ACCI Submission to the Department of Treasury

Australia's Future Tax System

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1. ACCI Leading Australian Business

ACCI has been the peak council of Australian business associations for 105 years and traces its heritage back to Australia's first chamber of commerce in 1826.

Our motto is "Leading Australian Business."

We are also the ongoing amalgamation of the nation's leading federal business organisations - Australian Chamber of Commerce, the Associated Chamber of Manufactures of Australia, the Australian Council of Employers Federations and the Confederation of Australian Industry.

Membership of ACCI is made up of the State and Territory Chambers of Commerce and Industry together with the major national industry associations.

Through our membership, ACCI represents over 350,000 businesses nation-wide, including over 280,000 enterprises employing less than 20 people, over 55,000 enterprises employing between 20-100 people and the top 100 companies.

Our employer network employs over 4 million people which makes ACCI the largest and most representative business organisation in Australia.

1.1. Our Activities

ACCI takes a leading role in representing the views of Australian business to Government.

Our objective is to ensure that the voice of Australian businesses is heard, whether they are one of the top 100 Australian companies or a small sole trader.

Our specific activities include:

- Representation and advocacy to Governments, parliaments, tribunals and policy makers both domestically and internationally.
- Business representation on a range of statutory and business boards, committees and other fora.
- Representing business in national and international fora including the Australian Fair Pay Commission, Australian Industrial Relations Commission, Australian Safety and Compensation Council, International Labour Organisation, International Organisation of Employers, International Chamber of Commerce, the Business and Industry Advisory Committee to the Organisation for Economic Co-operation and Development, the Confederation of Asia-Pacific Chambers of Commerce and Industry and the Confederation of Asia-Pacific Employers.
- Research and policy development on issues concerning Australian business.
- The publication of leading business surveys and other information products.
- Providing forums for collective discussion amongst businesses on matters of law and policy affecting commerce and industry.

1.2. Publications

A range of publications are available from ACCI, with details of our activities and policies including:

- The ACCI Policy Review; a analysis of major policy issues affecting the Australian economy and business.
- Issue papers commenting on business' views of contemporary policy issues.
- Policies of the Australian Chamber of Commerce and Industry – the annual bound compendium of ACCI's policy platforms.
- The Westpac-ACCI Survey of Industrial Trends - the longest, continuous running private sector survey in Australia. A leading barometer of economic activity and the most important survey of manufacturing industry in Australia.
- The ACCI Survey of Investor Confidence – which gives an analysis of the direction of investment by business in Australia.
- The Commonwealth-ACCI Business Expectations Survey - which aggregates individual surveys by ACCI member organisations and covers firms of all sizes in all States and Territories.
- The ACCI Small Business Survey – which is a survey of small business derived from the Business Expectations Survey data.
- Workplace relations reports and discussion papers, including the ACCI Modern Workplace: Modern Future 2002-2010 Policy Blueprint and the Functioning Federalism and the Case for a National Workplace Relations System and The Economic Case for Workplace Relations Reform Position Papers.
- Occupational health and safety guides and updates, including the National OHS Strategy and the Modern Workplace: Safer Workplace Policy Blueprint.
- Trade reports and discussion papers including the Riding the Chinese Dragon: Opportunities and Challenges for Australia and the World Position Paper.
- Education and training reports and discussion papers.
- The ACCI Annual Report providing a summary of major activities and achievements for the previous year.
- The ACCI Taxation Reform Blueprint: A Strategy for the Australian Taxation System 2004–2014.
- The ACCI Manufacturing Sector Position Paper: The Future of Australia's Manufacturing Sector: A Blueprint for Success.

Most of this information, as well as ACCI media releases, parliamentary submissions and reports, is available on our website – www.acci.asn.au

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3. EXECUTIVE SUMMARY

In the next decade Australia's economy will continue to experience the long process of intergenerational change, which has significant impacts for our future economic growth and living standards. Moreover, given the current era of globalisation with freer capital and labour mobility, there is an increasing pressure for Australia to remains competitive. An important element in addressing the above challenges is through the creation of an efficient, simple and equitable tax-transfer system.

According to the *World Economic Forum – Global Competiveness Report 2008-09*, Australia was ranked 18th out of 134 countries in terms of overall competitiveness. However looking into greater details, Australia was ranked 85th in terms of government regulation burden and 88th in terms of total tax rate. Thus, continuing tax reform remains key to enhancing Australia's competitiveness and economic growth.

ACCI also considers in the context of current world economic slowdown more urgency needs to be assigned to the taxation reform agenda. The capacity for Australian business to improve our productivity performance, maintain investment plans and provide job opportunities relies on a competitive tax system that delivers incentive and rewards entrepreneurship.

ACCI's comprehensive surveys of our membership continue to nominate business taxes and government charges as a major constraint on investment. This is particularly the case for small and medium sized enterprises, therefore the direction of our tax reform priorities strongly supports this sector. Further ACCI believes that reduction in the overall tax burden is an important driver of economic growth.

ACCI proposes that the Government should address the following issues in its Future Tax System Review:

- Reduce complexity and compliance costs of the tax system, particularly by better measurement of the regulatory costs of all tax measures (legislative and non-legislative);
- Gradually reduce the top marginal personal tax rate to the same level as the corporate tax rate;
- Ensure the elimination of bracket creep via the indexation of taxation thresholds;
- Over a longer period seek to reduce the number of tax thresholds to the minimum number possible and preferably not more than two;
- Introduce a stepped rate Capital Gains Tax to significantly reduce the burden of tax on capital gains and encourage increased investment;
- Consider carry-back of capital losses and an extension of rollover provisions;
- While reducing company tax is not something that should be ruled out in the future, the immediate priority is to reduce the top personal income tax rate to the current corporate tax rate of 30 per cent before further reductions in company tax are contemplated;
- Like all other income, Fringe Benefit Tax should be applied to the employee, with collection from employers in the same manner as the Pay As You Go system;
- R&D Tax Concession should be restored to 150 percent;
- Reduce high effective marginal tax rates on low and middle income earners by increasing the Low Income Tax Offset (LITO) and introducing an Earned Income Tax Credit (EITC);
- Continue to pressure the States to remove their most inefficient taxes and reduce payroll taxes; and

- Ensure that taxation issues arising from Carbon Pollution Reduction Scheme (CPRS) do not increase the tax burden of businesses and individuals.

4. THE CASE FOR FURTHER TAX REFORM

Over the course of Australia's history, the development of our taxation system has been as broad reaching and as profound as the transformation that has taken place in Australia's society and economic structure.

Growing out of a simple system of customs and excise duties designed to raise funds for rudimentary social spending, taxation now touches virtually every aspect of our private and business lives. Featured prominently within the overall tax system are Australia's income tax, state taxes, capital gains tax and retirement income taxes.

In recent times, policymakers have become more aware of the benefits of competition, efficiency and globalisation. There has also been increased awareness of the drivers of economic growth such as skills development, research and development (R&D), investment and education. Australia's future tax policy must provide a conducive environment that encourages each to flourish within an international context.

In the next ten years Australian economy will continue to experience the long process of intergenerational changes. Australia's future economic fortunes and wealth of its people will, in part, be determined by the decisions and actions taken today in reforming Australia's tax system.

By addressing the challenges of tomorrow, today, through the creation of an efficient, simple and equitable tax regime, current policymakers will be able to build a strong foundation for productivity and economic growth.

4.1. Principles of Taxation Policy

ACCI believes Australia needs a tax system that supports the achievement of important economic and social objectives. Australia's competitiveness should be assisted and not impeded by the tax system.

Tax revenue should be adequate to meet elected governments' reasonable expenditure needs, consistent with the exercise of fiscal responsibility principles. The tax system should be such that all taxpayers feel confident and satisfied in complying with it.

A sustainable tax structure will only be achieved through an integrated package of reform across all significant Commonwealth and State tax bases in the form of a balanced package covering consumption, income and assets.

4.2. Taxation Policy Objectives

ACCI is calling for fundamental reform of Australia's taxation system consistent with the following objectives:

- equity – there should be fairness in the distribution of resources between high and low income people as well as similar tax burdens for taxpayers with similar resources;
- economic efficiency – taxes should impact neutrally on the economy; commercial decisions must not be skewed by tax considerations. The tax system should improve the competitiveness of Australia by encouraging productive investment, risk taking and economic growth and attracting capital and skilled labour;

- adequacy – tax systems should raise sufficient revenue for public expenditure needs, be sustainable in the long run and be consistent with fiscal responsibility;
- simplicity – taxpayers should be able to clearly understand and meet their tax obligations;
- transparency – taxpayers should understand how and when they are paying tax and how much tax they are paying. Hidden taxes should be minimised.
- limit cost – compliance and collection costs should be minimised.
- limit evasion and avoidance – there should be minimum incentive and potential for avoidance or evasion of taxation.
- consistency – tax policy should be internally consistent and consistent with broader Government policies.
- flexibility – the tax system should be able to respond to developments in the economy and society, for example demographic changes, financial innovation, globalisation and the internet.
- public perception – there should be the widest possible public support for the tax system.

The objectives of Australia's future tax reform should be to reduce the overall burden of tax, eliminate economically damaging taxes, and generate greater incentives for workforce participation, productivity, investment, R&D and international competitiveness.

4.3. The Need for Tax Reform

ACCI welcomes the Government's commitment to reductions in personal taxes over the next few years.

ACCI supports tax cuts for many reasons, as summarised below.

4.3.1. Taxes reduce productivity and efficiency

Taxes have significant efficiency costs, so tax reductions will increase the efficiency and productivity of the Australian economy. To ensure sustainable economic growth, with wages growth not translating into inflation, it is absolutely essential that productivity start growing again. One of the most significant ways to further improve productivity is through tax reform.

Almost all taxes have an efficiency cost on the economy. Some Australian studies on the efficiency costs of taxes are summarised below:

- Campbell & Bond (1997)[1] find that the efficiency costs of taxation are at least 19-24 percent. This means that a reduction in tax by $1 has an economic return of 19-24 percent, which is a very high rate of return.
- Findlay & Jones (1982)[2] find that the efficiency costs of taxation are between 23 and 26 percent.
- Freebairn (1995)[3] finds broadly similar results if sticky wages and the demand for labours are included in models.
- Diewert & Lawrence (1998)[4] found that a cut in Australian taxes on capital would have a return of 48 percent.

1. Campbell & Bond (1997) "The Cost of Public Funds in Australia" *Economic Record* Vol 73 No 220.
2. Findlay & Jones (1982) "The Marginal Cost of Australian Income Taxation" *Economic Record* Vol 58 No 162.
3. Freebairn (1995) "Reconsidering the marginal welfare cost of taxation" *Economic Record* Vol 71 No 213.

Other studies show that the efficiency costs are even larger when taxpayers reduce their taxable income. This submission will use the generic term tax minimisation:

- Parry (2002)[5] finds that legitimate tax minimisation increases the efficiency costs of taxation to around 30 to 50 percent. Parry does not include tax evasion, which he suggests could increase this cost by 5 to 10 percent.
- Feldstein (1999)[6] finds that personal taxes have an efficiency cost of 204 percent in the US when tax minimisation is included, with the cost even higher for higher income earners.
- Fortin & Lacroix (1994)[7] find that legitimate tax minimisation means income taxes have an efficiency cost of 39-53 percent. Incorporating tax evasion through the cash economy increases the efficiency cost by between 2 and 5 percent, but this cost is larger at higher income tax rates.
- Cebula (1997) [8] found that a one percent increase in the US personal tax rate increased the size of the cash economy by 1.4 percent.

4.3.2. Taxes can reduce growth

While taxes can reduce the static efficiency of the economy, taxes can also have a long run adverse effect on growth. Table 1 below, adapted from Leach (2003)[9], summarises some literature about the negative effect of tax on growth. In general, previous studies found that a 1 percent tax reduction can increase economic growth by at least 0.1 percent per year.

Table 1: The Negative Impact of Taxation on Economic Growth

Study	Coverage	Effect of 1 percent cut in tax
Cashin (1995)	23 OECD countries over the 1971-1988 period.	output per worker increases by 2%
Engen & Skinner (1996)	US modelling together with a sample of OECD countries.	GDP growth increases by 0.08% to 0.12%
OECD - Leibfritz, Thornton & Bibbee (1997)	OECD countries over the 19651995 period.	Increase GDP growth by 0.05% to 0.1%
OECD (1997) additional model simulations	European Commission Quest 2 - model simulations.	Increase GDP by 2.4%
Bleaney, Gemmell & Kneller (2000)	17 OECD countries over the 1970-1994 period.	Increase GDP growth by 0.41%

4. Diewert & Lawrence (1998) "The Deadweight Costs of Capital Taxation in Australia", University of British Colombia Discussion Paper 1998-01.
5. Parry (2002) "Tax Deductions and the Marginal Welfare Cost of Taxation" *International Tax and Public Finance* Vol 9, pp 531-551
6. M Feldstein (1999) "Tax Avoidance and the Deadweight Loss of the Income Tax" *Review of Economics and Statistics*, Vol 81(4), pp 674-680.
7. B Fortin & G Lacroix (1994) "Labour supply, tax evasion and the marginal cost of public funds an empirical investigation" *Journal of Public Economics* 55(3), pp 407-431
8. R J Cebula (1997) "An Empirical Analysis of the Impact of Government Tax and Auditing Policies on the Size of the Underground Economy: The Case of the United States" *American Journal of Economics & Sociology*, 56 (2), 1997.
9. G Leach (2003) Negative Impact of taxation on economic growth – UK Reform

Study	Coverage	Effect of 1 percent cut in tax
Folster & Henrekson (2000)	Sample of rich OECD/non-OECD countries over the 19701995 period.	Increase GDP growth by 0.1%
Bassanini & Scarpetta (2001)	21 OECD countries over the 1971-1998 period.	Increase GDP growth by 0.3% to 0.6%
PricewaterhouseCoopers (2003)	18 OECD countries over the 1970-1999 period.	Increase GDP growth by 0.2% to 0.4%

Recognising the longer-run effects of taxes on growth, the US Department of Treasury is developing a model to estimate these effects (known in the US as dynamic scoring). The US is particularly interested in whether the growth effects of tax reforms can offset the short-run costs.

ACCI recommends that the Australian Government monitor this work and ask the Australian Treasury to undertake similar work.

4.3.3. Effect of tax on education and training

ACCI strongly supports the new Government's focus on improving education and training. ACCI considers that continuing tax reform plays an important role in encouraging investment in education and training (or human capital). Some studies supporting this include:

- Milesi-Ferretti & Roubini (1998)[10] find that personal income taxes reduce growth because they reduce investment in human capital.
- Lucas (1990)[11] shows that income taxation lowers the return to human capital and reduces the incentive to accumulate human capital.
- King and Rebelo (1990)[12] and Rebelo (1991)[13] find that an increase in the income tax rate decreases human capital accumulation and economic growth.

4.3.4. Other adverse effects of taxes

There are a number of other reasons why efficiency figures would underestimate the cost of taxes, including:

- Uncertainty, which increases the negative effect taxes have on the incentive to invest – see Agliardi (2001)[14]
- Existing inefficiencies in the economy, such as monopolies, externalities, regulations (particularly on the labour market) and trade restrictions. Browning (1994)[15] argues that a large number of non-tax distortions substantially increase the efficiency and welfare costs

10. G M Milesi-Ferretti & N Roubini (1998) "On the taxation of human and physical capital in models of endogenous growth" *Journal of Public Economics* 70(2), pp237-254.
11. R Lucas (1990) "Supply-side economics: an Analytical Review" *Oxford Economic Papers* Vol 42 (April) pp293-316.
12. R G King & S Rebelo (1990) "Public policy and economic growth: developing neoclassical implications" *Journal of Political Economy* Vol 98, pages s126–151.
13. S Rebelo (1991) "Long-run policy analysis and long-run growth" *Journal of Political Economy* Vol 99 p500–521.
14. E Agliardi (2001) "Taxation and Investment Decisions: A Real Options Approach" *Australian Economic Papers* vol 40, issue 1, pages 44-55.
15. Browning (1994) "The non-tax wedge" *Journal of Public Economics* 53(3), p419-433.

of taxes. Under plausible parameters, the welfare/efficiency cost of taxes is 40 percent higher when pre-existing inefficiencies are included.

- The effect of taxes on innovation, risk taking and entrepreneurship[16].
- Taxes increase inflationary pressures, not reduce them as argued by some commentators. This is clearly shown by the most recent significant tax increase - the GST. This lead to large increases in prices and hence inflation.

5. TAX COMPLIANCE ISSUES

Despite the significant overhaul of Australia's taxation regime, compliance costs remain a major concern for Australian businesses.

The problem is not so much with any individual tax, but the cumulative effect of many individual taxes imposed on businesses. Compliance is of greater concern amongst smaller businesses, which have fewer resources to devote to dealing with the demands of the Australian Tax Office (ATO).

Business believes that Governments and the ATO pay insufficient attention to the compliance difficulties created by extra legislation, particularly the total burden rather than measures taken individually.

5.1. Background

In 2001, the OECD released the report – *Businesses' Views on Red Tape: Administrative and Regulatory Burdens on Small and Medium-Sized Enterprises (SMEs)*. This report is based on 1998-99 data and looked at tax, environment, and employment compliance costs in 11 different countries, including Australia. This report showed that Australia's average tax compliance costs per SME at the time of the survey were estimated to be around USD8,922 and estimated to be around 1 percent of GDP.

Two major studies of taxpayer compliance costs have been conducted in Australia, both focused at the 'macro' level. These studies are 1997 ATAX study, for the Australian Taxation Office (ATO) by Evans, Ritchie, Tran-Nam and Walpole (1997, 1998), which is based on the 1994-95 fiscal year, and earlier studies by Pope et al (1990, 1991, 1992, 1993, 1994). There has been no major aggregate study of compliance costs in Australia since *The New Tax System* and the *Review of Business Taxation* reforms were implemented.

However, Cnossen[17] undertook an investigation of compliance costs for indirect taxes in 1994-5. He found that compliance costs were higher for smaller businesses in the UK, New Zealand and Canada. There is little doubt that similar conclusions would be reached if a similar study were conducted in Australia. The disproportionately larger costs of coping with the burdens of taxation amongst small and medium enterprises (SMEs) are an ongoing drain on their ability to focus on their core business.

16. Gentry and Hubbard (2004) "'Success Taxes', Entrepreneurial Entry, and Innovation", *NBER Working Paper* 10551.
17. Cnossen, S. (1994) " Administrative and Compliance Costs of the VAT: A Review of the Evidence" *Tax Note International*, 8(25), p. 1649-1668.

5.1.1. *Business surveys*

Supporting these concerns is the quarterly *Survey of Investor Confidence* run by ACCI, which consistently ranks *Business Taxes and Government Charges*, and *Cost of Compliance with Government Regulations* as critical constraints on the level of business investment.

In addition, ACCI's 2007 Pre-Election Survey showed that the complexity of the tax system was the third highest concern of business. The survey also showed that the specific Federal taxes of greatest concern were (in descending order) personal tax, Fringe Benefits Tax (FBT), company tax, Capital Gains Tax (CGT), super guarantee and the GST. ACCI considers that the key priorities for reform are personal tax and CGT, as outlined below. A more detailed analysis of the Pre-Election Survey results is available from ACCI's website.

Certified Practicing Accountants (CPA) Australia in April 2003 undertook a survey of its small business membership to examine issues in relation to taxation compliance. Major findings of this survey included (the words are those used by the CPA)[18]:

- "Sixty-two per cent resent the time needed to comply with tax obligations and 41 per cent feel the paperwork burden has increased to the point where they question staying in business. Fifty-two per cent are outsourcing more paperwork than ever before";
- "Many businesses, particularly non-employers, have experienced little change in compliance obligations over the past two years, however where change has occurred it is more likely to be an increase than a decrease";
- "Thirty-four per cent of small businesses have seen an increase in the time needed for Business Activity Statements (BAS) returns, 30 per cent experienced an increase in time required for annual income tax returns and around 16 per cent saw an increase in other taxes, Superannuation Guarantee Levy (SGL), and workers' compensation"; and
- "The time for CPAs to complete BAS and annual returns has increased by around 51 per cent and 89 per cent respectively".

Another Small Business Survey conducted by CPA Australia in May 2005[19] on the relationship between the record-keeping practices of small businesses' and their potential exposure to tax and related business compliance problems stated that:

> " These results [i.e. the Survey] do suggest an ongoing uncertainty about just how much complying with legislative requirements actually costs a business, both internally and externally. There was a wide variation in estimates of internal and external costs from SMEs, and these differed substantially from those provided by practitioners. These findings suggested that key stakeholders are often unaware of the quantum and composition of business tax compliance costs." (p.16)

There is a lack of major quantitative analysis of taxation or total regulation compliance costs since 2000 and there are very large discrepancies in the existing estimates of the compliance burden. As a result, we do not know whether regulatory reform (including the implementation of the GST), has assisted in reducing business compliance costs. There is however a growing body of evidence indicating that compliance costs remain a genuine concern.

5.2. ACCI Proposals

The Australian Government has, over a number of years, sought to reduce taxation complexity. We applaud the Government for what it has done.

However, it is evident that there are a large number of taxation compliance issues still being raised by the business sector.

18. CPA Australia Small Business Survey - Compliance Burden (April 2003)
19. CPA Australia Small Business Survey - Record Keeping: Its Effect on Tax Compliance (May 2005)

In our consultations with business ACCI has come to the conclusion that rather than proposing a solution to every one of these many issues, we would be better to focus on the systemic answers to the issues that arise. In particular there should be put in place better regulatory assessment processes for tax administration and better consultation mechanisms.

Thus, ACCI proposes that the Government should consider introducing a Tax Administration Impact Statement (the TAIS) to be administered by the Inspector General of Taxation. In introducing the TAIS:

- The Inspector General should undertake a survey of the time and money that business spends on complying with the Tax Act.
- The Inspector General in conjunction with the ATO should introduce a range of initiatives to assist business to identify, understand and implement new and existing taxation requirements. Information programs for small business in particular should involve all components of the small business network.
- The Inspector General should include within the TAIS a requirement that quantitative estimates of compliance costs, based on detailed proposals for implementation and administration, be attached to any new tax proposal.
- There should also be regular reviews of the accuracy of compliance estimates in the TAIS for regulations with a major impact on business.
- The Inspector General in conjunction with the ATO should regularly review its taxation impact assessment arrangements to ensure that they meet best practice standards in regards to minimising the compliance burden on business. International best practice should be continuously introduced into Australia.
- The Inspector General in conjunction with the ATO should develop a consistent methodology for measuring the tax compliance burdens imposed.
- Greater education, skill development, resources and priority within agencies are needed. The Inspector General, in conjunction with the Commissioner of Taxation, needs to address the corporate culture within the ATO to ensure that the TAIS is carefully constructed when each new tax change is proposed.

The Treasury should establish a committee similar to the Corporate Consultative Committee at the ATO that has the aim of tapping into business concerns and experience in the development of tax legislation and its administrative arrangements.

6. Personal Tax

ACCI has welcomed the Government's implementation of personal tax reforms over the next few years.

We especially welcome the Government's medium-term goal of moving towards a tax system with a top marginal tax rate of 40 percent.

ACCI would support any early movement towards this goal, particularly by cutting the top marginal tax rate.

ACCI also supports the Government's goal of eliminating one tax bracket so there are only three at 15, 30 and 40 percent

6.1. Top Marginal Tax Rate

ACCI places a particular priority on reducing the top rate, for the following reasons:

- Our top tax rate of 46.5 percent (including the Medicare levy) is still above the OECD average in 2007 of 46.2 percent[20], although our top tax threshold increased to $180,000 after July 1, 2008.
- The efficiency costs of a high top marginal tax rate are greater than the average, because higher income earners are more responsive to taxes than lower income earners.
- Reducing the top tax rate will reduce the tax rate on capital. Tax theory generally shows that capital taxes are very inefficient because they reduce growth – see Atkeson et al (1999)[21].
- There are many tax avoidance opportunities created by having significant differences between the top personal tax rate and the company tax rate, for example replacing dividend distributions with loans from the company.
- There is also evidence that high taxes on skilled workers discourages investment (see Büttner & Wamser (2006)[22]) and reduces productivity growth (see Eichler et al (2006)[23]).

6.2. Personal Tax thresholds

ACCI also supports the indexation of personal tax thresholds to wages growth. We consider the goal of ensuring certain proportions of taxpayers face a particular tax rate is a significant step towards this goal.

- ACCI would prefer indexation, because the movement in tax thresholds is locked in to legislation. A goal is not.

Indexation would be consistent with practice in a number of other countries. The 2006 *International Comparison of Australia's Taxes* Report showed that many of the OECD-10 comparison countries use partial or full indexation of personal tax thresholds.

It would also be consistent with the recommendation in 2006 survey of Australia by the OECD[24]:

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20. Source: *Architecture of Australia's Tax and Transfer System.*
21. Atkeson, Chari & Kehoe (1999) "Taxing Capital Income: A Bad Idea" *Federal Reserve Bank of Minneapolis Quarterly Review* Vol 23(3), Summer, pp3-17.
22. T Büttner & G Wamser (2006) "The impact of non-profit taxes on foreign direct investment" Paper prepared for the European Tax Policy Forum conference "The Impact of Corporation Taxes Across Borders" London, 24 April 2006.
23. M Eichler, M Grass, H Blöcliger & H Ott (2006) *Determinants of Productivity Growth*, BAK Basel Economics
24. OECD (2006) Economic Survey of Australia.

> "There is thus a precedent for Australia adopting some default indexation of tax thresholds as a means of making changes to the tax system more transparent." (p. 42)

All personal tax thresholds have to increase by wages growth just to ensure that taxpayers remain in the same position. If this indexation does not occur, the Government has imposed a *de-facto* tax increase on taxpayers.

ACCI supports the Government's goal of eliminating one tax bracket so there are only three at 15, 30 and 40 percent. However over the longer period, ACCI proposes that the Government should seek to reduce the number of tax threshold to the minimum number possible and preferably no more than two.

6.3. Difference between Personal and Company Tax Rates

ACCI argues for a reduction in the top two marginal tax rates (currently at 40 and 45 percent) to address the large difference between the personal and company tax rates (currently at 30 percent). A large difference creates the following problems:

- It creates a tax-related disincentive for dividends to be paid by companies. The decision to pay dividends should be based on business decisions, not driven by tax.
- It creates an incentive for wealthier taxpayers to set up companies and to hold many income-producing assets in a private company. They leave funds in the company, being taxed at 30 percent, and only withdraw funds when needed. All savings are left in the company.
- Taxpayers with a private company can rearrange their affairs to maximise the income earned by the company and maximise the deductions taken at the individual level.
- The Government has had to introduce complex anti-avoidance rules to address various tax minimisation strategies that are caused by the large difference between the company and personal tax rates, including:
  - The incentive for shareholders to try to withdraw funds from the company through a loan rather than a dividend, which is addressed by detailed anti-avoidance provisions (Division 7A), which are a burden on many private companies.
  - The incentive for workers to try to receive wages through a company, which is addressed through the detailed Alienation of Personal Services Income (APSI) measures, requiring detailed tests to determine whether a person is an employee or not.

Noting these concerns, the 2006 OECD survey of Australia[25] argues that "the large gap between the top personal marginal income and the corporate tax rate may encourage tax avoidance via the redefinition of personal income as company income" (p. 42).

6.4. Tax Cuts and Inflation

Some commentators argue that tax cuts are inflationary. However, the evidence for this position is weak:

- Importantly, appropriately designed tax cuts will reduce inflationary pressures, because they will encourage people to enter the labour force and encourage skilled migration, thus reducing wage pressures. Tax cuts will also encourage investment by unincorporated businesses.

25. OECD (2006) Economic Survey of Australia.

- Most of the studies found that a large portion of tax cuts are saved (see Loyoza, Schmidt-Hebbel and Serven (2000)[26] and de Mello, Kongsrud & Price (2004)[27]).
- Businesses often pass on tax increases as higher prices, and tax reductions as lower prices. The evidence for this is straight forward – the most recent large tax increase (the GST) led to significant price increases.
- Changes in the Budget surplus don't have much of an effect on GDP in an economy with a floating exchange rate.
- Recent tax cuts haven't actually reduced revenue by much, because they largely offset unexpected increases in tax revenues. A significant portion of the recent cuts are also just returning bracket creep.
- Government spending is more inflationary than tax cuts – so commentators should make that observation about government spending rather than tax cuts.

Even if tax cuts cause inflation, no one has demonstrated that people are worse off than if the tax cuts were abandoned.

6.5. Revenue Windfall from Commodity Boom

A separate argument is sometimes advanced that tax cuts are not affordable because the current Budget position is artificially increased by the current commodity boom. When the boom ends, the strong fiscal position will (allegedly) disappear.

However, this argument is not supported by the evidence.

The International Monetary Fund (IMF) in its 2006 country report for Australia[28] examined this issue, concluding that "The results show that increases in export commodity prices were clearly not the main driving force behind the strong fiscal performance of the general government in recent years." (p. 26). The IMF also argued that "there is no pressing need to use additional revenue for fiscal consolidation." (p. 22) and found that even with an early fall in commodity prices to their long-run levels, the Budget would remain in significant surplus of around 0.8 percent of GDP over the next few years (p. 27).

Therefore, tax cuts are affordable regardless of the future movements in commodity prices.

Moreover, IMF (2008)[29] argued that if the recent boom in commodity prices is permanent, there will be scope to lower labour and capital income taxes along with higher public investment, as this will generate the largest economic gain in the long run. In the IMF modelling, if the government pursued a delayed or gradual reduction of labour income taxes, the fiscal balance will increase and inflation will rise more quickly than the case when there is a prompt reduction in labour income taxes (i.e. the base case). In the absence of the offsetting impact of declining labour income taxes, the initial reduction on households' labour supply from rising permanent household wealth (due to rising commodity sector returns) will be larger than the base case, thereby reducing productive capacity. This subsequently leads to higher real wages and may fuel inflation.

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26. N Loyoza, K Schmidt-Hebbel & L Serven (2000) "What drives saving across the world?" *Review of Economics and Statistics* Vol 82, pp226-238
27. de Mello, Kongsrud & Price (2004) "Saving Behaviour and the effectiveness of Fiscal Policy" OECD Working Paper 397
28. IMF (2006) Country survey report for Australia – Selected Issues, pages 18-28
29. IMF (2008) Country Survey report for Australia – Selected Issues, page 3-17

In any case, ACCI argues that tax cuts can be funded by appropriate reductions in Government spending (see below), ensuring affordability when the commodity boom ends.

6.6. Arguments against Tax Reform

The remaining arguments against continuing tax reform are weak:

- Some argue that people on higher incomes work too hard and higher tax rates will discourage this excessive work. However, average hours worked by Australians continues to fall and the proportion of Australians who work long hours is also declining. The data is presented in ACCI Issues Paper on September 2007.
- Tax cuts should not make the tax system less equitable. In fact, tax cuts can reduce tax avoidance and evasion, increasing the effective tax rate paid by the highest income earners.

In addition, ACCI supports funding tax cuts by reducing Government spending. Some options for reducing expenditure were explored in a discussion paper released by ACCI in 2005, entitled *Government Spending (And Taxes) Can be Cut – And Should Be*. This Report is available from the ACCI website.

This Report argued that a strong case exists on both economic and social grounds for reducing the size of government and identifies savings that would reduce Government expenditure and revenue concessions by over $19 billion or around 2 per cent of GDP.

Reductions in the size of Government will have other benefits including:

- Reducing the inefficient 'churn' of money from higher income earners back to the same people;
- Reducing the fiscal pressures of the ageing population, by encouraging wealthier Australians to provide more for their own retirement;
- Encouraging saving, by requiring richer individuals to provide for unforseen problems (e.g. catastrophic health problems), rather than expecting the Government to provide for these problems;
- Limiting the inflationary pressures from Government activities. Governments use up scarce resources (particularly skilled labour), driving up their prices.
- Alesina et al (2002)[30] finds that US Government spending on wages drive up general wages and thus increases inflationary pressures. It also reduces profits and business investment.
- Reducing the scope for inefficient pork-barrelling and socially inefficient spending; and
- Increasing the private sector provision of services, which will increase efficiency (the private sector is usually more efficient than the public sector in providing the same product[31]).

For Government spending that is retained, ACCI recommends that the Government make greater use of cost-benefit analysis. This will assist in demonstrating that spending is achieving its goals at the lowest cost to the Budget, is increasing productivity and is reducing inflationary pressures.

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30. Alesina, Ardagna, Perotti & Schiantarelli (2002) "Fiscal Policy, Profits, and Investment" *American Economic Review* Vol 92, No 3, June
31. For a survey of many studies supporting this argument, see Gonenc, Maher & Nicoletti (2000) "The implementation and the effects of regulatory reform: past experience and current issues" OECD Working Paper 251, particularly Table 14 on pages 77-78.

While there is scope for significant moderation in Government spending, it is important that the Government ensure that programs addressing Australia's long-term needs (particularly addressing skill shortages and productivity growth) are maintained and developed.

7. CAPITAL GAINS TAX

Aside from personal income tax reform, the other main priority for ACCI is further reform to Capital Gains Tax (CGT).

Based on the *International Comparison of Australia's Taxes* Report (2006) and *Architecture of Australia's Tax and Transfer Systems (2008)*, Australia is clearly uncompetitive on capital gains tax (CGT). Among the OECD-10 countries, Australia has one of the higher top personal tax rates on capital gains, notwithstanding the 50 percent discount available for gains on assets held for at least 12 months. We imposed the highest withholding tax on interest earned from ordinary bank accounts and the third highest CGT on shares.

ACCI argues that the CGT has the following problems:

- Capital is very mobile internationally. Relatively high tax rates on capital are detrimental because of this mobility.
- It decreases the efficiency of markets, because CGT discourages asset turnover (the lock-in effect). Due to CGT, owners of assets are discouraged from selling those assets even when it would be efficient, because of the large CGT bill they would have to pay. This decreases market liquidity.
    - The lock-in effect also means that investors do not shift their funds to investments (such as high growth firms) that offer the highest rate of return.
- It double taxes retained earnings. A company's retained earnings have already been subject to company tax. Shareholders who sell their shares before retained earnings are distributed are taxed twice, because they pay tax once on the earnings and again on the capital gain caused by the retained earnings. The CGT therefore discourages retention of earnings, which means lower corporate saving and investment. It also discourages equity investment compared to debt investment[32].
- It discourages capital formation. The increase in CGT in the US in 1986 was found to reduce the capital stock by between 2 and 4 percent[33].
- A constant-rate CGT without inflation indexation means a gradual increase in effective tax rates the longer an asset is held[34].
- It discourages the financing and start-up of new businesses, particularly in high-tech industries[35]
- It discourages entrepreneurs from selling equity to outside parties. This discourages growth and efficiency in firms that have just passed the start-up phase[36].

32. Pozdena (1987) "Tax Police and Corporate Tax Structure" *Federal Reserve Bank of San Francisco Economic Review*, Fall, p. 49
33. Henderson (1989) "Capital Gains Rates and Revenues" Federal Reserve Bank of Boston *New England Economic Review*, January-February, 1989
34. Ernst & Young (2006) *Taxation of Investment in Australia: the need for ongoing reform*, page 42.
35. Moore & Silvia (1995) "The ABCs of the Capital Gains Tax", Cato Policy Analysis No 242.
36. Chari, Golosov & Tsyvinski (2005) "Business Start-ups, The Lock-in Effect, and Capital Gains Taxation"

- It reduces incentives for entrepreneurs and therefore reduces welfare for the economy as a whole[37]. This study also shows that lower CGT is better way of promoting entrepreneurial activity than subsidized interest, direct investment subsidies, or public credit guarantees.

Therefore, ACCI considers that it is important to revisit and improve on the CGT reforms introduced in 1999. As discussed in detailed below, we particularly consider that the Government should seriously consider:

- introducing a stepped rate CGT, where the proportion of the capital gain that is taxed diminishes over time;
- the carry-back of capital losses;
- an extension of rollover provisions; and
- franking credits for capital gains

7.1. A Possible Stepped Rate CGT

By steadily reducing the amount of capital gains included in assessable income investors are rewarded for investing long-term.

A possible stepped rate schedule is produced in Table 2 below.

Table 2: ACCI Option – Possible Stepped Rate Schedule

Time Asset Held	Proportion of Capital Gains Subject to Tax
Less than 1 Year	100%
1 to 2 Years	50% (25% for Small Businesses with underlying active asset)
2 to 5 Years	25%
5 to 10 Years	10%
More than 10 Years	0% (i.e. tax free)

Based on the number of years an asset is held, a certain proportion of capital gains would be exempt from assessable income. The net capital gains would then be taxed at the taxpayer's marginal tax rate.

For example: A business asset is acquired on 1 July 2007 and sold on 31 July 2009. The asset has been owned for two years and 30 days, so the qualifying holding period will therefore include two full years. The percentage of the gain chargeable for an asset held for between two and five years is 25%.

After 10 years capital gains would no longer be taxed. This reduces the complexities associated with record keeping although it may raise administrative complexities as capital gains enter and exit the system.

We note that more work would need to be done to design the actual tax schedule that would be used. It would not be ACCI's aim that the burden of CGT under the new regime would be any higher. It would therefore be necessary to ensure that the CGT paid on assets sold in years 1, 2 and 3 under the new schedule is no higher than under the existing schedule.

37. C Keuschnigg & S Nielsen (2004) "Taxation and Venture Capital Backed Entrepreneurship" *International Tax and Public Finance*, Springer, vol. 11(4), pages 369-390. Also see C Keuschnigg SB Neilsen (2003) "Taxes and Venture Capital Support" *European Finance Review* No 7

Moreover, ACCI's proposed stepped rate CGT regime would maintain Australia's current arrangement of not distinguishing between assets and would therefore not include a distinction between non-business and business assets.

7.2. Carry Back of Losses to Offset Earlier Gains

One issue that has also been raised in relation to the CGT is the lack of ability to carry back losses to offset earlier gains.

Realised capital losses can presently be offset against any capital gains in the current tax year in order to obtain tax relief. For example, a capital loss triggered in 2008 would be applied against any capital gains made in 2008, but cannot be applied against gains that were made in previous tax years. Carry back would allow capital gains to be offset against tax losses in previous years, say, for up to three years, or carried forward indefinitely, if it cannot be used in the year in which it was accrued.

International practice would suggest that generally three years is considered to be long enough for this purpose[38]. The greater the length of time in which losses can be offset against past gains, the larger the cost to government.

During periods of volatility investors are likely to experience capital losses, which may not be able to be used quickly. Carry back of losses to offset earlier gains allows greater flexibility for investors to manage such volatility.

If carry back were to be introduced then the carry-back of losses would need to be grandfathered in order to ensure that current year losses were not offset against gains prior to its introduction.

Allowing capital losses to offset gains would reduce the amount of complexity and allow businesses to use all their capital losses against any gain over the previous three years. However, of all the CGT changes proposed it is this one that would have the greatest impact on Government revenue.

The duration period for which capital losses could be offset against past capital gains would also need to be set. The most flexible CGT systems would allow for capital losses to be offset against capital gains without the need to match the length of time over which the loss occurred with that period over which the gain occurred.

One option to alleviate the financial impact of such changes to the CGT regime is to quarantine capital losses against capital gains subject to the same inclusion rate. That is, losses from a certain assets held for a period of time could only be offset against gains assessable at the rate applicable to that time period. This option provides the least flexibility with regard to capital losses. Businesses would also be unable to offset all losses until a comparable capital gain was made.

Another solution is to allow losses to be adjusted to match the inclusion rate. For example, if the capital gain inclusion rate was 50 per cent then 50 per cent of the capital loss could be used to offset that gain. These systems reduce the cost to Government's revenue.

7.3. CGT Rollover Provisions

Rollover provisions allow assets to be transferred between related entities without triggering a CGT event or other tax consequence. They also allow for the deferral of CGT on gains under special provisions of the law such as those applying for small business or from involuntary disposal of assets[39].

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38. This is the present system used in the Netherlands.
39. Review of Business Taxation (1999) " A Platform For Consultation" Discussion Paper Vol. II.

Recognising that CGT can act as an impediment to the efficient restructuring of business, the Government introduced a number of reforms to the rollover provisions to cope with acquisitions, takeovers and mergers.

However, the current rollover requirements are restrictive and onerous, making access to provisions very difficult.

Business believes that investors should be able to reinvest sales of assets without attracting CGT. Changes to Australia's rollover provisions will involve broadening their applicability to business.

Demerger provisions contained in the *New Business Tax System (Consolidation, Value Shifting, Demergers and other Measures) Bill 2002*, while welcome, still excludes some businesses from qualifying.

There should be an examination of whether the existing CGT rollover relief for small business assets could be extended by increasing net asset threshold above the current $6 million.

Small business taxpayers can receive relief from CGT if they sell assets called 'active assets' used in their business. The exemption does not apply to gains made from passive (investment) assets. The small business rollover allows a small business to defer making a capital gain from a CGT event on an asset if a replacement asset is acquired and meets certain conditions.

There should be serious examination of whether investors could be able to re-invest the proceeds from asset sales in investment assets (such as shares) without attracting a capital gain liability. This broad-based rollover regime would encourage income to be invested rather than consumed immediately. Of course, the deferral of CGT due to rollover could have a significant impact on government finances in the short term.

8. COMPANY TAX

The *Architecture of Australia's Tax and Transfer System (2008)* Report shows that companies in Australia pay taxes well above the average for developed countries. In 2008, Australia's corporate tax rate is above the OECD average of 26.6 percent. Australia's corporate tax as a proportion of GDP is the second highest in the OECD and significantly higher than the OECD average of 3.9 percent in 2006[40] . It is likely that a substantial proportion of this is due to the current high level of company profits due to the resource boom and will be dissipated if (or when) resource prices fall as forecast. Some of this may also be caused by companies responding to incentives created by Australia's imputation system.

However, at this stage, ACCI does not consider that the priority for tax reform should be reducing the company tax rate. Nevertheless, there is a strong trend downwards in company tax rates in developed countries[41], which suggests that our company tax rate may need reduction in future years. Moreover, the Lee & Gordon (2005) study[42] further strengthens the case for company tax reduction; their study showed that a 10 percent cut in company tax rate produces an increase in annual per capita growth of between 0.57 and 1.82 percent.

In the meantime, the priority for the moment is reducing the high rates of personal tax, particularly to reduce the difference between the company and personal tax rates – see Section 6.3 above. A reduction in the company tax rate without at least an equal reduction in the top marginal rate will increase the difference between the two rates, exacerbating tax avoidance problems mentioned in Section 6.3 above.

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40. Source: *OECD's Revenue Statistics*, 1965-2007, 2008 Edition.
41. See J Kelly & R Graziani (2004) "International trends in company tax rates – implications for Australia's company income tax" *Economic Record* Spring 2004.
42. Lee & Gordon (2005) " Tax structure and economic growth" *Journal of Public Economics*, p. 1027-43.

8.1. Fringe Benefit Tax

FBT has long been a matter of genuine concern to Australian business. The tax has been extended, business believes, well beyond its original purpose of ensuring consistent taxation of all forms of remuneration.

The extension of FBT coverage has added substantially to the costs of doing business, particularly by increasing the tax compliance burden. The resulting costs and complexities are borne disproportionately by smaller businesses, which are the heartland of future export growth, investment and employment creation for this country.

Various elements of the FBT apply inappropriately to genuine business related expenses in contrast to the original intention of capturing employee benefits.

Business is also concerned that application of FBT to allowances paid for employment in remote areas and certain costs relating to relocation are counter-productive to other economic and social objectives for Australia.

In 2006-07 there were 56,590 FBT payers. These taxpayers were liable for $3.4 billion in FBT, an average of $60,382 each. The number of FBT payers has declined over the past 10 years. This is partly because an increasing number of employers seek employee contributions to reduce their FBT liability to nil so they are not required to lodge FBT returns.

Despite the decreasing trend in the number of FBT payers, the amount of FBT paid has increased significantly during the past 16 years from $1.3 billion in 1992-93 to $3.4 billion in 2006-07, mainly due to the introduction of the gross-up rules.

The largest share of FBT payable came from the manufacturing industry (15 percent), the finance and insurance services industry (13 percent) and the wholesale trade industry (12 percent). See Table 3.

Dr Jeff Pope of the University of Western Australia has estimated, for 1990-91, the total costs of tax compliance were $3.3 billion (around 23 per cent of total revenues), with FBT the worst[43].

His work reinforces the fact compliance costs are comparatively higher for small business. In the case of FBT, Dr Pope estimated compliance costs borne by small enterprise represent almost 40 per cent of FBT revenue.

What does not show up in these calculations is the sheer confusion and frustration that FBT is causing amongst small business. Small business does not have the management systems, the expertise or the computer capacity of larger business or the Australian Taxation Office.

FBT is inappropriately adding to the genuine cost of doing business. In an environment when businesses are exhorted to be internationally competitive and succeed in foreign markets, the treatment of entertainment, employee share schemes and other so called 'minor benefits' (such as mobile phones, airport lounges, tax travel, etc) is sending the wrong signal. The complexity and high compliance cost of FBT are evident in the *Global Competitiveness Report 2008-09* by World Economic Forum, which ranked Australia's non-wage labour costs at 85th out of 134 countries.

If simple and sensible FBT rules were applied, it is likely that small business compliance would increase considerably, with potentially sizeable gains to revenue. Significant advances could be achieved by the ATO requiring less documentation and applying broad and simple formulas applying risk management techniques to compliance.

ACCI believes that FBT has been extended beyond its original purpose of ensuring consistent taxing of all forms of remuneration. The broad coverage of FBT has substantially added to the

43. Pope, Fayle and Chen (1993) Compliance Costs of Employment Related Taxation in Australia, Australian Tax Research Foundation.

bona fide costs of doing business, increasing the tax compliance burden. Major reforms are needed to address this problem.

Thus, ACCI supports the Board of Taxation's recommendation that the FBT to be taxed in the hands of employees rather than employers, with collection from employers in the same manner as PAYG.

Table 3: FBT Payable by Industry 2006-07 FBT Years

Industry[2]	FBT Payers		FBT Payable[1]	
	No.	%	$m	%
Manufacturing	6,935	12.3	505	14.8
Financial and Insurance Services	3,825	6.8	446	13.0
Wholesale Trade	7,130	12.6	422	12.4
Professional, Scientific and Technical Services	9,510	16.8	341	10.0
Public Administration and Safety	1,075	1.9	201	5.9
Retail Trade	4,205	7.4	187	5.5
Mining	930	1.6	179	5.2
Education and Training	1,970	3.5	144	4.2
Transport, Postal and Warehousing	1,610	2.8	137	4.0
Construction	3,965	7.0	133	3.9
Administrative and Support Services	2,375	4.2	132	3.9
Information Media and Telecommunications	1,095	1.9	129	3.8
Health Care and Social Assistance	3,000	5.3	84	2.5
Rental, Hiring and Real Estate Services	2,210	3.9	67	2.0
Electricity, Gas, Water and Waste Services	320	0.6	48	1.4
Accommodation and Food Services	1,545	2.7	43	1.3
Arts and Recreation Services	670	1.2	41	1.2
Agriculture, Forestry and Fishing	1,060	1.9	23	0.7
Other Services[3]	3,150	5.6	155	4.5
Total[4]	**56,590**	**100.0**	**3,417**	**100.0**

Source: ATO Taxation Statistics 2005-2006.

1. Refers to FBT Payable calculated before rebates were deducted. Excludes FBT payable by Government departments.
2. Industry groups are based on the Australian and New Zealand Standard Industrial Classification (ANZSIC) 2006 Code.
3. Includes 'Personal and other services', entities who did not state their industry and invalid industry codes.
4. Totals may differ from the sum of components due to rounding.

8.2. R&D Tax Concession

It is generally recognised that Research and Development (R&D) is an important driver of economic growth. Therefore, Government intervention to promote R&D is justified to the extent that this promotes efficiency, productivity and growth. The Government itself undertakes significant amounts of research through CSIRO, universities, the rural R&D corporations and various other bodies (such as Geoscience Australia).

Tax incentives for R&D are also provided to promote business R&D. The main tax incentive is the R&D Tax Concession. Business has supported the R&D Tax Concession as an effective policy instrument addressing a market failure.

There exists a strong correlation between the availability of Tax Concession and the steady increase in business expenditure on research and development (BERD). The decline of BERD from 1996 level to 2000 level following the reduction of Tax Concession from 150 percent to 125 percent in 1996-97 was sharp. At the same time syndication was closed and eligible expenditure was tightened.

The value of the Tax Concession has also evolved over time. According to the Cutler Review (2008):

> "Falls in the rate of corporate tax over the period since 1985 have reduced the effective value of the Tax concession by a factor of three… the Concession would need to be raised well over 175 percent to regain its original direct incentive value." (p.104)

The following Table is drawn directly from the Cutler Review (p.104).

Table 4: Impact of the Corporate Tax Rate on the Value of the Incentive

Financial Year(s)	Tax Rate (%)	Incentive Rate (%)	After Tax Benefit
87-88	49	150	24.5
88-89 to 92-93	39	150	19.5
93-94 to 94-95	33	150	16.5
95-96 to August 96	36	150	18.0
96-97 to July 2001	36	125	9.0
Current	30	125	7.5

Australia's ratio of BERD to GDP in 2005-06 was 1.04 compared to the OECD total of 1.53. This ratio and was below that of Canada (1.07) and the UK (1.1) and just above that of the Netherlands (1.02) and Ireland (0.82). On this measure, Australia was ranked 15th in the OECD in 2005-06, compared to 8th in 1995-96. The *Global Competitiveness Report 2008-09* ranked Australia's company spending on R&D at 23rd out of 134 countries.

ACCI proposes that:

- R&D Tax Concession should be restored to 150 percent. In addition, ACCI welcomed the release of the Cutler Review of the National Innovation System and is supportive of the 40% Tax Credit to large firms and a 50% refundable Tax Credit to small and medium sized enterprises with a turnover under $50 million. The Cutler Review's recommendation represents a sound approach and claws back part of the original 150% tax concession.
- the Government should reduce the administrative cost of applying for the R&D Tax Concession; and
- the Government should introduce a specific 175 percent tax concession on climate change research.

9. TAX CREDIT AND TRANSFER SYSTEM

An ever increasing proportion of the Australian population is dependent upon government transfer as their sole or major source of income. The second *Intergenerational Report 2007* estimated that the ageing of Australia's population, coupled with higher life expectancies, will drive a net increase in payments to individuals from 6.7 percent to 7.1 percent of GDP over the next 40 years. Age pension outlays are expected to increase from 2.5 to 4.4 percent of GDP.

The dependency ratio, the ratio of dependent population (those aged less than 15 or 65 or more) to the working age population, will increase as the population ages. Currently there are 5 people of working age to support every person aged 65 and over, but by 2047 there will only be 2.4. By 2046-47, government spending is projected to exceed revenue by 3½ percent of GDP with the spending pressures most significant in the areas of health, aged pensions and aged care.

Therefore, one way of ensuring and enhancing the affordability and sustainability of Australia's personal tax-transfer system is to encouraged workforce participation and increased productivity. Reforms in the tax and transfer systems can provide important incentives for participation in the labour market.

Labour force participation is discouraged by generous welfare payments and high effective tax rates on people moving from welfare to work. Conversely, participation is encouraged by requirements on welfare recipients to look for work.

9.1. Effective Marginal Tax Rate

People who move from welfare to work can find their disposable income is significantly reduced, because their welfare payments are cut and they pay more tax. The combined reduction in welfare plus increased tax from an extra dollar of income is called the Effective Marginal Tax Rate (EMTR).

ACCI supports the policies of the Government to reduce high effective marginal tax rates (EMTRs) on low and middle income earners. This is important in addressing Australia's labour shortages by encouraging more people to enter the labour force.

When examining options for reducing EMTRs, the main factors that should be considered are the budget cost and the effect on participation. Changes in EMTRs on the main income earner in a couple (usually the male) have less effect on participation than changes in the EMTRs for the secondary income earner (usually the female)[44]. Thus, there is particular scope for reducing EMTRs on households with two adults but only one income earner.

Various studies have examined the effects of tax and welfare changes on labour force participation. In particular, Buddelmeyer et al (2006)[45] suggested that there are three worthwhile options for reforming the tax and welfare system for lower income earners – reducing the lowest tax rate, increasing the Low Income Tax Offset (LITO) and introducing an Earned Income Tax Credit (EITC). Combinations of more than one option may be particularly effective at increasing participation. ACCI considers all are worth exploring.

9.2. Welfare Activity Tests

Australia has a fairly generous transfer system, but we require a significant number of welfare recipients to look for work and take up job offers (this is called activity testing). This mitigates the adverse effects of our transfer system.

Over time, more welfare recipients have been required to look for work. Recent changes include requiring single parents to look for work when their youngest child turns 6, requiring more people taking up the Disability Support Pension (DSP) to look for work, and increasing the work tests on older Australians. Together, these changes are expected to add significantly to the number of people looking for work.

In addition to increasing labour supply, reducing the number of people on welfare will reduce the Budget costs of welfare. These Budget savings can be used to lower taxes, which in turn will increase labour force participation.

44. Dandie Mercante (2007) "Australian labour supply elasticities - comparison and critical review" *Treasury Working Paper* 2007-04.
45. Buddelmeyer, Freebairn & Kalb (2006) "Evaluation of Policy Options to Encourage Welfare to Work" *Australian Economic Review* 39(3).

10. REFORMING STATE TAXATION

The ability of the state to raise adequate levels of revenue in order to meet service obligations is the central issue surrounding delegation of powers and Vertical Fiscal Imbalance (VFI). VFI is the difference between a states ability to raise revenue and its obligation to provide services. In 2006-07, the federal government transferred approximately $68 billion to the States in the form of GST revenue and specific purpose payments (SPPs), accounting for around 45 percent of total state revenue. A recent publication noted that Australia States own-source revenue accounted for approximately 40 per cent of own-purpose outlays.[46]

The significant difference between State and Local Government taxing and spending powers creates a number of problems, including:

- The States have reduced accountability to electorates in relation to taxes. For example, the Australian Government is held accountable for the GST even though all the GST revenue goes to the States;
- There is reduced competitive pressures between States to cut taxes; and
- The States rely on inefficient taxes such as stamp duties, with limited ability for States to switch to more efficient taxes.

ACCI strongly advocates tax reform to reform the most inefficient remaining State taxes. In particular, ACCI's Taxation Blueprint is calling for:

- The abolition of all taxes included in the *1999 Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, including stamp duties on business conveyances;
- The reform of fire service levies so that they are based on property values and apply to all property; and
- Major reductions in payroll taxes as a step towards their eventual abolition.

Australia's tax structure should reflect and support the jurisdictional and spending powers and responsibilities Australians want from their different levels of government. The current Commonwealth-State responsibilities mean that the States are financially dependent on the Commonwealth to deliver their services. Such is the extent of dependence that it also limits the opportunity for the States to deliver meaningful taxation reform and abolish their most inefficient State taxes.

Further taxation reform therefore necessitates Commonwealth and State taxation systems being reviewed collectively. Central to this review would be to address VFI. Moreover, we consider the allocation of responsibilities between State and Commonwealth government critical to solving the VFI problem.

ACCI argues that State Governments should also undertake significant spending reductions to minimise this problem. In particular, the allocation of functions to the private sector makes issues of Federalism much less relevant.

However, if this imbalance remains a concern, then the allocation of some taxing powers from the Commonwealth to State Governments may be worth examining, but only on the basis that this does not increase the total business tax burden.

46. Neil Warren (2006), Benchmarking Australia's Intergovernmental Fiscal Arrangements, Final Report, pg xxii.

In addition, States and Local Governments receive significant funding from the Commonwealth Government. This funding is allocated by a formula, called Horizontal Fiscal Equalisation (HFE), which attempts to redress any disadvantages that particular jurisdictions have in taxing or providing a standard level of service. Significant concerns have been raised over this formula, including:

- it is extremely complex and hard to understand;
- it may create perverse incentives, encouraging State Governments to 'game' the system; and
- it may not promote efficiency.

To address these concerns, ACCI considers the allocation formula should be reviewed in detail by the Productivity Commission.

11. TAXATION ISSUES ON CARBON POLLUTION REDUCTION SCHEME

In the *Carbon Pollution Reduction Scheme Green Paper*, the Government has committed that every cent raised from the Carbon Pollution Reduction Scheme (CPRS) will be used to help Australians – households and business – adjust to the scheme and to invest in clean energy options.

Aside from the issues of revenue recycling, the tax treatment of the new financial instruments, i.e. the emissions permits, is critically important in designing and efficient Emission Trading Scheme (ETS).

Other issues which have not been addressed by the Green Paper include the treatment of emissions permits under stamp duty and Capital Gains Taxes.

The trading of allowances/credits can be subject to two types of taxes:

- transaction taxes e.g., a sales tax or a stamp duty on each transaction based on the quantity or value; and
- taxes on the difference between the acquisition cost and the sale price. This difference may be subject to GST, income tax and/or capital gains tax.

An example of how stamp duty, transaction tax, might apply is provided below[47]:

> Stamp duty may apply to an emissions trading scheme (ETS) at more than one level. It may apply to the sale and purchase of credits under the scheme, which could be treated as dutiable property, within the terms of the duty legislation. For example, in Queensland, it could be dealt with as a statutory licence, depending on the structure of the ETS, or under an amendment specific to the purpose.
>
> There may also be duty at a lower level, on transactions which are necessary to create carbon credits, or those which relate to afforestation. The connection of that duty to the ETS is less obvious, as transactions could occur for purposes other than compliance.
>
> At the higher level, if duty were imposed on trading in carbon credits, it would essentially increase the price of those carbon credits by the rate of duty.

47. Craig Bowie "Should Emission Trading Permit be Exempt from Stamp Duty and Capital Gains Tax?" *Minter Ellison* 30 August 2007.

How a Capital Gains Tax, difference between sale price and acquisition cost, may apply[48]:

> By contrast, the states have begun to argue for the exclusion of capital gains tax (CGT) from an ETS. The Commonwealth could elect to place all trading in carbon credits outside the income tax net, which would eliminate the CGT burden from gains made on the disposal of credits.
>
> However, this would also mean the cost of acquiring credits would be non-deductible, and gains made on trading in credits, within the market, would be non-assessable.
>
> The result would be an advantage to the net producers of carbon credits, and a disadvantage to the net acquirers of carbon credits. Such a detriment and benefit could be priced into the cost of the credits themselves to achieve overall neutrality.
>
> By way of example, if an energy company spends $1 million acquiring carbon credits, but does not produce any carbon credits, then it would in the ordinary course claim a deduction for the $1 million. Conversely, if a tree plantation operator 'creates' credits worth $1 million, and sells them to an energy producer, then in the ordinary course it would be subject to income tax on the $1 million.

The net result from the Commonwealth's perspective is neutral, assuming that all the entities, which create and acquire credits are in business, and able to make use of deductions or capital losses, which they incur.

The Prime Ministers' Task Group on Emissions Trading noted that:

> 'ideally the tax outcome should be neutral', and that
>
> 'as the design of the scheme proceeds, there will be greater scope to determine if it can be accommodated within existing tax law in a way that meets the policy intent of least-cost emissions abatement.'
>
> 'It also would be desirable not to have stamp duty on the trade of emissions permits … GST and international tax implications would also require further consideration.'

A number of tax experts have expressed concerns that the taxation system is ill prepared to accommodate the introduction of an ETS. Furthermore, a private tax ruling by the ATO suggests that offsets for travel may not be tax deductible as it was not the carbon that 'directly incurred' in the course of the work.

In the UK allowances are treated as revenue items for tax purposes. The cost of purchased allowances is a business expense and revenue from the sale of allowances is taxable income. Allowances are not subject to stamp duty.

ACCI does not support transaction taxes and therefore would rule out supporting the imposition of a stamp duty on emissions permits. In relation to Capital Gains Tax and its interaction with an ETS, ACCI has not formed a particular view but noted under that stepped rate regime we propose the impact of a CGT would be reduced for assets held over a longer period.

ACCI does not support GST being applied to permits which are in effect financial instruments and should be zero rated.

An ETS is generally seen as the most efficient market mechanism for reducing greenhouse gases, however, if design improperly does not take account of other greenhouse gas taxes already present in the economy[49]. It is possible that a permit selling country will have a net welfare loss because the reduced use of the already taxed good may dominate the welfare gain from the permit-trading scheme. Therefore, any Government policy must include the effects of pre-

48. Ibid.
49. Australian Bureau of Agricultural and Resource Economics, 'The welfare consequences of emission trading with pre-existing taxes', 7th Annual Conference on Global Economic Analysis, Washington, D.C., June 17-19, 2004

existing taxes and the introduction of an ETS, against removing pre-existing taxes on goods and introducing an ETS.

ACCI considers that taxes already existing, which are designed for greenhouse gas purposes or have a greenhouse gas consequence, must be carefully analysed for their appropriateness when an Australian ETS is introduced.

ACCI also call on the Government to ensure that taxation issues arising from CPRS such as the treatment of emission permits under stamp duty, GST and capital gain tax, do not increase the tax burden of businesses and individuals.

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