Submission to the Australian Government's Review of the Tax and Transfer System

November 2008

Prepared by the Chamber of Commerce and Industry of Western Australia

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About CCI

The Chamber of Commerce and Industry of Western Australia (CCI) is the leading business association in Western Australia.

It is the second largest organisation of its kind in Australia, with a membership of over 5,000 organisations in all sectors including manufacturing, resources, agriculture, transport, communications, retailing, hospitality, building and construction, community services and finance.

Most members are private businesses, but CCI also has representation in the not-for-profit sector and the government sector. About 80 per cent of members are small businesses, and members are located in all geographical regions of WA.

Executive Summary

Taxation is the most costly and intrusive facet of the interaction between government and business. Tax probably has more effect on the profitability and day-to-day operations of most businesses than any other government activity. Getting the tax structure right is the single most constructive reform that governments can do to promote a productive economy and competitive business sector.

The objectives set out as part of this Review reflect many of the key policy challenges facing the economy now and into the future, including:

1. workforce participation and skill formation;
2. individuals to save and provide for their future, including access to affordable housing;
3. investment and the promotion of efficient resource allocation to enhance productivity and international competitiveness; and
4. reducing tax system complexity and compliance costs.

These are important objectives that can assist in maintaining Australia's economic prosperity in the future. However, the achievement of such objectives must be considered within the framework of sound tax policy principles of: equity, efficiency, transparency, adequacy and competitiveness.

The reform proposals highlighted in this submission demonstrate practical and achievable ways in which significant taxation reform can be delivered within the existing taxation framework.

The ability to achieve widespread taxation reform is contingent upon reviewing the Commonwealth and State taxation system as one regime. Probably the most significant reform that could be achieved would be to address the imbalance in Commonwealth and State financial relations. It is this imbalance in the taxing powers between the Commonwealth and the States which has effectively limited the ability of the States to reform the most inefficient State taxes.

There are nonetheless a range of reforms that could be undertaken in the absence of such a wide ranging reform agenda, including:

- reducing personal income taxes to align the top marginal tax rate to the 30 per cent corporate tax rate;
- indexing tax thresholds in order to remove bracket creep;
- reducing capital gains tax;
- changing fringe benefits tax so that it applies to employees (rather than employers) in the same way as all other income is treated;
- tackling complexity and compliance costs, which is particularly important for small business; and
- reducing high effective marginal tax rates on low and middle income earners, which act as a disincentive to participate in the workforce.

Findings

1. The evolution of the Federation has created imbalances between the funding and responsibilities of State and Federal Government. A review of functions and responsibilities could help to simplify the current arrangements and address the problems inherent within the relationship between the Commonwealth and the States.

2. If tax reform is to lessen vertical fiscal imbalance without transferring spending powers from the States to the Commonwealth, it must allow States to increase their own-source revenues.

3. In the absence of any reduction in the States' financial dependence on the Australian Government, the ability of the States to implement significant taxation reform is limited.

4. Moving to an equal per capita share of the GST pool would enhance equity and transparency in distribution while also promoting efficiency in government, resulting in fewer barriers to State based taxation reform.

5. The system of self-assessment for income tax is in need of reform. It has brought about a clear shift in accountability and responsibility towards the taxpayer which, in some cases, the taxpayer cannot reasonably comply with. The increasingly complex income tax laws and the threat of audit if taxpayers incorrectly complete their tax affairs, creates an uncertain environment.

6. The alignment and simplification of the two income tax acts represents a clear example of tax simplification that could be achieved, and should be pursued as a priority.

7. Any reforms to the tax system should focus on its current high level of complexity and aim to improve its efficiency and transparency. A consultative approach to reform would help ensure that future tax changes take into account the impact on taxpayers.

8. The Australian Government should introduce a Taxation Administration Impact Statement in order to ensure that all relevant information is presented to decision makers when determining the impact of changes to legislation in terms of taxation compliance.

9. In order to ensure Australia's taxation system remains internationally competitive and encourages greater labour force participation, a long term goal should be to cut the top marginal tax rate to equal the company tax rate of 30 per cent and for thresholds to be indexed to inflation.

10. It is critical that high effective marginal tax rates (EMTRs) be addressed to enhance workforce engagement. Further analysis of both income tax scales and the taper rates at which welfare benefits (such as NewStart Allowances and Family Tax Benefits) are withdrawn should be undertaken to address high EMTRs and thereby maximise the incentives to move from income support payments to increased participation in paid work.

11. If Australia is to be internationally competitive, reforms to capital gains tax must be considered in order to remove the disincentive to investment and encourage taxpayers to hold onto assets for longer periods.

12. Reform to fringe benefits tax (FBT) should aim to minimise the confusion and compliance costs imposed on business. This can be done by applying FBT to the employee in the same way as all other income is treated.

13. An important change to FBT is in relation to the treatment of child care, allowing it to be salary sacrificed, in the same way that salary sacrificing is allowed for motor vehicles, superannuation and computers, none of which

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require a business premises test or indeed any other test except that they are work related.

14. State tax reform is the area where the most significant reform can be achieved. While the ability to deliver meaningful reform is limited by the inherent problems associated with Commonwealth-State financial arrangements, State Governments retain the capacity to reform their tax systems, while maintaining control over their spending programs also provides the opportunity for genuine tax relief to be delivered.

15. The existence of multiple rate scales for conveyance duty, land tax and motor vehicle duty increase the complexity of these taxes, and introduce the problems associated with bracket creep. Sound tax policy would see multiple rate scales simplified and indexed to a reasonable measure of price changes.

16. The application of concessions and exemptions has further complicated an already complex State tax system. Tax concessions and exemptions should be reviewed and where possible be kept to a minimum.

17. Payroll tax is a tax on employment and a major cost on business. The objective should be to see this tax abolished over time. In the meantime, the application of an exemption threshold must also be indexed to ensure that bracket creep does not expand the tax base to include small businesses that would otherwise be exempt.

18. The States should continue to implement harmonisation measures to minimise compliance costs for businesses operating across Australia.

19. Conveyance duty is an inefficient transactions based tax which creates disincentives to make property transactions. Its longer term abolition should be considered as part of any broader reform agenda for Australia's taxation system, provided that the issues associated with vertical fiscal imbalance can be addressed.

Tax Principles

Taxation is the most costly and intrusive facet of the interaction between government and business. Tax probably has more effect on the profitability and day-to-day operations of most businesses than any other government activity. Getting the tax structure right is the single most constructive reform that governments can do to promote a productive economy and competitive business sector.

The key to maintaining a competitive taxation environment is to apply the principles of taxation to minimise the overall effect of the tax system on the business sector and incentives of individuals and therefore promote an economic environment that creates employment, income and wealth. The tax system is an important component of the economic environment for business and therefore government should seek to provide an overall taxation regime which encourages business investment.

For businesses whose investment is mobile, an uncompetitive tax system may be a determining factor for a business owner considering where to set up its operations. That has been evident in recent corporate decisions concerning home State locations for their operations.

While tax competition can encourage governments to match best practice in other jurisdictions and to strive to keep the overall tax burden at a minimum, CCI believes that governments should avoid contests in which States compete against each other to attract particular projects with targeted tax incentives and concessions. Such an approach is self-defeating, drawing labour and resources away from existing and prospective industries and reducing their comparative advantage.

There are five key principles commonly identified as being necessary to achieve these goals. CCI believes any fundamental reform of the taxation system should be consistent with the objectives outlined below. These broad principles which shape policy on taxes and charges are:

- **equity** – horizontal equity requires that taxpayers in similar circumstances should face a similar tax burden; while vertical equity requires that taxpayers with different abilities to pay remit taxes in proportion to their exposure to the tax base;

- **efficiency** – the system should be administratively efficient so that the cost of managing and complying with a tax are not excessive relative to the revenue raised; and it should be economically efficient so that that distortions caused by people changing behaviour because of tax are minimised;

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- **transparency** – a transparent tax system identifies clearly what is to be taxed and how the liability is calculated. Both taxpayers and those meeting the real costs of taxation should be able to identify how much tax they are paying;

- **adequacy** – taxation should be adequate to finance appropriate levels of government expenditure; and

- **competitiveness** – the size and structure of the tax burden should encourage people and businesses to locate and doing business in Australia rather than in alternative locations.

These principles must be considered when looking at reforms to Australia's taxation system.

The options for reform presented in this submission are framed in the context of these basic taxation policy principles.

Commonwealth-State Financial Relations

Issues with Australia's Federation

Australia is one of a relatively small number of countries with Federal constitutions. Australia's constitution was accepted by referenda in each of the Australian colonies, and it was created as a Federation 1 January 1901.

In the past hundred years there has been repeated conflict between the States and Commonwealth over jurisdictional boundaries, and in general an increase in the power of the central government relative to the States.

The effect of the Commonwealth's fiscal powers has been a significant force shaping the evolution of the federation. Under the constitution, the Commonwealth has had sole rights to levy customs and excise taxes, and during World War Two the States ceded their income taxing rights to the Commonwealth too, leaving them with a range of fairly narrow and distorting taxes and charges to provide own-source revenue. As a consequence, the States have become reliant on substantial transfers from the Commonwealth to fund their activities.

CCI believes that there is a need to revisit the allocation of responsibilities within the federation more systematically and rationally, with a view to simplifying the system, improving its efficiency and transparency and eliminating duplication and overlap. This would require both State and Commonwealth Governments to commit to a genuine review of functions and responsibilities, including a commitment to withdraw from areas deemed to be more appropriately sited in the jurisdiction of another layer of government. It also requires that funding adequacy and autonomy be addressed.

A starting point for such reform might be an independent review of jurisdictional boundaries and their efficiency by a body at arms-length from Government, perhaps modelled on the Productivity Commission or National Competition Council. Its first role would be to recommend new and clearly defined allocations of policy, spending and revenue raising responsibilities for funding, policy determination, and policy implementation.

Such a review of functions should be guided by five key principles:

- **subsidiarity**, which requires that that power should be exercised at the lowest level that produces efficient results;
- **competitive federalism**, which emphasises the benefits of diversity, experimentation and a degree of rivalry between the States' policies and practices;

- **cooperative federalism**, which identifies the benefits of a cooperative, consistent and co-ordinated policy approach on some issues, especially those which have effects beyond the jurisdiction of the government with authority to legislate on the issue, or where there are significant benefits from a unified approach;

- **financial adequacy**, which requires that governments have secure access to the funds necessary to implement their programs, which in turn demands that the drawbacks of vertical fiscal imbalance be addressed; and

- **appropriate redistribution**, which demands an appropriate means of distributing funds between jurisdictions, and requires a fresh look at the objectives and processes of horizontal fiscal equalisation.

***Finding**: The evolution of the Federation has created imbalances between the funding and responsibilities of State and Federal Government. A review of functions and responsibilities could help to simplify the current arrangements and address the problems inherent within the relationship between the Commonwealth and the States.*

Vertical Fiscal Imbalance

A key consideration in the assignment of functions is the principle of fiscal equivalence, which requires each level of government to finance its assigned functions with funds it raises itself.

Applying this principle, it could be argued that where the subsidiarity principle supports the allocation of a function to a lower level of government, then both the necessary expenditure and taxing powers should also be delegated to that level of government. Such assignment promotes accountability by placing a constraint on the extent to which the political agenda can deviate from the preference of citizens.

There are a wide range of considerations in deciding the allocation of expenditure and taxing functions between governments[1]. Potential advantages of having the major taxes collected and administered by only one level of government include:

- administrative advantages for both governments and taxpayers;

- the facilitation of policies aimed at achieving national economic stability and growth;

- the existence of adequate scope for the Commonwealth to provide grants producing a strong horizontal equalisation effect across the States;

- the facilitation of interpersonal horizontal equity through relatively uniform taxation and social welfare payments throughout the nation;

- the ability to take a more "national" approach to resource allocation and the setting of standards; and

- reduced scope for destructive "tax competition" amongst the States.

On the other hand, the disadvantages include:

- a loss of diversity and responsiveness to regional and local needs and preferences;

- the divorcement of revenue raising and expenditure decisions at each level of government may lead to fiscal inefficiencies – such as from imposed priorities not reflecting preferences, the lack of direct accountability to taxpayer expenditure decisions, "buck passing" amongst the various levels of government, and the waste of resources inherent in the grant negotiation process;

- the uncertainty on the part of the States as to future levels of funding, especially if the funding is ad hoc;

- the States have to resort to raising revenue from "nuisance" taxes, which are inefficient, inequitable and associated with high administration and compliance costs;

- there may be reduced scope for "constructive" tax competition between the States; and

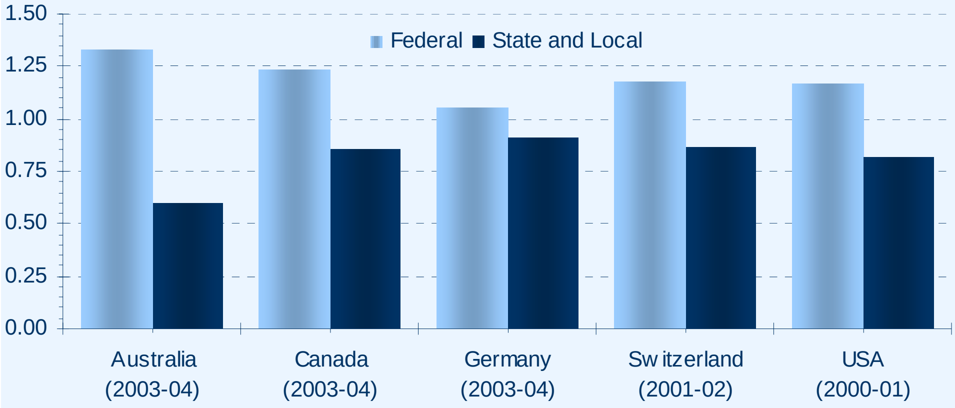
- the political power of the States is diminished through the financial power of the Commonwealth.

It is difficult to determine the optimal assignment of revenue sources and expenditure responsibilities. Complete vertical balance is not realistic or desirable if the Commonwealth is to continue to provide some mechanism for fiscal equalisation between the States.

All federal systems undertake some income transfers between their various levels of government. However, the degree of vertical imbalance in Australia is much greater than in other democratic federations around the world (Figure 1).

Since Federation, the Commonwealth has been very successful in gaining access to the major sources of taxation, resulting in an inequality between the financial responsibilities and the available financial resources of the Commonwealth and the

Figure 1
Vertical Fiscal Imbalance, Ratios
Own Source to Own Purpose Outlays



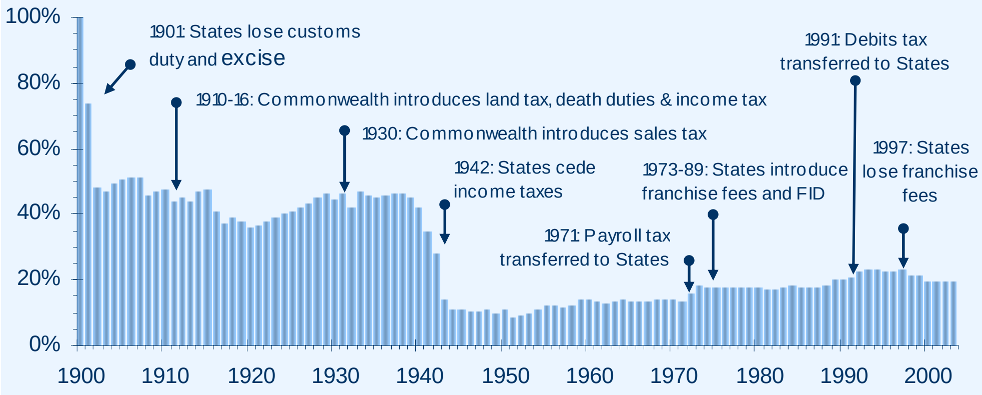
Source: IMF Government Finance Statistics Yearbook 2005

States. This is what is termed *vertical fiscal imbalance* and requires a system of intergovernmental transfers to correct the imbalance.

Today, the Commonwealth Government raises about three quarters of all tax revenues collected, but the States are responsible for about half of government expenditure. As a result, around 40 per cent of States' general government revenue comes from Commonwealth grants. Compared with other Federations, Australian States have a high degree of financial dependence on the central government.

The States' own-source revenues as a percentage of total government revenues have fallen in a series of steps since federation (Figure 2). Most changes have seen the States losing taxing powers – with the exceptions being the transfer of payroll tax to the States in 1971 and Debits tax in 1991, and the introduction of franchise fees from the 1970s and financial institutions duty in the late 1980's. As a

Figure 2
State Own Source Revenues As a
% of Commonwealth and State Revenues



Source: Department of Treasury and Finance

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consequence of a High Court decision the States lost the ability to levy franchise fee revenues in 1997.

The key problem with vertical fiscal imbalance is that it undermines the autonomy of the financially dependent government. Political authority is vulnerable without autonomy, which includes the financial capacity to deliver the goods and services that constitutional authority empowers the government to provide.

Although the introduction of the GST eased some of the pressures on States' revenue bases by giving them access to a "growth tax", this came at the cost of increased vertical fiscal imbalance. That increases the capacity of the Commonwealth to constrain in future the States' freedom to deliver services as they, and their residents, wish. The agreement to eliminate State "nuisance" taxes as a result of strong GST revenues has made this imbalance even more pronounced.

The GST is not a tax the States control – they have no influence over its incidence or level, and limited influence over its distribution. Rather, the GST is simply a transfer from the Commonwealth to the States and therefore increases vertical fiscal imbalance, a process likely to worsen over time. More problematic is the possibility that the Commonwealth will use its control over the level and distribution of GST funds to become progressively more powerful in the intergovernmental relationship. The fiscal history of the federation gives little ground for optimism that the Commonwealth will hand over this money indefinitely without seeking any political influence on, or advantage through, how it distributed or spent.

There are a number of ways in which greater fiscal balance could be achieved. A centralist approach could be to transfer expenditure responsibility to the Commonwealth or by the Commonwealth providing the States a greater share of its tax revenues. However, each of these has its complications. A better reform process would also see the extent of vertical fiscal imbalance reduced.

If tax reform is in future to achieve a lesser degree of vertical fiscal imbalance without transferring spending powers from the States to the Commonwealth, it must allow States to increase their own-source revenues. There are only three ways to reduce vertical fiscal imbalance without transferring spending responsibilities to the Commonwealth:

1. **raise existing State taxes** – the only State tax that has the theoretical potential to conform to the key taxation principles is payroll tax, and any increase in payroll tax would not be desirable as it would lead to a very sharp increase in the cost of labour;

2. **introduce new State taxes** – by giving the States new tax powers which would allow them to abolish existing inefficient taxes. Both measures (1) and (2) would need to be associated with a reduction in Commonwealth revenues and grants to avoid an overall increase in taxation collections; or

3. **pass tax powers from the Commonwealth to the States** – the most obvious candidate for such a shift is income tax. Passing the power for States to collect income tax is advantageous to the extent that:

   - it would be constitutionally possible. The States collected income tax prior to World War Two;

   - it could be done without changing the existing range of taxes raised – the States could take control of income taxes, while the Commonwealth uses GST revenues to finance its own activities; and

   - income tax generates more stable revenues than many of the States' own taxes such as stamp duties, and it is a "growth tax" whose revenues tend to increase automatically as the economy expands.

However, there are practical difficulties associated with such a proposal, including:

- it may undermine the Commonwealth's role in redistributing income and its ability to control the degree of progressivity in the income tax system;

- it could also impede its ability to determine the overall process of redistribution by coordinating the cumulative impacts of progressive income taxes, unemployment and other benefits and social spending;

- it is unlikely that the Commonwealth would be willing to give up its largest single source of revenue, or even part of it for that matter;

- there appears to be no satisfactory mechanism by which the States could share the business income tax base (company tax);

- if the States were to set different tax bases, "progressive" rates etc, the complexity of the income tax system, compliance costs and the potential for evasion would increase; and

- if the States agreed to align their income tax bases with the Commonwealth's, and set single tax rates and competed only on those rates, then these problems would be largely ameliorated. However, this would again reduce their flexibility to design their own revenue-raising mechanisms, and might provide the Commonwealth with a powerful incentive to contract the income tax base over time, or change its structure so that income was generated in activities only taxed by the Commonwealth (eg. by encouraging incorporation).

***Finding**: If tax reform is to lessen vertical fiscal imbalance without transferring spending powers from the States to the Commonwealth, it must allow States to increase their own-source revenues.*

Horizontal Fiscal Equalisation

Another key aspect of Commonwealth-State financial relations is the process of horizontal fiscal equalisation, which is typically a great source of tension and debate as to what the appropriate distribution of GST revenues should be.

The principle of "horizontal fiscal equalisation" (HFE) is defined as:

> *State governments should receive funding from the Commonwealth such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standards.* [2]

The States have different capacities to raise revenue and different spending "needs". For example, Western Australia has a relatively large capacity to raise revenue from the mining industry compared with Tasmania, while a State with a relatively younger population needs to spend relatively more on primary education.

To provide the States with equal capacity to provide services, States with below average revenue-raising capacity or above average spending needs to receive a larger share of funding. HFE thus redistributes resources from States with the capacity to provide above-average services to the other States.

One of the key grant payments that is made to the States is the GST, which was intended to provide the States access to a "growth tax", in return for abolishing a number of the most inefficient State taxes. What it did however, was increase the vertical fiscal imbalance, as the GST is not a tax the States control – they have no influence over its incidence or level, and limited influence over its distribution. More importantly, the way in which the GST is distributed to the States is not transparent and, in the case of growing States like WA, not a growth tax at all, as WA, with economic activity growing faster than other States is receiving a progressively smaller share of the GST pool (Figure 3).

If it is seen that the GST is in fact a "State tax" then the process for allocation must be reconsidered. One approach could be to provide a guaranteed share of the GST to the States, with the simplest and fairest approach to provide GST on an equal

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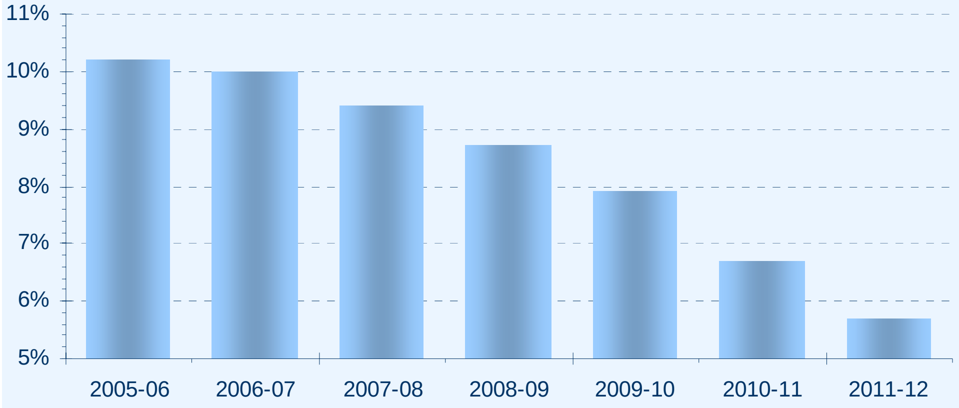
Figure 3
Horizontal Fiscal Equalisation
WA's Expected Share of the GST Pool



Source: Department of Treasury and Finance 2008-09 PFPS

per capita basis. For one, this would go some way to eliminating the uncertainty currently involved with the way grants are transferred to the States, and pave the way for meaningful State taxation reform.

Instead, GST revenue grants are allocated across the States according to the recommendations of the Commonwealth Grants Commission (CGC), using the principle of HFE. Consequently, the amount of GST a State receives differs from the amount it would receive if GST were distributed on an equal per capita basis.

When calculating spending needs and revenue-raising capacity, the CGC takes account of factors that a State cannot control. How a State raises revenue and spends it reflects policy choices. If the distribution of GST were based on actual spending and revenue, a State could (say) tax less to increase its share of GST revenue. The CGC therefore seeks to make its assessments of revenue-raising capacity and spending needs "policy-neutral" – meaning that a State will receive a larger share of GST revenue if it can demonstrate that it is unable to provide services at the national average level for reasons that are beyond its control. The CGC also takes account of "revenue raising effort", which compares each State's actual revenue with its assessed capacity.

There has been significant tension over the method by which the CGC redistributes GST grants to the States, especially by those States that are net losers from the process, namely New South Wales, Victoria, and Western Australia.

The objective of the grants allocation process is to provide all State Governments with the capacity to provide the same level and standard of services from the same tax effort regardless of costs or capacity to raise revenue, and regardless of whether the States actually do provide those services to the standard level.

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One key feature of this process is that it makes no presumptions about what a State "should" spend, meaning that States are free to adjust their own policy priorities individually and this is not taken into account in the equalisation process.

Briefly, the problems with the current system are:

- it is complex and not transparent, with CGC and State Treasury officials spending many hours arguing arcane technical points often laden more with self interest than sound argument that nonetheless can be worth millions to the States affected;
- it is based on an arguable rationale, has no clear constitutional warrant, and has never been defended explicitly before the electorate as a means of distributing its money;
- the WA Government believes that it penalises States with rapid population growth and large infrastructure needs; and
- it creates perverse incentives. The larger States, in particular, gain more funds when they allocate a larger proportion of spending to activities they are not especially good at. Conversely, it dampens incentives to promote economic growth, especially in smaller States like WA, where 90 per cent of any State government gain from growth in its tax base or royalties is clawed back though lower grants. Conversely, it keeps 90 per cent of any rise in the tax take arising from a more intense tax effort.

It is sometimes argued that the Commonwealth should use its power to control grants to encourage improved efficiency on behalf of the States, either by adjusting grants according to whether States meet some efficiency benchmarks or targets, or by factoring in assumed efficiency levels in service delivery when determining the size of grants. While CCI has sympathy with the aim of improving the efficiency of service delivery, it nonetheless supports State discretion on how to actually spend the grants they receive for two reasons:

- it is essential to the proper operation of a federation, and
- it is consistent with the principle of subsidiarity, which requires that public responsibilities should be exercised by those authorities closest to the citizens affected by their decisions.

The Western Australian Department of Treasury and Finance argues that once Commonwealth taxes and spending are factored into the equalisation process, Western Australia provides the highest fiscal subsidy of any State and territory after the ACT. [3] The subsidy to the other States reflects a number of factors

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including the high per capita taxes contributed by Western Australia and the State's low share of Commonwealth social security and health benefit payments.

The Department of Treasury and Finance discussion paper also makes the point that using measures of relative population shares and relative income tax shares are options that may be used in the distribution process.

It should be noted, however, that some of the tension surrounding HFE might be eased if the States were less reliant on the Commonwealth for revenue. The substantial vertical fiscal imbalance is a feature of Australia's Federation, and until this issue is addressed, concerns over the HFE process will continue.

***Finding**: In the absence of any reduction in the States' financial dependence on the Australian Government, the ability of the States to implement significant taxation reform is limited.*

Moving to an equal per capita share of the GST pool would enhance equity and transparency while also promoting efficiency among government, resulting in fewer barriers to State based taxation reform.

Commonwealth Tax Reforms

Tax Compliance and Administration

Despite reforms to Australia's taxation regime, compliance costs remain a major concern for Australian businesses. Taxation complexity and compliance represent a major drain on the time and finances of all businesses, in particular small business.

The recent changes to the Government's Luxury Car tax is a clear example of a tax that has been made unnecessarily complex as a result of policy changes made by Government. This tax could simply have had the threshold raised to $75,000 to exempt the average cost of a four-wheel-drive needed by primary producers and tourist operators from the tax increase. Instead, this tax has had a number of amendments made to exempt farmers, tourist operators and fuel efficient cars. The amendment to exempt fuel efficient cars is said to only affect 1,500 of the one million cars sold in Australia each year.[4] As a result of these exemptions, this tax has been subsequently turned into an over-complicated piece of legislation where compliance is likely to be an issue, while at the same time also potentially opening loopholes for tax avoidance.

The Luxury Car tax changes comes after the Joint Standing Committee of Public Accounts and Audit 'Report 410 Tax Administration' stated that Australian governments and the Parliament need to spend more time in developing simple, coherent tax policies and legislation in an effort to deliver a simpler tax system and decrease tax burden on business.

The complexity of the tax system imposes huge compliance costs on businesses. The case for reducing the complexity of the Australian taxation system is compelling, especially when Australia is identified as having the third most complex taxation system of the 20 largest economies of the world according to the Joint Standing Committee of Public Accounts and Audit.[5] Reducing the complexity and compliance costs with the tax system should therefore be a key area for reform. In addition, the regulatory costs of all tax measures should be better measured, with any new tax rulings being appropriately field tested with a small sample of businesses to determine whether it is practical for business to implement.

These concerns are of particular relevance to small business. Because of their limited resources, small businesses do not always have the capacity (time, money, and skills) to decipher and comply with all regulation. The effect is that the regulatory compliance cost burden, when compared with dollars per turnover, has a greater, disproportionate impact upon small firms. In other words, compliance costs are regressive and prohibit innovation and entrepreneurship.

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Case Study 1: Margin Scheme

The Brady King Pty Ltd v Commissioner of Taxation [2008] FCA 81 case demonstrates the uncertainty surrounding how a business should interpret and self assesses tax rulings. This case relates to Brady King Pty Ltd's interpretation of how to calculate GST using a margin scheme.

The Federal Court handed down its final decision in June 2008. This decision has created a significant change to the interpretation and operations of the margin scheme. It is also contrary to the ATO's current public rulings regarding the margin scheme.

Tax rulings regarding GST have been occurring since 1999, yet in 2008 the Brady King Pty Ltd case demonstrates that these interpretations can be proven to be wrong almost a decade later.

The ATO has indicated it will adhere to its previous rulings and appeal the decision, which leaves businesses with little confidence about how to appropriately calculate their businesses taxes.

The case studies presented suggest any long-term solution is to not only simplify the current system but also to recognise that new legislation needs to be carefully assessed, with necessary cost/benefit analyses undertaken to determine the net social benefit of taxation rulings for its compliance impact. At the same time, the system of public rulings is becoming increasingly unworkable. The increasingly large number of public rulings for one gives rise to further ambiguities.

The key to good tax administration is to focus on maintaining a culture of good compliance. However, this needs high levels of confidence in the system, which can be attained by providing the necessary support, assistance and education for its taxpayers, while at the same time making it easy to comply by removing the uncertainty and costs complex tax laws impose on the community. Case Study 2 about the valuation of stock provides one example of a tax ruling where little guidance was provided to business about how to implement or interpret this particular tax ruling.

The administration costs imposed on both business and government in attempting to comply with increasingly complex tax legislation needs to be minimised with clearer and simpler legislation.

Case Study 2: Valuation of Stock TR 2006/8

A medium size manufacturing business has considered using the 'cost' method to value its trading stock for income tax purposes. They aren't eligible for the small business exemption and they are aware that the difference in their closing and opening stock over the last year will be greater than $5,000.

According to the Taxation Ruling 2006/08 they must calculate the direct and indirect costs associated with bringing the item to its present locations on the shop floor.

The business has many types of stock, all different sizes and weights and stock that is sometimes sold directly as a non stock item. The business' purchasing department also shares a space and resources with the sales department.

According to the Ruling some of the expenses that must be apportioned to the stock include the cost of freight, insurance whilst in transit, adjustments and assembly, operating a purchasing department including the cost of light bulbs, power, computers, staff pay (no guidance is given on whether it should include superannuation and leave loadings), as well as the administration costs when receiving and inspecting stock, among many others.

For this business to comply with this Ruling the business must spend an exorbitant number of weeks calculating the 'cost' and documenting copious amounts of notes to justify the company's calculation in case of an audit. To maintain this activity they would need to customise and upgrade their software to process this information. When this Ruling was released in 2006 they were also required to back date their stock level which is almost impossible for some stock items.

This business would waste significant time and money attempting to comply with this Ruling. Although this Ruling is in line with accounting standards it is not practical for a business to implement and simply defers a deduction from being made when the stock is sold. Therefore, the net benefit of collecting this tax is low.

The Chairman of the Productivity Commission, Gary Banks, has previously raised a number of concerns with regulation:

- more and more pieces of legislation or regulation are being passed relative to previous periods;
- these Acts are, on average, longer than they used to be, and consequently are more complex and impose greater compliance requirements;
- there are more departments, agencies, ministerial councils and national standard setting bodies designing and implementing regulation than ever before;

- governments have not improved their performance in making regulations 'nonprescriptive, clear, and concise';

- the methodology used by Commonwealth agencies (i.e. Regulatory Impact Statements (RISs) in estimating the economic costs of proposed regulation is not yet to a satisfactory standard;

- RISs are too often used as a means to justify the introduction of a regulation rather than a means to impartially assess whether it is suitable or not; and

- regulations often do not differentiate between small, medium and large businesses.

To assist in any process of tax simplification, Government should be willing to consult with businesses and tax agents about new or existing regulation.

Self Assessment

The introduction of self-assessment in 1986-87 was initially welcomed, having merit since it was intended to make tax administration easier by facilitating the internalisation of tax compliance. However, many businesses do not have the confidence to self-assess given the systems complexity. Self-assessment has ultimately led to the over-complication of the tax system. In this regard, it would be worthwhile introducing a range of initiatives aimed at assisting business in identifying, understanding and implementing taxation requirements.

Under the system of self-assessment, the ATO has been able to move from the position of having to understand and be able to apply the income tax law on a consistent basis, to instead passing on that responsibility to taxpayers and their advisers.

Feedback from the accounting profession and small business suggests taxpayers are accepting a high level of risk from a self-assessed taxation system where the ATO is able to amend a business tax assessment at a later date. Complex tax laws are increasing the chance of taxpayer error.

The system of self-assessment has been made all the more difficult for taxpayers given that the tax laws have become increasingly complex and lengthy, with over 8,500 pages of legislation spread over two different Acts (*Income Tax Assessment Act 1936*, and *Income Tax Assessment Act 1997*) and many more thousands of pages in general public rulings. [6]

In part, the increased amount of detailed income tax legislation has been an attempt to clarify all possible events or circumstances that can arise to increase certainty for taxpayers. However, it has had the opposite effect. The average taxpayer now finds it more difficult to understand and comply with the tax laws.

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Such is the complexity of the system, the ATO has reported that around 75 per cent of all tax returns and activity statements are lodged with either complete or partial involvement of a tax professional. This is the highest of any country in the world.

The pressures on taxpayers and tax advisers to fulfil their tax obligations are compounded due to the uncertainty as to whether they will be audited for incorrectly completing their tax returns (potentially requiring payment of additional tax plus interest), or, worse still, avoiding tax (which can attract large penalties).

Despite the ATO's best efforts and intentions in providing rulings when requested, the practical issues for taxpayers and tax agents means that, for many reasons, the need for an ATO ruling may not be identified or, if it is considered, it may not be sought for any number of valid pragmatic reasons (not to do with minimising tax). By doing this, however, the onus on the taxpayer has now meant the ATO does not have to take a position on a tax matter until after the event.

Another area of concern is that up to 75 per cent of personal income tax returns submitted by income tax professionals are revenue neutral, that is, the PAYE structure does its intended job. Coupled with the current backlogs and staffing issues evident at both the Australian Tax Office and accounting firms in general, streamlining the process is an issue to be considered. One option could be to allow PAYE taxpayers the option of not filing a tax return, on the basis that they would be revenue neutral.

Finding*: The system of self-assessment for income tax is in need of reform. It has brought about a clear shift in accountability and responsibility towards the taxpayer which, in some cases, the taxpayer cannot reasonably comply with. The increasingly complex income tax laws, and the threat of audit if taxpayers incorrectly complete their tax affairs, creates an uncertain environment.*

While the ATO's efforts to provide taxpayers with information in order to explain complicated tax law and its application are to be commended, this has not improved the system. If anything, the flood of additional information has complicated matters further.

International comparisons show Australia has a highly complex tax system, being ranked the third worst in 2007 out of the 20 largest economies in the world in terms of the volume of tax legislation according to the Joint Committee of Public Accounts and Audit. The two income tax acts are in need of urgent alignment and simplification. In an attempt to minimise tax avoidance, an over-complication of what should be clear rulings has led to the creation of loopholes, ultimately encouraging harmful tax minimisation.

***Finding**: The alignment and simplification of the two income tax acts represents a clear example of tax simplification that could be achieved, and should be pursued as a priority.*

Tax Administration Impact Statements

The Government should consider adopting measures in assessing the provisions of the Tax Act by introducing a Tax Administration Impact Statement (the TAIS) to be administered by the Inspector General of Taxation. [7]

This process would be similar in scope to the current RIS process, but with a focus on the impact of changes to legislation in terms of the administration of taxation.

This should include:

- surveys of the time and money that business spends on complying with the Tax Act;
- the introduction of 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;
- a requirement that quantitative estimates of compliance costs, based on detailed proposals for implementation and administration, be attached to any new tax proposal. Estimates should be based on consistent methodology in line with international best practice;
- regular reviews of the accuracy of compliance estimates in the TAIS for regulations with a major impact on business; and
- greater education, skill development, resources and priority within agencies. 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.

***Finding**: Any reforms to the tax system should focus on its current high level of complexity and aim to improve its efficiency and transparency. A consultative approach to reform would help ensure that future tax changes take into account the impact on taxpayers.*

The Australian Government should introduce a Taxation Administration Impact Statement in order to ensure that all relevant information is presented to decision makers when determining the impact of changes to legislation in terms of taxation compliance.

Personal Income Tax

The case for income tax reform is compelling as it affects almost all households and businesses. With an ageing population, labour will become an increasingly scarce resource. Personal income tax directly impacts on labour, and the nation's ability to attract suitable labour should be recognised as a determinant of the nation's economic success.

A major feature of Australia's income tax regime is its progressive nature, with taxes rising sharply with income. While this progressive income tax system contributes to the high level of income equality in Australia, a recent OECD report found that income equality is primarily achieved through target service delivery. Therefore the most effective way to enhance income equality is through means tested service delivery rather than through progressive income taxes.

An unfortunate consequence of Australia's progressive tax system is that it may encourage high-skilled persons to leave the country and discouraging others from entering Australia. This problem is becoming more significant as a result of the widespread labour shortages which are not only a national issue but a global phenomenon. According to the Business Council of Australia (BCA), the main economies competing with Australia for highly skilled workers typically have marginal tax rates at these income levels of around 40 per cent (taking account of national and sub-national taxes) with much lower average tax rates.[8] This means that as incomes rise in those countries into the levels typically paid for highly skilled workers, lower, more competitive marginal rates and less steeply rising average rates apply than in Australia.

High marginal tax rates undermine Australia's competitiveness as a location for high-value occupations and activities. In considering the importance of taxes on highly skilled workers, the ability of Australian businesses to attract skilled migrants and also to retain skilled workers in the Australian economy must be taken into account. Income and earnings are an important determinant influencing decisions about where to work and live in increasingly global labour markets.

A 2003 Committee for Economic Development of Australia (CEDA) research paper found that over one-third of respondents in a recent survey of Australians migrating to other countries cited higher incomes as an important factor influencing their decisions to leave Australia.[9] The reality is that many can earn significantly higher incomes overseas, and lower taxes make these incomes all the more attractive. While the cost of living may be higher in some cases, they still earn more than in Australia.

In order to assess how Australia's taxation system compares with other developed economies, the former Commonwealth Treasurer commissioned and subsequently released the report, *International Comparison of Australia's Taxes* in April 2006. The report found that Australia's top marginal tax rate (48.5 per cent at the time of publication) and the threshold to which the top marginal tax rate applies, is higher than the average top marginal tax rate across the OECD.[10]

In addition, the report found that at least three of the OECD nations (Canada, the Netherlands and the United States) automatically index their national personal income tax thresholds to inflation, with many other nations use some form of partial indexation. Australia does not.

In May 2006, the CEDA information paper, *Tax Cuts for Growth: The impact of marginal tax rates on Australia's labour supply*, suggested that cutting low marginal tax rates would be a more effective means of boosting labour supply than cuts to marginal tax rates for high income earners.[11] The paper argued that Australians facing the strongest disincentives to work are mostly on middle and lower incomes, and would therefore be the ones most likely to respond to incentives provided by tax cuts. This is primarily because of high effective marginal tax rates due to the interaction with welfare measures.

Measures to lower the marginal income tax rates and increase the thresholds at which the rates start to apply provide improved incentives to lift workforce participation.

Since the release of these studies, the Commonwealth has announced significant personal income tax cuts in the 2005-06, 2006-07, 2007-08 and 2008-09 Budgets, including cuts to the top two marginal tax rates, and increases in tax thresholds. These changes have seen the top marginal rate come down to 46.5 per cent for 2008-09, however this is still above the 2007 OECD average of 46.2 per cent, while the top personal tax threshold has been increased to $180,000.

Modelling undertaken by the Melbourne Institute of Applied Economic and Social Research estimated that the 2005-06 tax reforms would increase the labour supply by 52,100[12], and the 2006-07 tax reforms would increase the labour supply by a further 49,000 workers.[13]

While these changes are welcome developments, it is important that in an environment of global labour shortages, the Commonwealth ensure that Australia's income tax system does not act as a disincentive to people moving to Australia to take up job opportunities, nor result in an increasing flow of people from Australia to other countries with more generous taxation regimes.

A long term goal to cut the top marginal tax rate over time to equal the company tax rate of 30 per cent and for the thresholds to be indexed to inflation should be pursued, not only on the basis of broad tax design principles, but to ensure Australia's tax system is internationally competitive.

The existence of a gap between personal and corporate tax rates also gives rise to tax avoidance. Any reforms to personal income tax should therefore aim to reduce the top marginal rate to the 30 per cent corporate rate.

The personal income tax system also suffers from bracket creep. This problem has worsened in recent years as tight labour markets induce strong wages growth, something which is most obvious in Western Australia. It would be prudent to ensure bracket creep is eliminated via the indexation of taxation thresholds to wages growth, while at the same time seek to reduce the number of tax thresholds. Indexation would be consistent with the promotion of international competitiveness as many of the OECD-10 comparison countries use partial or full indexation of personal tax thresholds.

Finding: *In order to ensure Australia's taxation system remains internationally competitive and encourages greater labour force participation, a long term goal should be to cut the top marginal tax rate to equal the company tax rate of 30 per cent and for thresholds to be indexed to inflation.*

Effective Marginal Tax Rates (EMTR)

Where people receive family payments and face tax on their earnings, the incentives they face are a function not just of the tax they pay but also of the rate at which family payments are "clawed back" from them as their earnings rise. The EMTR is the sum of these effects, and measures the extent to which people benefit from additional exertion at work.[14] Where a tax rate of 15 per cent is combined with a reduction in their family payments of 50 cents in the dollar, this means that their EMTR is 65 per cent.

While high income earners face a marginal tax rate of 46.5 per cent, there is also a substantial number of families on middle and lower incomes which face higher EMTRs. Because of the highly targeted nature of Australia's welfare system, benefits are clawed back from families as means tests cut in. Once earnings rise over the tax free threshold, the combined effect of tax and the withdrawal of benefits often produced EMTR of 60 per cent or more, thereby acting as a significant constraint on labour supply.[15]

A high EMTR can mean that, looking at financial benefits alone, for some it is simply not worth entering the workforce, or working longer hours because the combination of their loss of benefit and/or greater income tax liability diminishes the increase in income they receive from an increase in earnings. This can create "poverty traps", locking families into a situation where it is difficult for them to increase their incomes.

Certain groups are more likely to experience high EMTRs – particularly lower income earners, people with dependent children, and married mothers.

Considering the critical labour shortages being experienced in WA, addressing high EMTRs is critical.

Lowering the nation's high marginal tax rates would also have a positive impact on the decision of primary income earners to work over-time as a lower tax rate is not likely to impact as much on a decision to work on a weekend. This phenomena has been well documented with the labour market experience in Australia, the US and Europe consistent with taxation being an important determinant of the decision to work.[16]

***Finding**: It is critical that high EMTRs be addressed to enhance workforce engagement. Further analysis of both income tax scales and the taper rates at which welfare benefits (such as NewStart Allowances and Family Tax Benefits) are withdrawn should be undertaken to address high EMTRs and thereby maximise the incentives to move from income support payments to increased participation in paid work.*

Capital Gains Tax

Capital Gains Tax (CGT) remains one of the specific Federal taxes of greatest concern for business. It has been consistently argued that Australia imposes high rates of taxation on its capital. Based on the *International Comparison of Australia's Taxes Report* (2006) and *Architecture of Australia's Tax and Transfer Systems* (2008), Australia's CGT regime is uncompetitive. 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. Australia imposes the highest withholding tax on interest earned from ordinary bank accounts and the third highest CGT on shares.

Capital is very mobile internationally and relatively high tax rates on capital create the disincentive to capital investment in Australia. High tax on capital also discourages the retention of earnings, which means lower corporate saving and investment.

Significant taxes on investment ultimately limit the nation's potential for productivity and innovation improvements. If tax reform is to focus on investment and the promotion of efficient resource allocation to enhance both productivity and international competitiveness, capital gains tax should be revisited.

Australia is clearly uncompetitive on capital gains tax and while reforms in 1999 substantially reduced the capital gains tax burden, other countries continue to implement capital gains tax reforms to attract greater investment. In addition, the need for record keeping is costly for older, well established business.

One key aspect of this tax which is in need of reform is its complexity. To illustrate, the small business concessions introduced in 1999, while substantial, replaced the original 50 per cent goodwill exemption of 1985 with four different concessions. And while not arguing against small business concessions, the most efficient way to further reduce capital gains tax on small business is to reduce the burden of capital gains tax more generally.

Capital gains tax decreases the efficiency of markets as it has a "lock-in" effect which discourages assets to be sold, decreasing asset turnover and hence liquidity.

Capital gains tax impedes economic growth and productivity by creating clear disincentives for people to save and invest. Reducing capital gains tax and therefore the cost of realising capital gains will see the Government increase both the number of transactions and revenue, as increasing market efficiency more than offsets the reduced revenue from a capital gains tax reduction.

A reduction in the level of capital gains taxation should be considered as a part of any reforms to the nation's tax system. In the long run, reducing the tax on capital will have a positive impact on all four of the Review's key focus areas.

A possible improvement on the capital gains tax would involve introducing a stepped rate tax similar to the system introduced in the UK, where the proportion of the capital gains that is taxed diminishes over time. This would act as an incentive to hold assets longer and reduce the amount of speculation taking place.

Similar to the UK system that was introduced in 1998, a possible stepped rate schedule for Australia would exempt a certain proportion of capital gains based on the number of years an asset is held. The net capital gains would then be taxed at the taxpayer's marginal tax rate.

For example, a business held for less than one year would pay the full capital gains tax, a business held for 1 to 2 years would receive a 50 per cent exemption, a business held for between 2 and 5 years would only pay capital gains tax on 25 per cent of the capital, while a business held for more than ten years would not be liable for any capital gains tax. This would eliminate the costs and complexities associated with record keeping.

***Finding**: If Australia is to be internationally competitive, reforms to capital gains tax must be considered in order to remove the disincentive to investment and encourage taxpayers to hold onto assets for longer periods.*

Fringe Benefits Tax

After its initial introduction in 1986 to bring non-salary benefits paid to workers by their employers into the income tax stream, Fringe Benefits Tax (FBT) has been extended well beyond its original purpose and has substantially added to the cost of doing business. As a result, it now encompasses legitimate business expenses rather than fringe benefits to employees.

Research indicates FBT is inappropriately adding to the cost of doing business and is plagued by compliance issues, adding the most of any tax to the total costs of compliance. Moreover, compliance costs are disproportionately borne by small business.

Any reforms to FBT would look to apply simple and sensible FBT rules to minimise the confusion and frustration it is causing small business. Improvements in this regard would be consistent with the Review's focus on investment and enhancing international competitiveness, as well as reducing tax system complexity and compliance costs.

The application of FBT to the employee, as all other income is treated, with collection from the employers in the same manner as PAYG, would go some way to minimising the confusion and excess compliance costs which are currently impacting business.

A key reform to FBT would also involve the treatment of childcare. CCI strongly supports the concept of increasing workforce participation, which is consistent with one of the Review's key focus areas, by looking at extending the FBT exemption on childcare. CCI research[17] shows that making the cost of childcare able to be salary sacrificed would help increase female participation rates.

Current FBT rules only allow childcare to businesses where child care facilities are provided at their business location, while discriminating against employees whose employers do not provide on site child care. This requirement should be removed. Further, childcare expenses should be made fully tax deductible where the expenses relate to deriving an income.

Offering families a tax deduction would acknowledge child care as a legitimate cost of working, and would align government expenditure in this area more closely with workforce participation outcomes. This is consistent with OECD recommendations that Australia's child care assistance be made conditional on employment.

By giving a benefit proportional to the marginal tax rate of the worker, a tax deduction would actually give an incentive for increased participation in the workforce, as it would reward parents by returning to them some of their income which would otherwise go to government revenue.

***Finding**: Reform to fringe benefits tax (FBT) should aim to minimise the confusion and compliance costs imposed on business. This can be done by applying FBT to the employee in the same way as all other income is treated.*

An important change to FBT is in relation to the treatment of child care, allowing it to be salary sacrificed, in the same way that salary sacrificing is allowed for motor vehicles, superannuation and computers, none of which require a business premises test or indeed any other test except that they are work related. That would encourage greater workforce participation, particularly by females

State Tax Reform

Capacity for Broader Tax Reform

While State Governments play a limited role in economic management at a macroeconomic level, their influence at a microeconomic level can be significant. State Governments play a role in encouraging competition; ensuring a regulatory environment that encourages growth and development; providing the necessary social and economic infrastructure; providing public goods; and ensuring that taxation revenues are adequate and minimise the overall effect on the economy.

State taxation issues are amongst the most important of the tax issues facing business. While State taxation remains an area where important developments can be made to produce a more efficient and equitable tax regime, the ability to deliver meaningful reform is limited by the inherent problems associated with Commonwealth-State financial arrangements. In particular, the States' limited capacity to raise revenue and its high dependence on grants from the national government means the States are reluctant to undertake significant reforms to State taxes, particularly if the reforms reduce their revenue base.

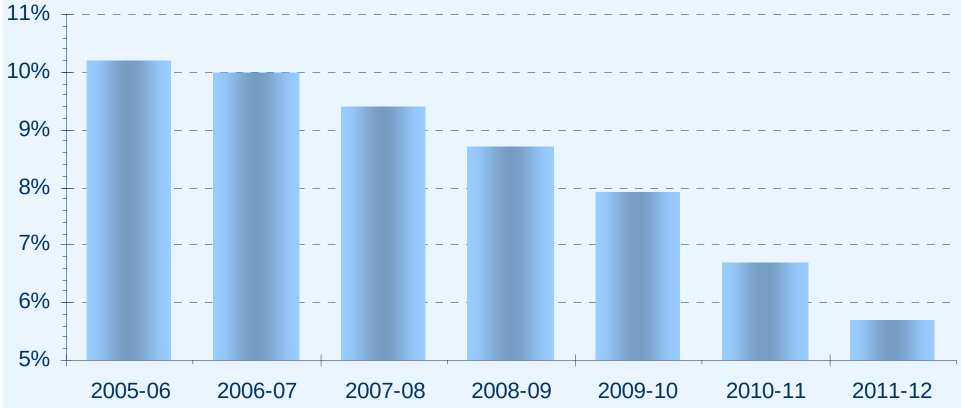
This is why State Governments have refused to abolish stamp duty on non-residential conveyances, which was originally anticipated would be abolished as part of the GST agreement, much to the disappointment of the previous Commonwealth Government and the business community.

This is not to say that States have not been willing to reform their tax system. While CCI was critical of the high tax rates imposed by the previous WA Government , it did welcome a number of key reforms that it undertook, including the introduction of a single rate of payroll tax and the rewrite of the stamp duty legislation to simplify the regime and accommodate modern business practices.

While State Governments have endeavoured to achieve reforms to their existing tax bases, they still remain reliant on a narrow set of inefficient taxes. Further limiting their reform agenda has been the absence of any controls on general government spending, which in WA's case has been growing at unsustainable levels in recent years.

The excessive growth in recurrent government expenses has been a long term problem in Western Australia and CCI has been disappointed at the failure of successive WA governments to meet their expenditure targets to the extent that it requires taxes to remain high.

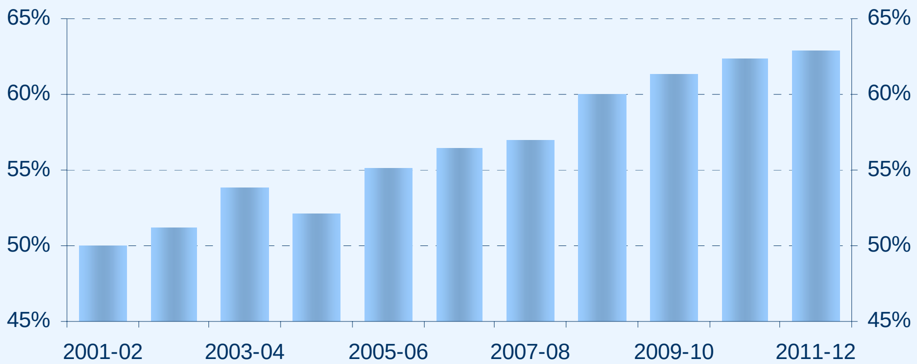
Figure 4
Horizontal Fiscal Equalisation
WA's Expected Share of the GST Pool



Source: Department of Treasury and Finance 2008-09 PFPS

In WA's case, the ability of the State Government to deliver meaningful tax reforms is further limited because of its declining share of the GST pool, which is expected to fall from around 10 per cent (its population share) in 2005-06, down to 5.7 per cent by 2011-12 (Figure 4). As a result, its reliance on its own source revenue will increase further, from 55 per cent in 2005-06 up to an expected 62 per cent in 2011-12 (Figure 5).

Figure 5
WA Own Source Revenue a Percent of Total Revenue
2001-02 to 2011-12



Source: State Budget Papers

***Finding**: State tax reform is the area where the most significant reform can be achieved. While the ability to deliver meaningful reform is limited by the inherent problems associated with Commonwealth-State financial arrangements, State Governments retain the capacity to reform their tax systems, while maintaining control over their spending programs also provides the opportunity for genuine tax relief to be delivered.*

Opportunities for Reform

Tax Simplification

Little uniformity applies in the application of many taxes across the States. At the same time, the duties applied at the State level are inherently complex, with various scales and rates applying depending on the tax. For WA, this is obvious in three of its largest tax revenue sources, with their numerous scales making the taxes overly complex, and also exposes taxpayers to higher levels of taxation because of the effects of bracket creep.

In relation to conveyance duty, there are five thresholds in WA, ranging from an initial marginal tax rate of 1.9 per cent on residential property valued at less than $80,000, increasing up to a rate of 5.15 per cent on properties purchased over $500,000. Recent changes in the 2008-09 Budget have, however, introduced additional complications by introducing differential scales for residential and non-residential property.

Despite the thresholds being increased in the 2008-09 Budget, the fact they had been unchanged since 1981 means these recent changes have done little to address bracket creep. The median priced Perth home still falls in the second top threshold, with relatively few properties falling within the lowest three threshold rates of little use.

Land tax in WA is applied at a progressive six rate scale. While a key reform from the *2001 Review of State Business Taxes* saw the number of land tax scales reduced from 10 to six, the ultimate goal should be for a single rate of land tax on all taxable property. Such a move would make the tax system fairer and simpler.

Western Australia is also the only State to apply an additional tax on the unimproved value of land which is both liable for land tax and located within the boundaries of the metropolitan region. The Metropolitan Region Improvement Tax (MRIT) is a small "nuisance" tax which could be abolished without impacting considerably on the budget position.

Despite recent increases in motor vehicle duty thresholds, WA still remains uncompetitive compared to the rest of Australia given its very high rates of duty. Moreover, the system applies different rates of duty based on the value and type of the motor vehicle. This system would benefit enormously from simplification.

While the complexities within the WA motor vehicle duty regime dealing with heavy vehicles have been addressed with the extension of the single flat 3 per cent rate for heavy vehicles to used heavy vehicles, there is still the inequity of different rates for heavy vehicles and other vehicles (which are subject to stamp duty of between 2.75 per cent and 6.5 per cent).

A good policy approach would see a flat rate of stamp duty re-introduced (prior to 1 July 1999 a flat rate three per cent scale applied), which would remove distortions currently in existence.

***Finding**: The existence of multiple rate scales for conveyance duty, land tax and motor vehicle duty increase the complexity of these taxes, and introduces the problems associated with bracket creep. Sound tax policy would see multiple rate scales simplified and indexed to a reasonable measure of price changes.*

As a policy principle, exemptions and concessions from certain taxes should be kept to a minimum due to the economic distortions they can create. Exemptions narrow the tax base, reduce the number of taxpayers and, in doing so, forego potential tax revenue.

However, exemptions and concessions are valid in some cases, such as when the revenue foregone is less than the administration and compliance costs that would been incurred if the exemption did not apply (eg. payroll tax exemption threshold for small business). There are also different policy approaches across the States which further complicates tax compliance for business.

***Finding**: The application of concessions and exemptions has further complicated an already complex State tax system. Tax concessions and exemptions should be reviewed and where possible be kept to a minimum.*

Payroll Tax

The case for cutting payroll tax is based on the need to improve WA's national and international business tax competitiveness.

CCI has consistently argued that payroll tax represents a major cost of doing business. Payroll tax has the greatest impact on business activity, and is consistently regarded as the most undesirable tax from a business perspective.

As a tax on employment, the abolition of payroll tax would remove the disincentive to hire more staff and be in line with the Review's key focus on workforce participation, while also enhancing international competitiveness.

The abolition of payroll tax remains a key long-term tax policy objective for CCI. However, its abolition might not be feasible until State Governments can find an alternative source of revenue or maintains a sustained period of constraint in expenses growth.

At a national level, a recent survey undertaken by the Australian Chamber of Commerce and Industry, found that 75 per cent of businesses surveyed said payroll tax was the tax most in need of reform.[18] In particular, business was most concerned with the level of payroll tax and the pressure this tax is placing on struggling small and medium businesses. This is consistent with surveys that have been conducted by CCI in recent years.

While CCI has long argued for cuts to the payroll tax rate over increases in the exemption threshold, the extent of bracket creep suggests that this is also an important reform objective so that genuine small businesses continue to be exempt from payroll tax.

Whilst not specifically identified, the exemption threshold was established to ensure that genuine small businesses are exempt from paying payroll tax. However, given significant wages pressures and buoyant economic conditions in the State, many businesses find themselves growing to the point where payroll tax becomes an imposition on expansion plans.

Based on latest earnings data, a business in Western Australia would only be able to employ 10 full-time workers on average wages of $69,000 a year before being liable for payroll tax.

The ABS defines a small business to be one employing between one and 19 persons. The number of small businesses now liable for payroll tax is clearly on the increase in WA. In 2003 (when the $750,000 payroll tax exemption threshold came into force) a business could employ 15 workers on average wages before being liable for payroll tax.

Based on average weekly earnings, the exemption threshold would need to increase considerably, to $1.4 million, and be indexed thereafter to ensure that all small businesses are exempt from payroll tax.

Since the transfer of payroll tax from the Commonwealth to the States in 1971, different payroll tax regimes have evolved in each jurisdiction. For businesses that employ staff in different jurisdictions, this has made payroll tax compliance complex and difficult. It also acts to decrease the abilities of businesses to expand across Australia and reduces the abilities to obtain economies of scale.

Given the normal evolution of taxing legislation there have been many changes made over time and, unfortunately, not all the changes have taken the same policy approach. It is because of this that taxpayers who have a liability in multiple jurisdictions experience high payroll tax compliance costs.

If a more consistent approach to policy were adopted, this would provide a greater degree of certainty for taxpayers as well as the revenue authorities to the extent that there is appropriate compliance with the legislation and thus reduce their own taxpayer audit costs.

The variances that arise between jurisdictions are often in relation to relatively minor items which are usually considered to be "wages". It is not clear why such differentiation is required in each jurisdiction when it is unlikely to impact on the revenue base in any significant manner.

Inconsistencies in the payroll tax base between the States is therefore a key area for reform. This area is important for businesses either currently operating in, or looking to expand their operations to, other States. Interstate consistency in the administration of payroll tax is worth pursuing and would be consistent with the Review's key focus on reducing tax system complexity and compliance costs, while also promoting investment and economic growth.

The payroll tax harmonisation measures currently being coordinated across all States are seen as a step in the right direction.

Finding: *Payroll tax is a tax on employment and a major cost on business. The objective should be to see this tax abolished over time. In the meantime, the application of an exemption threshold must be indexed to ensure that bracket creep does not expand the tax base to include small businesses that would otherwise be exempt.*

The States should continue to implement harmonisation measures to minimise compliance costs for businesses operating across Australia.

Stamp Duty

Stamp duty is one of the most inefficient taxes in Australia's taxation system. In the case of stamp duty on property (conveyance duty), this transactions-based tax acts as a disincentive to transfer ownership, and impacts more heavily on properties with high turnover rates.

As a turnover tax, those properties that are subject to a higher turnover are likely to be more heavily taxed than those that do not turnover as frequently. This is likely to impede the efficient flow of resources since, for example, a property may well earn a higher return as a hairdressing salon rather than a corner deli but the tax on transfer of the property may prohibit or delay the transfer of the resource.

As a tax paid by the purchaser of property, this creates a disincentive to purchase which may well be reflected in the actual sale price (the impact may well be different to the incidence).

The abolition of stamp duty would represent a worthwhile reform to Australia's taxation system and in the case of conveyance duty, would not act as a disincentive to property transfers. However, it is recognised that in the absence of another source of revenue, its future abolition is unlikely.

In the absence of its abolition, there are opportunities for reforms to the system. In this regard, CCI welcomed the replacement of the current *Stamp Act 1921*, with the *Duties Act 2008*. This move represented a significant and worthwhile reform to the State taxation system as it better accommodates modern commercial practices, and does so in a way that makes it far easier to understand possible stamp duty obligations, thereby reducing compliance costs for taxpayers and facilitating more efficient administration. Importantly, the *Duties Act 2008*, reduced the size of stamp duty legislation by more than half.

In line with key taxation principles, the reforms introduced with the *Duties Act 2008* have improved the equity, efficiency, transparency and competitiveness of WA's stamp duty regime.

The process by which such a reform was introduced is also a sound model for future tax initiatives, as it involved a high degree of consultation with key stakeholders.

While the reforms to the stamp duty regime in Western Australia were supported, some of the benefits of simplicity and efficiency associated with that were unwound when the then Government advanced two separate stamp duty scales, for residential and commercial properties.

CCI believes there is a compelling case for conveyance duty thresholds to be indexed to address bracket creep and impose an additional fiscal discipline on State Governments.

Such conveyance duty reforms are also important insofar as it will help to address the home affordability crisis in WA, a key objective of this Review. Addressing home affordability has become one of the most pressing issues facing WA and if not addressed as a matter of urgency, has the potential to significantly undermine the capacity to attract people to a State that has critical labour shortages.

***Finding**: Conveyance duty is an inefficient transactions based tax which creates disincentives to make property transactions. Its longer term abolition should be considered as part of any broader reform agenda for Australia's taxation system, provided that the issues associated with vertical-fiscal imbalance can be addressed.*

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Endnotes

[1] These issues have been summarised from James (1992).

[2] Commonwealth Grants Commission (2005), p. 5.

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