases the specific tax has a distributional purpose (such as the luxury car tax). It is often difficult to find goods or services that reliably target only higher income groups and these taxes can generate complexities and anomalies.**

Fuel excises

The largest indirect tax is excise imposed on fuels. Fuel taxes were the subject of a comprehensive review in 2002–03, and the Government took decisions to gradually introduce more neutral arrangements over the next decade. In particular, these arrangements will reduce concessions for fuels produced from certain higher-cost sources. In addition, non-road business uses of fuels will become excise-free. These reforms have long lead times and will not be complete until 2012.

The rationale for fuel taxes includes a de facto road user charge and possibly environmental charge, although rates of tax are not explicitly struck for either purpose, and all revenues are collected for general purposes. To the extent that fuel excises are general revenue taxes, they fail efficiency criteria: they impose higher taxes on fuel-related activities than alternatives and enter into the costs of production with the same cascade effects as the former wholesale sales tax.

Natural resources

The production of many minerals and crude liquid petroleum and gas are subject to royalties, excises and/or resource rent taxes. In each case, the taxes are based mainly on the concept that the community has effective ownership rights to these resources and so shares in the value of their exploitation. The key design issue for natural resource taxes is incentive. Taxes must be struck in a way that maintains adequate incentive for continued exploration and investment in production facilities.

Taxes on 'social bads'

Taxes on alcoholic beverages, tobacco products and gambling are often justified on the basis of the social costs arising from each of these areas of consumption. However, none of these taxes are struck to equate with a measure of social costs. Indeed, within each sector the taxes vary substantially between the different classes of product so that there is little direct relation between the tax rate and the social cost. It is apparent that these taxes are also general revenue taxes imposed at high rates on these goods for other reasons.

Many of these taxes are imposed at very high rates and, perhaps as a result, most of these tax bases are in relative decline.

Inefficient State taxes

The States continue to levy a range of inefficient stamp duties, notwithstanding some were abolished as part of the Commonwealth–State Agreement on tax reform, which saw revenues replaced by the GST. Table 11.4 provides a list of those abolished and still in existence. These include taxes on bank transactions (most scheduled for abolition in 2005), stamp duties on a range of financial instruments, and perhaps worst of all, taxes on insurance (including fire service levies in some States).

Most of these taxes are highly inefficient in economic terms (see Figure 11.2). They represent a direct impost on business transactions, raising costs and distorting choices. Insurance taxes are particularly perverse given the frequency with which Government is expected to provide relief arising from adverse contingencies where insurance is unavailable. Moreover, insurance funds are a form of saving that is already subject to tax bias through the income tax.

The States each set their own payroll tax thresholds and rates – typically at around 6 per cent – but the thresholds exempt most small businesses with only a few employees. Australia is one of very few countries to collect significant revenues from a general revenue payroll tax. It is common for other countries to include a payroll tax as part of social security taxes.

Payroll taxes contribute to the wedge between the cost of labour to the employer and the after-tax income of the employee. The tax wedge (like a tax rate) can be measured either as an average or marginal burden.

In some market conditions the payroll tax may be reflected in the prices charged for goods and services produced and sold by employers. In this case, the tax may directly reduce the competitiveness of Australian producers compared with competitors.

TABLE 11.4
INEFFICIENT STATE TAXES

State and Territory Taxes yet to be removed (as at March 2005)

Tax	Status	Comments
Debits (BAD) Tax	To be removed by 1 July 2005	Tax will be removed by mid-2005. It has already been removed in NSW
Non-residential conveyances Stamp duty on leases Stamp duties on mortgages, debentures, bonds and other loan securities	The Ministerial Council 'will by 2005 review the need for retention' of these taxes.	Removed by Tasmania and South Australia
Stamp duties on credit arrangements, installment purchase arrangements and rental arrangements		Removed by Tasmania
Stamp duties on cheques, bills of exchange, and promissory notes		South Australia removed cheque duty from July 2004
Stamp duties on unquoted marketable securities		Removed by Victoria and Tasmania

Note: See www.treasury.nsw.gov.au, Treasury Research & Information Papers – Interstate Comparison of Taxes 2004 –2005 for the most recent survey.

Source: Business Coalition for Tax Reform, Fact Sheet on State Taxes (available on www.bctr.org).

Customs duties

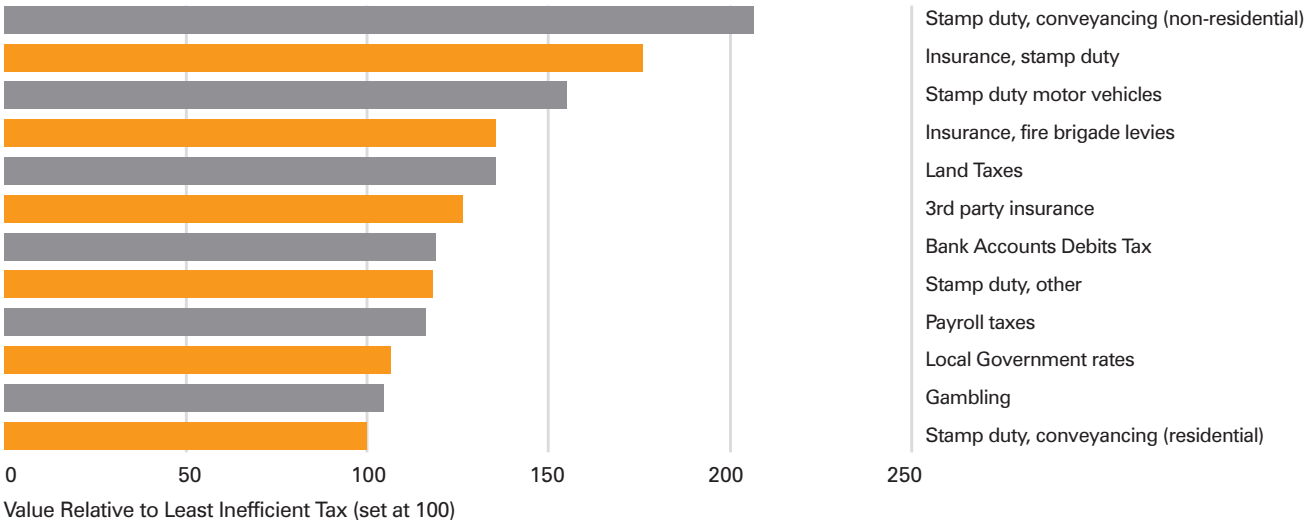
Most taxes on imports were introduced to protect local industry from competition from imports. Duties have the principal effect of raising prices sufficiently to allow higher-cost local producers to compete in the domestic market. The incidence of these taxes is on both local consumers who pay higher prices and on exporters who face higher costs. In the long run, protection results in an economic structure that produces less value than one based on greater specialisation and trade.

Protective tariffs have been greatly reduced in Australia to promote the benefits of economic restructuring, and this has underpinned much of the advance in productivity levels in Australia over the past 20 years.

Significant customs duties remain, however, and continue to collect over $5 billion annually. But the ongoing decline in this revenue source will (and should) continue. This in itself presents a fiscal pressure that must be taken into account in the design of tax strategies. It is important to remember that the main beneficiaries of this trend are consumers and that reductions in customs duties are reductions in consumption taxes.

FIGURE 11.2
EFFICIENCY RANKING FOR STATE TAXES

Economic Welfare Gain From a $100 Million Reduction in State Taxes (some labour supply responsiveness)



Source: Access Economics' modelling provided in 'Axing the Alcabala: A Program for a 21st Century State Tax System', report by Access Economics for the Business Coalition for Tax Reform, 2004.

Economic charges

Many specific taxes have been introduced in Australia as charges to fund specific industry regulation or assistance programs (e.g. for industry marketing or research). Many of these are in the agricultural sector but others apply in a range of service industries including the prudentially regulated financial system. Several are also imposed by the States as registration fees and the like.

One relatively recent innovation that is also consistent with efficiency (and equity) principles has been the introduction of specific taxes on products to fund structural assistance programs. For example, the deregulation of the dairy industry had the effect of disadvantaging many existing producers but advantaging consumers. Taxes were imposed, on a temporary basis, to recover some of the gains to consumers for payment as structural assistance to the disadvantaged farmers. This facilitated the reform and so served both efficiency and equity goals, and the taxes were linked to the benefits of the reform.

Most of these taxes are designed to impose the actual costs of regulation or assistance on the industries (and hence the customers) to which they relate. This is consistent with efficiency criteria as the result is to ensure that prices reflect the true social costs of these activities.

However, in recent years a number of serious anomalies have arisen in the design of some of these taxes. Three main types of anomaly have arisen:

- **Some taxes have been imposed on only some of the beneficiaries of programs. The worst example is the fire services levy in New South Wales and Victoria, which is imposed on those who insure for fire risk but not on those who do not. This is highly anomalous on equity and efficiency grounds.**
- **Some industry-specific taxes fund assistance programs which benefit unrelated third parties. An example is the tax imposed on airlines (that is air travellers) to fund a discretionary Government decision to provide benefits to former employees of a failed airline. There is no meaningful link between those paying this tax and the program it funds.**[56]
- **Some taxes are imposed at levels far exceeding the cost of programs to which they relate. Company registration fees for example collect far more revenue than the cost of company registration and regulation and so operate inequitably as general revenue poll taxes and a disincentive to incorporation that is particularly unfair on small business.**

11.3 Taxes on wealth and property

Taxes on assets at time of death were abolished in the 1970s, and general wealth taxes have never applied in Australia. There is no significant public support for these taxes.

The main taxes imposed on asset values in Australia relate to real estate. General rates are levied by Local Government and land taxes by the States. There are relatively high efficiency costs associated with land taxes imposed on commercial land. These directly raise industry costs, depending on the intensity of land use; distort prices; and reduce competitiveness.

The motor vehicle registration charge also operates as a type of wealth tax, albeit one not linked to relative values. However, it is also largely a de facto user charge.

The assets test in the social security system operates more as an integrity measure for the means tests linked to incomes than an assets tax.

11.4 Conclusions

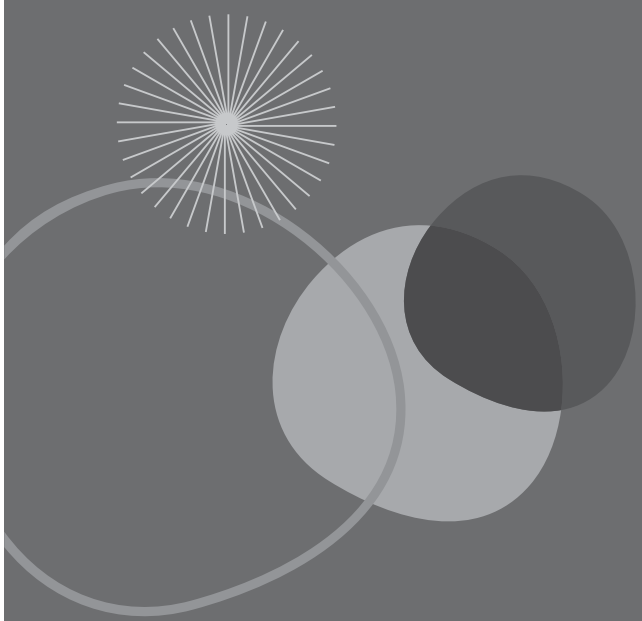
The GST represents a major improvement in the Australian tax system but it is capable of making a better contribution to national tax performance. It is possible that the GST design, including thresholds, could be altered to significantly reduce compliance costs without major revenue losses, and that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

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

State taxes on financial instruments, transactions, insurance and land taxes on non-residential property are highly inefficient and should be abolished or substantially reduced.

Chapter 12

Tax Administration, Compliance and Policy Advice



12.1 Tax administration and compliance systems

The impact of the tax system depends not only on the tax policy rules setting out the tax to pay but also their administration and how this affects the work that taxpayers are required to do to comply. In turn, the nature of the administrative impact depends on a range of factors.

One factor is the nature of tax authorities themselves: their governance, structure, culture and the incentives under which they operate. A second is the nature of the relationships between the tax authorities and taxpayers, particularly the formal set of rules imposing compliance obligations. A third factor is the technology used in these interactions.

The following sections introduce the current state of play on each of these factors and point to some possible issues for further consideration.

Tax authorities and their governance

The Australian Tax Office (ATO) collects most of Australia's taxes – almost $200 billion in 2003–04. At the Commonwealth level, customs and some industry departments also collect relatively small amounts of tax revenue. The States and Local Governments also collect taxes – compared with the ATO, however, State revenue offices are quite small, and therefore the focus of attention on the reform of tax administration is overwhelmingly on the ATO.

In 2003–04, the ATO had operating expenses of approximately $2.3 billion and almost 21,000 employees. Although the ATO does not exclusively collect taxes – it also delivers grants and transfers – the implied average tax collection cost is a little over one per cent of revenues. This is broadly comparable with the UK system (which is being reformed) but much more costly than the federal tax system in the US (where, although it needs to be noted that the IRS does not collect sales tax, the average costs of the IRS are still less than half a cent per dollar collected).

The ATO administers the tax laws subject to individual taxpayer rights of appeal. Beyond the internal review processes provided by the ATO itself, taxpayers may appeal to the Administrative Appeals Tribunal or to a court. In addition, taxpayers have been afforded the further right to seek the assistance of a Tax Ombudsman, although in this case the ATO administrative decision is not formally overturned (in practice the ATO generally acts on the recommendations of the Ombudsman). Taxpayers also have certain rights of recourse and compensation under defective administration provisions, in common with like provisions applying to all forms of public administration. In larger value cases, the Revenue Minister considers defective administration claims while small value cases are delegated to a quasi-independent tax officer.

Separately from these individual rights, the general administrative policies and practices of the ATO are subject to review and recommendation (but not direction) by three authorities:

- **the Australian National Audit Office (as for other Commonwealth agencies);**
- **the Ombudsman (additional to investigating individual matters); and**
- **the Inspector-General of Taxation, established in 2003, to advise the Treasury ministers on tax administration policies.**

With the exception of the defective administration arrangements, the ATO is effectively independent from Ministers in its dealings on individual tax matters. The secrecy provisions of the tax law, at least by convention, reinforce the ATO's independence.[57] The ATO is part of the Treasury portfolio and Treasury Ministers are responsible for tax administration laws and the ATO budget. As for any portfolio agency, Ministers therefore exercise some influence over the general administrative policies of the ATO.

The ATO is formed by virtue of tax laws establishing the Office of the Commissioner of Taxation. All of the functions and powers of the ATO are vested in the first instance in the Commissioner, who is appointed for a fixed term by the Governor General (which means in effect by the Government of the day). Ultimately, then, the ATO is a single-person authority.[58] The Commissioner reports to the Minister but the Minister does not exercise substantive powers of direction in relation to tax laws, and there is no corporate board.

A range of issues could be raised in relation to current arrangements.

Is a single taxation administration authority the ideal administrative arrangement, or could there be advantage in other arrangements?

- **The vast scale of the ATO as a single business unit could be argued to represent an excessive or unreasonable burden for its governance and management systems. There may be information advantages in the administrative combination of all taxes, but these may be maintained in alternative structures.**
- **The unity of the income tax, where income from all sources is combined in a single calculation, probably underlies the unity of the tax administration. This has come at the cost, however, of the separation of the social transfer system from the personal income tax system.**
- **A more radical option might be to combine the personal tax system with the social transfer system, under a single administrative authority and a single set of rules, for example a common measure of income for means tests and the tax system. This might more readily lead to the removal of the current administrative duplication and conflicting rules of the two systems. Other taxes could then be collected by a separate business tax authority.**

Is a single-person authority the ideal governance structure for the ATO?

- **The alternatives may include a larger commission or possibly a board, but the issues are not straightforward and accountability problems can arise in these structures. The recent report on public agency governance by John Uhrig canvassed many of the issues.[59]**

- **A quite different approach is to question whether there could be merit in a separation of some of the lines of authority. In particular, rather than vesting every tax administration power in a single Commissioner, the administrative authority for issuing some or all rulings could be vested in a separate statutory chief counsel. It is not uncommon in other jurisdictions for (at least some classes of) rulings to be issued by persons other than the head of the tax office.**

Are the existing arrangements for the review of individual administrative decisions and the general review of administrative policies ideally structured and resourced?

- **There is some concern about the timeliness of some of the individual review processes, but the problems do not appear intractable.**
- **The more immediate and greater concern has been the review of administrative policies and practices. An additional agency, the Inspector-General of Taxation, was recently established to increase capacity and powers of investigation in this area.**
- **To this has been added the recent Treasury review of self-assessment. While it is perhaps too early to judge the effectiveness of these initiatives, it is of concern that progress is slow in a field where shortcomings are so widely perceived.**

12.2 Personal income complexity and compliance costs

The features of the personal tax system discussed above illustrate the considerable complexity of the personal tax system. Much of this complexity is due to the need to administer tax concessions targeting particular groups, or to prevent large-scale exploitation of existing 'holes' in the tax base by administrative means. For all this complexity, many significant non-neutralities and inequities remain. Reform of the income tax system to remove any unwarranted tax expenditures would aid in simplifying administration and compliance, while improving efficiency and equity.

Complexities arise also in many other features of the law. For example, for many individuals, income must be assessed on more than one basis, reflecting different requirements for means test and taxable income. Sometimes these burdens are imposed on people receiving welfare payments, that is from social groups that often include those least able to deal with the task.

It is remarkable but not surprising that the majority of individual taxpayers use tax agents to assist them in meeting their income tax obligations. While perhaps this is to be expected in the case of business income, it is also true of the much larger part of the population whose income derives only from employment and passive investments.

While the tax assistance industry is undergoing some restructuring, including a trend towards more work being done by bookkeepers rather than fully qualified accountants, the continued high-level reliance on help has considerable costs and highlights the complexities of the current tax system even for people in everyday circumstances.

It is likely that the achievement of substantial simplification would require a radical change in approach to individual income taxation. One issue that illustrates the tradeoffs involved is the treatment of work-related expenses.

Illustrating complexity: work-related expenses

In the UK, work-related expenses are almost never deductible for employees. This has encouraged employment arrangements where employees do not meet their own work expenses, and has been one of the critical features making it possible to develop a simple individual tax system in which the majority of taxpayers do not need to lodge an annual tax return.

In Australia, an employee (like a business taxpayer) is entitled to a deduction for expenditure incurred in gaining or producing assessable income (unless of a private, domestic or capital nature). A wide range of expenses have come to be deductible.

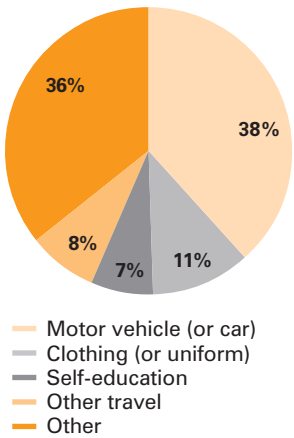
Under the income tax system, it is fully appropriate (and efficient) that costs incurred in the course of earning assessable income be tax deductible. However, there has been some concern by the ATO and others at the fast growth in work-related expenses and the implications of any inappropriate claiming on the integrity of the revenue base (see Figures 12.2 and 12.3). These deductions are also a major source of complexity in the operation of the personal tax system.

Around 6.6 million taxpayers claimed personal income tax deductions for work-related expenses totalling $9.6 billion in 2001–02. At 49 per cent of the total value of personal deductions, they are the most common type of claim.[60]

Figure 12.1 shows that, of work-related expenses, motor vehicle expenses and clothing were the two largest individual categories.

There has been strong growth in the value of work-related deductions in recent years, both in absolute terms and as a proportion of total income, as can be seen in Figures 12.2 and 12.3. Over the three years to 2001–02, average annual growth has been 9.6 per cent.

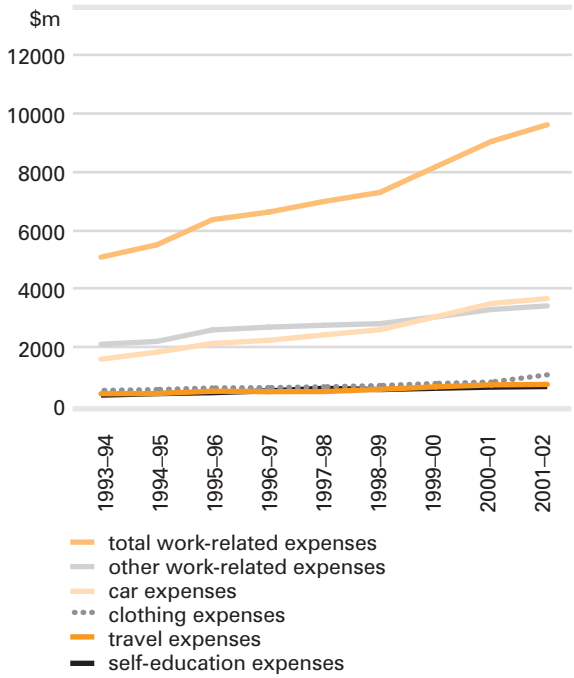
FIGURE 12.1
COMPOSITION OF PERSONAL TAX WORK-RELATED EXPENSES, 2001–02



Note: Components do not add to total number of taxpayers claiming work-related expenses as taxpayers may claim more than one type of work-related expense. Total amounts claimed may differ slightly from the sum of components due to rounding.

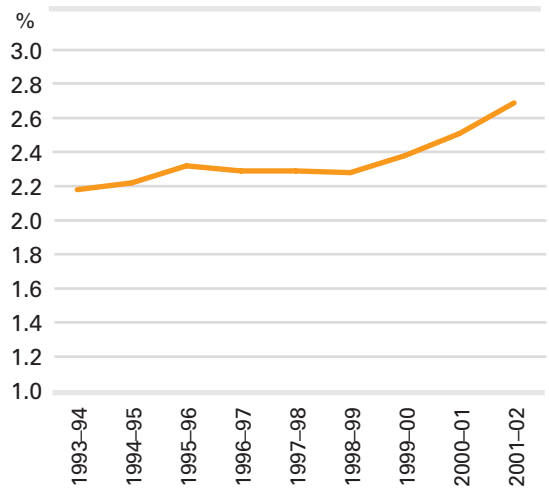
Source: Australian Taxation Office, Taxation Statistics 2001–02.

FIGURE 12.2
GROWTH IN WORK-RELATED EXPENSES BY TYPE



Source: Australian Taxation Office, Taxation Statistics 2001–02.

FIGURE 12.3
GROWTH OF WORK-RELATED EXPENSES AS A PERCANTAGE OF TOTAL INCOME



Note: Total income is aggregated across all taxpayers, income being net of losses before deductions.

Source: Australian Taxation Office, Taxation Statistics 2001–02.

Self-assessment, tax professions and taxpayers

Current taxation laws are built on the principle of taxpayer self-assessment. This principle confers responsibility in the first instance on taxpayers for applying the tax law to taxpayer circumstances. Failure to correctly self-assess may result not only in an assessment imposed by the ATO but penalties as well. If the position taken by the taxpayer is not reasonably arguable, prosecution also may result.

This approach replaced one where the tax authority was responsible for assessment while the taxpayer was responsible for fully disclosing the necessary facts to the authority. The reason given by Government for the change to self-assessment was pragmatic – the ATO did not have sufficient resources to reliably ensure that assessments were correct and that the necessary information was obtained. Self-assessment was introduced along with stronger penalties, more powerful anti-avoidance provisions and additional tax auditing capabilities to increase the risk of discovery of incorrect assessments.

Self-assessment was also 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 help. Repeated subjective surveys and studies show that taxpayers find the system burdensome and risky.

With the advent of the GST and a range of other changes more recently, these concerns have been extended further. Now, even the tax advising industry itself is under considerable strain. It is an industry characterised by excessive workloads and the struggle to keep up with the scale and pace of change.

With time, some of the pressures inevitably ease. Taxpayers and the advising industry develop improved ways of working, and learning curves are surmounted. However, the burden of work still reaches a higher plateau. Costs remain very high.

Shortages of accountants loom in Australia for two other reasons. Supply is under pressure due to the age profile of the industry. Meanwhile, demand has increased as a result of several trends in addition to tax workloads. These include regulatory reforms, internationalisation of business and the strengthened focus on governance.

It would be highly advantageous if a reduction in tax workload could contribute to solving these work pressure problems, particularly as many of the demand pressures arise from worthwhile developments that will bring national benefits.

The Government commissioned the Treasury to undertake a review of self-assessment (ROSA) in 2003. The report of that review was published late in 2004 and its recommendations have been adopted by the Government. This will provide many useful improvements to the administrative law and practice, and reduce the risks faced by many taxpayers. However, a comprehensive study providing measures of the costs and benefits of all aspects of the present system and meaningful alternatives has not been undertaken. For this, a more substantial study would be necessary based on researching taxpayer compliance costs and their sources.

The compliance burdens of the tax law arise in a myriad of 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.

The uncertain nature of Australia's tax laws has recently been exacerbated by the High Court decision in Hart's case which significantly broadens the reach of the general anti- avoidance provision, Part IVA. Among the business community and tax professionals generally, it is widely accepted that the High Court's broad interpretation of this provision has overlaid a new level of uncertainty over any form of tax planning. Moreover, the level of penalties to which taxpayers are exposed for breaches of Part IVA are such that uncertain laws are coupled with debilitating consequences. This comes at a time when the self-assessment regime places the onus of getting tax matters right squarely on taxpayers (including corporate boards) and their advisers. Certainty in tax laws should be a clear policy objective and certainty does not come simply from any attempt to reduce the volume of legislation or write it in 'plain English' – but rather, from a serious reconsideration of the law making and law administration process.

12.3 Tax reporting and collection technologies

The tax system has undergone substantial technological change over the past 20 years. As for other sectors, the main driver of change has been the advance of information and communication technologies. This has enabled, for example:

- **electronic lodgement of tax returns;**
- **electronic methods of audit selection and information checking;**
- **on-line accounts; and**
- **on-line taxpayer and adviser relationship portals.**

It has been frustrating, however, that these developments have often lagged other sectors. More importantly, there is little evidence that tax policy has been actively designed to take full account of the potential benefits of modern information technology. Too often it appears that policy has been developed in an expectation that technology can quickly and easily solve very complex tasks. In practice, policy changes that pay little heed to administrative and compliance technologies often generate system gridlocks that take a long time and considerable investment to overcome. Worse, this effort then displaces the higher rewards that could come from an actively creative search for new approaches to problem solving.

The costs of the tax system often fall on business. It is well established that tax compliance is highest if tax is withheld at source – a task that falls to business. This is acceptable if the task is as simple as possible and there is a clear and consistent direction in the evolution of the arrangements.

Systems reliant on annual assessment have lower compliance and generate a range of payment problems, for example the problems associated with overpayments of family tax benefits. But withholding systems combined with assessment systems duplicate tasks – this is most often necessary only because policy design is complex.

At least a hint of the potential benefits of a much closer alignment of technology and tax design is provided by the British personal tax system. This system uses information techniques and appropriate policy design to render annual tax returns unnecessary for very large numbers of taxpayers.

It is very likely that even more radical options could emerge if this issue was given appropriate whole-of-government attention. For example, with a concerted design effort, it may well be possible that virtually all interactions between Government and individuals (income tax, transfers, health subsidies and so on) could operate on a single-account, real-time basis. The nature of the arrangements would need to be re-engineered and in turn this would often be much easier if rules were modified.

But at least potentially, and by way only of illustration:

- **most individual tax returns could be unnecessary;**
- **taxes and transfers could operate on a common system with common rules (which could also overcome unfair interactions between them), for many quite possibly through a system common also with wage or income support payments;**
- **subsidies for health expenditures could be simplified and automated;**
- **many other deductions and subsidies, particularly if paid at a common rate, could operate on a real-time basis (or generate an ongoing withholding adjustment); and**
- **flat rates and perhaps final withholding could apply to some income classes.**

The discussion in this section barely scratches the surface of possibilities. Some will be concerned at equity implications but as noted in other sections of this paper, many reforms of this type can be more equitable in practice than current arrangements.

This direction of reform goes beyond the tax system as it is currently structured – if it were to be the subject of further consideration it would be best to take a much wider approach than traditional tax inquiries.

At the very least there is scope for Government to develop and share with the community a long-range vision of where current systems are heading and what alternative arrangements could look like.

12.4 Tax policy and legislation systems

The Commonwealth and State/Territory tax systems are the responsibility of Treasury Ministers, advised principally by the respective Treasury departments.

The Commonwealth's tax policy and legislation advisory system has been overhauled substantially in recent years. The tax policy capacity of the Treasury expanded steadily after 1983 and was merged in 2002 with the legislative functions previously undertaken by the ATO. The Board of Taxation was established following the Ralph Review of Business Tax, and provides an avenue for the Government to obtain business and community views on tax policy issues.

Direct consultation with business, tax professional and other taxpayer interests has also become more comprehensive and systematic. However, the scope remains focused mainly on legislation and implementation issues after policies are announced, or in some defined areas of review. There are no systematic processes for earlier stage policy discussion.

The Treasury or the Board of Taxation has conducted most of the reviews of tax policy issues in recent years. The Inspector-General of Taxation has a role in the review of administrative policy. Parliamentary committees and the Productivity Commission are further sources of advice. Some stand-alone inquiries have also been established, principally the Review of Business Taxes.[61]

All of these processes produce public reports, other than many undertaken by the Treasury. While the confidentiality of Treasury advice to the Government represents a longstanding convention under Australia's system of Government, it is less clear that all of the systemic tax information and analysis held by the Treasury should be withheld from community access.

The generation of information about taxation issues is largely dependent on official sources, supplemented from time to time by the work of business or community organisations. In most spheres, the universities produce relatively little tax policy research (the main exceptions being the fields of research on equity issues and tax compliance studies). Two broader research organisations – the Australian Tax Research Foundation and the Council for Federal Financial Relations – were active at earlier times but have lost funding support.

Overall, amid several points of strength, there are two main weaknesses in the fabric of tax policy and legislation research in Australia:

- **a paucity of information on the scale and drivers of tax compliance costs; and**
- **little published empirical evidence on the main economic effects of taxation or specific tax provisions on the Australian economy.**[62]

The improvements in the integration of work on tax policy and legislation and the efforts being made to produce better form and structure of tax laws will suffer considerably if the gap in understanding compliance costs remains so great.

12.5 Conclusions

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 attach to developing and implementing a comprehensive research program into the administrative, compliance and decsion-making costs of the tax system and the drivers of those costs. This should form the basis for long-term reform of tax policy and tax administration to deliver simplification and reduce costs.

Notes

1 A more comprehensive explanation of the drivers of future economic growth and the relationship of the BCA's reform agenda to them can be found in the BCA's 2005-06 Pre-Budget Submission entitled Action Plan for Future Prosperity, available at www.bca.com.au.

2 Commonwealth of Australia 2002, 2002–03 Budget Paper No. 5, Intergenerational Report 2002–03.

3 One source is likely to be expressed as a desire to reduce the fiscal cost of the measure, but as with any horizontal equity measure, this disguises the real equity choice being made. In this case, the choice is that higher income earners with children should pay the same tax as those without; or put another way, that their lower capacity to pay tax is not recognised so that others pay less tax instead.

4 Productivity Commission 2004, Economic Implications of an Ageing Australia, Draft Research Report.

5 Commonwealth of Australia 2004, Australia's Demographic Challenges.

6 Henry, K., Secretary to the Treasury, The Fiscal and Economic Outlook, Address to the Australian Business Economists, Sydney 18 May 2004.

7 This analysis is based on information contained in: 'Singapore – Advanced Economy, New Economy' briefing by the Ministry of Trade and Industry, Singapore.

8 Krueger, A.O. 2004, 'The Gorgeous East: What the Asian Economies Can Teach the World', Address to the Harvard Project for Asian and International Relations (HPAIR) Business Conference, Shanghai, China.

9 Scale can also be critical, a further reason why Australia must specialise and trade, as we have a relatively small domestic market.

10 Some may argue that the in general terms the global environment now is not that different to 100 years ago. However, the advent of information and communication technologies can be argued to have significantly accelerated the pace of change and innovation.

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

12 See Building Effective Systems for the Commercialisation of University Research, August 2004 BCA, available on www.bca.com.au.

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

14 World Bank 2004, World Development Indicators and 'China at a Glance' 2004 Briefing Note.

15 Andrieu, M. 'China – 'A demographic time bomb', OECD Observer, September 1999.

16 Dahlman, C. 2004, The Challenge of Knowledge Economy for Education and Training in China, http://siteresources.worldbank.org/KFDLP/Resources/DahlmanChinaChallenge12152004.pdf.

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

18 Ibid.

19 If other countries have moved to improve on the efficiency of their taxation systems this will put further pressure on Australia's system.

20 Unless income is exempt from personal income tax this system would involve double taxation.

21 See for example Lindert, P. 2004, Growing Public, Cambridge University Press.

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

23 The alternative being that workers may not come to Australia.

24 Australia's imputation system would be enhanced through a measure such as extending it to foreign source income or at least progressing the system through mutual recognition between tax jurisdictions.

25 Given the competitive pressures reducing the company tax rate was vital at that time.

26 The Commissioner's effective lives are effectively a 'safe haven' rate for companies as there remains an option to 'self-assess'. However, self-assessment provides no investment certainty (the Commissioner could unpick the basis of the investment decision years after the project was in operation). Consequently self-assessment is not frequently used for significant investment projects.

27 The GST was primarily a key reform to the indirect tax system. Apart from associated small net income tax cuts, it did not address the income structure.

28 In recent years it has often appeared that forward estimates of the Budget position suggest declining expenditures as a share of GDP in the out-years. The difficulty with these projections is that they are based on unchanged policy. It is more realistic to assume that policy change will continue to address emerging developments through initiatives having a net fiscal cost.

29 The concessional rates are subject to conditions and limitations and State taxes may also apply.

30 The Terms of Reference that establishes the Board of Taxation (BoT) do not limit the BoT to business taxation issues, although this has been the focus. Excess and unnecessary deadweight costs in the tax system need to be pinpointed, fully understood and steps taken where possible to remove them. As this area is crucial for both the effective operation of business and the economy as a whole, the BCA seeks to have it examined thoroughly by a body such as the BoT.

31 The thresholds were moved in two stages where the 30% rates stops and the 42% rate starts (previously $52,000) was moved to $58,000 from 1 July 2004 and to $63,000 from 1 July 2005. The threshold where the 42% rate stops and the 47% rate starts (previously $62,500) was moved to $70,000 from 1 July 2004 and to $80,000 from 1 July 2005.

32 Wachtel, M. and Capito, A. 2001, 'Removing Tax Barriers to International Growth – Positional Australia's Tax System to Maximise the Potential Growth Opportunities from International Business'.

33 'Black holes' are where capital expenditures by companies are neither deductible nor subject to amortisation.

34 Both the Super Guarantee and worker's compensation arguably work as types of social security taxes.

35 A further complication is that many social security tax systems include a payroll tax component while some countries, including Australia, impose a general-purpose payroll tax.

36 Unless we remove VFI by shifting spending responsibilities to the Commonwealth or increasing own-revenue raising powers for the State and Local Government sector, Australia must accept VFI as a cost of having revenue raised where it is most efficiently done. However, this must occur with cooperative tax sharing, requiring a greater level of cooperation between levels of Government than currently occurs.

37 There has been a range of other developments. The State franchise taxes were found to be unconstitutional in the late 1980s and the Commonwealth imposed taxes to replace them. A reverse move was made in 1971 when payroll tax was transferred to the States.

38 Tax-funded expenses are total expenses of the general Government sector excluding expenses funded from non-tax sources (e.g. user charges, interest income). As such, tax-funded expenses are expenses funded by either own-source taxes or grants received from other levels of Government.

39 Own-purpose expenses of a particular level of Government are the total expenses of that level of Government excluding grants paid to other levels of Government.

40 Australian Taxation Office, Taxation Statistics 2001–02, p. 16.

41 Domestic excise, not including collections on excisable goods collected at the border as customs duty. The Budget Papers do not separately report customs duty on excisable products, as opposed to 'protective' customs duty such as import tariff revenue.

42 It is also illustrative of the Ramsey Pricing principle of efficiently taxing inelastic goods.

43 The main change was the removal of the 5/3 depreciation system in 1988, replaced by an effective life basis accelerated by 20%, which was then followed by the reintroduction of accelerated depreciation bands (though less generous than 5/3) in 1992.

44 For domestic sourced income.

45 Including 'non-taxable' taxpayers, defined by the ATO as personal (or individual) taxpayers with net tax payable equal to $0 (no amount of net tax charged). In 2001–02, of Australia's 10.3 million taxpayers, 1.9 million were non-taxable.

46 Bracket creep includes movement within tax brackets, not just into higher brackets, both result in increasing average tax rates due to lack of indexation. The Federal Government defines bracket creep as the increase in taxation due to inflation (and does not include wage growth). Either way, an increasing proportion of Australia's population are being taxed at the top rates.

47 Non-resident investors are not necessarily taxed at lower rates than the top marginal rate. In the absence of recognition of Australian tax paid in the foreign jurisdiction the non-resident investor may be double taxed.

NOTES

48 Assuming that the taxpayer does not also pay the additional 1 per cent Medicare levy surcharge imposed if private hospital insurance has not been purchased.

49 Beer, G. 2002, 'Work Incentives under a New Tax System: The Distribution of Effective Marginal Tax Rates', Economic Record, vol. 79, Special Issue, pp. S14-S25.

50 Taxes may be compared with either an income or expenditure tax benchmark. The income tax benchmark involves taxing any income that is saved as well as taxing the accruing interest or other investment earnings on those savings. This is typically what happens when salary income (which bears tax) is saved in a bank account (which pays interest that is also taxed). An expenditure tax imposes no taxes on accruing interest or investment earnings (such as rental incomes).

51 A voucher system was suggested, for example, in 2001 in a submission on behalf of the Australian Constructors' Association by Tasman Economics to the Inquiry into Infrastructure and Development of Australia's Regional Areas, available on: www.constructors.com.au/main/index.htm.

52 In a number of cases, allowing tax preferences to flow through to the ultimate beneficiary, consistent with the policy intention of Government, is thwarted in practice.

53 Effective tax rates are calculated by Ernst & Young using ATO data on actual tax paid by individuals, companies and superannuation funds on their respective income from capital gains.

54 Australian Taxation Office, Taxation Statistics 2001–02, p. 156.

55 Amount transferred to States and Territories.

56 The tax introduced to fund compensation for policyholders of the failed HIH group may at least in part be distinguished from the airline case. All policy holders may benefit in some measure from the apparent Government guarantee of insurance liabilities, and the levy in this case could be said to operate as ex post premium insurance (analogous to deposit insurance for banks).

57 However, the extent of this independence and the reach of the secrecy provisions in the Parliament are largely untested, depending mainly on conventions.

58 Second commissioners have some similar but subordinate powers.

59 Uhrig, J., 'The Review of the Corporate Governance of Statutory Authorities and Office Holders', 2004 (available at www.finance.gov.au/governance structures). The Government's response to this report was issued by the Minister for Finance and Administration, Senator the Hon. Nick Minchin, on 12 August 2004 (press release 57/04).

60 Australian Taxation Office, Taxation Statistics 2001–02, p. 17.

61 Other inquiries in recent years have made tax recommendations in fields such as fuel taxation, venture capital, philanthropy and employee share ownership.

62 For instance, unique features of Australian arrangements, such as Commonwealth–State financial arrangements and retirement income systems, may be worthy candidates for more local study.

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