

# The Future of Tax

Tax White Paper  
Initial Submission



**Business Council  
of Australia**

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The Business Council of Australia (BCA) is a forum for the chief executives of Australia's largest companies to promote economic and social progress in the national interest.

*This paper presents the Business Council of Australia's response to Re:think tax discussion paper.*

## THE CASE FOR AND APPROACH TO REFORM

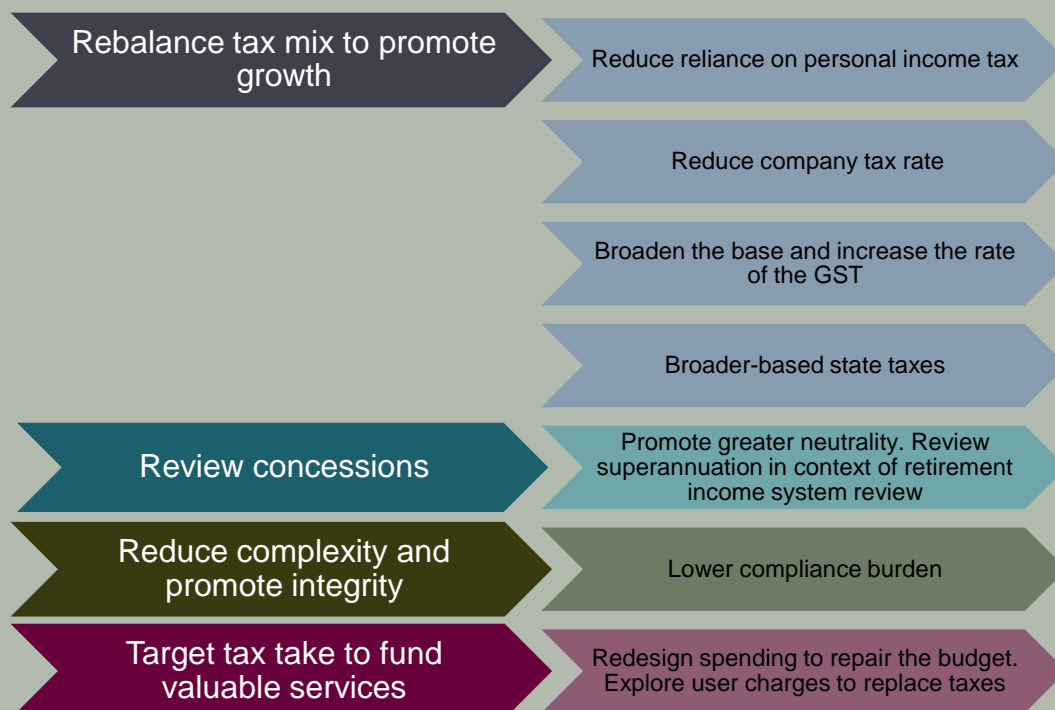
- The case for comprehensive tax reform is urgent and compelling – no change is not an option. Our tax system is holding back economic growth. The costs are already large and without action will build over time, detracting from living standards across the Australian community.
- Australia's capacity to offer secure, rewarding job opportunities will be seriously compromised by a tax system increasingly out of step with our competitors.
- The global economic context is changing dramatically. The Australian economy needs to diversify through innovation and the development of new markets. This demands improved competitiveness and capital investment.
  - Tax reform is essential for providing efficient incentives for businesses and individuals – in existing and new sectors – to invest, innovate and take risks. We cannot afford a tax system that impedes entrepreneurship and wealth creation.
- Our materially higher company tax rate seriously detracts from the business case for investing in Australia.
  - With capital and skilled labour increasingly mobile across borders, uncompetitive rates of corporate and individual income tax are a recipe for lower economic growth, lower incomes and diminishing, less stable revenues.
- Our tax system is struggling with rapid technological change and digitisation which are fundamentally disrupting business models and corporate structures.
  - The way and where we produce, sell, work and buy are evolving rapidly. Intangible investment and assets are growing faster than physical capital. New asset classes will be created; the 'internet of things' will challenge traditional business and investment models. The tax system must be agile enough to accommodate and respond to these dynamics.
- These forces make the broad directions for tax reform patently clear. The tax system must be rebalanced towards broad-based taxes with lower rates to lift the burden off investing, risk-taking, entrepreneurship and working.
  - Primarily this means shifting from a reliance on relatively high-cost personal and company income taxation to greater use of broad-based consumption taxes.
- All options must be kept on the table. The tax system must be reviewed holistically.
  - The community deserves to be informed about the full suite of possibilities, the benefits they bring and trade-offs they involve.
- The white paper process must clearly articulate the case for reform to bring the community along and to build bipartisanship on the core elements. A genuinely transparent process that builds a credible evidence base will be essential.
- Potential difficulties in implementing reforms, such as preconceptions about their political palatability or Commonwealth–state distributional arrangements must not be used as an excuse to shackle the process.
- Equity is an essential consideration in redesigning and ultimately achieving tax reform. But equity is multidimensional and needs to consider impacts across generations and over lifetimes. In particular, tax reform must build growth and create job opportunities for future generations who have no voice – or vote – today.



## SEVEN KEY DIRECTIONS FOR TAX REFORM

Australia's tax system relies too heavily on taxes that impose high costs (including company tax and stamp duties) and too little on more efficient taxes (such as the GST). This means we are holding back growth unnecessarily. It is why we must have a fundamental remix of taxes, including:

1. A more competitive personal income tax system that encourages and rewards effort and participation, and investment in education and skills.
  - Thresholds should be recalibrated relative to earnings benchmarks to improve incentives. The integrity of the tax structure should not be whittled away – consideration should be given to indexation to ameliorate bracket creep over time. To the extent possible, high effective marginal tax rates at the lower end of the income scale should be addressed to promote participation.
2. A more competitive company tax system that encourages a culture of entrepreneurship and reduces disincentives to innovate and invest.
  - A company tax rate of 25 per cent is urgently needed to stop Australia falling further behind our competitors. Combined with dividend imputation this would help drive investment and productivity growth. Further reductions may be required over time to maintain our competitive position. Appropriate investment, and research and development provisions will be essential for encouraging risk-taking and innovation.
3. Broadening the base and increasing the rate of the GST to reduce Australia's reliance on taxes that inhibit growth and better deal with the challenges of digital disruption.
  - The Business Council is not advocating a particular rate or base at this stage, but believes there is scope to move on both margins to rebalance the tax mix. This will require appropriate compensation for some groups, and if the tax changes are sound, there should be more than enough capacity to do so.
4. Replacing highly distorting state taxes such as stamp duties and other transaction-based taxes with more neutral taxes, and more streamlined payroll taxes. Importantly, national tax reform should not be constrained by existing revenue-sharing arrangements between the Commonwealth and states.
5. More neutral, concessional treatment of savings to relieve the compounding effects of taxing savings over time.
  - The Business Council strongly supports a comprehensive and concurrent review of the retirement income system, encompassing superannuation concessions and their interrelationships with the age pension system.
  - Arrangements such as negative gearing should be assessed on their merits and within the context of overall tax system progressivity and other impacts.
6. A simpler tax system overall to reduce the compliance burden. Fewer, broader-based taxes with lower rates and fewer exemptions will reduce complexity and compliance burdens and enhance tax system integrity.
7. Ensuring aggregate tax revenues are the minimum required to fund income redistribution and government services that deliver net community benefits. Where appropriate, user charges should replace funding from general taxation.

**Figure 1: Rebalancing Australia's tax system to promote growth**

### **A coherent 10-year plan for comprehensive reform is required**

- The Business Council is realistic that not all the reforms outlined above can be implemented overnight. However, a necessary outcome of the tax review must be a comprehensive package of reforms with a coherent plan for their prioritised implementation over the next decade. It is vital that reforms are locked in and completed by 2025, not just promised, to provide certainty.
- As well as setting out options for reform, the forthcoming options paper should outline appropriate transitions and governance.
  - Tax changes with major distributional impacts should be accompanied by appropriate compensation or phased implementation, enabling Australia to maintain an equitable tax and transfer system overall.
  - Serious consideration should be given to the establishment of an independent advisory body, such as a Tax Reform Commission, to help steward tax reform over the next decade and to reduce the risk of policy reversals we cannot afford.
- Comprehensive consultation, including open forums and robust discussions involving all stakeholders, must be undertaken throughout the white paper process. Stakeholders across business, the wider community and all levels of government should be involved and given adequate time to respond to options.

# EXECUTIVE SUMMARY

## Introduction

The tax white paper process is a welcome and timely opportunity for an open, national dialogue about Australia's tax system.

The Business Council of Australia agrees with the tax discussion paper that tax reform is arguably the most pressing area of reform for our economy. The case for tax reform is compelling – no change is not an option. The costs of our uncompetitive tax system are already too high and doing nothing can only mean that they build over time.

## Why we need comprehensive tax reform

There is broad consensus that Australia needs a tax system that:

- expands economic opportunities, jobs, growth and builds economic resilience
- encourages and rewards risk-taking, entrepreneurship, investment and innovation by individuals and enterprises
- provides sufficient revenue for efficient government spending and enhances the stability of the tax base
- supports a better-functioning federation
- promotes tax equity and equitable economic opportunities
- is simple, minimises the compliance burden and promotes system integrity and trust
- better aligns with the transfer system and other economic policies to encourage and reward effort
- complements and augments other important economic reforms.

The current tax system unnecessarily discourages productive activity, most particularly investment, as well as participation in the workforce. It relies too heavily on taxes that impose high rates, are often too narrowly based and impose unduly burdensome compliance costs. In a world where both capital and skilled labour are increasingly mobile across borders, high rates of corporate and individual income tax and narrow bases are a recipe for lower economic growth and diminishing, less stable revenues.

The reality is that without comprehensive tax reform, Australia's future economic growth and capacity to offer secure job opportunities will be seriously compromised.

The global economic context has changed dramatically. The Australian economy needs to innovate and develop new markets. This will require capital investment and improved competitiveness in new and existing sectors.

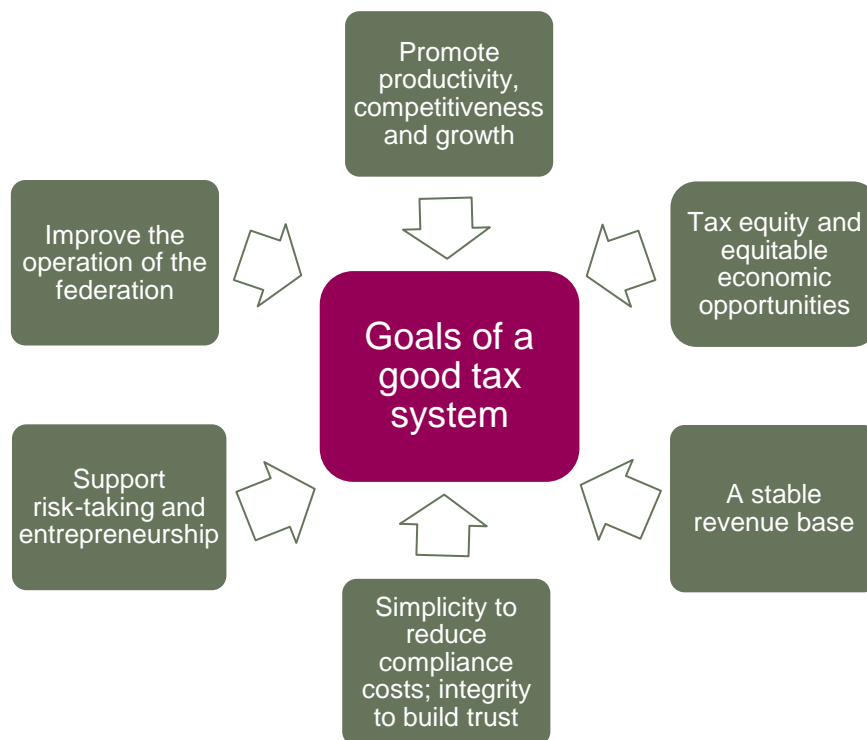
Tax reform is essential for providing the right incentives for businesses in existing and new sectors to invest, innovate and take risks as well as to underpin other important economic reforms designed to enhance economic flexibility and our international competitiveness.

*All reform options must be kept on the table*

It is vital that the white paper process does not peremptorily rule out options for reform. All options must be kept on the table. Measures must be carefully assessed on their merits and how they collectively contribute to a more effective tax system, not preconceptions about their political palatability or myriad other conceivable hurdles.

The white paper process primarily must be about bringing to the community the full suite of possibilities and clarity about the benefits they bring and trade-offs they involve, not constricting the range of options before debate has started. That would be grossly unfair to the Australian community and disrespect its capacity for understanding and embracing choices to achieve reform that delivers overall benefits.

**Figure 2: Goals of a good tax system**



## Australia is confronting extraordinary economic challenges

Australia is a prosperous country. However, we face many challenges that mean ongoing growth and prosperity cannot be taken for granted.

### *An ageing population, fiscal pressures and declining participation*

Like many industrialised countries, our population is ageing. One in five Australians will be 65 years or older by 2055 compared with one in seven today. An older population will drive increased government spending in health, aged care and age pensions while reducing labour force participation and thus the capacity to pay. By 2055 there will be only 2.7 workers for every person over 65, compared with 4.5 today (Australian Government 2015e). Without action to slow spending, ageing is projected to generate increasing structural deficits even on the back of reasonably strong economic growth projections.

### *Falling terms of trade, weak investment and low productivity growth*

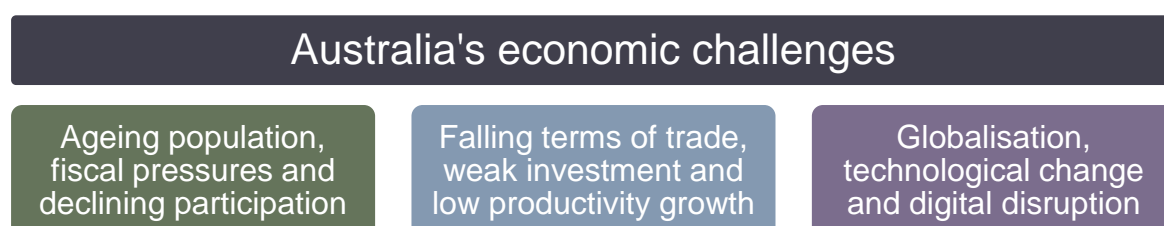
In the immediate term, the Australian economy continues to adjust to the largest fall in the terms of trade in 50 years and the end of the mining investment boom. The terms of trade are 'normalising' closer to historical levels. This means that future income and revenue growth will have to come primarily from investment and innovation to lift productivity and competitiveness, rather than windfall gains in the terms of trade. Yet private business investment has slowed and at 4.3 per cent of GDP, non-mining investment is at its lowest point in more than half a century.<sup>1</sup> Australia's relative global competitiveness ranking was 16th around a decade ago. It then peaked at 15th in 2009-10 and has since deteriorated to 22nd (World Economic Forum 2014a).

### *Globalisation, technological change and digital disruption*

Like the rest of the world, we are facing great challenges, uncertainties and opportunities from rapid technological advances. Technology has long driven structural change but the pace of change today is arguably unprecedented. Digitisation is disrupting business models and corporate structures and fragmenting global supply chains. In short, it is fundamentally changing the way and where we produce, sell, work and consume.

The challenge for policy is that technology and the intellectual property it embodies, and increasingly the people who develop it, are highly mobile. Australia's relatively high company taxes detract from the business case for investing in Australia.

**Figure 3: Australia faces short-term and structural economic challenges**



<sup>1</sup> Calculated using the ABS Private New Capital Expenditure survey, National Accounts (2014a; 2015d) and RBA historical data (1997).

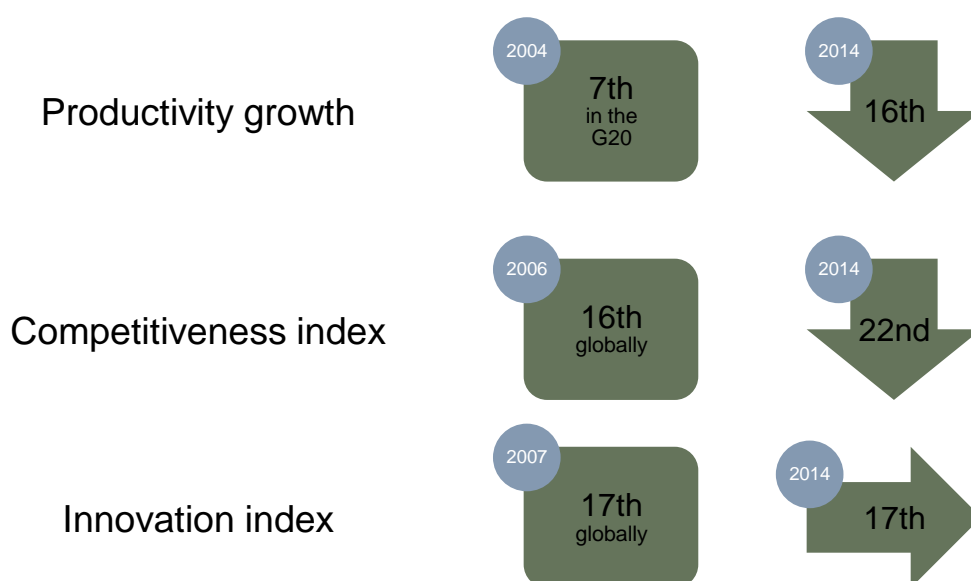
## Comprehensive tax reform is needed to expand our economic opportunities

All of these challenges demand reform of our tax system to improve productivity and make Australia an attractive place to live, work and do business. It is imperative that we offer an internationally competitive tax system that is fit for purpose for Australia's future.

Tax reform is pivotal for promoting growth through encouraging stronger and diversified investment, innovation and participation across the economy.

Tax reform is needed to support other vital reforms that promote growth including enhancing workplace flexibility, focusing the deregulation agenda on improving competitiveness and improving our human capital capability.

**Figure 4: Australia is falling behind or stagnating in crucial areas**



Source: Cornell University, INSEAD, and WIPO 2014; Dutta, Caulkin, and INSEAD 2007; The Conference Board 2015; World Economic Forum 2014a.

Note: Productivity growth is the annual average growth over the decades to 2004 and 2014. The G20 comparison excludes the European Union.

### *Tax reform should not be about underwriting inefficient spending*

Tax reform is also needed to provide a more stable and durable revenue base. However, the motivator for tax reform should not be increasing revenues to fund ever-spiralling outlays. Notwithstanding falling terms of trade, Commonwealth tax receipts as a share of GDP are roughly at their long-term average and projected to increase in coming years, largely due to bracket creep.

Imposing ever-higher taxes to pay for ineffective or low-value government spending would only exacerbate disincentives to work, save and invest without addressing the spending problem at its source. Raising taxes to cover ever-increasing expenditure allows governments to underwrite low-value or wasteful spending and dodge the difficult but necessary discussion with the community about the need to contain spending growth.

Tax revenues should be kept to the minimum required to fund the income redistribution and government services that deliver community benefits in excess of the full costs of delivering them. These costs include the deadweight cost of raising the taxes. This means that budget repair first and foremost will require the redesign of spending programs. Program redesign should include greater use of user charges, where appropriate, in place of general taxation.

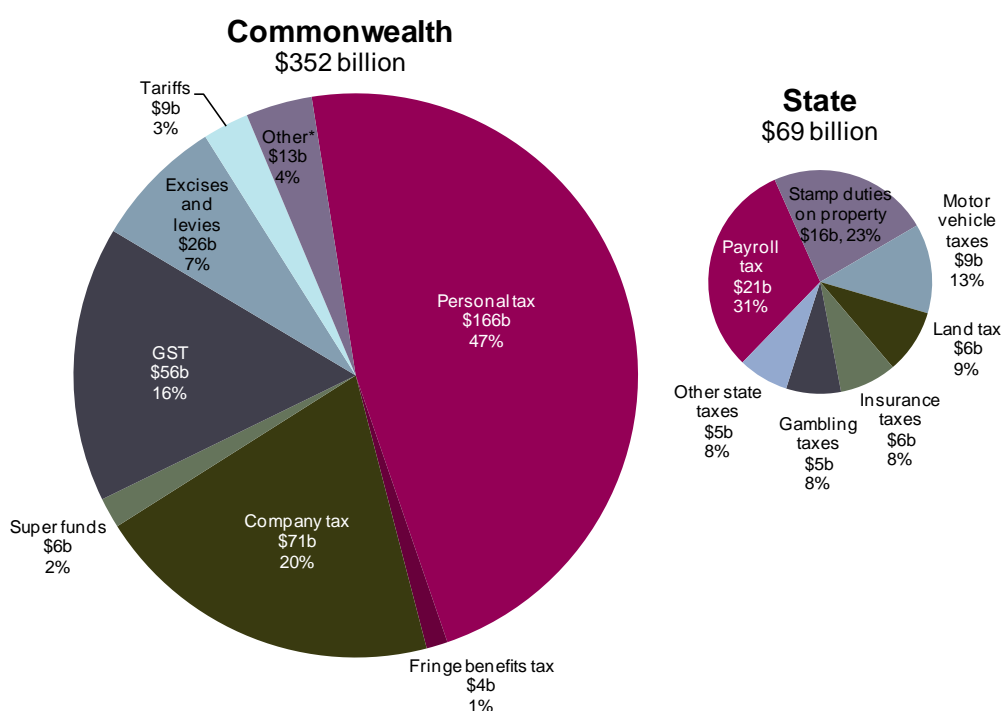
*Australia's tax system is overly reliant on income taxes and many smaller taxes*

Australia relies much more on personal income and company taxes than most other OECD economies (OECD 2014b). Respectively these two taxes contribute 47 per cent and 20 per cent of total Commonwealth tax revenues (Figure 5).

The GST provides 16 per cent of Commonwealth revenue, which is distributed to the states and territories. This is low by world standards because Australia's GST has a relatively low rate and narrow base compared with other OECD economies (Figure 6).

Australia also has a plethora of other taxes across the Commonwealth and states, which contribute one-third of total revenue nationally. Many of them are highly inefficient and tax specific transactions (such as property sales), or have multiple exemptions (such as payroll tax).

**Figure 5: Income taxes dominate Australia's tax base**

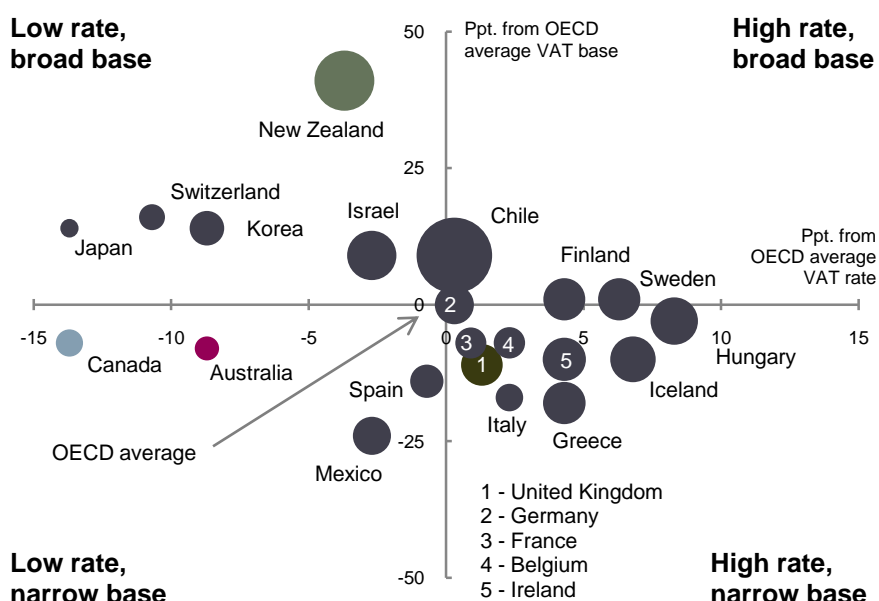


\*Includes other general sales taxes, income tax levied on non-residents, superannuation guarantee charge, property taxes.

Source: ABS 2015e.

**Figure 6: Australia's GST has a relatively low rate and narrow base**

(Size of bubble shows value-added tax revenue (i.e. GST) as a percentage of total revenue)



Source: OECD 2014a.

**Note:** On both axes zero represents the unweighted OECD average (average tax coverage is 55 per cent and average tax rate is 18.7 per cent). Does not include sub-national VAT or discounts for certain products (e.g. Canadian provinces apply VAT in addition to the national rate). The US does not have a national VAT.

*Australia's company and personal income taxes are becoming increasingly uncompetitive*

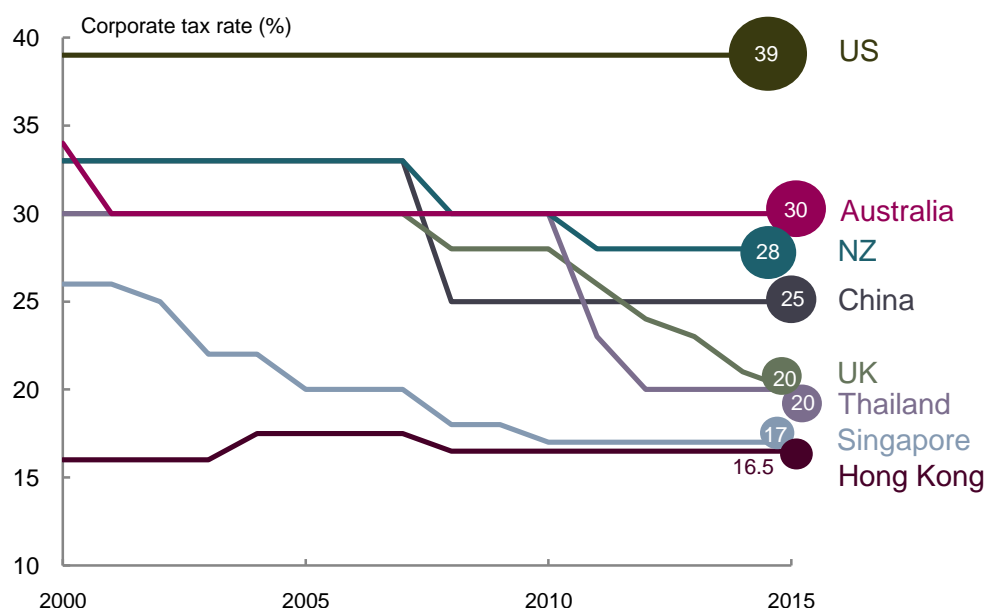
Australia is heavily reliant on foreign capital to fund additional investment. Higher investment and capital deepening generate higher labour productivity, higher real wages and more job opportunities.

Tax is one important factor influencing decisions to invest in Australia. The statutory corporate tax rate of 30 per cent competes with an average of 22 per cent in Asia and 25 per cent across the OECD (KPMG 2015; OECD 2015a). The trend to further lower company tax rates abroad is leaving Australia behind, exacerbating the already large costs of lost investment opportunities. The UK has recently announced its company tax rate will fall to 18 per cent by 2020. The World Economic Forum (2014b) ranks 'tax rates' the second most problematic factor for doing business in Australia.

Australia's top marginal personal income tax rate, now nudging 50 per cent following the introduction of the Temporary Budget Repair Levy, is not far out of line with many other OECD countries but compares with an average top marginal tax rate in Asia of around 30 per cent (KPMG 2015; OECD 2015a).

Perhaps even more importantly, the top rate currently cuts in at a little more than double average earnings, which is at the lower end of the OECD range. For example, both the UK and Germany have top marginal income tax rates around the same as Australia, but they cut in at incomes of around four and six times average earnings respectively (OECD 2015a). Competitive personal income tax rates will become increasingly important as people, particularly those with specialist skills, have more opportunities to work overseas.



**Figure 7: Many other nations have lowered their corporate tax rate**

Source: KPMG 2006, 2015; OECD 2015a.

### *Bracket creep and high effective marginal tax rates erode incentives to work*

A progressive tax system is one of the primary mechanisms used to redistribute income and support equity. The issue is how to balance progressivity against incentives to work, invest in skills and participate in the labour force.

Australia's income tax system is highly progressive. The top 3 per cent of Australian individual taxpayers currently account for almost 30 per cent of personal tax revenue, notwithstanding concessional treatment of some forms of savings income (ATO 2015b).

Progressive rate schedules that are not indexed or regularly adjusted for inflation inevitably lead to 'bracket creep', reducing the progressivity of the system overall. Bracket creep will see the average tax rate for the average income earner increase from 23 per cent to 28 per cent in just a decade, even with relatively low inflation (Parkinson 2014). A combination of inflation and real wage growth is projected to increase the percentage of taxpayers in the top two tax brackets from around 27 to 43 per cent (Figure 8).

**Figure 8: Share of people in top two tax brackets to double in next decade**

Source: Australian Government, 2015c.

Historically, bracket creep has been partly offset by occasional, ad hoc changes in tax thresholds or targeted tax benefits (such as family tax benefits). But these changes have generally paid scant regard to the overall

impact of the tax system on work incentives and indeed may have aggravated disincentive effects. Moreover, in the absence of broader tax reform, today's fiscal circumstances mean that there is little scope to offer any relief for bracket creep in the foreseeable future.

At the lower end of the income scale, interactions with the transfer system create high effective marginal tax rates that can significantly discourage workforce participation.

#### *Revenue volatility is increasing*

Globalisation means Australia is becoming even more exposed to external economic developments. The recent rapid fall in the price of iron ore has wiped \$20 billion off the budget bottom line in the past year through corporate tax collections and other taxes, including on wages (Australian Government 2015a). Over the past decade, mining's contribution to the corporate income tax base has increased, exposing government budgets to greater volatility. Commodity prices have become the canary signalling the health of federal budget revenues.

The bulk of company tax receipts also comes from comparatively few companies. Around 2,000 companies paid approximately two-thirds of company tax receipts in the 2012 financial year (Australian Government 2015c). Indeed, the 12 largest taxpayers paid one-third of company tax in 2012-13, up from around one-fifth a decade ago (Heferen 2015).

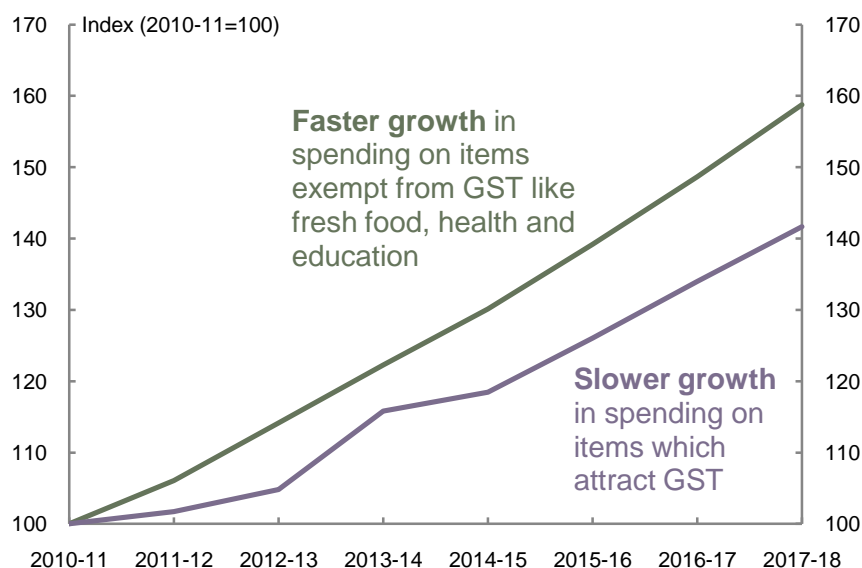
Surges and falls in house prices also expose state revenues to volatility through stamp duties applied to property transactions.

Unpredictable misalignment between ongoing government spending commitments and fluctuating revenues can pressure governments to make blunt spending cuts or to impose ad hoc tax increases, compromising tax and spending efficiency and harming consumer and investor confidence.

#### *Key tax bases are steadily eroding*

Some key tax bases are shrinking over time due to exemptions, changing preferences and changes in technology.

For example, the GST tax base is eroding as a consequence of our increased consumption of goods and services that are exempt, including fresh food, health and education (Figure 9).

**Figure 9: Spending on GST-exempt items is growing faster than the GST**

Source: Based on Australian Government 2015a, 2015d.

With aggregate participation rates plateauing, the increasing proportion of the labour force utilising flexible, part-time work arrangements – nearly one-third of workers today are part-time – is also eroding the personal income tax base. Part-time workers on average earn less than full-time workers and pay disproportionately less income tax because of the progressive rate structure, particularly through the tax-free threshold. In addition, worker mobility and migration rates, particularly for highly skilled workers, are increasing.

*The tax system is not keeping up with the new ways we make, buy and sell things*

The internet and technology have changed what, where and how we produce, buy and sell. The tax system is struggling to catch up.

In the case of e-products, globalisation has meant that companies do not have to be physically located in a country to offer services to the people in that country.

The rapid growth in relatively mobile, intangible production inputs such as intellectual property, which encompasses patents, brands and copyright, pose particular challenges for traditional company taxes. More than 70 per cent of international trade now comprises trade in capital and intermediate goods and services (OECD, WTO, and World Bank 2014). Fragmentation of supply chains is the main driver of growth in global trade.

As a result, pinning down where production takes place and profits are generated is challenging in concept and practice, with consequences for a traditional source-based company tax system like Australia's in particular.

New approaches will be needed. In part, this will require reviewing global tax conventions, which is the focus of the multilateral Base Erosion and Profit Shifting (BEPS) process in the OECD. More fundamentally, greater mobility of production and high-skilled labour, which compromises both Australia's company and personal income tax bases, will require greater reliance on less mobile bases, such as consumption.

*Our tax system is too complex and burdensome*

The tax discussion paper (2015c) estimates annual tax compliance costs are around \$40 billion, the equivalent of 2.6 per cent of GDP. The World Bank (2014) ranks Australia 39th for 'ease of paying taxes', compared with New Zealand ranked 22nd.

Lower compliance costs represent a huge opportunity for an efficiency dividend to be shared across the community.

Taxpayers already have the opportunity to complete their tax return online, with pre-filled information about earnings and a more customer-friendly interface. Yet three-quarters of personal tax returns are currently being submitted by tax agents, about the same proportion as 20 years ago (ATO 2015b).

Our tax law is highly complex – the Tax Act itself is more than 4,700 pages long. In part, this is an inevitable outcome of balancing fundamental principles of efficiency and equity, but it also reflects arrangements and exemptions to meet particular objectives and interests. This is a by-product of a tax system that comprises a large number of taxes that impose high compliance costs yet raise relatively little revenue.

Our unnecessarily complex system also reflects the accumulation of decades of ad hoc tax changes and indicates the potential compliance benefits from holistic reform.

**State variants of the same tax multiply the compliance burden**

The Henry tax review (2010) estimated that Australians pay at least 125 different taxes. It was estimated that 99 were levied by the Australian Government (mostly agricultural levies), 25 by states and one by local government.

From a compliance perspective, taxes levied by different states should be counted separately as they differ in terms of bases (and exemptions), rates and thresholds. Examples include payroll tax and land tax. By this estimate there are as many as 160 different state taxes, or 259 taxes nationally (excluding local government rates).

A move to more consistent tax bases across all jurisdictions would deliver benefits to both compliance and efficiency outcomes. This could be achieved through harmonisation across states, or administration of some state taxes at a national level.

**We need to fundamentally rebalance and rebase our tax system to promote growth**

Put simply, Australia's tax system is out of balance and will become increasingly so in the modern global economy, holding back economic growth and diminishing its capacity to deliver a stable revenue base.

In practice all taxes impose costs, but some are more costly than others. An efficient tax system is one where the costs of raising each additional dollar of revenue from different taxes are roughly equal – that is, the mix of taxes is balanced to raise aggregate revenue at least cost.

Narrowly-based taxes or taxes with high tax rates generally impose disproportionately high costs. Treasury estimates that raising an extra dollar of company tax currently imposes a cost of around 50 cents, reflecting the value of investment forgone. An extra dollar raised from personal income tax is estimated to cost about 25 cents (the value of work forgone), but this is likely an underestimate as it assumes all taxpayers pay the average marginal rate of tax. An extra dollar of stamp duty is estimated to impose a high cost of more than 70 cents. In contrast, raising an extra dollar from the GST even with its current quite narrow base and low rate is estimated to cost about 19 cents (Cao et al. 2015). This is why we must have a fundamental remix of taxes.

**Figure 10: Australia's tax mix risks making us uncompetitive**



Source: OECD 2015a.

Note: Does not include sub-national VAT. The US does not have a national VAT.

*The costs of inaction are already large and will build over time*

The disparities in marginal excess burdens highlight the potentially large efficiency dividends from comprehensive tax reform. They also highlight the substantial and unnecessary costs we are imposing on ourselves by doing nothing. And the costs of doing nothing will only build as additional dollars of revenue are raised from relatively inefficient taxes.

Keeping our company tax rate at 30 per cent means we are forgoing higher GDP, real incomes and jobs. Treasury estimates that lowering the company tax rate by just one percentage point would increase GDP by up to 0.35 per cent per year or more than \$5 billion in today's economy (Rimmer, Smith, and Wende 2014).

This is why the tax system must be reviewed holistically. Looking at each tax in isolation will impede our ability to design the best tax system overall.

*The status quo persists largely because of a failure to consider the system as a whole.*

Source: Mirrlees et al. 2012.

The tax system must be rebalanced towards broader-based taxes with lower rates to lift the burden off investing, risk-taking and working. Primarily this means moving away from personal and company income taxation to broad-based consumption taxation.

Without changes to the GST in the mix of options, the scope for growth-enhancing tax reform will be severely curtailed.

Moreover, just as globalisation and digitisation increase the costs of company and personal income taxes, they correspondingly strengthen the case for a shift to expenditure or consumption taxes. Put simply, consumption provides a far more stable, identifiable and less mobile base than personal or business income in the digital economy.

*In a globalising world, expenditures have relatively clear geographic associations, reducing the potential for international tax avoidance and generally reducing the mobility of the tax base compared to ... personal income taxes or ... the corporate income tax.*

Source: Hines and Summers 2009.

**Figure 11: No change is not an option**



Source: The Conference Board 2015; World Economic Forum 2014b; Cornell University, INSEAD, and WIPO 2014; Dutta, Caulkin, and INSEAD 2007; Australian Government 2015a, 2015c; OECD 2015a; Cao et al. 2015; Rimmer, Smith, and Wende 2014.

### All taxes are costly... and some more than others

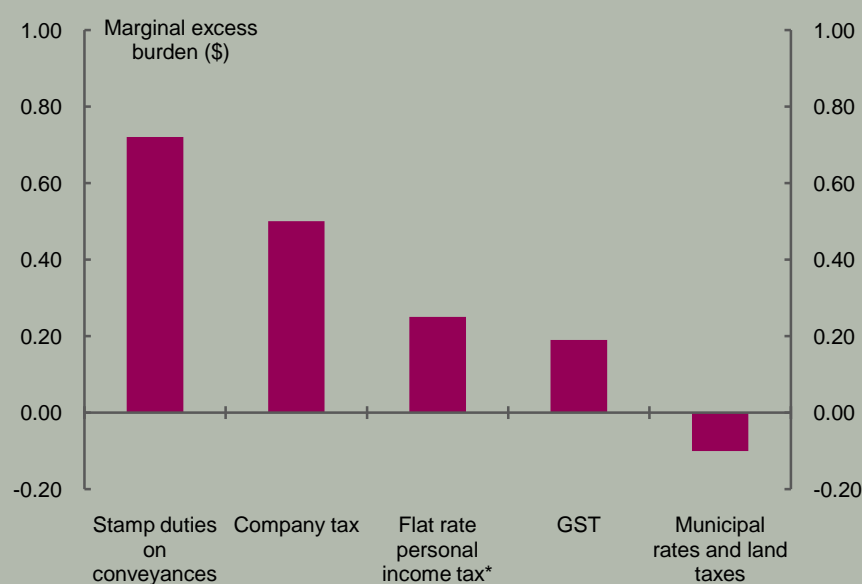
Taxes impose costs on our economy because they change prices and incentives, influencing people to change their behaviour and not undertake activities and transactions which, in the absence of a tax, would have been valuable to them. The net benefits of these activities forgone are the so-called deadweight costs of taxation, or the marginal excess burden. They are called deadweight costs because they represent an irretrievable loss of community value.

Taxes are also costly to administer and comply with. These are also deadweight costs as they use up scarce resources that could have been used in other activities.

Narrowly based taxes with high rates tend to impose the highest costs. Narrow bases typically encourage greater changes in behaviour, requiring higher rates to raise a given amount of revenue. Deadweight costs of taxes generally increase more than proportionately as tax rates increase. Higher tax rates drive greater price distortions or 'wedges' that discourage increasingly higher-valued activities.

This is why, as a rule of thumb, broader tax bases with low rates deliver a given amount of revenue more efficiently. Or put another way, a tax system is more efficient when the marginal deadweight losses of the major taxes are roughly equal. Yet Treasury estimates indicate that the marginal excess burdens of Australia's taxes vary widely.

**Figure 12: Marginal excess burdens of Australia's current taxes vary widely**



\*Likely underestimates the marginal excess burden as does not include progressive rates

Source: Cao et al. 2015.

## **A tax reform package with seven core elements**

The Business Council is recommending consideration of a reform package comprising seven core elements:

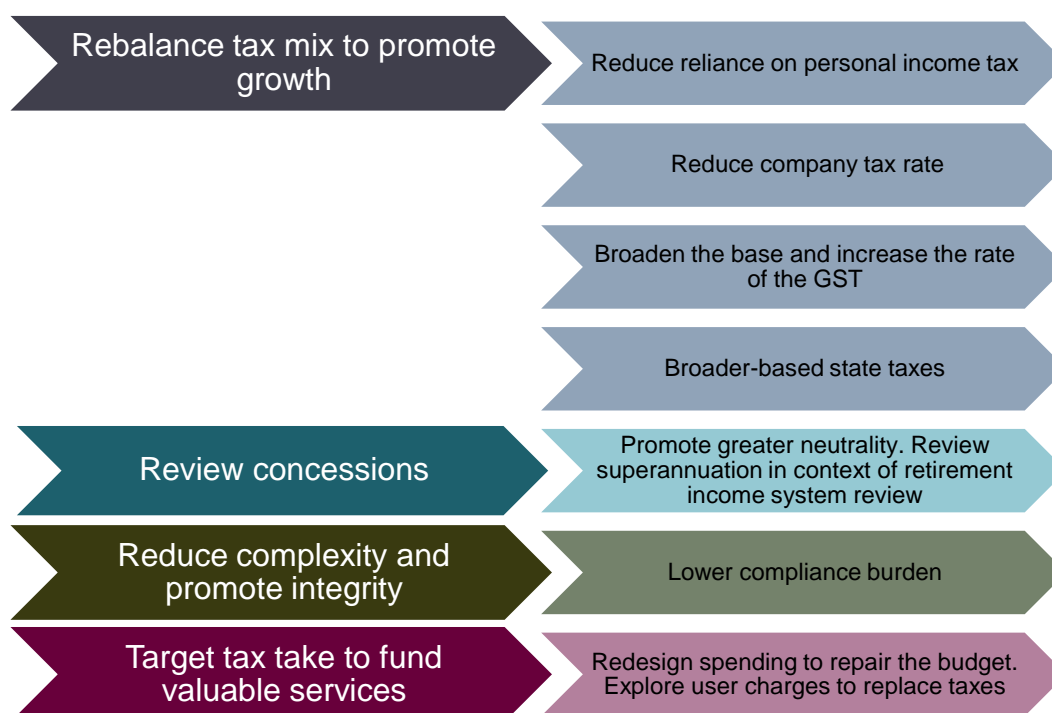
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2. A more competitive company tax system that encourages a culture of entrepreneurship and reduces disincentives to innovate and invest.
  - A company tax rate of 25 per cent is urgently needed to stop Australia falling further behind our competitors. Combined with dividend imputation this would help drive investment and productivity growth. Further reductions may be required over time to maintain our competitive position. Appropriate investment, and research and development provisions will be essential for encouraging risk-taking and innovation.
3. Broadening the base and increasing the rate of the GST to reduce Australia's reliance on taxes that inhibit growth and better deal with the challenges of digital disruption.
  - The Business Council is not advocating a particular rate or base at this stage, but believes there is scope to move on both margins to rebalance the tax mix. This will require appropriate compensation for some groups, and if the tax changes are sound, there should be more than enough capacity to do so.
4. Replacing highly distorting state taxes such as stamp duties and other transaction-based taxes with more neutral taxes, and more streamlined payroll taxes. Importantly, national tax reform should not be constrained by existing revenue-sharing arrangements between the Commonwealth and states.
5. More neutral, concessional treatment of savings to relieve the compounding effects of taxing savings over time.
  - The Business Council strongly supports a comprehensive and concurrent review of the retirement income system, encompassing all superannuation concessions and the interrelationships with the age pension system. A failure to understand and account for these interrelationships and impacts on lifetime savings decisions could lead to inequities, add further complexity to an already complex system and generate unintended adverse consequences.
6. Some current arrangements for taxing savings have been questioned by parts of the community including, for example superannuation concessions for high-income earners, negative gearing and the capital gains tax discount. However, published estimates of tax expenditures do not necessarily indicate the potential revenues that could be recouped or whether their removal would deliver net economic benefits or



more equitable outcomes. Such arrangements should be carefully assessed on their merits and within the context of overall tax system progressivity and other impacts, for example, on housing affordability and complexity of the tax system. A simpler tax system overall to reduce the compliance burden. Fewer, broader-based taxes with lower rates and fewer exemptions will reduce complexity and compliance burdens and enhance tax system integrity.

7. Ensuring aggregate tax revenues are the minimum required to fund income redistribution and government services that deliver net community benefits. Where appropriate, user charges should replace funding from general taxation.

**Figure 13: Key directions for tax reform**



### The review must be ambitious

Comprehensive tax reform is difficult. But potential difficulties should not be used as an excuse to shackle the white paper process.

*Tax and federation reform processes will need to move together*

The white paper process is an opportunity to undertake a root and branch review to deliver the best-possible tax system for Australia. Both the tax white paper process and the federation review will need to complement each other: a failure to do so creates a risk that both processes will fail.

The tax white paper process should not seek to solve the problems of the federation. State boundaries or distributional agreements should not artificially constrain reform options. Agreements can be renegotiated. The overriding objective should be an optimal tax system that delivers a growth dividend for the entire nation to be shared among all jurisdictions.

*Avoid unnecessary risks*

Limiting the menu of reform options will make reform more difficult and raise the risk that changes could leave us worse off.

For example, tying a company tax reduction to removal of dividend imputation and the reinstatement of double taxation of dividends would be a case of throwing the baby out with the bathwater. Dividend imputation brings substantial benefits to the Australian capital market, including wider community share ownership and more efficient capital allocation, and contributes to capital market stability. We cannot afford to risk capital market efficiency and stability when more investment is required, not less.

*Equity is a critical objective but all its dimensions must be explored*

Equity must be an essential consideration in designing and ultimately for achieving tax reform. But equity is multidimensional. It needs to consider treatment across generations and over lifetimes. Context matters. Changes in tax arrangements inevitably create both winners and losers. That some people may not be better off from an isolated change is not a sufficient reason for not making changes. Compensation for some may be warranted and if the tax changes are sound, there should be more than enough capacity to do so. Other changes could be phased in to give people adequate transition times.

In particular, we must not lose sight of the intergenerational welfare implications of a tax system that undermines growth and economic opportunities for future generations who have no voice – or vote – in today's Australia.

**Principles for promoting equity**

- People in similar circumstances should be treated in a similar way (horizontal equity).
- Those with greater capacity should pay more (vertical equity).
- Decisions taken today should consider the impacts on future generations (intergenerational equity).
- The beneficiaries of services should contribute to the cost (beneficiary principle).
- Decisions should recognise the personal and social costs that raising taxes has for economic growth and job opportunities.

For example, ruling out changes to the GST because it is less progressive than the income tax system would be grossly short-sighted. The community deserves to be apprised of the implications of broad tax reform for future growth (and scope for appropriate compensation) rather than simply focusing on the perceived fairness of changes to particular taxes considered in isolation. The community should also be made aware of what they will be giving up if reform does not take place.

*Not all taxes need to address all objectives.*

*... Not all taxes need be progressive as long as the overall system is.*

Source: Mirrlees Review of UK Taxation 2011.

*The politics are largely what you make it*

The appetite of the community for reform is not set in concrete. Research conducted for the Business Council indicates that the community is deeply concerned about Australia's economic future and job opportunities in particular. Personal economic security is also a concern: 83 per cent of people believe 'a worsening of economic conditions in Australia will affect them personally'.

There is a recognition that the status quo is untenable, but there are very low expectations of the ability of political leaders to adequately confront the upcoming challenges. Only 13 per cent believe the management of our national finances is good, and for an unprecedented 18 per cent, the competency of government ranks as a major concern.

While tax is not front of mind, people appear very open to change where they believe it will enhance Australia's growth prospects.

A genuine transparent process that builds a credible evidence base will be essential for convincing them. Credibility will be enhanced by transparency around assumptions and data underlying modelling and the modelling itself.

*We cannot afford to squib growth-enhancing tax reform*

Current fiscal circumstances might be seen as limiting the capacity for compensation and hence the scope to undertake comprehensive reform. But changing the tax mix can be calibrated to be roughly revenue neutral and over time will deliver a growth dividend that can be used in the best interests of the community.

It would be short-sighted to limit assessment or delay implementation of growth-enhancing tax reforms such as a reduction in the company tax burden because of the current deficit situation. It would be a case of good policy being crowded out by a reluctance to tackle the structural spending reforms needed to improve the budget position. Ideally we should be doing both.

### **The options paper must articulate the case for reform to build community and bipartisan support**

It is essential that the options paper articulate the case for reform to bring along the community and to build bipartisanship. All elements of the system should be considered and debated as part of the review. Not to do so may limit and restrict input and involvement, and only increase the level of difficulty for achieving meaningful reform.

Comprehensive consultation, including open forums and robust discussions involving all stakeholders, must be undertaken throughout the process. Stakeholders across business, the wider community and all levels of government should be involved and given adequate time to respond to options.

**A 10-year prioritised plan for reform**

The options paper should set out options for reform with appropriate transitions – a tax reform plan to be implemented over the next 10 years to complement a 10-year strategy to contain spending growth.

The Business Council is realistic that not all the directions for reform we have outlined can be implemented overnight. However, a necessary outcome of the tax review process must be a comprehensive package of reforms with a clear, coherent and prioritised plan for its progressive implementation. It is vital that reforms are locked in, not just promised.

Serious consideration should be given to the establishment of an independent body such as a Tax Reform Commission to help steward tax reform over the next decade and to reduce the risk of policy reversals we cannot afford. This new body could be modelled on the Productivity Commission and the Australian Law Reform Commission.

# 1 ECONOMIC GROWTH MUST BE THE MAIN GOAL

Australia is facing substantial challenges and uncertainties from demographic and technological change, globalisation and the transition away from mining as the major driver of growth. The one certainty is that businesses will need to be nimble, competitive and innovative to keep the Australian economy strong and to support our high living standards.

Ultimately it is enterprises large and small that drive wealth creation through investment and innovation. Only enterprises create jobs and drive higher real incomes through wages growth and supplying better quality goods and services at lower prices.

To encourage growth we will need a business environment that better incentivises risk-taking and entrepreneurship, and encourages investment and wealth creation in Australia. Tax reform will be essential for improving the incentives for businesses in existing and new sectors to invest, innovate and take risks.

The balance of incentives and disincentives provided by our tax system will become even more important in a global economy where capital and skilled labour are increasingly mobile and where technology makes production increasingly 'footloose'. An uncompetitive tax system will only succeed in driving investment and production offshore, further reducing growth and undermining tax revenues.

**Figure 14: Goals of a good tax system**



*Other goals are also essential and not necessarily in conflict*

While economic growth must be the principal objective for reform, our tax system must also be equitable, have integrity and support a better functioning federation. The tax system should also provide a stable revenue base and sufficient revenues to fund efficient spending. Promoting all these goals requires careful balance. Fortunately they are more consistent and mutually reinforcing than it might first appear.

The ultimate burden of company taxes in Australia, for example, tends to fall more heavily on labour incomes because mobile capital can be redeployed overseas. Lower capital investment translates to lower economic growth and fewer jobs. This means that growth-enhancing tax reform can increase jobs and real wages growth, as well as underpin revenues to fund income transfers and social services. All of these outcomes are necessary for achieving a society with equitable economic opportunities.

A more efficient tax base will also provide a national growth dividend that can be shared across jurisdictions in the federation and support more stable revenues. A simpler and more transparent tax system can also promote better compliance and trust and generate any given amount of revenue at lower cost.

**Improving productivity is the key to promoting business competitiveness and higher real wages**

Improving productivity is the only sure way of increasing business competitiveness and national incomes. While the terms of trade made a strong contribution to income growth in the 2000s, their impact will likely be negative over the next decade and at best benign beyond then (Figure 15). Labour productivity growth will need to strengthen yet current projections are for only modest productivity growth.

There is no single policy lever to increase productivity. Productivity ultimately depends on the performance of individual enterprises – how efficiently they produce goods and services, which relates to how innovative they are (multifactor productivity growth) and how much and where they invest (capital deepening).

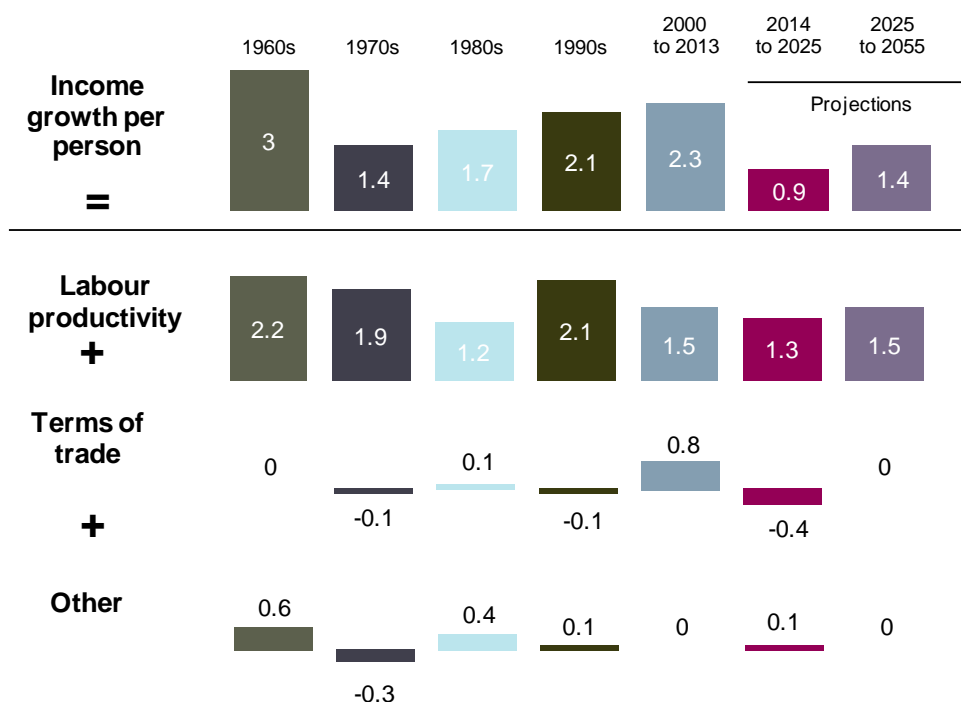
*Taxes deter investments that drive productivity growth and higher incomes*

People in enterprises must make decisions every day about what and how much to produce, how many people to employ, what technology to use and whether or not to invest in the context of incentives provided by markets, taxes, regulations and institutions.

Inefficient taxes can impose large costs by obstructing efficient production and investment choices and impeding adjustment to market price signals. High taxes lower the return for effort and risk-taking and deter investments at the margin, reducing job opportunities and constraining income growth.

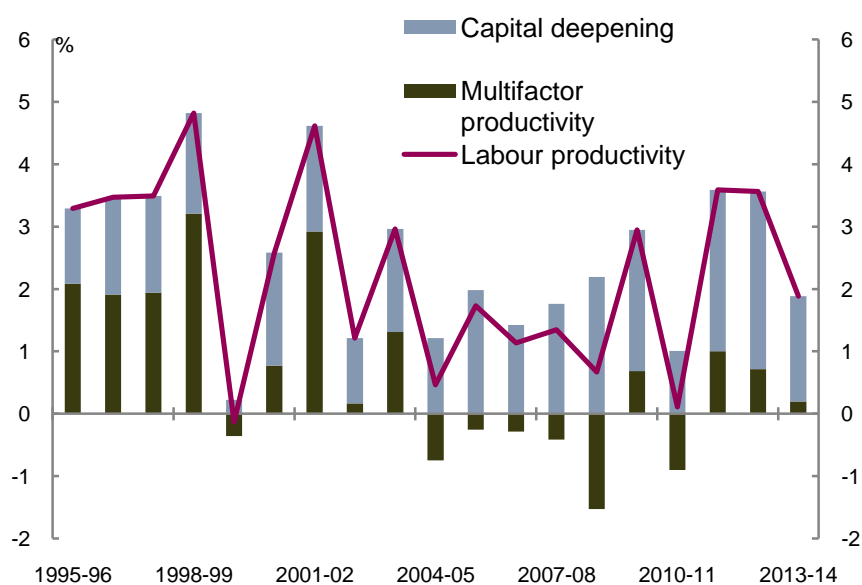
The extent to which taxes encourage or discourage investment is particularly important for productivity growth. Strong growth in capital inputs historically has been the largest single source of labour productivity growth – and real income growth – in Australia (Figure 16). Spillovers from technological progress and innovation (multifactor productivity growth) are also critically important and usually flow from complementary investments.

**Figure 15: Strong labour productivity growth will be needed for future income growth**



Source: Australian Government 2015c.

**Figure 16: Investment and innovation drive labour productivity growth**



Source: ABS 2014b.

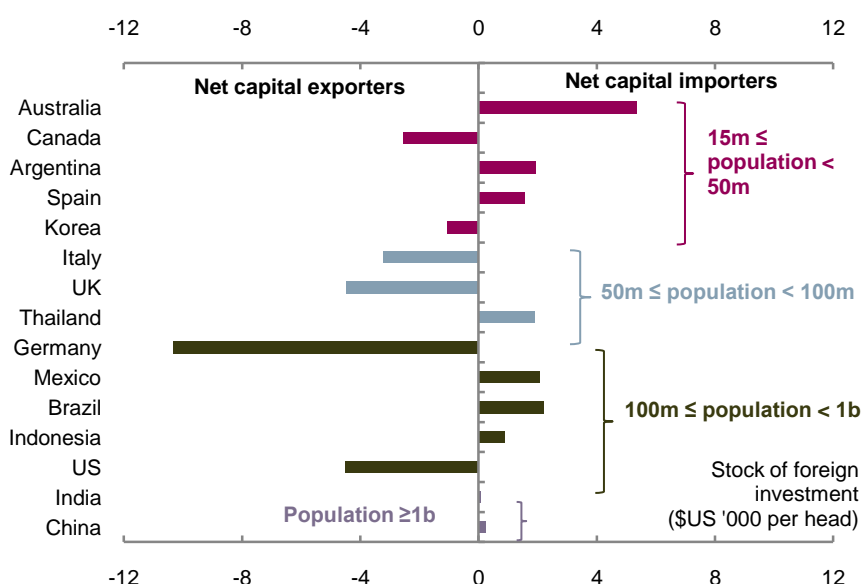
## A more competitive tax system is needed to drive efficient investment, create wealth and make our economy more resilient to economic shocks

Capital deepening, whether funded from domestic or overseas savings, is crucial for productivity growth. Yet Australia's private business investment has slowed. With the economy needing to restructure in the wake of the mining investment boom, at 4.3 per cent of GDP, non-mining business investment has fallen to its lowest point for more than half a century.<sup>2</sup> New investment is urgently needed across the economy in both new and traditional sectors, such as agribusiness, to replace mining investment.

With its relatively small population, Australia is heavily reliant on foreign sources of capital to finance a significantly greater quantity of domestic investment than our savings would otherwise allow (Figure 17). Foreign direct investment can bring many additional benefits including increased competition, new business models and new technologies.

Global mobility and competition means capital is increasingly responsive to corporate tax rates and other costs, including labour. It is imperative that Australia offers an internationally competitive tax regime to attract stable, diversified investments that build a resilient economic base and provide secure jobs. The story is similar for high-performing workers who complement investments in physical capital. They too have greater opportunities to work and live overseas, making them more responsive to relative rewards for work when deciding where to work and pay tax. A competitive tax system should also avoid taxing business inputs that can distort efficient production and investment choices.

**Figure 17: Australia is heavily reliant on overseas investment, even among economies of the same size**



Source: Foreign investment stock data from United Nations 2014b. Population data from United Nations 2013.

<sup>2</sup> Calculated using the ABS Private New Capital Expenditure survey, National Accounts (2015d; 2014a) and RBA historical data (1997).



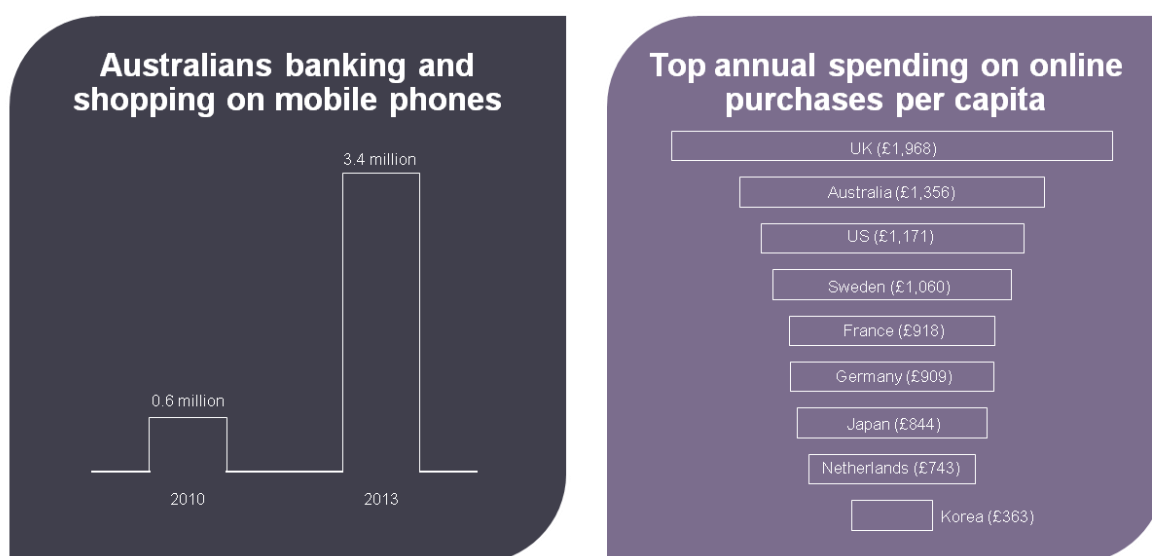
## The tax system must promote flexibility, innovation and entrepreneurship

Innovation is the key driver of productivity and economic growth. Innovation encompasses much more than invention. It can also come from the creation of new products and services, new business models and the adoption of new production processes that reduce costs. Adopting innovations enables businesses to improve their competitiveness, create high-quality jobs and generate greater value. Innovating is essential for responding to rapid changes in global supply chains.

The pressures for businesses to innovate and adapt today are enormous and, arguably, unprecedented. Technology and digitisation have facilitated new business models, changing the buyer–seller relationship and the types of products on offer. More goods and services are becoming tradeable, with opportunities to buy and sell to almost anyone with internet access (Figure 18). In the case of e-products, companies do not have to be physically set up in a country to offer services to the people in that country.

The internet has also aided the development of new ways of offering services – such as share economy services like Airbnb and Uber. Policies, including taxation and regulation, must adapt to ensure Australian businesses are not left behind.

**Figure 18: Australians embrace technology, changing how we buy and sell**



Source: Australian Communications and Media Authority 2014; Ofcom 2014.

A tax system that encourages and supports the competitiveness of established businesses and start-ups is vital for driving innovation and productivity growth. Appropriate policy support for research and development and innovation is broader than tax policy, but the tax system can play a crucial facilitating role.

A reduced reliance on income taxes, primarily a lower company tax rate, would improve the competitiveness of Australian companies and improve incentives for entrepreneurs. Stable and predictable tax arrangements can provide investors with confidence to make long-term investment decisions. Appropriately calibrated research and development incentives are essential for encouraging business to commercialise innovations in Australia.

Tax treatment of employee share schemes also plays an important role. Recent changes to taxation of employee share options in particular should assist start-ups to compete with global rivals for scarce global talent.

### **Employee share schemes are important for start-ups**

Start-up companies are an important contributor to innovation outcomes. Employee share schemes can allow start-ups to drive better firm performance, attract and retain top-level talent and to address funding issues. The increasingly global nature of the business world means that start-up companies themselves, as well as the capital to fund new ideas, are increasingly mobile.

Creating a business environment in Australia that makes it easy for start-up companies to establish themselves and to operate is essential in the competitive global marketplace. Differences in the availability of, and access to, employee share schemes is one example of how different countries can make themselves more or less attractive as an environment for start-ups to establish themselves.

Deloitte's survey 'Barriers to Innovation' (2014) identified three key reasons why employee share option plans were important to organisations and their employees. They:

- contribute to better firm performance through the aligning of incentives, i.e. if the firm does well the employee does well and vice versa (91 per cent of respondents)
- enable better quality and staff attraction and retention (86 per cent of respondents)
- address funding issues (61 per cent of respondents).

While the rationale for employee share schemes is perhaps strongest for start-ups, the logic underpinning them can also be applied to larger, established businesses.

## Equity is an essential element of our tax system

A good tax system must be equitable as well as efficient and simple. A system that is (and is viewed as) fair and promotes social capital and cohesion will be more durable and less likely to be compromised by ad hoc changes to address community concerns.

Australia has a long-standing social compact that uses the tax system as one of the main means of targeted redistribution. But the extent to which income should be redistributed and the best mechanism to achieve it will inevitably continue to be debated. This is because assessing equity is subjective and contextual.

Attempting to satisfy all possible equity principles is likely to lead to administrative complexity and compromise the efficiency of the tax system, which could have flow-on consequences for fairness. Applying any one equity principle may compromise others.

### Principles for promoting equity

- People in similar circumstances should be treated in a similar way (horizontal equity).
- Those with greater capacity should pay more (vertical equity).
- Decisions taken today should consider the cost to future generations (intergenerational equity).
- The beneficiaries of services should contribute to the cost (beneficiary principle).
- Decisions should recognise the personal and social costs that raising taxes has for economic growth and job creation.

*Distributional impacts of tax reform should be considered as a whole*

Changes in tax arrangements inevitably create winners and losers. Distributional impacts must be carefully assessed, not least because the person who ultimately bears the tax burden is often not the person or entity who is legally obliged to pay it. This means that looking at the immediate distributional impacts of changes to one tax in isolation will likely give a misleading impression that could jeopardise welfare-improving tax reform.

For example, there are concerns that the GST is a regressive tax and inherently unfair. Yet an expansion of the GST that allows contraction of inefficient taxes will encourage economic and jobs growth. Rather than peremptorily ruling out changes to the GST on equity grounds, it would be far preferable to undertake a thorough analysis of the economic and distributional impacts of rebalancing the tax mix and different feasible compensation measures.

*Not all taxes need to address all objectives.*

*... Not all taxes need be progressive as long as the overall system is.*

Source: Mirrlees Review of UK Taxation 2011.

*There are numerous ways of moderating adverse distributional impacts*

That some people may not be left better off is not sufficient to stall growth-promoting reforms. Compensating tax arrangements can be devised to offset significant impacts on lower-income earners without compromising the benefits of reform itself.

In some instances, it may be more appropriate to phase in a tax change over time or delay its introduction to give those affected adequate time to adjust. Changes to taxation of retirement income are an obvious example. Phasing or grandfathering can moderate the need for direct compensation while still protecting beneficiaries of the current system from significant income shocks.

### **Efficiency, equity and simplicity underpin a good tax system**

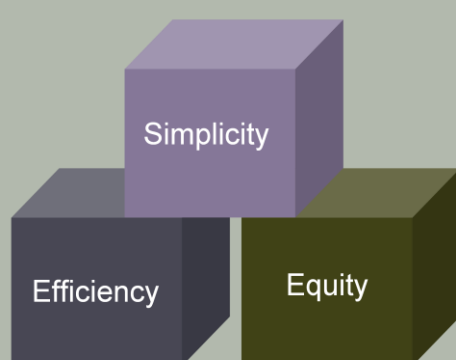
Ever since the Asprey Report in 1975, there has been broad agreement that Australia's tax system should be underpinned by the principles of efficiency, equity and simplicity. The most recent tax discussion paper continues in this tradition.

Any improvements to the tax system will involve a debate on how to best balance these principles and the trade-offs involved.

Australia's tax system has developed through a combination of planned reform and an accumulation of ad hoc decisions. But even carefully planned, well-designed tax systems will distort the choices people make as they decide how to allocate their resources (money, time and skills) to their most valued use.

Ideally, the tax system and the incentives it creates should follow explicit policy decisions based on a clear set of principles instead of unintended outcomes of ad hoc or revenue-raising decisions.

**Figure 19: Principles for a robust tax system**



### **Simplicity makes the tax system more transparent and builds trust**

The tax system should be low cost to administer and easy to understand. This enables taxpayers to comply with the rules at minimum cost. Excessive tax compliance wastes effort, diverting scarce time and focus from more productive activities.

A simple tax system is likely to be more transparent. As a consequence, taxpayers can better understand the tax costs of actual and planned actions.

As stated in the tax discussion paper (2015c), 'complexity is rarely introduced intentionally'. It is the likely consequence of a tax system which seeks to achieve multiple policy objectives as well as being a source of government revenue. Even when the policy principle is simple, complexity can emerge through poorly drafted tax law, evolving regulator interpretations or explanatory documents using overly technical or cumbersome language. This should be acknowledged, and where possible, addressed.

The tax system is just one way the government can influence and improve individual and social welfare and business conditions. It is essential that all arms of government policy maintain internal consistency. In particular, the tax and transfer system should work in harmony to achieve policy objectives.

Simplicity and transparency bring confidence and stability. Simple tax systems give taxpayers confidence that the system will not be subject to sudden changes.

### **Implications for the tax white paper**

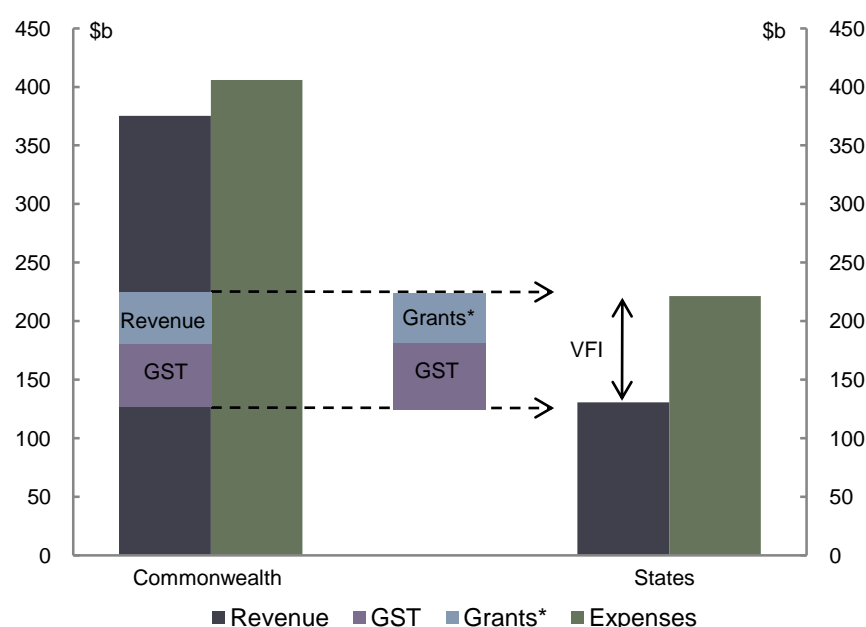
- ▶ Reform proposals primarily must be considered against their implications for economic growth, particularly for investment in all forms of capital and innovation.
- ▶ Distributional impacts must be carefully assessed in the context of the wider impacts of broad tax reform.
- ▶ Tax compliance costs place a significant drag on national income. Reform options ideally should seek to simplify the tax system.
- ▶ The government should undertake and publicly release modelling (including assumptions) on the welfare effects of different tax package options. This should quantify the economy-wide benefits and distributional impacts of a holistic set of changes.
  - For example, modelling of the broad economic impacts of increasing the GST, including its distributional impacts, should inform discussions on appropriate compensation and transitional arrangements.

## 2 IMPROVING THE OPERATION OF THE FEDERATION

Under the current tax system, the Commonwealth collects more revenue than it directly spends on services. The states and territories are responsible for spending that well exceeds their own revenues; states control around 25 per cent of all revenue collected by both tiers of government, but they are responsible for around 40 per cent of spending (ABS 2015c, 2015e). This is known as vertical fiscal imbalance (VFI).

The gap is bridged through GST transfers and Commonwealth grants to the states for specific purposes. GST revenue (net of collection costs) on average provides around half of the federal funding given to the states, although this differs considerably among them (Figure 20).

**Figure 20: The states spend more than they tax**



\*97 per cent tied grants, 3 per cent untied grants

Source: ABS 2015c; Australian Government 2014b.

The GST is centrally collected by the Commonwealth. This reduces the administrative cost of raising the tax, and lowers compliance costs for businesses operating across multiple jurisdictions.

But with weak growth in the GST over the past decade, Commonwealth grants for specific purposes have swelled (Figure 21). These grants range from large agreements where states have flexibility about how they reach nationally agreed outcomes (\$16.4 billion for National Health Reform in 2015-16) to small agreements for specific projects (\$0.3 million for a commemorative flagstaff in Bathurst).

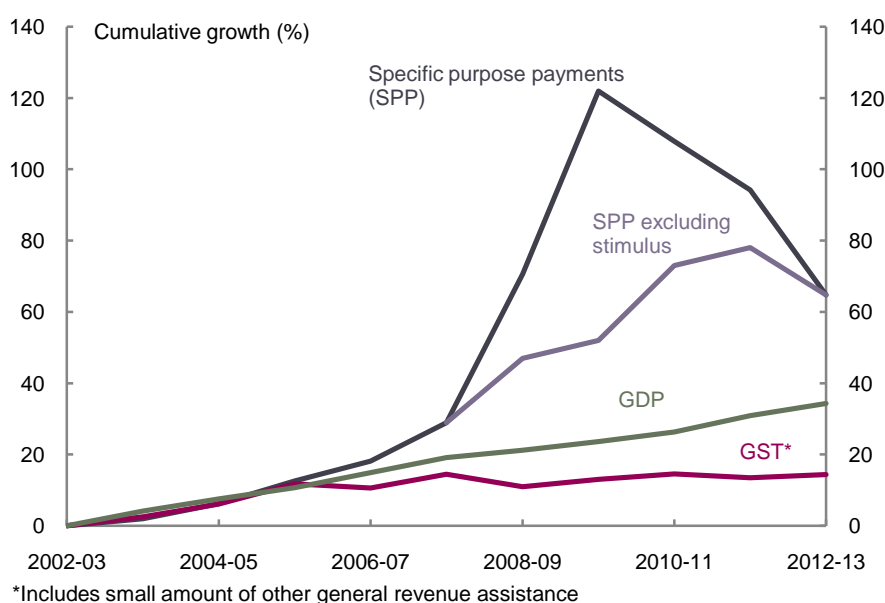
Commonwealth transfers to the states can limit the effectiveness and efficiency of the federation and the relationship between the Commonwealth and the states.

For example, there may be incentives for states to blame the federal government for insufficient funding and seek recompense for revenue shortfalls, instead of making a case to their electorates that spending should be cut or additional revenue should be raised.

On the flip side, the federal government may have the opportunity to play a larger and in some cases more prescriptive role in policy and program areas that are the responsibility of the states.

It also increases the potential for overlap and wasteful spending.

**Figure 21: GST growth has been weak, grants for specific purposes have swelled**



Source: Parliamentary Budget Office 2015.

From the perspective of the consumer, as long as the service is provided efficiently it should not matter how it is funded. But when federal and state governments offer services jointly or in the same policy space, it can reduce transparency and accountability, making it difficult to navigate services and ultimately to know who to punish or reward at the ballot box.

Resolving these issues by completely removing VFI is theoretically possible, but would have major implications for the efficiency, fairness and simplicity of the national tax system. Businesses would face significant compliance costs if GST or income tax bases and administration differed between states.

The solution lies in finding an appropriate balance based on:

- clearly defined responsibilities assigned to the level of government best equipped to deliver the services effectively
- a high degree of certainty for the states on the amount of Commonwealth funding
- more spending discretion for state governments, acknowledging the instances where harmonisation or national consistency are important.

These issues are currently the focus of the concurrent review of the federation.

The recently released draft federation discussion paper (2015b) canvasses a number of options to reduce some of the problems of VFI, including sharing the Commonwealth's income tax with states and expanding the GST. All revenue-sharing options, including the ones raised in the paper, are worth detailed and considered examination through the federation white paper process.

The Business Council recommends first determining the best combination of taxes for raising revenue across the federation. The primary objective of the tax white paper should be national tax reform that supports growth, productivity and investment. Responsibility for raising revenues should be based on which government can do so most efficiently, accounting for issues like tax-base mobility and administrative costs.

Revenue-sharing options, including those raised in the federation discussion paper, are worth detailed and considered examination through the federation white paper process. Revenue sharing can be tied to one or several efficient tax bases, or even all tax revenue. However, the new arrangements should not unintentionally create new barriers to future tax reform.

Limiting the scope of the tax review process because of current distributional agreements around the GST, for example, would undermine prospects for a fundamental rebalancing of our tax system to promote jobs and growth. A failure to deliver tax reforms would in turn constrain the ability of all levels of government to provide services into the future.

At the same time, viewing reform of the federation through the prism of current tax and distributional arrangements would hinder efficient allocation of tasks and improvements in service delivery. The two processes are inherently interrelated and must complement each other to ensure mutually reinforcing outcomes. The alternative is likely failure of both processes.

### **Implications for the tax white paper**

- ▶ The tax white paper should determine the best combination of taxes for raising revenue across the federation. Its primary objective should be national tax reform that supports growth, productivity and investment.
- ▶ Revenue-sharing options, including the ones raised in the draft federation discussion paper, are worth detailed and considered examination. Revenue sharing can be tied to one or several efficient tax bases, or even all tax revenue.
- ▶ Limiting the scope of the tax review process because of current distributional agreements around the GST would undermine prospects for a fundamental rebalancing of our tax system to promote jobs and growth.



### 3 KEY DIRECTION: INCOME TAXES THAT REWARD EFFORT

- ▶ Bracket creep is a growing issue and disproportionately affects individuals on lower incomes.
- ▶ High effective marginal tax rates discourage participation, particularly by low and secondary income earners and older workers.
- ▶ Workers, particularly skilled workers, are becoming increasingly mobile.



Australia is heavily reliant on personal income tax. It is the largest source of tax revenue, worth around 40 per cent of national tax collections, or \$166 billion in 2013-14 (ABS 2015e).

Taxes on individuals can influence decisions to work, save and invest by creating a tax wedge between pre- and post-tax income. Distortions may be greater for taxpayers with lower and higher incomes. Low-income earners, particularly secondary earners, may face high effective marginal tax rates as their income rises. This is a consequence of the interactions between the tax and transfer system, particularly Australia's highly targeted transfer system. Distortions for higher-income earners arise because they can be more mobile.

#### **Bracket creep is a growing issue**

Bracket creep refers to inflationary wage increases, as opposed to real wage increases, pushing workers into high-income tax brackets. Taxpayers will face higher marginal tax rates as they move into higher tax brackets, but also higher average tax rates due to the progressivity of personal tax rates and thresholds. This reduces the rewards for effort and creates a disincentive to work, and gradually reduces the progressivity of the tax system.

Bracket creep disproportionately affects individuals on lower incomes. For example, an individual earning \$40,000 a year has their earnings grow in line with wage price index forecasts from the latest budget. They are projected to pay around a quarter more tax in just four years' time. By contrast, someone earning \$150,000 a year, and using the same forecasts, would face an 11 per cent increase in tax over the same period.

Addressing bracket creep will require recalibration of tax thresholds (possibly linked to multiples of average wages) and/or indexation of tax brackets.

#### **Taxes reduce participation**

The Intergenerational Report (2015e) forecast participation falling to 62.4 per cent by 2055, down from 64.6 per cent today, largely due to the ageing population. This is equivalent to around 450,000 fewer workers in today's terms.

If income tax continues to represent the same share of total taxes as today, this implies a significantly increased tax burden on future taxpayers. High effective marginal tax rates through the interaction between the tax and transfer system, particularly on low and secondary income earners, or older workers, may discourage participation. This in turn can hinder the accumulation of human capital, and have a negative effect on lifetime incomes and productivity.

The effects of tax wedges on employment can be seen by comparing the effective retirement age across different countries. An analysis of OECD countries found interactions of income taxes, contributions and forgone pension benefits influenced participation decisions to continue work (International Monetary Fund 2014). Countries with a lower implicit tax rate were found to have a higher effective retirement age.

### Changes in the labour market are eroding the income tax base

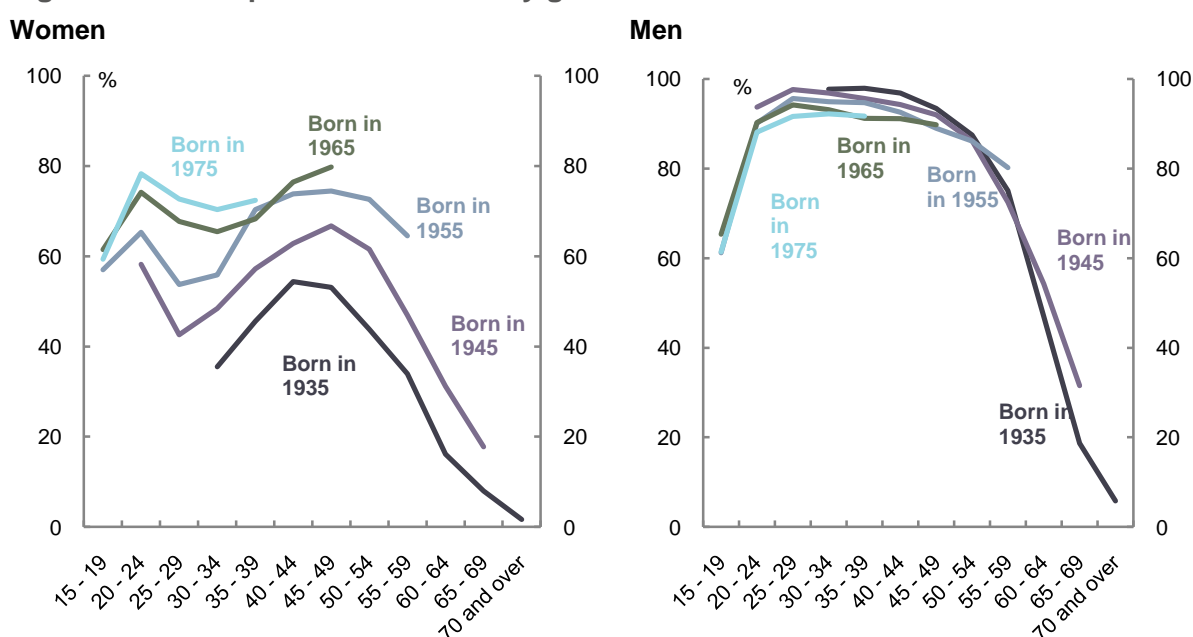
The labour market has changed in recent years. Part-time workers have moved from the margins to a mainstay of the labour market. Labour mobility has increased in recent years as globalisation continues to open countries to trade and investment.

This has consequences for the future of the personal income tax base.

*Part-time workers are changing the structure of the labour force*

The increasing importance of part-time work has implications for the tax base. In 1967, 10 per cent of the workforce was part-time, compared with 30 per cent today (ABS 2015g). This change has been influenced by increased female participation, older workers working longer and sub-trend growth since the global financial crisis. It is also conceivable that increases in the tax-free threshold have encouraged part-time work arrangements. While part-time workers have added to the workforce, there has also been a movement of workers from full-time to part-time work.

**Figure 22: Participation rates differ by gender and have evolved over time**



Source: ABS 2011, 2015a.

In the context of the tax system, this may erode the personal tax base. For example, one full-time worker earning \$60,000 pays around \$12,000 in personal tax. In contrast, two part-time workers, each earning \$30,000 pay around \$1,500 in personal tax. The total wage bill is \$60,000 in each scenario, however \$9,000 less tax is collected due to the progressivity of the tax system.

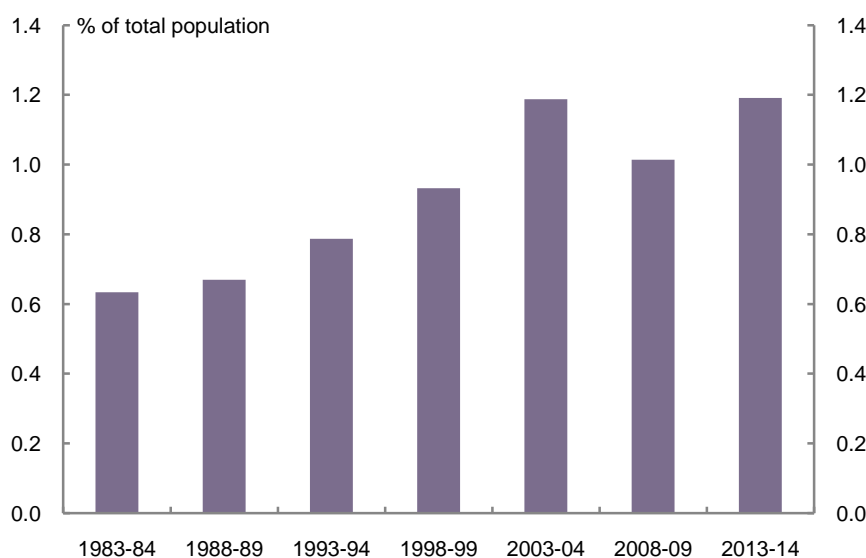
### *Workers are becoming increasingly mobile*

In a globalised world, workers have more opportunities to work overseas, particularly if they are highly skilled. Labour on the whole is generally less mobile than capital, but taxes can influence this mobility. Migration can improve economic growth by increasing the size of the workforce, supporting domestic demand, and bringing new skills, ideas and connections to domestic businesses.

The share of the Australian population departing overseas each year has increased from 0.6 per cent more than 30 years ago, to 1.2 per cent in 2013-14 (Figure 23). That is, around 300,000 people left Australia for overseas last year.

This phenomenon is seen across the globe, with Australia both a source of and destination for migrants. At the OECD level, 3.2 per cent of the broader population have emigrated to another country. For Australia, emigration is around 2.0 per cent for the broader population, while estimates for highly skilled workers vary between 2.9 and 4.0 per cent. By comparison, emigration in New Zealand is 14.1 per cent, and estimated to be up to 17.0 per cent for highly skilled workers (Arslan et al. 2014).

**Figure 23: More Australians are moving overseas, even as our population grows**



Source: ABS 2015b. Departures refer to those who leave Australia for 12 months or more over a 16-month period, who are currently counted within the population.

Australia's taxation settings affect worker mobility both within and outside Australia. For example, at the domestic level, stamp duties can limit worker mobility by discouraging the sale and purchase of housing. At the international level, reductions in top marginal tax rates are influencing worker decisions about where to locate, with Australia's top marginal tax rate slightly above the OECD average. Similarly, tax thresholds affect average tax

rates. In Australia's case, the top marginal tax rate starts at around 2.3 times the average wage. This is in the low range compared with other OECD countries (OECD 2015a).

The migration of highly skilled workers will have an impact beyond tax revenue. For example, positive spillovers such as skills, ideas and connections can ultimately improve productivity and economic growth.

### **Young, entrepreneurial and high-skilled workers are more likely to work abroad**

The evidence of worker mobility is increasing. Boston Consulting Group worldwide analysis found that younger workers with bachelor degree qualifications or higher were more mobile compared with other workers (Strack et al. 2014). One in five had already spent time abroad. In particular, workers in engineering, IT and telecommunications were more likely to move.

Competition for highly skilled workers is growing, as are their potential destinations. The US, UK and Canada were selected as the top destinations, while Australia ranked 7th.

According to the World Intellectual Property Organisation, inventors and highly skilled workers are highly mobile, with a migration rate of around 8 per cent (Migueluez and Fink 2013). Recent international analysis of the most prolific inventors found they are significantly affected by top marginal tax rates when choosing where to locate (Akcigit, Baslandze, and Stantcheva 2015). In contrast, less prolific inventors were found to be less sensitive to top marginal tax rates.

Companies were also found to have an important influence on decisions to relocate, highlighting the importance of fostering domestic innovation, and research and development. To illustrate, inventors were found to be more sensitive to taxes when working for a multinational company, except where the company was located in a country where it had a significant share of its innovative activity.

An analysis of changes in a preferential tax scheme for high-earning immigrants in Denmark also found evidence of the responsiveness of international migration by high-skilled workers to tax differentials (Kleven et al. 2013).

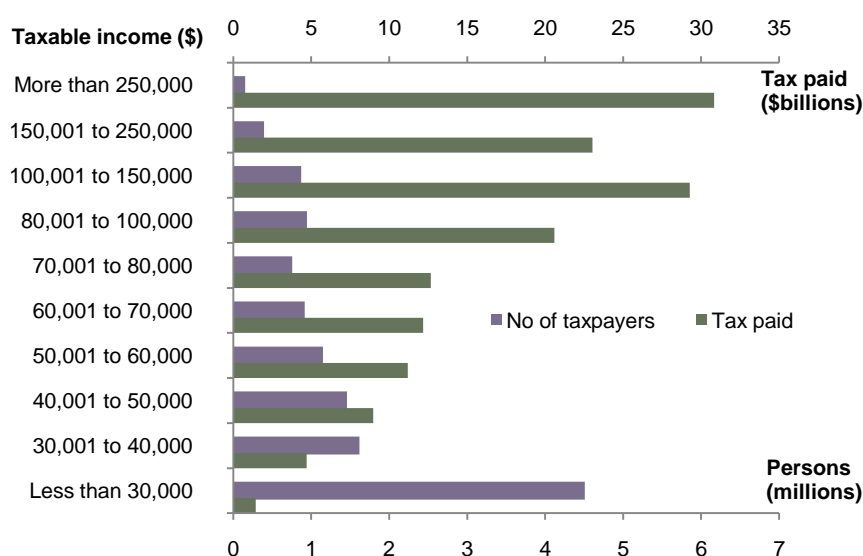
### **The personal tax system is highly progressive**

The tax and transfer system must balance a number of objectives, including efficiency and equity. Australia's tax system is highly progressive, meaning the burden of taxation increases significantly with income. For example, the top 3 per cent of taxpayers account for almost 30 per cent of personal tax revenue (ATO 2015b). Similarly, the transfer system is highly targeted, with the ratio of benefits received by households in the bottom quintile relative to the top quintile the highest in the OECD (Whiteford 2010). In addition, the bottom quintile receives 42 per cent of welfare spending, while the top quintile receives 3 per cent (Whiteford 2013).

Equity considerations may favour high marginal tax rates and low thresholds. However, decisions to work an extra hour, save an extra dollar or consume it are shaped by the tax rate on the last dollar earned. Lower tax rates reduce distortions. There is also evidence of tax planning, with some bunching just below each tax threshold (Chart 3.2 of the tax discussion paper).

Tax changes must be assessed through the lens of both equity and efficiency over time and in the context of the whole system, rather than changes to individual taxes.

**Figure 24: The income tax system is highly progressive**



Source: ATO 2015b.

The taxation of households as individuals compared with family units is one way to consider the efficiency and equity trade-off. There has been a sizeable social and economic shift, with more households now having a secondary income earner. Equity considerations support taxation on a family basis, particularly with relatively more elastic secondary earners, as the transfer system in part already does. In contrast, from an efficiency perspective, particularly around participation rates for secondary earners, an individual basis for taxation would be preferable.

### Implications for the tax white paper

- A progressive income tax system should be maintained, with tax thresholds recalibrated to make the tax system more competitive for highly skilled workers and to ameliorate bracket creep. The system could then be maintained by linking tax thresholds to multiples of earnings benchmarks, or through indexation of tax brackets.
- To the extent possible, high effective marginal tax rates that discourage participation, particularly by low and secondary income earners or older workers, should be reduced.

## 4 KEY DIRECTION: A MORE COMPETITIVE BUSINESS ENVIRONMENT

- ▶ Australia's corporate tax rate is increasingly uncompetitive.
- ▶ Australia's company tax system is highly volatile and reliant on a relatively small number of taxpayers.
- ▶ Dividend imputation continues to deliver net benefits to the Australian economy.
- ▶ Capital is becoming increasingly mobile and responsive to tax rates, meaning the incidence of corporate tax is more likely to fall on workers who are less mobile.



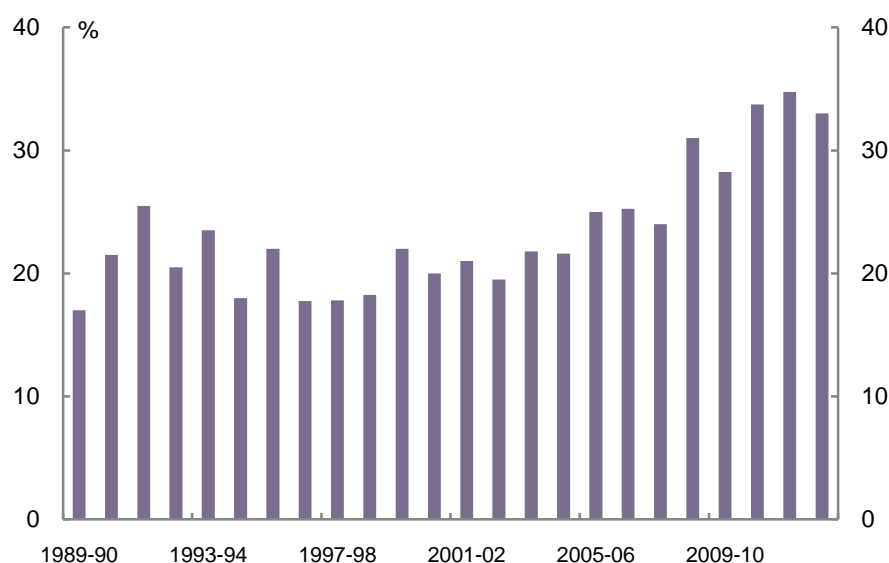
Company tax is the second largest source of national tax revenue, with collections expected to be around \$70 billion in 2014-15 (Australian Government 2015a). Australia's 30 per cent corporate tax rate is high relative to the OECD and our competitors in Asia.

A competitive corporate tax system is an important element of maintaining a strong economy and lifting living standards. The corporate tax system should encourage investment, risk-taking, innovation and entrepreneurship. In addition, the community needs to have confidence in the integrity of the corporate tax system if it is to support broader tax reform.

Australia is more than twice as reliant on corporate income taxes as a share of all taxes than the OECD average. In part, this reflects the integration of the personal and company tax systems through the imputation system. As a result, company tax acts as a withholding tax on Australian shareholders, and is essentially a tax on foreign investment. The corporate tax base is also relatively small, with around 2,000 companies paying approximately two-thirds of company tax in the 2012 financial year (Australian Government 2015c). The 12 largest taxpayers paid one-third of company tax in 2012-13, up from around a fifth a decade ago (Figure 25).

Company tax can influence investment across assets and industries (through concessions), discourage foreign investment, reduce investment in innovative activities, distort financing decisions, and absorb resources due to complexity that could otherwise be better allocated.

A lower corporate tax rate would encourage investment and facilitate economic growth. As investment increases, capital deepening increases labour productivity, which in turn flows through to higher real wages. A reduction will also benefit both new and existing investments and may be more beneficial than new targeted tax expenditures in terms of the overall efficiency, equity and simplicity within the system. This highlights the importance of considering tax reform in the context of reforming the entire tax system so as to balance trade-offs and changes.

**Figure 25: The share of company tax paid by the 12 largest companies is growing**

Source: Heferen 2015.

A company tax rate reduction could be phased in as part of a broader tax reform package. However, to provide investors with confidence and certainty, a timetable of progressive reductions would need to be legislated upfront. Many investments have long lives and an early signal would help lock in future growth. The UK's phased corporate tax rate reduction is a recent example of this.

### **Capital is increasingly mobile and responsive to tax rates**

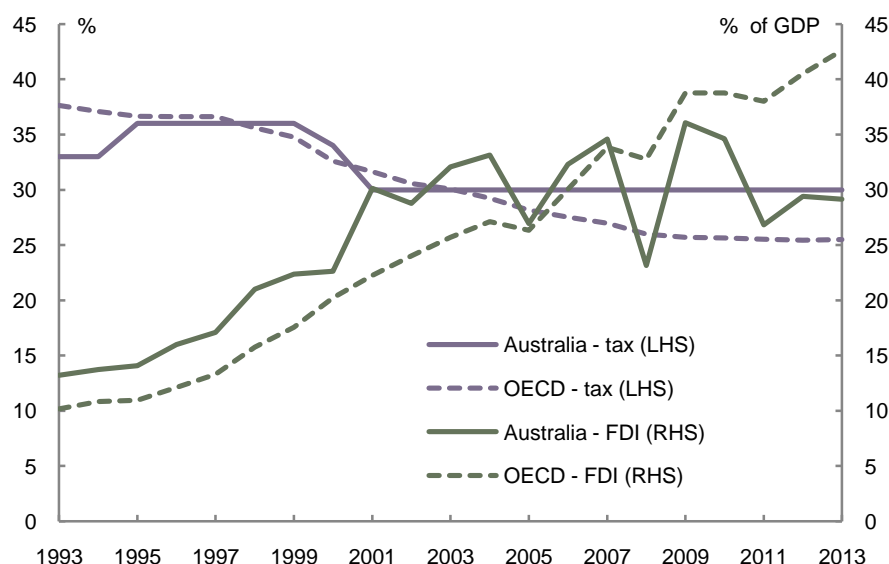
Globalisation and the liberalisation and integration of markets and value chains have made capital increasingly mobile. For example, the stock of OECD outward foreign domestic investment to GDP increased from 10 per cent in 1990 to 43 per cent in 2013. The stock of OECD inward foreign domestic investment to GDP increased from 8 per cent to 32 per cent over the same period. Concurrently, the OECD average corporate tax rate fell from 41 per cent to 25 per cent, while Australia's corporate rate fell from 39 per cent to 30 per cent (Figure 26). While disentangling the extent to which lower company tax rates increased investment is a matter for empirical research, it is generally accepted that corporate tax competition is driven by increasing capital mobility.

This mobility and disaggregation in supply chains has meant tax regimes can play a larger role in influencing decisions on how and where to invest, with investors looking to maximise post-tax returns. It also has broader implications for the design of domestic tax systems. Small, open economies have tended to adapt and are found to be less reliant on income taxes and more reliant on expenditure-type taxes (Hines and Summers 2009). Australia, which fits this description, may be particularly vulnerable and cannot consider domestic tax policy in isolation from the global economy.

In a world of highly mobile capital and with Australia a relatively small country in relation to international capital markets, the incidence of corporate tax is more likely to fall on less mobile factors such as workers. The burden may be mitigated for more mobile workers,

such as those who are highly skilled, though their departure would come at a cost to the Australian economy. A recent analysis of the burden of corporate taxes in Germany found a higher share of the burden was borne by low-skilled and part-time workers (Fuest, Peichl, and Siegloch 2012).

**Figure 26: Increasing capital mobility is leading to corporate tax rate competition**



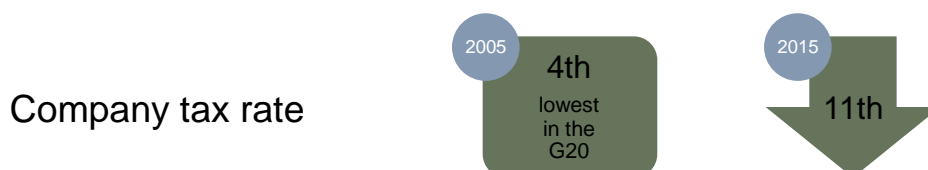
Source: OECD 2015b.

Note: FDI refers to the outbound stock of capital investment.

*Global competitive pressure is driving down corporate tax rates*

Continued competition for highly mobile capital means that global competitive pressure is more likely to drive reductions in corporate tax rates, and convergence and harmonisation of tax systems. If Australia is a price taker in global capital markets, which would seem to be the case for many investments, the implications are stark – if our company tax rate is out of line with global rates we will forgo investment. To illustrate, the UK and Spain have lowered their corporate tax rates this year to 20 per cent and 28 per cent respectively, to boost investment and growth. The UK has just announced a further reduction to 18 per cent by 2020. Both major political parties in Australia have recognised this challenge and support a lowering of Australia's corporate tax rate.

**Figure 27: Australia's company tax rate is becoming less competitive**



Source: KPMG 2006, 2015.

Note: The G20 comparison excludes the European Union.

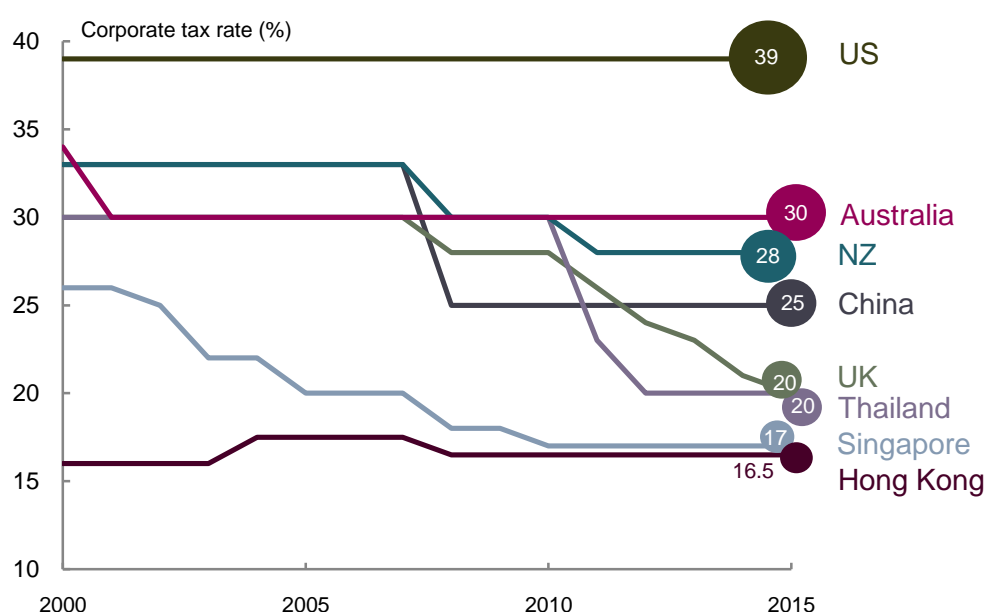


In 2006 Australia's corporate tax rate of 30 per cent was a little above the averages of the OECD and our competitors in Asia – about 28 and 29 per cent, respectively. Since then, these averages have fallen to about 25 and 22 per cent respectively, while our corporate tax rate has remained unchanged (KPMG 2015).

Over the past decade Australia experienced a once-in-a-lifetime resources boom. The flow of foreign direct investment into Australia was the 20th largest in the world in 2003, before the boom. It reached 7th in 2011 and has since slipped to 8th (United Nations 2014a). There are a number of implications for Australia's corporate tax system as the economy transitions from the resources investment boom. Consideration must be given to Australia's ability to influence prices in global capital markets, and the increasing mobility of capital and intense competitive pressure from other countries.

Any analysis of the company tax rate needs to acknowledge that businesses can often choose where to invest and every aspect should be considered in terms of being competitive, raising enough revenue and any other policy considerations.

**Figure 28: Many other nations have lowered their corporate tax rate**



Source: KPMG 2006, 2015; OECD 2015a.

#### *Intangible investment makes production and profits more mobile*

Capital investment need not be physical; there is also 'soft' capital such as knowledge, firm-specific skills, computerised information and innovative property (such as research and development). Intangible investment represents a rapidly growing source of investment and productivity, particularly in the services sector.

In Australia, intangibles investment reached about \$80 billion in 2012-13, or around 28 per cent of market sector investment. From 1974-75 to 2012-13, the stock of intangibles grew an average annual rate of 5 per cent compared with 3 per cent for tangibles (Elnasri and Fox 2014). This is equivalent to an almost sixfold increase in the stock of intangibles, compared with a tripling in the stock of tangibles.

At a global level, intangible investment is now higher than tangible investment in the US, France, the Netherlands, Denmark and the UK (Imperial College London, The Conference Board, and LUISS Lab of European Economics 2014). In the US, intangible assets have grown from 17 per cent of market value to over 80 per cent this year for the S&P 500 (Ocean Tomo 2015).

Commensurate with the growth of intangibles investment, Australia's uncompetitive tax treatment of acquired intangibles is a growing issue. The Ralph Review (1999) recognised the inability to depreciate some intangibles as putting Australian entities at a disadvantage in competitive takeover situations where they compete with companies that can write off these investments.

### **Addressing base erosion and profit shifting**

There is a legitimate debate underway at the global level about the suitability of long-standing international tax arrangements due to globalisation and increased digitisation of the economy. Laws have been challenged by these phenomena as they have either been not robust enough or mismatches have emerged. The Business Council believes companies must meet their tax obligations and where arrangements do not keep pace with community norms, they should be reviewed.

The G20 commissioned the OECD to be the key multilateral forum for progressing tax integrity reforms through the BEPS Action Plan. The OECD's final recommendations are due by the end of this year.

The international community is the appropriate forum in which to agree on multilateral action on how to tax the global profits of multinational companies. Acting alone or prematurely may lead to unintended consequences such as double taxation, deterring investment, or distorting genuine commercial activity. Unilateral action outside of the BEPS project may encourage other countries to act alone and splinter international taxation norms.

Australia comes at the BEPS process from a strong starting position, with some of the most stringent tax integrity laws in the developed world. Successive governments, through bipartisan support, have sought to maintain this integrity by updating measures such as transfer pricing rules, the foreign source income anti-tax-deferral regime, general anti-avoidance rule and thin capitalisation rules. These measures complement each other and provide Australia with a robust and holistic set of integrity measures that balances against the need to maintain a competitive corporate tax system and an attractive destination for investment.

The OECD's BEPS process is of great importance to Australia as a medium-sized, open economy that is heavily dependent on trade and foreign investment. International tax issues are broad and complex, and a solution will take both time and a coordinated, multilateral approach.

If the global community does not see positive actions arising from the BEPS project, there may be increased pressure in some countries to go it alone despite the risks.

### **The Australian corporate tax base is increasingly volatile**

Corporate income tax revenues have proven to be the most cyclical of major categories of tax revenues. At the Commonwealth level, corporate taxes account for a large degree of the volatility, despite accounting for only a fifth of the Commonwealth tax base.

The increased reliance on company tax from the resources and resources-related sectors has meant government revenues and forecasts are more susceptible to commodity price swings. To illustrate, mining accounted for more than a fifth of corporate tax collected in 2012-13, compared with 12 per cent a decade earlier (ATO 2005, 2015b).

### **The corporate tax system should be reviewed holistically**

There are many elements contributing to the overall competitiveness of the corporate tax system. Business tax expenditures are one element of the system and have recently been rationalised – there are 85 business tax expenditures today, down from 108 last year (Australian Government 2015d, 2014a). They seek to counter to some degree the disincentive effects of a high statutory company tax rate and inflation on investing and risk-taking.

The Ralph Review (1999) recommended that an ongoing process be implemented to periodically and systematically review all tax expenditures to ensure they remain current, and most appropriately deliver their objectives through the tax system.

All features of the company tax system should be considered as part of the tax white paper process. A compelling, evidence-based case for change, that is mindful of the investment and innovation impacts, should be made if any changes are to be considered. In short, these features should be assessed on their merits, rather than with respect to funding a reduction in the company tax rate. The effectiveness of tax expenditures in achieving objectives could be assessed using recent policy changes, as well as through consultations with relevant parties.

As the tax discussion paper (2015c) notes, changes to the company tax system must be mindful of the interactions with the imputation system.

For example, to the extent dividends are distributed, the imputation system reduces the effectiveness of tax concessions such as the R&D Tax Incentive. Dividends received by domestic shareholders who are partially exempt from tax may receive a lower tax credit and hence be subject to more personal tax. In contrast, foreign shareholders would benefit from the concession through a lower company tax burden.

### **Dividend imputation continues to deliver net benefits**

Dividend imputation removes double taxation of dividends paid from profits earned and taxed in Australia to Australian resident shareholders. The company tax in effect operates as a withholding tax on dividends for domestic equity owners. As the discussion paper observes, dividend imputation has brought a number of significant benefits to the Australian economy. Arguably, most importantly for growth, it promotes more efficient allocation of capital across the economy by making the choice between profit retention and dividend allocation more neutral (Ballard et al. 1985).

It is acknowledged that one of the principal sources of benefit from dividend imputation – the ‘home’ equity basis – can be also interpreted as a source of distortion. Dividend imputation makes outbound investments relatively less attractive to domestic investors, which may discourage better balanced, less risky shareholdings as well as overseas expansion of Australian multinational companies.

### **The benefits of dividend imputation**

- Greater savings neutrality. Taxation of dividends from domestic equity investment is brought more in line with taxation of other forms of saving and taxed only once as personal income, thus encouraging equity investment.
- Wide community share ownership. Together with superannuation and privatisation, dividend imputation has led to widely dispersed share ownership.
- More efficient allocation of capital. Companies face more neutral incentives to distribute profits to shareholders rather than reinvesting them in marginally viable projects or acquisitions.
- All else given, lower debt/equity ratios. Domestic equity finance has been made relatively more attractive for Australian companies, lowering the overall cost of capital and promoting economic stability. Some cite this as an important reason why Australia weathered the GFC better than many other countries.
- Greater tax integrity. Companies have incentives to pay tax in Australia in order to provide shareholders with franked dividends.
- Business model neutrality. The choice between incorporation and unincorporated business models (such as partnerships) is made more neutral.

### *Reintroduction of double taxation of dividends would come at a high cost*

The discussion paper essentially poses the question whether the benefits of dividend imputation continue to outweigh the costs, particularly as Australia has become more integrated into the global economy and global capital markets. The suggestion is that global capital markets increasingly determine the cost of capital in Australia, reducing and possibly eliminating the impacts of dividend imputation.

The Business Council considers that the net benefits of dividend imputation remain substantial. A reversion to double taxation would still mean relatively high taxation of dividends. And while estimates vary, franking credits are generally positively valued.

The discussion paper observes that the effect of tax on domestic savings is unlikely to significantly affect the aggregate level of investment due to Australia’s reliance on foreign capital to fund additional investment.

While it may be the case that the aggregate level of investment in Australia is not highly sensitive to taxation of domestic savings, Australia’s economic welfare ultimately depends on how efficiently we use our limited resources, not only the aggregate level of activity. If

Australian savings are discouraged or investment choices distorted by inefficient tax arrangements, we are effectively giving up profitable domestic investment opportunities.

*Tying a company tax reduction to removal of dividend imputation is the wrong approach*

It has been suggested by some that removing dividend imputation could fund a reduction in the company tax rate – estimates range from about 5 to 10 percentage points, depending on treatment of inter-company dividends and behavioural responses.

Removing dividend imputation to fund a company tax cut involves a trade-off. Of course, such trade-offs are what tax reform is all about and it is a matter of assessing the net effects of proposed changes. For the reasons outlined above, the Business Council considers that there are far more efficient ways of funding a reduction in company tax.

The discussion paper also outlines scope for changes to dividend imputation, for example, removal of cash rebates where the taxpayer's tax rate is less than 30 per cent.

In principle, removing double taxation should mean just that – the taxpayer should only pay their marginal rate of tax on dividends. If the company tax is simply pre-payment for individual taxation of dividends, then 'over-payment' should be fully refundable. If there are issues around tax rates imposed on superannuation investments or on personal income, they would be better addressed directly.

The paper also alludes to different arrangements in other countries ranging from the classical system of double taxation to imputation systems similar to Australia's. A number of imputation schemes in European countries have been removed or modified due to European treaty obligations. While we can always learn from overseas experience, there does not appear to be any clear pattern, except that most countries offer some form of allowance for company tax paid. The various approaches would need to be assessed in the light of each country's broader tax system, including personal taxation rates and the tax treatment of savings income and superannuation earnings.

### **Implications for the tax white paper**

- ▶ The company tax rate should be reduced to 25 per cent to encourage both domestic and foreign investment and reward innovation. Further reductions may be required over time to maintain our competitive position. Change should be legislated to provide investors with confidence and certainty.
- ▶ Dividend imputation continues to deliver net benefits to the Australian economy and should be retained. Company tax reductions should not be tied to removal of imputation.
- ▶ The OECD's BEPS Action Plan is the appropriate forum in which to agree on multilateral action on how to tax the global profits of multinational companies. Unilateral action outside of the BEPS project may encourage other countries to act alone and splinter international taxation norms.

## 5 KEY DIRECTION: GREATER USE OF THE CONSUMPTION BASE

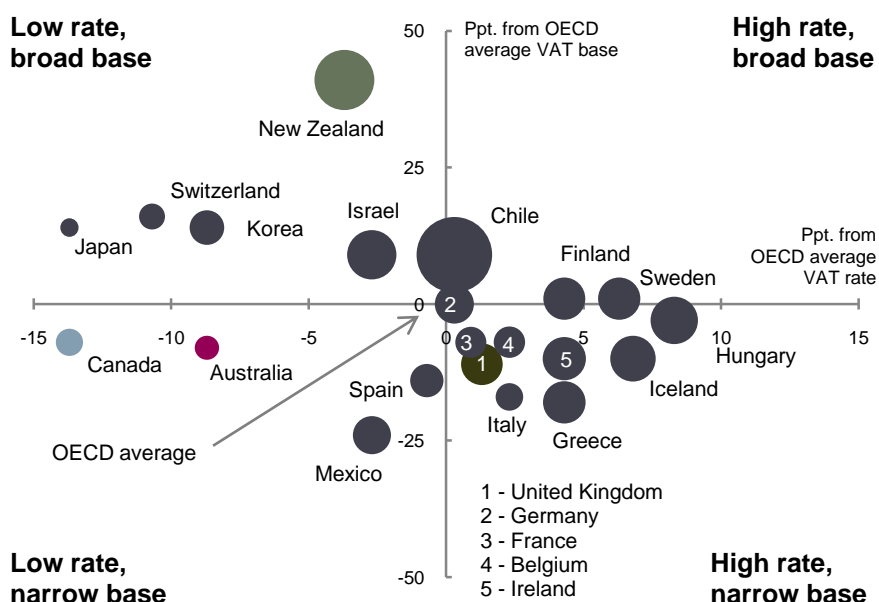
- ▶ Australia's GST is applied at a low rate on a narrow base compared with other OECD countries.
- ▶ The GST base has eroded, and will erode further, due to increased expenditure on GST-exempt items. It is less mobile than some other tax bases.
- ▶ The GST's exemptions do not effectively address equity concerns and significantly increase complexity and compliance costs.



The GST is Australia's main consumption tax and third largest source of national tax revenue, raising \$56 billion in 2013-14 (ABS 2015e). Broad-based consumption taxes are among the most efficient taxes, generating a relatively low loss of consumer welfare per dollar of revenue raised. Australia's GST is applied at a relatively low rate on a relatively narrow base. If Australia is to reduce its reliance on taxes that inhibit growth, a switch to greater reliance on consumption taxation must be seriously considered.

**Figure 29: Australia's GST has a relatively low rate and narrow base**

(Size of bubble shows value-added tax revenue (i.e. GST) as a percentage of total revenue)



Source: OECD 2014a.

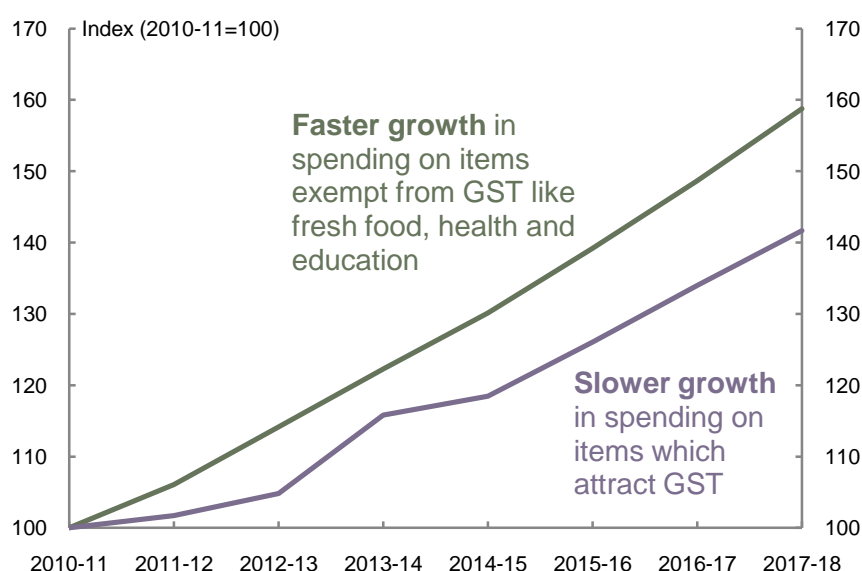
**Note:** On both axes zero represents the unweighted OECD average (average tax coverage is 55 per cent and average tax rate is 18.7 per cent). Does not include sub-national VAT or discounts for certain products (e.g. Canadian provinces apply VAT in addition to the national rate). The US does not have a VAT.

## The GST base is eroding

The GST is levied at a rate of 10 per cent on less than half of all consumption. GST revenue has been falling over the past few years relative to the size of the economy and the base is expected to erode further. This fall has been a consequence of soft domestic and imported goods prices growth, growth in expenditure on exempt items, and the increase in overseas online spending. Consumption growth has also slowed to an average 2.5 per cent a year since the global financial crisis, compared with an average 3 per cent a year in the preceding five years. This has corresponded with a rise in the household saving ratio (ABS 2015f).

The goods and services covered by the GST have generally not changed since its introduction. Spending on GST-exempt items is expected to grow an average 7 per cent a year over the next few years, compared with an average 6 per cent a year for the GST (Figure 30). The key drivers of the increase in GST-exempt items are expenditure on health, education and food.

**Figure 30: Spending on GST-exempt items is growing faster than the GST**



Source: Based on Australian Government 2015a, 2015d.

### *Consumption is less mobile than other tax bases*

The consumption tax base is generally considered to be less mobile than other tax bases. This is because consumption, or spending, tends to have clearer geographic associations which generally reduces the mobility of the tax base, notwithstanding challenges from the digital economy. As discussed earlier in the submission, while some workers are relatively more mobile, labour is generally less mobile than capital and hence so is consumption. There is evidence that countries already account for this, with smaller and more open economies less reliant on income taxes and more reliant on expenditure taxes (Furceri and Karras 2010; Hines and Summers 2009).



*Exemptions increase complexity and do not effectively address equity concerns*

GST exemptions distort decision making as some goods and services are made more expensive relative to others. These exemptions, and the way they are dealt with administratively, also significantly add to the complexity and compliance costs of the GST. There is a disproportionately high burden imposed on small businesses. Analysis by MYOB (2015) found GST compliance costs for small and medium-sized enterprises to be over \$13 billion a year in Australia, with GST compliance taking more than twice the time compared with compliance in New Zealand. Compliance costs include recording relevant information, completing the tax return and paying tax, and interactions with the Australian Tax Office (ATO) and external tax advisers.

The GST-exempt status of a number of goods and services should be considered as part of the review. For example, as the tax discussion paper (2015c) notes, the rationale behind the taxation of pizza rolls based on the thickness of topping is unclear. Another example is the change in tax treatment of tiramisu last year, which is now GST-free (ATO 2014). These types of exemptions increase complexity and compliance costs, while their effectiveness in promoting equity is limited.

**Table 1: Similar items often have a different GST status**

	Tax status	
	GST-free	GST
Cake decorating	Cake decorating gel	Edible cake decorations
Yoghurt	Yoghurt	Drinking yoghurt
Dried fruit	Dried apricots	Banana chips
Herbs	Fresh coriander	Potted coriander plant
Dessert	Mousse and instant desserts	Ice-cream
Pizza roll	Italian rolls if they - can be cut and filled - are made from bread dough, or - are less than 30% pizza toppings	Italian rolls if they - cannot be cut and filled - are made from pizza dough, and - are more than 30% pizza toppings
Unfilled dessert casing	Cannoli (unfilled pastry tube)	Meringue cases (unfilled)
Pasta dinner	Uncooked pasta and pre-prepared sauce bought separately	Pre-prepared pasta meal
Honey	Honey (used as a condiment)	Honey (used for medicinal or therapeutic purposes)

Source: ATO 2015a.

To the extent that exemptions are used to address equity concerns, there may be better ways to target and address these concerns. To illustrate, the tax discussion paper (2015c) notes that low-income households spend more on GST-exempt items than high-income households as a share of income. However, high-income households benefit more from GST-exemptions in terms of aggregate spending. The latest OECD (2014a) analysis of consumption taxes found lower rates and exemptions to be a 'very poor tool' for targeting support to low-income households.



## **GST is efficient and can be better used, with appropriate compensation**

The GST is a relatively efficient tax as it does not distort between consumption decisions today and in the future. In contrast, a tax on capital income (such as interest, dividends and capital gains) discourages saving and future consumption, encouraging spending today. This can lead to lower levels of savings, investment and economic growth. Living standards may also be lower as consumption brought forward today would result in lower levels of saving. This would lead to lower possible levels of future consumption than would otherwise have been the case. Consumption taxes indirectly tax all returns to labour and capital. The burden on labour versus capital will vary depending on the mobility of the two factors. To the extent capital is more mobile, a consumption tax would tax relatively more of the returns to labour.

Any change to the rate or base of the GST should not be to raise additional revenue of itself, but to reduce the reliance on more distorting taxes that are harmful to growth, and improve the sustainability of the base. A change to the rate of GST and not the base could achieve this, but may increase the behavioural distortions around the current base. A broadening of the GST base would deliver efficiency gains, reduce complexity, and lower compliance and administration costs.

Appropriate compensation and transitional arrangements through the tax and transfer system will be important if change is to be considered. There will also be implications for funding arrangements across the federation.

There are a number of other issues to consider in changing the rate or base of the GST, including:

- competitive neutrality with respect to goods and services provided by the public and private sectors, such as health and education
- compliance behaviour may change as the benefits of tax evasion and remaining under the GST threshold increase
- the impact on the financial services sector, particularly international competitiveness, given its input-taxed treatment.

## **Implications for the tax white paper**

- Broaden the base and increase the rate of the GST to reduce Australia's reliance on taxes that inhibit growth and better deal with the challenges of digital disruption.
  - The Business Council is not advocating a particular rate or base at this stage, but believes there is scope to move on both elements to rebalance the tax mix.
  - Greater reliance on the GST will require determination of adequate compensation for some groups. If the tax changes are sound, there should be more than enough capacity to do so.

## 6 KEY DIRECTION: MORE EFFICIENT, LESS VOLATILE STATE TAXES

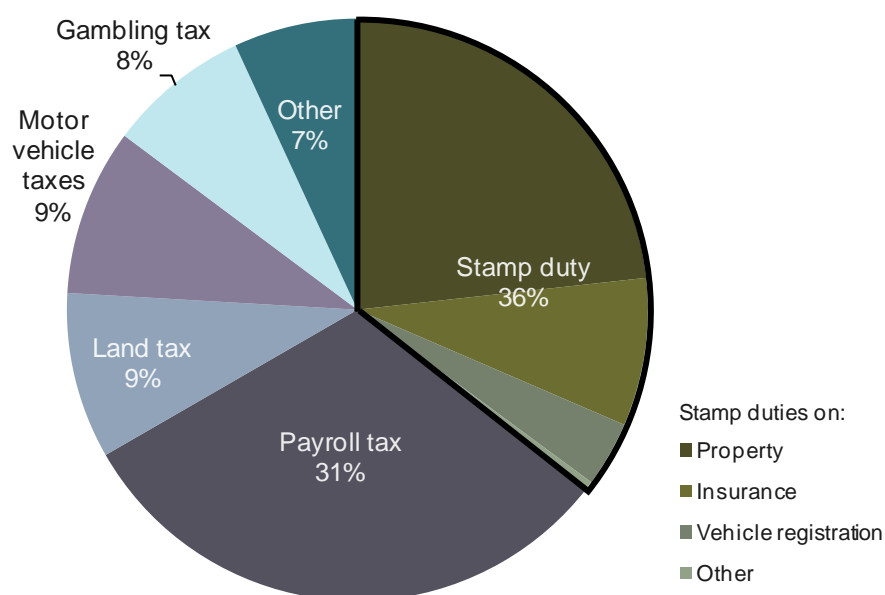
- States are reliant on transaction-based taxes that are inefficient and volatile.
- Substantial parts of the payroll tax base are exempt.
- Extending land tax is theoretically sound, but complex in practice.



State and territory governments largely rely on three main taxes: stamp duties, payroll tax and land tax.<sup>3</sup> Together these provide three-quarters of state tax revenue (Figure 31).

Institutional incentives stymie major state tax reform. Through a combination of High Court rulings and conditions attached to Commonwealth grants, the tax bases available to state governments have gradually receded. Vertical fiscal imbalance means state governments have incentives to make taxes in their state more attractive to businesses by extending exemptions. Any windfall gain in revenue due to tax reform that lifts economic performance is likely to largely end up in Commonwealth rather than state coffers through higher income tax receipts.

**Figure 31: States largely rely on stamp duties, payroll tax and land tax**



Source: ABS 2015e.

It does not have to be like this. The Commonwealth could take decisive action to improve the fiscal position and policy flexibility of state governments through expanding the base or increasing the rate of the GST or introducing new revenue-sharing arrangements.

<sup>3</sup> Local governments also raise revenue through municipal rates.

These aside, there are large economic gains that could be made by state governments within their current tax systems. This includes reducing state government reliance on inefficient taxes, such as stamp duties, and widening and harmonising the payroll and land tax bases.

### **Transaction taxes are inefficient, volatile and inequitable**

Stamp duties apply to the sale of residential and commercial property, insurance contracts, motor vehicles and other financial transactions. Together these taxes are the largest source of state tax revenue, raising \$24 billion in 2013-14.

Stamp duties are highly inefficient. Treasury estimates that each dollar of revenue raised through stamp duties on property costs the economy an additional 72 cents (Cao et al. 2015).

Stamp duties increase the cost of buying a house and discourage people from moving, for example, to a house that is better suited to their family size. Stamp duty can also discourage new housing development as stamp duty is paid twice: once by the developer when the land is acquired and again when the final owner buys the new house.

Insurance taxes can provide a disincentive to people to adequately insure. Insurance taxes are also regressive if they cause lower-income people to abandon insurance and expose themselves to more risk (as rates of non-insurance decline with higher income). The cost of underinsurance has broader social ramifications. For example, the cost of underinsurance when there is a large-scale natural disaster is often borne by taxpayers.

Stamp duties are a volatile source of revenue. Stamp duties on properties make up two-thirds of all stamp duty collected and account for almost all the volatility. This is because the tax take follows the fluctuations in the housing market, in both volume and price of houses sold.

While stamp duties increase with property values, they do not pass one of the important measures of equity: treating people in similar circumstances in a similar manner. They place a higher tax burden on people who move more frequently and buy more insurance, which may not relate directly to their wealth or income.

While it would be desirable to eliminate or lower stamp duties, they are a substantial source of state government revenue. To maintain current revenue levels, state governments would need an alternative large and stable revenue source. Reforms to payroll and land tax would go some way to addressing the shortfall. However, it would likely also require new approaches to Commonwealth revenue transfers to the states.

### **There is scope to streamline payroll taxes**

Payroll taxes are generally considered to be efficient in theory because they are levied on a broad base (wages), which is relatively immobile.

However, in practice around 95 per cent of Australian businesses are exempt from payroll tax (Treasury 2010). Businesses with small wage bills are exempt, as are a range of other organisations and some types of employees. On average 45 per cent of the potential tax base is excluded (Figure 32).

**Figure 32: Close to half of the payroll tax base is exempt**

Source: BCA calculation using ABS 2015e, 2014a and state revenue offices.

Narrow bases generally require higher tax rates to raise a given amount of revenue. If the exemptions were discarded, it would be possible to maintain current revenue levels and reduce current tax rates from over 5 per cent on average to a uniform rate of 2.8 per cent.<sup>4</sup> Harmonising payroll tax bases across states could deliver benefits through reducing the costs of complying with multiple regimes.

### Who ultimately pays payroll tax?

Businesses have legal responsibility for payroll tax. This means the immediate effect of changing the rate or threshold and any administration and compliance costs fall on business.

But because payroll tax leads to higher labour costs, over time the tax will reduce demand for labour and after-tax wages. Higher production costs may also lead to higher market prices and lower sales.

This means the tax burden will be shifted from employers to employees (through wage changes) and consumers (through higher prices). The extent to which this happens will depend in part on the flexibility of the labour market and competitive pressures in goods markets.

<sup>4</sup> BCA calculation using ABS 2015f, 2015e and state revenue offices.

It is likely that the thresholds place artificial caps on business activity. However, expanding the payroll tax base by reducing exemptions would likely impose significant administrative costs on small businesses. In general, tax compliance costs are disproportionately high in very small businesses. Micro businesses pay an estimated \$90 for every \$1,000 of turnover compared to \$2 for medium businesses (Lignier, Evans, and Tran-Nam 2014).

### **Land tax is theoretically sound but complex in practice**

Land tax is also generally considered to be efficient because it has a broad and immobile base. A 'pure' land tax cannot reduce the supply of land or distort decision making, as it cannot be avoided.

Around 60 per cent of land values are currently exempt from land tax. Land tax generally only applies to a limited range of commercial and investor-owned residential land. A number of different types of property are excluded, including owner-occupied housing and rural properties.

As with payroll tax, removing exemptions would enable lower tax rates while maintaining the same revenue level. In addition, as the tax discussion paper (2015c) notes, land taxes are unusual because in addition to the revenue raised by the government, the taxes provide a net welfare benefit to Australian households. This is because the supply of land is fixed and immobile, and although land tax is paid by both domestic and foreign landowners, the revenue is used to the sole benefit of domestic households.

While there are substantial benefits of moving to broader land taxes, the consequences of transitioning from current arrangements are substantial. An increased reliance on land taxes would likely result in a reduction in land values. This would be to the benefit of future land-owners, reduce the wealth of existing owners, and create an incentive for land developers to develop land instead of letting it sit idly. This may create solvency issues in connection with balance sheets for some investors as land values fall.

A practical concern often raised is the implications for land-owners with high asset values but low incomes, such as retirees. While it would be possible to defer the tax until land is sold, this can induce behavioural responses similar to stamp duties (which deter transactions).

Because of these issues, any changes to land tax would need to be phased in over long horizons and carefully consider the effect on asset-rich but income-poor households. For example, the ACT Government (2012) is phasing out stamp duties on properties and increasing reliance on land tax over two decades.

**The effects of land taxes on property values**

Take a simple example of a parcel of unimproved land valued at \$600,000. This land value is based on the net present value of an annual rental income stream of \$30,000 (in perpetuity), at a discount rate of 5 per cent.

The introduction of a 0.5 per cent land tax would reduce the value of the land by the net present value of future land tax liabilities. In this example, the new value of the land is around \$545,000, or a 9 per cent drop in value. If the land tax rate is increased to 0.75 per cent, the value of land would fall to around \$520,000, around a 4 per cent additional fall in value.

**Implications for the tax white paper**

- ▶ There are opportunities to make state taxes more efficient and less volatile, including by rebalancing highly distorting transaction-based taxes to more neutral bases, and streamlining payroll taxes.
- ▶ Greater reliance on land taxes has merit in principle, but would need appropriate transition time.
- ▶ To address some of the issues with VFI, Commonwealth revenue assistance should be more stable and less prescriptive.

## 7 KEY DIRECTION: ENCOURAGING EFFICIENT SAVINGS

- ▶ Savings are important for domestic wealth creation. Savings provide funds for investment and support lifetime consumption choices.
  - ▶ Taxing savings at full personal income tax rates leads to compounding tax effects over time, discouraging savings and encouraging current consumption relative to future consumption. These effects are exacerbated by inflationary impacts.
  - ▶ More neutral tax treatment of income from different forms of savings is generally desirable, although there is a strong case for relatively favourable treatment of superannuation because savings are locked in for very long periods and compounding tax effects could have punitive impacts.
- The considerable social benefits of owner-occupied housing also support continued special treatment of the family home.

### Review concessions

Promote greater neutrality. Review superannuation in context of retirement income system review

Taxing savings at a lower rate than labour income is generally regarded as desirable to mitigate cascading tax effects over time, which can deter savings relative to current consumption. The issue is how much lower. As the discussion paper notes, this desirable objective must be balanced against the consequential impacts of imposing higher taxes elsewhere to raise any given level of revenue, as well as distributional implications.

The tax discussion paper (2015c) outlines the different tax treatment of various forms of saving. These differences, unsurprisingly, encourage more savings being held in relatively lightly taxed forms, such as superannuation and owner-occupied housing, compared with bank deposits. As a general principle more neutral treatment of different forms of savings is desirable.

The Henry tax review (2010) proposal for a uniform tax discount on income from bank deposits, rental income and capital gains is one approach warranting further consideration. This would mitigate the compounding impact of taxation on savings income over time and roughly compensate for the impact of inflation, while maintaining some rate progressivity. Explicit adjustment for inflation also warrants consideration.

Some current arrangements for taxing savings have been questioned by parts of the community including, for example, superannuation concessions for high-income earners, negative gearing and the capital gains tax discount. However, published estimates of tax expenditures do not indicate the potential revenues that could be recouped if particular deductions or concessions were removed. Nor do they indicate whether the removal of concessions would deliver net economic benefits. The relevant policy question is what is the tax treatment that will efficiently achieve policy objectives. This requires careful analysis of effective marginal tax burdens and their compounding effects on savings over time and likely behavioural responses to changes. For superannuation, lifecycle effects should be analysed.

## **Superannuation and owner-occupied housing may warrant special treatment**

Notwithstanding the desirability of more neutral treatment of savings, some forms of saving may warrant special treatment. For example, the Productivity Commission (2004) has noted the considerable social benefits of owner-occupied housing. It also noted the likely substantial costs of subjecting owner-occupied homes to capital gains tax (including allowing interest deductions). For these reasons, the Business Council agrees with the discussion paper that taxing imputed rents or capital gains from owner-occupied housing would be inappropriate.

There is also a strong case for relatively favourable treatment of superannuation because savings are locked in for very long periods and cascading tax effects could have punitive impacts. While there is much debate about the size of tax concessions for superannuation saving, the estimates do not indicate the opportunity for tax savings as, without them, savings behaviour could be quite different. The magnitude and implications of behavioural responses to changes in effective tax rates need to be understood before changes are implemented. This is one important reason why the Business Council believes there must be a comprehensive and thorough review of the retirement incomes system, including superannuation concessions for both high- and low-income earners and interrelationships with the age pension system.

### **The retirement income system must be reviewed holistically**

Superannuation is one pillar of Australia's three-pillar retirement income system. The other two are the age pension and voluntary retirement savings. As the three pillars form one interrelated system, potential changes must be considered holistically, with transitional arrangements that account for the long-term horizons over which retirement decisions are made.

The dual purpose of the retirement income system should be to provide for comfortable living standards during retirement, and to reduce reliance on the age pension. Reforms of the system should focus on improving the capacity of the system to deliver those outcomes in a sustainable way, not simply achieving savings.

The current tax treatment of superannuation is extremely complex, reflecting many ad hoc changes over recent years. Concerns have also been raised around the level and distribution of superannuation tax concessions, particularly their effectiveness in meeting the objectives of the system. Any reforms must be undertaken with careful and holistic analysis of the interactions between the three pillars, and in a way that does not discourage lifetime saving, such as by better targeting of superannuation concessions, and addressing complexity and administration issues.

(cont.)



An holistic review of the retirement income system would allow consideration of the alignment of all incentives and concessional arrangements. The review should consider issues such as an ageing population, increasing longevity, the low interest rate world, the sustainability of existing arrangements and the maturity of the superannuation system.

Decisions around the appropriate balance between the three pillars should adopt an evidence-based approach. While ad hoc changes in recent years have led to uncertainty for individuals, they have unintentionally provided a basis for quantifying their effects.

Recent analysis of Danish retirement savings policies measured their effectiveness in raising total savings between active and passive savers (Chetty et al. 2013). An important yet perhaps unsurprising conclusion is that the impact of savings policies depends on the behavioural responses of savers to tax incentives and disincentives.

A similar analysis of Australia's superannuation system would assist in identifying the impacts and effectiveness of current arrangements and possible directions for change. In addition, it could point to other measures to be pursued in improving living standards and reducing the reliance on the age pension. These may include improving people's awareness and engagement with the retirement income system, particularly by improving saver education and simpler interactions with the retirement income system.

### Interest deductibility

As the tax discussion paper (2015c) observes, negative gearing is a longstanding general tax provision that allows investors to deduct interest payments on borrowings and other expenses incurred in producing assessable income. The provision simply recognises interest paid as a legitimate expense. But the provision is most well known for the purchase of rental housing. It allows landlords to deduct the excess of their borrowing costs over rental receipts (net of other allowable costs such as maintenance, depreciation and fees) from their other taxable income.

Use of negative gearing to buy property is fairly evenly spread across all income groups. For example, taxpayers in the middle-income bracket (\$37,000 – \$80,000) account for one-third of rent received, one-third of claimed interest payments and one-third of capital works and other deductions (ATO 2015b).

The Business Council agrees with the tax discussion paper (2015c) that negative gearing does not, of itself, create a distortion. There is a misperception that allowing a deduction for borrowing costs favours debt over equity financing. On the contrary, allowing deductions for interest on borrowings ensures that the choice between using debt or equity financing is tax neutral. This is because the interest paid on debt finance is taxed as income in the hands of the lender.<sup>5</sup>

As Fane and Richardson (2004) note 'the case for NG [negative gearing] is that in its absence the income tax would cascade whenever investments in rental housing are

<sup>5</sup> It is acknowledged that were a lower rate of tax on income from lending and other forms of savings introduced, this symmetry would no longer hold.

financed by borrowing'. In other words, removal of negative gearing would lead to taxation of financial intermediation making debt finance less attractive than equity. While 'vertical integration' of lender and house owner/borrower could avoid this cascading tax effect, such integration is not costless.

This suggests that negative gearing will encourage investor demand for rental housing, but to the extent this results from more neutral tax treatment, it is not necessarily an inefficient outcome.

*Changing negative gearing is unlikely to be the best way to address housing supply constraints*

Nonetheless, by encouraging investment in housing stock, negative gearing will contribute to higher house prices than otherwise because the supply of dwellings is less than perfectly elastic. The OECD estimates that for Australia a 1 per cent increase in real house prices leads to 0.5 per cent increase in residential investment (Caldera Sánchez and Johansson 2011). However, the first-best solution is to address inefficient housing supply constraints directly rather than remove or constrain negative gearing.

**Housing supply is unduly constrained by planning and other regulations**

It is widely agreed that housing supply is unduly constrained by planning and other regulations and policies that constrain land release and forms of housing development and inflate construction costs. For example, the Productivity Commission (2011) identified delays in land subdivision projects as a major factor impeding timely land supply. Auerbach and Hassett (2015) also cite evidence of building codes and land use regulation creating artificial scarcity and driving up housing costs.

In these circumstances, increased demand, whether arising from tax treatment, home buyer bonuses, lower interest rates or population growth, will push up prices without eliciting a timely supply response.

*Stamp duties impede efficient use of the housing stock*

Stamp duties may also discourage a more efficient allocation of housing as they discourage sales and purchases of existing properties. The efficient upsizing and downsizing of homes as household circumstances change is likely to be hindered.

The average number of bedrooms per household increased from 2.9 to 3.1 between 1994-95 and 2011-12, while the average number of persons in a household fell from 2.7 to 2.6 over the same period. In terms of utilisation, 90 per cent of households that owned their home outright had one or more bedrooms spare, compared with over 60 per cent of private renters (ABS 2013). While these trends will to a large extent reflect rising incomes and changing preferences, downsizing in particular may be discouraged by transaction costs including stamp duties.

*Restricting negative gearing to new housing could have undesirable consequences*

Various proposals have been put forward to contain negative gearing, including to confine it to the purchase of new dwellings. The argument is that most negatively geared properties are existing dwellings (the supply of which by definition is inelastic) and thus negative gearing simply contributes to higher dwelling prices.

Prices allocate supply to its most highly valued use. Investors will tend to purchase dwellings where there is high rental demand, often in inner city areas reflecting the amenity and other preferences of renters. Higher prices in these areas in turn will act as a signal to developers to increase dwellings in areas where infill development is permitted. Not allowing negative gearing where demand for rental accommodation is likely to be strongest, and allowing it where rental demand is low, could risk introducing further distortions into the market.

*Capital gains tax and negative gearing interact*

Negative gearing will only be attractive to a borrower where there is an expectation of an overall income gain: making perpetual losses, even if they reduce taxable income, are still losses. But as the discussion paper (2015c) observes, the interaction of negative gearing and tax treatment of capital gains tax may encourage investment in rental properties. In particular, discounted taxation of capital gains may be pro-cyclical – that is, investors increase their negative gearing to leverage capital gains in boom times.

*Capital gains taxation warrants review*

The original rationale for the 50 per cent capital gains tax discount seems to have been to provide a concessional tax rate within a progressive rate structure while also removing adjustment for inflationary gains.

The 50 per cent discount on nominal capital gains can distort investor behaviour, particularly at a time of rapid capital gains, such as in a housing or equity boom (Fane and Richardson 2004). On the other hand, if capital gains lag inflation, the current regime works in the opposite direction to penalise investors.

Prior to the introduction of the discount in 1999, real capital gains (deflated by the CPI) were taxable at the individual's income tax rate. Taxing real gains would remove the pro-cyclical bias of the current system (with little if any additional complexity) although there would remain an issue about the appropriate rate of capital gains tax (and taxation of savings more widely). As noted earlier, the Henry tax review (2010) proposed a uniform discount of 40 per cent on nominal capital gains and some other forms of savings income.

Evans et al. (2015) have also suggested the introduction of a CGT-free threshold, such as in the UK, to enhance the equity, efficiency, simplicity and fiscal sustainability of the system. To illustrate, the authors estimate that a threshold of \$10,000 would remove around 70 per cent of taxpayers. The revenue costs would obviously need to be weighed against the compliance savings.

### **Implications for the tax white paper**

- ▶ Concessional treatment of different forms of saving should be reviewed with the aim of promoting more neutral concessional treatment, taking into account implications for other taxes and income distribution.
  - Negative gearing and the 50 per cent capital gains tax discount should be considered in the context of any recalibration of taxation of savings more broadly, but their removal would likely be inefficient and not address fundamental drivers of housing prices.
- ▶ There should be a comprehensive and holistic review of the retirement incomes system, including superannuation concessions and the interrelationship of the superannuation and age pension systems. This will require analysis of effective marginal tax burdens and their compounding effects on savings over lifetimes and likely behavioural responses to any changes.

## 8 KEY DIRECTION: A SIMPLER TAX SYSTEM

- ▶ A simple, fair and transparent tax system that is easy to comply with helps foster more willing participation and trust, and reduce costs.
- ▶ Technology provides new scope to reduce red tape and enhance interactions and trust with the tax system.
- ▶ Australia's tax policymaking, institutions and administration are strong but could be improved.



A simple, fair and transparent tax system that is easy to comply with helps foster more willing participation and trust. Enforcement is also a key driver of compliance, both directly and indirectly, by promoting system integrity and fairness in application. Trust influences compliance decisions, driving increased voluntary compliance and creating a culture of compliance. The design and administration of the system can also support compliance, including through pay-as-you-go, withholding taxes and dividend imputation.

Australia's level of voluntary compliance is high, with more than 95 per cent of revenue collected by the ATO derived from voluntary compliance, with the remainder a result of active compliance. By comparison, almost a quarter of net tax revenue collected in Italy results from active compliance (Jordan 2014). It is important that any changes to the tax system have regard to, and seek to build on, the already high level of voluntary compliance in Australia.

A number of other factors affect compliance, such as attitudes towards government more generally and tax system fairness, and views around the appropriateness of government delivery and funding of services (Feld and Frey 2002; Hofmann, Hoelzl, and Kirchler 2008). There is international evidence that where there is high voluntary compliance and strong social norms of compliance, people are more willing to bear a higher tax burden. The efficiency costs of taxation may be smaller as a result, although the effects on taxpayer welfare are unclear (Doerrenberg et al. 2012). Furthermore, an implication of this is that the same amount of revenue can be collected from lower taxes overall due to higher compliance.

### **Complexity increases the costs of taxation**

Tax simplicity may not be a goal in and of itself, but compliance imposes real efficiency costs, the reduction of which would increase economic wellbeing. Complexity can be measured through administration and compliance costs, but may also have indirect effects such as behavioural change. For example, exempting the primary residence from capital gains tax delivers savings in compliance and administration costs.

Complexity increases costs to both taxpayers and administrators, reduces transparency, distorts decision making and the allocation of resources, and can reduce confidence in the fairness of the tax system. Complexity can also contribute to non-compliance due to honest errors or by providing increased scope for avoidance. The US General Accountability Office (2011) recently argued that complexity contributes to the tax gap, but measuring its contribution is difficult.

Where complexity has been introduced to address specific issues or drive behaviour, these incentives create choice but can also increase compliance costs for all taxpayers and administrators. They may also affect the efficiency, equity and simplicity within the tax system. As such, consideration should be given as to whether the tax system is the most appropriate means through which to achieve certain objectives. A more regular review of these measures could be warranted to ensure they meet their stated objectives and policy aims effectively.

Recent analysis of how complexity influences choices found that those using a relatively more complex tax system were more likely to under-react to new taxes (Abeler and Jäger 2013). An area for further research is in understanding the role of experience, education and tax agents in decision making.

Compliance costs tend to be lower where the tax base is broader and hence simpler with one or few rates, and few boundaries and reliefs. For example, GST compliance takes twice as long for small and medium enterprises (SMEs) in Australia compared with New Zealand, where there is a broad-based GST (MYOB 2015). Similarly, more consistent administration, definitions and procedures across different taxes and between states can also reduce compliance costs. For example, a payroll tax regime that applied a consistent base and definition of wages and was universally administered could deliver significant compliance benefits and a lower tax rate.

#### *There are merits in exploring a metric for measuring complexity*

The Business Council supports the development of a metric to measure the underlying complexity of the tax system. Such a measure could not be used in isolation to manage complexity, but could usefully identify trends and areas to focus on for improvement. Components of the metric could include the number of exemptions, the number and frequency of amendments, the number of federal, state and local taxes (with separate counts where taxes differ across jurisdictions), the frequency of reporting and payments, and record-keeping requirements for taxpayers.

#### *Complex tax laws and continued incremental changes drive compliance costs*

There are a number of measures of compliance costs. Treasury's Annual Deregulation Report (2015) estimates tax-related compliance costs to be around \$40 billion a year. There is no single feature of the tax system that drives tax compliance costs, but incremental changes to tax laws and the accumulation of laws all contribute. Compliance costs can also vary by taxes. For example, one Business Council member's compliance costs are \$1,250 for every \$1 million of company tax paid, but \$50,000 for every \$1 million in fringe benefits tax paid (National Australia Bank 2015).

As the tax discussion paper (2015c) notes, the compliance burden is more significant for small business, relative to their size. For large business, the three broad drivers of

compliance costs are the complexity and uncertainty of tax rules, the administrative compliance requirements, and international exposure (UNSW Australian School of Business 2014). At the large business level, more than half of internal compliance costs are spent on record keeping and the preparation and lodgement of tax documents (Evans, Lignier, and Tran-Nam 2013). Income tax accounts for two-thirds of external costs, with GST about 9 per cent. By comparison, SMEs are heavily reliant on external advice and external services for GST (Lignier, Evans, and Tran-Nam 2014).

At the personal level, the use of tax agents has increased from 61 per cent in 1985-86 to 74 per cent in 2012-13 (ATO 2015b). A survey of personal taxpayers found the top three reasons for using a tax agent are:

- to comply with tax obligation (72 per cent)
- to maximise allowable deductions/rebates (52 per cent)
- tax returns were too complicated (45 per cent).

When compared with a previous survey, the use of tax agents to comply with tax obligations has increased over time, while it has decreased for the other factors. The research also found there has been an improvement in terms of individuals finding their tax return easier to understand and ATO publications more useful (Tran-Nam, Evans, and Lignier 2013). While the various simplification initiatives over time have been important, they have been unable to halt the overall rise in compliance costs.

#### *Technology should be used to reduce compliance red tape*

Technology and data analytics can drive productivity, efficiency and deregulatory gains by helping to identify systemic issues, real-time audits and streamlining compliance. Administration costs also have broader implications, as they must ultimately be funded by raising more tax revenue. Current methods to reduce compliance costs could be improved by using more customer-centric models and replacing intrusive and resource-intensive audits with more extensive use of data analysis and matching.

The ATO is already using technology to reduce complexity, but more can be done to reduce the cost of red tape. The ATO's risk-differentiation framework helps assess the tax risk of businesses and the ATO response. The framework is based on both the likelihood of a taxpayer taking a position the ATO disagrees with, and the fiscal consequences of potential non-compliance. It has been recognised as being in line with global best practice, and has been extended from large businesses, to SMEs and high-wealth individuals. This approach ensures resources are directed as needed, minimises administration costs and focuses on tax risks in real time.

Pre-filling of tax returns and expanded data matching with third-party information are in development. The evolution of e-tax to myTax makes voluntary compliance easier, and this should continue to be extended and improved. But improved engagement with taxpayers could facilitate better outcomes, including through the External Compliance Assurance Program pilot, the use of the Independent Review process and a much greater willingness to explore Alternative Dispute Resolution.

A more sophisticated IT system, integrated between the ATO and broader government, could reduce reporting requirements and capture and integrate real-time data. For



example, hours of work data could be collected to improve ease of administration and transparency for individuals around how working hours affect payments from some social programs. The Single Touch Payroll is one possible option, which has been raised in the Productivity Commission's Inquiry into Childcare and Early Childhood Learning (2015) and the McClure Review (2015).

Embracing technology is crucial, but there are policy levers available as well, such as integrating administration of taxes across the federation, such as payroll tax.

#### *Technology has enabled increased global competition*

At the international level, technology has enabled increased global cooperation. This includes Australia's double tax treaties and 36 Tax Information Exchange Agreements, the Common Reporting Standard, and the recently committed to country-by-country reporting coming out of the OECD's BEPS Action Plan. Global cooperation is expanding, such as through the expansion of the Joint International Tax Shelter Information and Collaboration Network to a broader international platform representing more countries in addressing cross-border tax avoidance.

#### **Tax policymaking, institutions and administration should be regularly reviewed**

The tax white paper process should look for opportunities to improve tax governance arrangements, such as policymaking, institutions and administration. This could include addressing overlaps in governance arrangements, or improved governance in policy design and implementation. As noted in the tax discussion paper (2015c), New Zealand and the UK could provide a good model for institutional change.

A consultation framework may improve accountability around the policy and legislation design process. Consultation is important to ensure effective implementation of policy in a way that ensures the policy intent is met, but minimises compliance and administration costs, and avoids unintended consequences. Post-implementation reviews can also provide benchmarks to assess the effectiveness of policy changes and the process.

The Business Council, and other groups, have suggested that an independent Tax Reform Commission be formed to conduct whole-of-system reviews, specific consultations, ongoing law maintenance and consultation, and post-implementation reviews of laws and tax rules. The UK's Office of Tax Simplification is also a model that could be explored further.

Consideration should also be given to making data more readily available to improve research, analysis and evidence-based decision making. We acknowledge privacy concerns and data management costs exist, although they are not insurmountable and the benefits may outweigh the cost – as demonstrated by the wealth of research based on the Danish tax and transfer system. To further illustrate this point, many of the questions posed in the tax discussion paper (2015c) may require empirical research to substantiate claims, which this approach would support.



### **Implications for the tax white paper**

- ▶ Continued steps should be taken to address the increase in complexity and compliance costs of the Australian tax system. This includes developing a metric for measuring complexity.
- ▶ Technology should be used to reduce compliance red tape and enhance interactions and trust with the tax system.
- ▶ Tax policymaking, institutions and administration should be regularly reviewed and more data should be made publicly available to improve research and analysis. Consideration should be given to an independent body for tax reform.

## 9 KEY DIRECTION: GREATER USE OF USER CHARGES

- User charges can be an effective alternative to general taxation because they encourage efficient use and supply of goods, and mean those directly receiving the benefits bear the cost.



Taxes should be kept to the minimum required to fund the income redistribution and government services that deliver community benefits in excess of the full costs of delivering them. As the Business Council argued in our submission to the 2015-16 budget, budget repair will require the redesign of spending programs, of which user charges could play a greater role.

In contrast to taxes, a user charge is a charge on the consumption of a specific good or service provided by government. User charges are thus more akin to market prices, providing important signals to both consumers and government providers.

There are a number of examples of user charges in Australia today. They include the co-payment made for pharmaceuticals under the Pharmaceutical Benefits Scheme, charges for ambulance services, and false alarm charges from fire departments.

The potential benefits of well-designed user charges relative to general taxes include:

- More 'efficient' use and supply of goods and services as consumers will only consume services they value at least as much as the cost, meaning less waste and overuse. Governments or private providers have greater incentives and better information to provide the level and quality of services that people value and are prepared to pay for.
- Improved equity as the costs of providing the good or service are paid for by the individuals receiving the benefits, not taxpayers more generally.
- Less tax needs to be collected, which allows for lower tax rates, reducing distorting effects on economic growth.

Equity concerns may arise where people are either unable to pay or where paying for services would significantly diminish their living standards. These can be managed through various means such as concessional rates, safety nets and exemptions for benefit recipients.

While there appears to be significant scope to expand the application of user charges and reduce the call on general taxation, there are limits. User charges should only be applied to the extent the good or service being provided and consumed delivers so-called 'private' benefits. This means that others in the community do not benefit from the consumption of the services by another. Of course, many government services generate significant public benefits that should continue to be funded from general revenues.

## **User charging to fund infrastructure**

The alternative to governments funding infrastructure is for the users and beneficiaries of the infrastructure to pay for it, for example tolls on roads, full-cost charging by utilities, or tax measures that capture increases in property values linked to the infrastructure. User charges for infrastructure are reasonably widespread today, although they are arguably underused in road service provision and rural water.

The Business Council (2013) has previously recommended that:

- Governments should deploy user charges as much as possible on public projects.
- Governments should also pursue value-capture initiatives on individual projects so that other beneficiaries of the infrastructure also pay, such as local landholders. This may be achieved through area levies or by sourcing land tax increases to pay for infrastructure.
- Infrastructure regulation should enable pricing based on full efficient cost-recovery in each infrastructure sector.

In particular, cost-reflective road pricing has the potential to promote efficient investment in transport, ameliorate congestion, and improve the supply of infrastructure that people value.

The Business Council supports the recommendations by the Productivity Commission (2014) and the Competition Policy Review (2015) for greater use of road pricing. The Competition Policy Review Final Report recommended the introduction of cost-reflective road pricing offset by a reduction in, or elimination of, indirect taxes and charges such as fuel excise and registration fees. Fuel excise is raising relatively less tax as fuel consumption per kilometre driven declines, while road user charging could provide additional benefits such as reducing road congestion and better factoring wear and tear on roads. To the extent fuel excise remains, and as the tax discussion paper (2015c) notes, fuel tax credits are an important complement to ensure 'that fuel tax on business inputs is minimised'.

It is acknowledged that these reforms will require substantive policy development and consultation with the community. As the tax discussion paper (2015c) notes, road pricing is complex and raises issues such as equity, privacy and technology. As a first practical step the government should reinvigorate COAG's heavy-vehicle road charging reform process and set out clear time lines for its implementation. In particular, governments should commit to practical pilots and trials that apply and test the design work done to date, and generate tangible results.

## **Implications for the tax white paper**

- User charges should be further explored to replace funding from general taxation. Public infrastructure is an example where user charges could be better deployed.

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