

20 October 2008

Submission to the review of Australia's future tax system

This submission presents the Australian Conservation Foundation's (ACF) views to the Review of Australia's Future Tax System. ACF is committed to inspiring people to achieve a healthy environment for all Australians. ACF works with the community, business and government to protect, restore and sustain the Australian environment. For 40 years, ACF has been a strong voice for the environment, promoting solutions through research, consultation, education and partnerships. From this position, ACF is well placed to provide feedback to inform development of Australia's tax system, with particular reference to the environmental impacts of various tax policy options.

This submission was prepared by Charles Berger, ACF Director of Strategic Ideas, and Wayne Gumley, Senior Lecturer in Business Law and Taxation at Monash University. ACF would be pleased to meet with members of the Review Panel to discuss further any of the ideas and concepts outlined in this submission.

Summary

Australia's prosperity depends on a healthy environment, yet each state of the environment report chronicles ongoing and accelerating decline in most key environmental indicators. One of Australia's biggest challenges for the 21st Century is making the transition to sustainable cities and industries that are far less intensive in their use scarce resources and generation of greenhouse pollution.

Because the tax system plays a central role in shaping private investment patterns, it is critical that the design of tax policy encourage activities that help us to reduce waste and pollution, increase resource efficiency, and pursue sustainable models of development.

1. The traditional principles of efficiency, equity and simplicity in tax design can and should be reconciled with the **principles of sustainable development**. The means, for example, that intergenerational equity and the efficient use of energy, water and other scarce resources should be fundamental goals of tax policy.

Recommendation 1	In assessing the desirability of all proposed tax policies, the review should apply the tax design principles of efficiency, equity and simplicity consistently with the principles of ecologically sustainable development.
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2. The review of the tax system should prioritise measures to facilitate the **efficiency of the proposed Carbon Pollution Reduction Scheme**.

Recommendation 2	Measures that would increase the efficiency of the carbon pollution reduction scheme should be recommended as a matter of urgency for adoption in the 2009 budget. These would include recommendations 4.2 and 5.1-5.5 of this submission.
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3. The **taxation of capital gains** has encouraged over-investment in some residential property markets, with flow-on effects on housing affordability in urban centres and unsustainable peri-urban, automobile-dependent development patterns. Restructuring capital gains taxation so that it does not unintentionally distort investment towards unsustainable developments should be a priority.

Recommendation 3.1	Consider capping the principal residence exemption from capital gains tax, with real estate gains above the cap taxable on disposal.
Recommendation 3.2	Limit negative gearing by requiring losses on investment properties to be carried forward to offset future capital gains, rather than allowing immediate offset against income.
Recommendation 3.3	Apply the company tax rate of 30% to capital gains, rather than the current 50% discount on the applicable income tax rate.
Recommendation 3.4	Exempt residential properties from State stamp duty where purchasers are willing to commit to sustainability retrofitting.

4. **Capital allowances for depreciating assets** results in unintended distortions in favour of investment in energy- and resource-intensive activities. In general, depreciation rules favour capital-intensive activities above labour-intensive activities, and there are special rules favouring high environmental impact industries including oil and gas and air travel.

Recommendation 4.1	Remove the accelerated depreciation and capped effective life provisions that benefit mining, airline, and certain primary production industries.
Recommendation 4.2	Expand accelerated depreciation provisions for environmental protection activities to include a broader range of investments, including into renewable energy and retrofitting of residential and commercial buildings.
Recommendation 4.3	Consider immediate deductibility of investment in plant and equipment that replaces older, less efficient assets.
Recommendation 4.4	Reduce the depreciation allowance for capital assets generally from 200 percent to 150 percent.

5. **Tax expenditures** are another area where special exemptions may have the unintended effect of skewing investment towards energy- and resource-intensive activities. The existence of such policies are economically inefficient, undermine revenue collection, may benefit affluent individuals disproportionately, and if retained will undermine the efficiency of the Carbon Pollution Reduction Scheme.

Recommendation 5.1	Phase-out most elements of the fuel tax credits scheme, including the tax credits for on-road transport and off-road mining use.
Recommendation 5.2	Phase-out the concessional rate of excise for aviation fuels.
Recommendation 5.3	Restructure the fringe benefits tax concessions for company cars so that the schedule for valuing benefits is tied to the efficiency of the vehicle, rather than kilometres driven.
Recommendation 5.4	Exempt public transport and active transport benefits from the fringe benefits tax.
Recommendation 5.5	Eliminate fringe benefits tax concessions for parking benefits (except where justified on equity grounds, such as for certain disabled workers).

6. The **pricing of natural resources** continues to be misaligned with actual market values for such resources. Despite some reforms, pricing of many natural resources is not clearly in line with national competition principles and the need to sustain renewable resources and conserve non-renewable resources.

Recommendation 6	Comprehensive reviews of pricing of water, timber, mineral resources, fish, and oil & gas should be undertaken to ensure that rights to exploit such resources are priced at a minimum consistent with market prices on an ongoing basis, and in addition that long-term sustainability of renewable resources and steady reductions in the use of non-renewable resources are achieved.
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7. Finally, **environmental tax reform** initiatives around the world have shown that reducing taxes on labour and increasing taxes on resource use and pollution typically generates a 'double dividend' of environmental and economic benefits. This review is an unprecedented opportunity to consider far-reaching reforms to shift the burden of taxation from labour and productivity to resource consumption and waste.

Recommendation 7	The review should undertake modelling of the possible social, economic and environmental benefits of a broad-based shift towards resource and pollution taxes -- for example, replacement of the existing company tax with a tax on material use and waste generation.
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Introduction: Australia's climate and sustainability challenges

Whilst Australia has many natural assets and natural resources, extensive damage has occurred during the short time since European settlement. Such damage continues today, as Australian society consumes its resources at an increasing rate. The environmental impacts of this consumption are evidenced in countless statistics and reports. The following snapshots from the 2008 give a sense of the contours of Australia's environmental track-record:

- Realising a sustainable human environment requires a reduction in net consumption and waste. This will involve greater population densities than currently is the case, significant increases in building and material recycling, the capture and use of stormwater, the recycling of wastewater and biological waste, and improved urban form and urban structures.
- Energy use in Australia has increased by 10.5 GJ per capita from 1994 to 2004. Australia's levels of greenhouse gas pollution increased by 2.3% from 1990 to 2004, although this figure masks a significantly higher rate of increase in emissions, which is offset by a one-off decrease in land clearing during this time period. Australia's emissions continue to increase year on year.
- Australia's biodiversity continues to be in serious decline. 39 per cent of Australia's 85 bioregions have more than 30 per cent of their ecosystems described as 'threatened', according to the National Land and Water Resources Audit (2002). More than half of the ecosystems in the developed coastal areas and the Murray–Darling Basin are under severe pressure and significant declines are likely.
- Total consumption of water increased by around 10% from 1996 to 2001, the last time comprehensive national water accounts were available.
- 90% of the original wetlands in the Murray-Darling Basin have been cleared, with catastrophic impacts on bird breeding populations and other biodiversity in this region.

The fact of ongoing decline in the condition of Australia's environment, coupled with the threat of dangerous climate change, is the salient issue for our country at this moment in history. The design of our tax system must be informed by these facts, and must contribute to the urgent solutions that are required.

1. Principles of tax policy and ecological sustainability – a reconciliation

The traditional trinity of equity, efficiency and simplicity as the measures of good tax policy were popularised in 1776 by Adam Smith in *The Wealth of Nations*. The world in which we operate today is characterised by resource scarcity and environmental issues that were hardly a priority in mainstream western thought during Smith's time.

This does not of necessity invalidate the principles which he expounded and which have largely withstood the test of time. It does suggest that the interpretation of these principles today must rest upon a deeper and more far-sighted understanding of the relationship between human economies and the natural environment.

The specific inclusion of the 'environmental challenges of the 21st century' and 'social and environmental wellbeing' as specific objectives in the third and fourth terms of reference of this

review is therefore highly significant. This is the first major national tax system review in Australia to include such objectives explicitly within its terms.

The principles of ecologically sustainable development are of crucial relevance to the tax review. These may be seen not as supplanting the traditional principles of efficiency, equity, and simplicity, but rather as informing our understanding of how tax policies should be assessed according to these principles.

A full account of the principles of ecologically sustainable development (ESD) is beyond the scope of this submission. Australia and most other developed nations have made strong commitments to ESD by adopting the Rio Declaration in 1992. These principles have now been refined to a set of core statements that are commonly applied in international conventions and local laws. Australia's *National Strategy for ESD* includes five key objectives which are based upon the ESD principles:¹

- integrating economic and environmental goals in policies and activities;
- ensuring that environmental assets are properly valued;
- providing for equity within and between generations;
- dealing cautiously with risk and irreversibility; and
- recognising the global dimension

Australian governments have subsequently enacting a wide range of legislation at both federal and state levels which mandate that the principles of ESD are fundamental considerations in decision making about the use of natural resources.²

The principles of ESD can be related to the principles of tax policy in the following way:

Efficiency: a too-narrow concept of economic efficiency in the past has resulted in utilisation of natural resources in unsustainable ways; the current stress on the Murray-Darling river systems is just one result of this. The principle of efficiency broadly construed must incorporate the efficient use of resources as well as the efficient allocation of those resources in the usual economic sense of the term. In a world of finite resources and limited ecological resilience, ensuring that waste and pollution are minimised and that we exploit natural resources within the bounds of their ability to regenerate are fundamental goals. It follows that we should seek to avoid structuring tax policies which may shift behaviour towards more intensive or less efficient use of natural resources. In general, environmental taxes (such as taxes on the use of scarce resources and on the generation of pollution) will encourage more efficient use of our environment.

Equity: One of the questions often posed, rightly, in considering tax policy is whether similarly situated individuals are treated similarly by the tax system. In light of the principles of ESD, the environmental impact of the activities of individuals and businesses must be seen as relevant to this inquiry. For example, in considering tax concessions for individual and business transport use, taking the disparate environmental impacts of different modes of transport into account is more equitable than disregarding those impacts.

In addition to the usual concepts of horizontal and vertical equity, the question of intergenerational equity is of particular importance in light of the principles of ESD.

¹ Commonwealth of Australia (1992) *National Strategy for ESD*

² Eg. see the *Environment Protection and Biodiversity Conservation Act 1999* (Cth) at s 3A.

Intergenerational equity suggests that we must avoid tax policies which encourage the depletion of resources and degradation of the environment, which may limit the ability of future generations to enjoy the same amenities as we do.

Simplicity: In many cases, environmental taxes (ie, taxes on the use of resources or the generation of waste and pollution) are conceptually and administratively simpler than taxes based on measures of productivity, profitability, and so forth. Whereas income, corporate and similar taxes depend upon complex accounting structures (and are subject to complex forms of manipulation), direct taxation of resources and waste is a relatively straightforward administrative proposition.

The above discussion is at best only a crude beginning of an effort to bring together the principles of ecologically sustainable development and the principles of taxation. We would strongly encourage the Review to develop its own reconciliation of these principles; and suggest that such a reconciliation is critical if the Review is to fulfil its mandate of creating a tax system that will “position Australia to deal with the ... environmental challenges of the 21st century.”

Recommendation 1	In assessing the desirability of all proposed tax policies, the review should apply the tax design principles of efficiency, equity and simplicity consistently with the principles of ecologically sustainable development.
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2. The interaction between the taxation system and the Carbon Pollution Reduction Scheme – areas for urgent action

The strong link between our economy and the environment has been dramatically brought together by the issue of climate change and the need to reduce greenhouse gas emissions. It is now beyond doubt that climate change will have highly adverse effects on Australia’s economic interests. The Garnaut Review has concluded that:

Australia would be a big loser—possibly the biggest loser amongst developed countries—from unmitigated climate change. The pace of global emissions growth under “business as usual” is pushing the world rapidly towards critical points, which would impose large costs on Australia directly and also indirectly through the effects on other countries of importance to Australia. The world of business as usual would be deeply problematic for Australia, not least because of the stress that it would place on vulnerable economies, societies and politics in Australia’s Asian and Pacific neighbourhood.³

Australia has recently made a strong commitment to address greenhouse emissions through ratification of the Kyoto Protocol and the proposal for a comprehensive national emissions trading scheme. It has also made good progress with a wide range of other greenhouse reduction measures, like the mandatory renewable energy scheme.

³ Garnaut Climate Change Review (2008), Interim Report to the Commonwealth, State and Territory Governments of Australia, February 2008, at 56 (para 5.1); see also Commonwealth of Australia (2008) Garnaut Climate Change Review: Final Report, (Cambridge University Press), at Chapter 6 Climate Change Impacts on Australia.

The Garnaut Review has recently considered the appropriate responses to the greenhouse problem and clearly favoured a 'well-designed emissions trading scheme (cap and trade)'.⁴ However Professor Garnaut also commented that:

For the emissions trading scheme to have the desired effect of driving new consumption behaviour and investment decisions, it must be well integrated within the broader economy. Barriers to change must be removed or minimised in order that there may be an efficient economic response to the ever diminishing supply of permits.⁵

He then went on to identify the various barriers to change as market failures associated with transport infrastructure and energy, as a result of misplaced incentives, and externalities in gathering and analysing information.

As already noted, governments will need to review existing policies to ensure that they do not adversely interact with the emissions trading scheme. Reviews should cover federal and state taxes and subsidies, procurement policies, industry assistance programs, product and technology standards, accounting standards and taxation rules. Such reviews will need to extend beyond programs and policies that directly compete with the emissions trading scheme for emissions reductions. The aim should also be to identify perverse incentives that might inadvertently inhibit investment in low-emissions technologies or promote activities associated with high emissions.⁶

This highlights the importance of redesigning the tax and transfer system in a way that is consistent with Australia's greenhouse reduction strategies, and in particular, the proposed Carbon Pollution Reduction Scheme.

The urgency of signalling needed changes to the tax system to ensure that the CPRS operates with maximum efficiency can hardly be overstated. In the coming months, businesses will be making major investment decisions on energy generation and efficiency, commercial building construction and manufacturing that will be based on the anticipated regulatory environment (including the price of carbon) following the introduction of the CPRS.

Features of the tax system that tend to dampen the price signal that is to be given through the CPRS will render that scheme less efficient, because they will weaken the financial case for investments or activities that could efficiently reduce pollution. To give just one an example, because of the rebate for fuel excise for off-road mining purposes, it is commercially less attractive to mining operators to invest in fuel efficiency measures than it would be if such fuel were subject to excise. It follows that some greenhouse abatement projects involving fuel efficiency will likely not be undertaken as a result of the rebates – but if we are missing abatement opportunities in this sector, other sectors will face a correspondingly increased burden if we are still to reach our national pollution reduction goals.

Tax reforms that can remove distortions in the economy that may reduce abatement potential should therefore be addressed as a matter of priority. Such reforms should be signalled early,

⁴ Garnaut Climate Change Review (2008) Draft Report, June 2008, para 14.2.3 The preferred approach for Australia, at 345; available at <http://www.garnautreview.org.au/CA25734E0016A131/pages/all-reports--resources>

⁵ Ibid at 347

⁶ Ibid at 356

in any event no later than the 2009 Commonwealth budget. Such priority reforms should include at least the following measures, each of which are addressed in more detail below:

- Extension of accelerated depreciation to investments in renewable energy and residential and commercial building retrofitting
- Reform of fuel tax credits
- Phase-out of aviation fuel tax concessions
- Removal of fringe benefits tax concessions for company cars and car parking

Recommendation 2	Measures that would increase the efficiency of the carbon pollution reduction scheme should be recommended as a matter of urgency for adoption in the 2009 budget. These would include recommendations 4.2 and 5.1-5.5 of this submission.
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3. Eliminating environmentally damaging distortions in the residential property sector

Residential and commercial buildings are responsible for around 23% of Australia's greenhouse emissions.⁷ Significant growth in emissions from this sector is caused by increasing size of Australian homes in conjunction with decreasing occupancy proportional to size and energy efficiency of Australian housing stock. Census data for the city of Melbourne shows that between 1991 and 2003 a steady decline in household size (number of occupants) has accompanied a significant increase in the average floor area of homes, which has produced a substantial increase in both aggregate and per capita greenhouse emissions over that period.⁸

The Garnaut Review has highlighted a wide range of market failures that will undermine the success of the proposed CPRS in implementing a carbon price signal to deter these trends, and thus recommended the consideration of a range of regulatory responses such as energy efficiency standards for buildings and appliances.⁹

There are several design features of the current tax system which, taken as a whole, have contributed to an overall policy context that strongly encourages unsustainable urban development patterns:

- i) The **principal residence exemption from capital gains tax** encourages Australians to create personal wealth through maximising the size and value of their home. This is one of the major tax preferred investment options provided under Australian tax system, along with superannuation.¹⁰ Whilst the policy supports personal home ownership, it also distorts investment patterns towards residential property. It also is the source of enormous vertical inequity, because the value of the tax concession is proportional to the value of the home.

⁷ Centre for International Economics (2007) Capitalising on the building sector's potential to lessen the costs of a broad based GHG emission cut. Centre for International Economics, Canberra.

⁸Department of Planning and Community Development (2006) Melbourne Atlas 2006 Housing, available at <http://www.dse.vic.gov.au/DSE/dsenres.nsf>

⁹ Garnaut, Final Report at Ch 17.

¹⁰ The amount of revenue foregone by the principal residence exemption is not specified in the Taxation Expenditure Statement but it is listed as 'Category 4+' which signifies the highest possible category exceeding \$1 billion - see Commonwealth of Australia 2007 *Tax Expenditures Statement* Item E4 at p 161

Homeowners in Point Piper and Toorak regularly generate multi-million dollar profits on realising their homes without paying any tax.¹¹

- ii) The **allowance of negative gearing** on residential investment properties encourages investors to borrow large sums with the expectation of deducting investment expenses against income from other sources in the short term, and making a substantial capital gain in the longer term. Although deemed to be a 'design feature' of the tax system rather than a tax expenditure, the allowance of negative gearing is one of the features that both costs significant revenue and distorts investment patterns towards residential property.¹²
- iii) **Concessional treatment of capital gains** is one of the largest tax expenditures provided by the Federal government, costing over \$6.8 billion per annum.¹³ Capital gains are assessable only upon realisation, may be offset by capital losses and revenue losses, and are reduced by indexation and an automatic 50% discount (with the possibility of a further 50% discount for 'active assets' used in a business activity).

An unfortunate side effect of these concessions is urban sprawl and automobile dependence, with the proliferation of low density housing estates on the fringes of major cities. These outer suburban estates have been created at the social cost of a host of long-term structural disadvantages, including increasing pressure on remnant ecosystems and biodiversity in urban areas, high infrastructure costs on local and State governments, erosion of community interaction, and a model of single-family detached housing that is both inefficient in terms of energy and heavily automobile-dependent. This automotive dependency in such areas is an inequitable result, as it renders residents of such areas disproportionately vulnerable to fuel price fluctuations and high transport costs, in the absence of effective public transport and active transport options.¹⁴

Another adverse consequence is reduced housing affordability. A recent study has shown that 1.1 million low to middle income households spend more than 30% of their income on housing.¹⁵ The distortions mentioned above encourage speculation in real estate which puts heavily geared investors in direct competition with owner-occupiers in the residential property market. As a consequence, more convenient inner city housing stock has become over-valued and home buyers are attracted to lower priced housing in outer suburban areas, or they find it cheaper to build a new home in the expanding outer suburbs. Recent Australian governments have tried to alleviate this problem through first home buyer grant schemes, and the Rudd Government has just announced a generous extension to its scheme.¹⁶ However this approach is likely to aggravate the problem by pushing up prices further. University of Western Sydney

¹¹ May (2008) 'How one man makes \$8200 a day by living in Sydney's best street', *Sydney Morning Herald*, April 6 2008.

¹² According to a 2003 Parliamentary Library research paper the cost to revenue of negative gearing in Australia was in the order of \$1.4 billion by 2002, which would suggest it is now costing at least \$3 or 4 billion; see Smith J (2003) 'Tax Expenditures: The 30 Billion Twilight Zone of Government Spending' Research Paper No 8 2002-03 at p 9.

¹³ Commonwealth of Australia 2007 *Tax Expenditures Statement* Item E9 at p 10 and 164.

¹⁴ On the high costs of low-density automobile-dependent suburbs, see Newman, P. and Kenworthy, J. (1999). The problem of automobile dependence at the end of the twentieth century, in, *Sustainability and Cities: overcoming automobile dependence*. Washington, D.C. Island Press, at 52.

¹⁵ National Centre for Economic and Social Modelling, referred to by Michelle Grattan in 'Rudd determined to act on housing affordability' *The Age* 3 March 2008.

¹⁶ *The Age* 'Rudd unveils \$10.4b stimulus plan', *Business Day* October 14, 2008.

economist, Associate Professor Steven Keen, has declared that house prices are already artificially inflated due to the scheme.¹⁷

In short, while the various capital gains tax concessions for residential property were intended to make home ownership easier and more accessible for Australians, in practice they have had the opposite effect, encouraging over-investment in large detached single-family homes and decreasing housing affordability in inner urban areas. This has created unrelenting pressure for release of land on urban fringes and consequently an unsustainable model of urban growth based on ever-expanding peri-urban sprawl.

It is time to question whether the massive CGT concessions to property owners are justified. Because they apply to the passive investment income of relatively affluent citizens but not active employment earnings of low income citizens, they raise significant equity concerns in addition to the environmental and social issues raised above. The opportunity to hold property investments in a trust also allows investors to allocate a taxable capital gain amongst a group of beneficiaries (eg. family members, or entities with tax losses) which can further reduce the liability, often to zero or very low effective marginal rates. There is also a conflict between CGT concessions which promote property development at the expense of resource conservation to meet climate change and sustainability objectives.

In this context it should also be recognised that there are State government stamp duties and land taxes affecting real estate investment, which impose very substantial financial burdens upon first home buyers and real estate investors. These State taxes provide a fiscal dampener upon real estate ownership in some sectors.

In summary, the incentives in the taxation treatment of real estate investments (in combination with other policies, including planning schemes and direct government payments) contribute to a range of greenhouse, resource consumption, and equity problems. These policies were introduced within a real estate development and automobile-centric 'mindset' which is no longer consistent with the Federal Government's commitment to greenhouse reduction targets and the broader principles of ESD.

The review panel should evaluate the environmental consequences of the current taxation scheme for real estate investment. The panel should consider alternative arrangements which can be revenue neutral, assist home owners, and also promote climate and environmental objectives:

- i) **Place a cap on the principal residence exemption from capital gains tax, with amounts above the cap taxable proportionally on disposal.** A cap would counteract to some extent the tendency of the exemption to encourage over-investment in housing, at the expense of affordable housing development in inner urban areas. Taxing on disposal provides a cash flow advantage as this is the time when the vendor has funds. This change should be introduced prospectively so that current owners are not affected.
- ii) **Restrict deductions from negative gearing arrangements.** Losses on investment in residential investment properties should not be immediately deductible against other

¹⁷ Macquarie Network Live News (2008) "Rudd's \$1.5b home buyers boost 'nonsense'" 15 Oct 2008.

income; instead, such losses should be carried forward and allowed to reduce capital gains tax liability upon realisation of the asset (or other assets).

- iii) **Remove the CGT discount.** The 50% discount applicable to taxable capital gains is both arbitrary and, when combined with other CGT concessions and tax planning opportunities like the use of interposed entities, can lead to inequitable outcomes. For the purposes of simplicity and equity, the company tax rate of 30% should be applied to all taxable gains. This will retain a significant concession for individuals (compared to the top marginal rate of 45%) whilst increasing overall revenue collection from property transactions.
- iv) **Exempt residential properties from State stamp duty where purchasers are willing to commit to sustainability retrofitting.** The steady improvement of building standards for new housing is improving the sustainability of most new housing in Australia; however, poor energy and water efficiency characterises much of the existing housing stock, and improvements through retrofitting are occurring very slowly. Exempting residential properties from stamp duty where the purchaser is willing to commit to retrofitting the property to meet sustainability criteria would help to trigger the large-scale investment required in our housing stock. Total annual revenue from stamp duty in all States is currently over \$13 billion.¹⁸ Most States already have stamp duty concessions for first home buyers and the low end of the property market.

Recommendation 3.1	Consider capping the principal residence exemption from capital gains tax, with real estate gains above the cap taxable on disposal.
Recommendation 3.2	Limit negative gearing by requiring losses on investment properties to be carried forward to offset future capital gains, rather than allowing immediate offset against income.
Recommendation 3.3	Apply the company tax rate of 30% to capital gains, rather than the current 50% discount on the applicable income tax rate.
Recommendation 3.4	Exempt residential properties from State stamp duty where purchasers are willing to commit to sustainability retrofitting.

4. Ensuring depreciation is aligned to the efficiency of the carbon pollution reduction scheme

Depreciation deductions are normally allowed for a percentage of the capital cost of an asset, spread evenly over the effective life of the asset. The Federal Government removed most accelerated depreciation provisions in 2000 following the recommendations of the Ralph Review of Business, in exchange for a lowering of the company tax rate.

However, anomalies in the system remain which effectively encourage energy- and resource-intensive activities. Further, there are significant opportunities to leverage large-scale investment into renewable energy, retrofitting of residential and commercial property, and other activities that have social and environmental benefits.

¹⁸ Commonwealth of Australia, at note 1, Table 2.17.

The features of capital allowances that distort business activity towards capital-intensive (and often pollution-intensive) activities include the following:

- The retention of accelerated depreciation provisions for resource exploration and prospecting;
- The creation of statutory “capped effective lives” for major capital assets in the oil and gas, primary production, and airline industries, which operates as a functional equivalence to accelerated depreciation;
- The introduction of 200 percent depreciation for tangible assets, which operates as a subsidy for existing large, profitable businesses over new or start-up businesses, and supports capital-intensive industries as opposed to service industries;¹⁹
- The distinction between business expenses and capital investment itself can result in unintended adverse environmental decisions. For example, maintenance expenses on old inefficient plant may be immediately deductible as ordinary expenses, whereas replacement of inefficient plant by more efficient new equipment may constitute a capital investment, depreciable over time. This may skew decisions away from new investment in water- and energy-efficient plant.

On the face of it, these rules may undermine the efficiency of Australia’s efforts to reduce greenhouse pollution and improve resource efficiency. There is a strong case for a systematic re-examination of the rules around capital allowances, with the goal of ensuring that unintended incentives to energy- and resource-intensive activities are removed.

In addition, we should build on the current limited range of accelerated depreciation provisions for expenditure on environment protection activities. Such provisions should be extended to include investments in renewable energy and sustainable building retrofitting. Analysis by the Australia Institute makes a strong case for re-establishment of accelerated depreciation rules to promote capital investment in renewable energy technologies.²⁰ The Australian Sustainable Built Environment Council has similarly established the effectiveness that green depreciation allowances would have in promoting sustainable retrofitting of existing residential and commercial building stock.²¹

Recommendation 4.1	Remove the accelerated depreciation and capped effective life provisions that benefit mining, airline, and certain primary production industries.
Recommendation 4.2	Expand accelerated depreciation provisions for environmental protection activities to include a broader range of investments, including into renewable energy and retrofitting of residential and commercial buildings.

¹⁹ See Stewart M, ‘Capital Allowances for Depreciating Assets: A Successful Reform?’, University of Melbourne Law School Legal Studies Research Paper No. 320 (available at <http://ssrn.com/abstract=1116102>)

²⁰ Richardson D (2008) ‘The tax treatment of capital investment in renewable energy’ (The Australia Institute, October 2008).

²¹ Australian Sustainable Built Environment Council, “Building a Low Carbon Economy with Energy Efficient Buildings”, 2008

Recommendation 4.3	Consider immediate deductibility of investment in plant and equipment that replaces older, less efficient assets.
Recommendation 4.4	Reduce the depreciation allowance for capital assets generally from 200 percent to 150 percent.

5. Restructuring inefficient and inequitable tax expenditures

A persistent feature of the Australian taxation system is the existence of tax expenditures that create unintended distortions towards high-environmental impact activities, particularly those that effectively subsidise the use of fossil fuels. This submission focuses on four of the most important of these concessions: the fuel tax credits scheme, concessional excise rates for aviation fuels; and the FBT concessions for company cars and parking.

The fuel tax credits program

According to the 2008 budget, the Commonwealth collects \$14.5 billion in excise duties from petrol, diesel and other fuel products. Petrol and diesel are subject to a fixed rate excise at 38.145 c/L and also the 10% GST. However, Australia's fuel taxes are the fourth lowest of all OECD countries (see AATTS, Chart 5.12 at p 212). Even this low ranking understates the reality as almost half of the fuel excise paid in Australia is reimbursed under the fuel tax credit program, and GST is paid only by private consumers. The 2008 budget shows expenses of fuel and energy for 2007-08 to be 5.1 billion, which is largely attributable to the fuel tax credit program. This program provides a tax credit for federal excise duty imposed upon fuels used in qualifying activities including a credit for all taxable fuels (diesel and petrol):

- used in vehicles with a gross vehicle mass (GVM) greater than 4.5 tonne travelling on a public road, or
- certain 'off road' activities including agriculture, forestry, fishing, mining, marine and rail transport, nursing and medical, electricity generation, and non-fuel uses, machinery, plant or equipment

This scheme was originally justified on the basis that fuel excise was hypothecated for road construction purposes, and thus off-road fuel consumers should be exempt. Despite the official abandonment of hypothecation in 1959, the concession has been continued and progressively expanded in 1982, 2000 and 2006.²²

The operation of the fuel tax credits scheme entails significant adverse efficiency and equity impacts. In terms of equity, there is a serious discrepancy when individual commuters (who may have no alternative to automotive transport) pay full excise rates while businesses in the transport sector, using the same roads and generating the same pollution per unit of fuel, are effectively exempt. The efficiency of carbon pollution reductions will also be significantly undermined by the fuel tax credits. The credits distort investment towards on-road transport to the detriment of other modes, such as rail, and dampen the price signal that emissions trading is intended to create. To the extent that certain fuel users are insulated from the full price of fuel, they will have less of an incentive to use fuel efficiently, and the burden of emissions reductions will accordingly fall more heavily on other activities.

²² The original scheme was converted into the Diesel Fuel Rebate Scheme in 1982. Further changes were included as part of *A New Tax System* in July 2000.

The serious disconnect between the concessional treatment of fossil fuels under this scheme and the objectives of greenhouse emission reduction must be redressed. A phase-out of the excise concessions for most sectors should be implemented. Further, the proposal in the Federal Government's CPRS Green paper to offset fuel price impacts of the CPRS during the first three years by cutting fuel excise on a cent-for-cent basis should be rejected.

Concessional excise on aviation fuels

Domestic air transport is three to five times as energy-intensive as other forms of intercity transport, such as rail, bus or multi-passenger vehicle. Yet while petrol attracts excise of about 38 cents per litre, aviation fuels are taxed at just over 3 cents per litre. This distorts travel patterns towards polluting air travel and away from more efficient alternatives, in addition to costing the government nearly \$1 billion in potential revenue per year.

The aviation fuels excise concession is both inequitable, insofar as it disproportionately benefits relatively wealthy Australians who can afford to travel by air frequently, and inefficient in the distortionary impact it has on travel choices.

Aviation fuels should be taxed at the same rate as petrol.

Concessional treatment of employer provided cars under FBT rules.

The concessional valuation of private use of employer provided cars under Fringe Benefits Tax (FBT) rules²³ has been repeatedly recognised as having a perverse environmental impact. The Taxation Statistics 2005-2006 shows that 'car benefits' were the most popular form of fringe benefit in that year, with some 52,570 car benefits provided. The 2007 Tax Expenditures Statement estimated this concession to be costing \$1,490 million per annum in forgone revenue, which makes it one of the largest tax concessions currently provided.²⁴ The consequence of these rules is that there is a strong incentive for employees to take a company car in lieu of salary and then drive sufficient kilometres to exceed the various thresholds and thereby reduce the FBT rate (which will reduce the amount of salary to be sacrificed in order to obtain the car). In this way it is made financially attractive for individuals to commute by car over very long distances (about 500km per week achieves the second lowest rate of 11%), and/or take long interstate driving holidays at the end of the FBT period. The value of this concession is also considerably enhanced by the exclusion from FBT of any related running expenses such as petrol, registration and insurance (which do not appear to be included in the Taxation Expenditure Statement). In broad terms these concessions can amount to a total subsidy of several thousand dollars per year to recipients of a company car, which greatly violates the principle of horizontal equity by taxing persons with similar income at different rates, as well

²³ Fringe benefits tax (FBT) applies to employers who provide non-cash benefits to staff in lieu of salary or wages. The system requires payment of FBT by the employer on the taxable value of the benefit, at the flat rate of 46.5%, whilst making the benefit value exempt from income tax for the employee.²³ The taxable value of private use of employer provided cars (known as car benefits), is determined deemed to be a prescribed percentage of the base value of the car. The prescribed percentage varies according to the annual number of kilometres travelled by the vehicle. The environmental anomaly is that the percentage starts at 26% for vehicles which travel less than 15,000 kilometres per annum and then it progressively *reduces* to as little as 7% for vehicles travelling over 40,000 km.

²⁴ Commonwealth of Australia (2007), *Tax Expenditures Statement* at D26, p 150.

as vertical equity as the biggest benefit of salary sacrifice accrues to those with the largest salaries, making this is a highly regressive concession.

This company car concession was assessed as a major distortion by the Ralph Review of Business Taxation, which recommended a range of carefully considered reforms, including the taxing of fringe benefits in the hands of the employees and more accurate valuation techniques.²⁵ More recently the criticism has continued with a Federal government inquiry on sustainable cities in the 2005 recommending that the 'Australian Government review the current FBT concessions for car use with a view to removing incentives for greater car use...'.²⁶ A major study by the economist Neil Warren in 2006 renewed these calls for reform.²⁷ In February 2007 a Federal Senate inquiry on transport fuels recommended that the government review the car benefit formula as it encourages car use for peak hour commuting.²⁸ *The Age* economics journalist Kenneth Davidson has regularly emphasised the need to reduce car use and the elimination of the FBT rules that subsidise '40 per cent of peak-hour car travel, and 'exacerbates greenhouse gas emissions'²⁹

A recent study by Diane Kraal and colleagues at Latrobe University has given weight to these arguments by demonstrating that the statutory formula does in practice generate unnecessary journeys by owners of salary packaged vehicles.³⁰ Professor Ross Garnaut has also assessed these concessions as detrimental to achieving greenhouse abatement, noting that:

' ... the current treatment of vehicles and parking spaces distorts decisions towards private vehicle use and greater demand of transport overall. These provisions could be improved by:

- ensuring the salary sacrifice arrangements are mode neutral
- amending the statutory fraction method to ensure it is distance neutral.³¹

Even judged as a support measure for the car manufacturing industry, the concessions are poorly targeted, as they benefit overseas manufacturers just as much as Australian ones.

The review panel should consider a range of options to remove the anomalous perverse incentives created by the FBT company car concessions, including:

- a) adjusting the schedule for valuing FBT car benefits so that it is based on the fuel efficiency of a vehicle, rather than the number of kilometres driven;
- b) including running costs in the calculation of benefits;
- c) extending FBT exemptions to salary-packaged public transport and active transport options; and

²⁵ Commonwealth of Australia (1999) *Ralph Review of Business Taxation: a Tax System Redesigned*

²⁶ *Sustainable Cities* (House of Representatives' Standing Committee on Environment and Heritage, Canberra: 2005). See p. 77, para. 5.79.

²⁷ Warren, N., 2006, *Fringe Benefit Tax Design: decision time*, Institute of Chartered Accountants in Australia, Sydney, p. 8.

²⁸ *Australia's Future Oil Supply and Alternative Transport Fuels* (Standing Committee on Rural and Regional Affairs and Transport, Canberra: 2007.) p.160. See paragraphs 8.89 and 8.91.

²⁹ Davidson, K, "Our Petrol Problems are about Peak Oil, not Snake Oil," *The Age*, June 14, 2007. Davidson, K, *Fringe Benefit that exacerbates greenhouse gas emissions is a march of folly*", *The Age*, October 15, 2007.

³⁰ Kraal D, Yapa S and Harvey D (2008) The Impact of Australia's Fringe Benefits Tax for Cars on Petrol Consumption and Greenhouse Emissions 2008 *Australian Tax Forum* (July 08).

³¹ Garnaut Climate Review (2008) Final Report at 527.

- d) fundamental reconsideration of the FBT regime itself, including the option of making fringe benefits assessable as income in the hands of employees rather than assessed under a separate tax regime.

Concessional treatment of car parking under FBT rules

The 2007 Taxation Expenditure Statement identifies a range of tax concessions for car parking including exemption from FBT for small business employers (\$17 million in 2007-08), discounted FBT valuation (\$22 million) and car parking provided by scientific, religious, charitable or public education institutions or for certain disabled employees (not quantified, categorised as over \$10 million).³² The preferential treatment of car parking under FBT rules is another vestige of a by-gone vision of an automobile-dependent city. The car parking benefits contribute to traffic congestion and other urban problems, and are at odds with worldwide trends to discourage use of cars in central business districts; eg London and Singapore have introduced congestion taxes to reduce congestion and improve environmental conditions.³³ City parking levies have been introduced in recent years in Sydney, Perth and Melbourne, but the effect of these are counteracted to some degree by preferential FBT treatment.³⁴

The various car parking benefit concessions under the FBT system must be removed, except for narrow exceptions where justified on equity or social grounds (such as for disabled employees requiring personalised vehicle transport).

Recommendation 5.1	Phase-out most elements of the fuel tax credits scheme, including the tax credits for on-road transport and off-road mining use.
Recommendation 5.2	Phase-out the concessional rate of excise for aviation fuels.
Recommendation 5.3	Restructure the fringe benefits tax concessions for company cars so that the schedule for valuing benefits is tied to the efficiency of the vehicle, rather than kilometres driven.
Recommendation 5.4	Exempt public transport and active transport benefits from the fringe benefits tax.
Recommendation 5.5	Eliminate fringe benefits tax concessions for parking benefits (except where justified on equity grounds, such as for certain disabled workers).

6. Getting resource pricing right

One function of government which has critical importance for environmental and social outcomes, but largely undervalued as a revenue base in Australia, is resource use charges – particularly for oil, gas, coal, water, timber and fisheries. In the early years of European settlement, there was a deliberate policy to subsidise access to natural resources, particularly in the mining, agriculture, forestry and fishing industries. There are still many vestiges of this historical approach in the resource user charges. For example, coal royalties imposed by States

³² See 2007 Taxation Expenditure Statement items D28, D34 and D44.

³³ See London Congestion Charge website at: <http://www.tfl.gov.uk/roadusers/congestioncharging/default.aspx>

³⁴ Eg. See Office of the Premier of Victoria' Media Release date: Friday, April 22, 2005 'City car parking levy to ease congestion'

were in the range of 2.7% to 7% in 2005-06, oil and gas royalties were 10% and value based mineral royalties ranged from 2.5% to 5%.³⁵

It may be open to question whether a payment of as little as 1/40th of the ultimate commercial value of these commodities for the right to sell them for private gain best serves the public interest in the modern era of increasing concerns about resource depletion. We are certainly now witnessing the consequences of over-allocation of water resources, often at minimal or no cost to the private users of such resources.

But it is in forestry where underpricing of natural resources has perhaps reached its apogee. A 2001 study showed conclusively that the key NCP principles of Competitive Neutrality and appropriate Pricing Oversight were not being applied by State forest agencies within the Australian wood products industry.³⁶ The study found:

“In all states of Australia, timber from state-owned established native forests competes with timber from plantations – but not on a level playing field. In all States, the playing field is tilted against plantations and farm forestry in favour of exploitation of native forests.”

The study showed the lack of competitive neutrality between State forestry arrangements in established forests and those of private forestry activities:

- makes private investment in farm forestry and plantations much less attractive;
- distorts the allocation of wood sources within the forestry sector;
- undercuts competing uses of public native forests; and
- worsens the Australian environment and resource base.

While some states scored better than others on individual components of national competition policy requirements, it is telling that all states failed the cost recovery test.

Recent research also shows that the carbon sequestration value of eucalypt forests of south eastern Australia have been understated by over two-thirds in IPCC estimates.³⁷ The current resource royalty rates applied to natural resources use by State and Federal government thus continue to be contrary to the competitive neutrality policy set out in the National Competition Principles, which provides for the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities.³⁸

Recommendation 6	Comprehensive reviews of pricing of water, timber, mineral resources, fish, and oil & gas should be undertaken to ensure that rights to exploit such resources are prices are at a minimum consistent with market prices on an ongoing basis, and in addition that long-term sustainability of renewable resources and steady reductions in the use of non-renewable resources are achieved.
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³⁵ Commonwealth Grants Commission (2006) Working Papers Update, Volume 2 Revenue: Mining Revenue at Table 3; Available at: http://www.cgc.gov.au/state_finances_inquiries/2007_update_report2/working_papers

³⁶ Forestry & National Competition Policy. Marsden Jacob Assoc. 2001, available at http://www.acfonline.org.au/uploads/res_Forestry_NCP.pdf.

³⁷ Brendan Mackey et al (2008) 'Green Carbon; The Role of Natural Forests in Carbon Storage' (ANU E Press)

³⁸ COAG (2007) *Competition Principles Agreement – 11 April 1995* (As amended to 13 April 2007) at paragraph 3(5) - available at: <http://www.ncc.gov.au/activity.asp?activityID=39>

7. Towards a taxation system for a resource efficient economy

The Australian government currently relies upon a relatively narrow taxation base. The 2008 federal budget show that income taxes (including company taxes and capital gains tax) made up 69% of total revenue in 2007-08. Income growth also provides the driver for federal sales taxes collections (including GST) which made up a further 15% of total revenue. Excise duties, customs and other levies contribute a modest 11% of total revenue, with the remaining 5% from non-tax sources. The disproportionate dependence upon income taxes places Australia in a vulnerable budgetary position for several reasons:

- i) The global economy has just in the last month entered what appears to be a severe downturn. Australia's income growth has been largely based upon supply of raw materials (particularly minerals, coal and woodchips) to emerging nations like China and India and longer term trading partners like the US, Japan, Korea and Taiwan. The future of these economies is increasingly uncertain, which may in turn call into question Australia's income growth for the foreseeable future (and thus, taxation revenue).
- ii) Australia's economy is energy intensive. We have among the highest greenhouse emissions per capita of any country. Our low density urban centres, travel patterns and leading industries (like mining and agriculture) are all highly energy intensive. Oil shortages and resultant escalation in oil prices in the last few years has contributed to the world economic slowdown and had an even greater impact on the Australian economy. Our predominantly outer-urban, car dependent population is trapped in an upward cost spiral as higher oil prices work their way through every facet of Australian life. This cost spiral reduces taxable incomes across most of the economy (and thus, taxation revenue).
- iii) There are more long standing concerns about tax avoidance opportunities provided by the income base, particularly since the advent of electronic commerce – and the difficulties of a tax base built around outdated concepts like 'residence' and 'source'. The ability of wealthy taxpayers to legally split investment income (and substantial amounts of services income) through artificial interposed entities is another long standing problem (wrt horizontal and vertical equity).
- iv) The generous income tax cuts (and superannuation concessions) granted by our federal governments in recent years have heightened the revenue risk. In 2006 two Canadian tax scholars, Neil Brooks and Thaddeus Hwong, found that 'tax cuts are disastrous for the well-being of a nation's citizens.' They based this conclusion after examination of 50 indicators that are commonly used to measure a country's social progress. On over half of these indicators (29), the outcomes in high-tax Nordic countries are significantly better than those in low-tax Anglo-American countries, and on most of the remaining indicators (13), social outcomes are somewhat better in Nordic countries.
- v) Climate change responses and other resource shortages now require that the global economy to be restructured in a way that disconnects economic growth from resource consumption.

These circumstances make it highly questionable for Australia to continue our heavy reliance upon an income tax base, which for now seems to entail continuing growth in consumption of natural resources, and greenhouse emissions.

A more sustainable economic model would proceed from the well recognised principles of ecologically sustainable development, which require as a minimum, the conservation of resources and significant reduction of greenhouse emissions.

These factors set the scene for a tax shift towards resource consumption and away from productivity.

A growing body of economic evidence suggests that such a process of environmental tax reform can pay a 'double dividend'. Lowering taxes on work creates more jobs. Increasing taxes on pollution and waste helps protect the environment and conserve scarce resources. David Gee, of the European Environment Agency, has set out the goal of environmental tax reform as follows:

Ecological tax reform involves shifting a large proportion of taxation off the value-adding activities of people (employment, enterprise and investment) and onto the value-subtracting use of energy and resources and associated creation of wastes and pollution.

Environmental taxation thus ensures activities are priced at a level that fully takes into account those activities' real societal and environmental costs. The purpose is not to punish, but to create proper incentives to minimise environmental damage. Most European nations have undertaken some degree of environmental taxation reform. Notably, Germany initiated a reform process in 1999 that increased fuel taxation, with the revenues being directed to employee pension contributions. The result: lower labour costs that offset the higher energy costs.

A 2005 study by Ecologic and the highly-regarded German Institute for Economic Research concluded that, over seven years, the environmental tax reform package reduced greenhouse gas emissions by 2.6 per cent, increased employment by 0.5 per cent and increased Germany's GDP by 0.3 per cent over the business-as-usual baseline.³⁹ Far from damaging the economy, the shift to environmental taxation stimulated economic development.

This Review is a major opportunity to explore the possibilities of dramatic shifts in the basis of taxation, and in particular to model whether a far-reaching environmental tax reform program would result in environmental, economic and social benefits for Australia.

One example that we would encourage the Review to consider is the revenue-neutral replacement of corporate taxation with a broad-based system of taxes on resource use and waste. Taxing the material and energy inputs into production rather than the profits a business generates would entail major shifts in accounting and tax administration, and the interaction with other parts of the tax system would have to be carefully considered. However, the relative reduction in the cost of labour versus the cost of material inputs to production could be

³⁹ Report available (in German only) at http://www.diw.de/deutsch/dasinstitut/abteilungen/stt/projekte/projekt_oekologische-steuerreform.html

expected to generate substantial jobs growth, and a step change in the incentives that businesses have to utilise our scarce resources efficiently.

Recommendation 7	The review should undertake modelling of the possible social, economic and environmental benefits of a broad-based shift towards resource and pollution taxes -- for example, replacement of the existing company tax with a tax on material use and waste generation.
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The Australian Conservation Foundation is committed to achieve a healthy environment for all Australians. We work with the community, business and government to protect, restore and sustain our environment.