MINERALS COUNCIL OF AUSTRALIA
HENRY TAX REVIEW

NOVEMBER 2008

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EXECUTIVE SUMMARY

The Minerals Council of Australia (MCA) has prepared this submission to the Review of Australia's Future Tax System (the Henry Review) as an initial framework setting, principles-focussed, contribution to the Review Panel's deliberations.

The MCA has given particular attention to the stated objectives of the Henry Review. The primary focus of this submission is on high-level design issues, with indications of the MCA's preferred directions for change based on improving the efficiency, simplicity and fairness of Australia's tax system across all levels of government.

It is noted by the MCA that the indirect tax most appropriate to reform would be the GST, particularly in relation to a base broadening, but also in relation to possible rate increases. However it is noted that both of these worthwhile reforms are currently out of scope for the Henry Tax Review, and so the MCA has not commented further on them.

The MCA may wish to present additional detailed submissions on specific areas of reform depending upon the findings presented in the Consultation Paper[1] released by the Review Panel.

Problems with the current tax and transfer system: some general observations

In the MCA's opinion, at the broadest level, the problems with Australia's current tax and transfer system can be summarised as follows:

- ***Uncoordinated, overlapping and often-inefficient tax bases***. The current tax system inconsistently utilises a variety of tax bases: income, expenditure, consumption, turnover, asset values, specific products, etc. The utilisation of these uncoordinated tax bases can often result in anomalies, inefficiency and complexity.
- ***Inconsistent tax bases*** Tax bases under the current tax system are rarely comprehensive and include inconsistencies such as taxing business inputs.
- ***Non-uniform tax rate structures***. The rate structures applied to the relevant tax bases are also rarely uniform. Non-uniformity usually means rising rate scales and intensifying disincentive effects at the margin.
- ***Effective Marginal Tax Rate (EMTR) disincentives***. The tax-transfer interface has grown in an uncoordinated, ad hoc way, resulting in high EMTRs.
- ***High complexity, and high administrative and compliance costs***. The sheer complexity of Australia's tax and transfer system results in an inappropriately disproportionate resource diversion to administration and compliance.

Accordingly, root and branch reform starting from the 'big picture' and covering all elements, is necessary.

Reforms needed to address these problems: a 'big picture' view

On the basis of the foregoing summary of the current problems with Australia's tax and transfer system and in light of the major challenges the MCA sees confronting Australia in the period ahead, the following general reform framework is proposed:

[1] Review Panel press release No. 2008/01, 19 August 2008, *Tax review calls for submissions and sets out consultation process*, paragraph six.

I. ***Determine which tax bases should be used for the tax and transfer system*, *and move as quickly as possible to discard the rest*.**

II. ***Make those tax bases as comprehensive as possible and remove taxes on business inputs*.**

III. ***Make the tax rate structures applied to those tax bases as uniform as possible*.**

IV. ***Allocate the Government tax revenue via a new Intergovernmental Agreement (IGA) between Commonwealth, state and local government levels in a way that more closely reflects the spending responsibilities of each level of government*.**

Specific areas for reform

More specific areas for tax reform advocated by the MCA, include the following:

- **Mining royalties** – the MCA advocates for a further debate on appropriate changes to the State based royalty systems, particularly around the appropriateness of profit based royalty schemes. However, such debate, and any future policy changes that may flow therefrom, will need to be prospective in nature to reduce significant sovereign risk concerns. That is, the existing royalty systems should be allowed to continue to apply to existing projects, with any revised system only applying to new projects for which an analysis of the implications of the new system can be factored into the investment decision for the projects. The MCA wishes to work closely with the Henry Tax Review in relation to these matters.

- **Corporate Tax Rate** – the existing 30% corporate tax rate should be decreased to restore Australia's competitive position on this "headline" rate and so contribute to stronger growth and increased productivity.

- **Capital Expenditures** – a 20 year cap on the tax depreciation lives of long lived assets should be introduced.

- **Tax Consolidation Regime** – the tax consolidation regime should be reformed on a prospective basis to implement a pure 'asset based model'.

- **Commonwealth Customs Duties** - the existing systems to give effect to duty-free imports are unwieldy and inefficient and should be reformed.

- **Stamp Duties** – on business conveyancing and on the transfer of shares in land rich companies should be abolished.

- **High EMTRs** – a review should be undertaken of the most efficient and effective ways to reduce the existing high EMTRs, to encourage further workforce participation.

- **Indigenous Tax Reforms** – there are a range of problems with the way that the existing tax system applies to the interactions between mining companies and indigenous groups. A number of possible reforms are recommended.

- **Tax Policy Development** - The MCA advocates for the scope of the existing Board of Taxation to be formally and statutorily expanded so that it has a role in the provision of formal input into the Australian Government and Federal Treasury on all material tax policy developments in Australia.

- **Reducing Tax Complexity**: there is a need for greater tax system simplicity. A range of possible ways of achieving this are discussed, including: increased use of audited financial statements to prepare tax returns, a consolidation of the existing Commonwealth tax legislation into one main Act, harmonisation of a range of State Tax Acts, and the possibility of a single revenue collection agency in Australia.

Each of these matters is discussed in more detail in the body of this submission, on a without prejudice basis in respect to any specific position put by the MCA in the past or future on existing taxation law and its administration.

1. ABOUT THE MCA

The MCA is the peak industry organisation representing Australia's exploration, mining and minerals processing industry nationally and internationally in its contribution to sustainable development. The MCA's strategic objective is to advocate public policy and operational practice for a world-class industry that is safe, profitable, innovative, environmentally and socially responsible and attuned to its communities' needs and expectations.

The industry is well placed to contribute to the tax reform debate. MCA members account for 85 per cent of the minerals extraction and processing industry in Australia. The sector makes up 8 per cent of the economy and 42 per cent of the nation's exports. It employees approximately 340,000 people, directly and in related industries, mostly in regional Australia.

The minerals sector's contribution to taxation revenues is substantial. In 2006/7 it accounted for approximately $9.7 billion of Federal and State taxes and charges, up from $8.8 billion the year before, and that contribution has risen markedly over the past 18 months. Payments in royalties to the States have risen from $3.6 billion in 2006/7 to an estimated $7.4 billion this financial year according to State Budget papers (an increase of 86 per cent by July 2009).

Work commissioned by Access Economics for the MCA examining the mining sectors contribution to both State and Federal Budgets shows tax and other revenues (direct and indirect, corporate and individual) are accelerating. The total tax paid by companies (in royalties, income tax, payroll tax and fringe benefits tax) and individuals working in the mining sector is expected to be $18.489 billion in 2008/9. This is a 49 per cent rise over the previous financial year ($12.443 billion). The 2007/8 result was 9 per cent higher than 2006/7 ($11.370 billion) which in turn was 10 per cent higher than 2005/6 ($10.344 billion). From 2005/6 to 2008/9 this is an increase of 79 per cent. Access Economics projections on royalties income – calculated using global demand scenarios in October 2008 – suggest payments will rise at least 70 per cent in 2008/9.

2. MINING INDUSTRY CONCERNS

The mining industry is a capital intensive, globally mobile, technologically intensive, competitive industry.

It is characterised by often very large exploration outlays, longer term capital investment (including in infrastructure) and volatile market conditions. Market risk can be high. 'Sovereign risk' can be a major additional concern. Indeed, actual and perceived 'sovereign risk' has increased in Australia as a result of some recent decisions by governments.

For these reasons, *investment certainty* is a requisite feature of the mining industry's investment environment. As a major contributor to the nation's economic growth and budgetary stability, the mining industry looks to governments to understand these concerns and foster predictable policy climates for investment.

Concern about policy risks is not an argument that policy should never change. Rather the MCA argues that:

- Retrospective disadvantage to the industry from tax and other policy changes should not occur.
- As far as possible reforms should promote broad bases and the lowest possible tax rates applied to those bases.

In the light of the discussion above, the MCA notes that the Review has some important questions to consider.

3. FOCUS OF SUBMISSION

The MCA has prepared this submission to the Henry Review as an initial framework setting, principles-focussed, contribution to the Review Panel's deliberations.

The MCA may wish to present additional detailed submissions on specific areas of reform depending upon the findings presented in the Consultation Paper[2] released by the Review Panel.

Accordingly, the focus of the initial part of this submission is primarily on high-level design issues, with indications of the MCA's preferred directions for change based on improving the efficiency, simplicity and fairness of Australia's tax system across all levels of government. This submission also addresses in more detail some specific areas that the MCA considers are appropriate for reform.

4. CRITERIA FOR 'GOOD' TAX DESIGN

Public finance policymakers – if not others – make judgements about the adequacy or otherwise of taxes, and tax systems, using three criteria: economic efficiency, equity, and simplicity. These three criteria encapsulate the key areas through which people and businesses can be affected and are an accepted part of tax policy debates around the world.

These three criteria are discussed in more detail in Appendix 1.

4.1 Balancing the key principles

To some extent but not completely, these principles are inconsistent. For example:

- a single-minded effort to ensure an economically efficient tax system might end up being inequitable (eg, in the vertical equity sense). Replacing personal income tax with a fixed lump-sum tax on all taxpayers, regardless of their incomes, might make the tax system less distorting, but at the expense of broad-based violation of the equity principle;
- an alternative approach to efficiency, the so-called 'optimal taxation' approach, might require a large number of different tax rates on individuals and products, depending upon their particular sensitivities to the imposition of tax. This might be both unfair ('necessities' might be taxed more than 'luxuries') and require an extremely complex tax structure, violating the simplicity principle; and
- pushing too far to promote equity may generate large efficiency costs. For example, an extremely progressive personal income tax, with a top marginal rate of, say, 90%, is likely to induce large changes in taxpayer behaviour, with strong incentives to avoid and evade tax (including by taking up residence in another country).

A *balancing* of these three principles therefore is needed for a workable tax system. *There is no objective basis by which this balancing can be determined.* Some will assign a high weighting to equity principles. Others will effectively assign a higher weighting to efficiency criteria. So, even if people agree precisely on the meaning of efficiency, equity, and simplicity, there is still plenty of scope for argument about the appropriate *balance* between the three.

2 Review Panel press release No. 2008/01, 19 August 2008, *Tax review calls for submissions and sets out consultation process*, paragraph six.

4.2 Practical tax design features: broad, stable growth base, low uniform tax rate

For any given revenue target it might be possible to get fairly wide agreement on two very general tax design features that should dominate the tax system:

- The first is that the *tax base* should be as *comprehensive* as possible.
- The second is that the *tax rate structure* applied to the tax base should be as *uniform* as possible.

What are the advantages of these design features?

- Broad tax bases allow low average tax rates for any given revenue target.
- Low uniform tax rates themselves are more efficient, implying lower distorting effects, both absolutely and as between different products/activities/investments.
- A broad tax base means fewer revenue leakages, implying a fairer (i.e., more even-handed or horizontally equitable) and more efficient revenue-raising system.
- A broad tax base/uniform rate structure is simpler to administer and with which to comply..

So a broad tax base/low uniform tax rate system scores highly in terms of simplicity, effective revenue-raising, and horizontal equity. It also scores highly in terms of *neutrality*. In general, such a tax system minimises any influence on consumer choice, investment vehicle for savings, etc. This is not to say that important distortions do not remain. But the low rate feature minimises even these.

Where the focus is on *indirect* taxes (ie, taxes on products or transactions, rather than incomes), these tax design principles suggest additional evaluation criteria:

- As far as possible, business inputs should not be taxed: efficient tax systems would place the tax burden on final demand, not intermediate demand.
- Taxes should not be levied on other taxes: that generates multiple effective tax rates and associated distortions, undermining efficiency, equity and simplicity.

These design principles are well known and widely accepted – in theory. In many cases, they are as well known, in practice, in the breach as in the observance.

More importantly, in the context of the Henry Review, these principles need some sharpening or re-weighting to address the challenges and problems intended to frame the Review Panel's deliberations.

The next section of this submission considers these 'big picture' issues.

5. 'BIG PICTURE' TAX ISSUES

This section of the MCA's submission provides some general observations in response to each of the 'framing questions' posed in the Review Panel's 19 August 2008 press release.

5.1 Major challenges facing Australia

In the MCA's opinion, at the highest level of generality, the major challenges facing Australia include the following four issues:

I. **The Development of the BRIC Economies**: Externally, and taking short-, medium- and longer-term perspectives, the focus of economic activity is shifting away from North America, Western Europe and Japan to the BRICs – Brazil, Russia, India and China (especially the last two countries) as well as to other parts of Asia and South America. The population forces behind the strong growth in China and India, in particular, imply strong growth momentum has shifted closer to Australia, reducing the 'tyranny of distance', and playing to Australia's resource endowments and comparative trade advantage.

- This provides strong ***opportunities*** for Australia in terms of export-driven growth and higher living standards, including via strong terms of trade.
- But it provides ***capacity and competitive challenges*** as well. By way of example, Access Economics, in its work for the MCA's Vision 2020 Project estimates that the lost opportunity from export infrastructure bottlenecks over the five years to 2007 was as high as $17 billion or 1.6 per cent of nominal national income
- This challenge is not just cyclical. Potentially, it is likely to be longer-term in nature. Despite the current financial crisis it is still expected that the world demand for commodities will continue to grow rapidly over the coming decade as it has since 2002. Yet Australia lost market share from 2002 to 2007 just as that demand accelerated. Capital investment by firms is likely to improve the national performance in the five years from 2007 to 2013, again according to the Access Economics study. Yet the combination of increasing demand and international competition will be enormous with Access estimating that production of coal and iron ore will have to increase by **three times** as much as they have from 2002 and 2007 just to maintain Australia's market share through to 2020. It should be noted that coal and iron ore make up half of all minerals exports. Minerals exports make up 40 per cent of the nation's exports.
- Current financial market pressures emanating from the USA-sourced 'sub-prime' crisis have spread from those markets to real markets. 'Wall Street' contagion is threatening 'Main Street' stability. These forces, and proposed remedies, are injecting near-term uncertainty into the world economy, and threaten Western economy recession and developing economy growth slowdowns. Hopefully, these pressures are more cyclical, but the long build up of asset price inflation may require a longish adjustment period as these imbalances are unwound via de-leveraging. During this period, a lack of confidence about earnings and asset price prospects could dampen financial market, investment and consumer confidence. Confidence is an important lubricant for modern (especially developed) economies.

II. **An Ageing Population**: Internally, (but as a feature also of other higher income economies) Australia faces another medium- to longer-term problem: population ageing and an increased population dependency ratio. This is a slowly building, but inexorable, challenge. It has been well documented already. It has critical implications for Australia in terms of productivity, workforce participation and intergenerational equity.

III. **An Efficient Allocation of Resources**: Internally, Australia faces a resource management/allocation problem. Nowhere is this more important or serious than in the pricing and property rights associated with water. Other resources, such as old-growth forests, marine resource stocks, and soil depth and quality, are also under threat, and in some cases the threats are neither well measured nor (as a result) well monitored. In relation to water scarcity, this is particularly evident in the south, and nowhere more so than in the southeast, concentrated on the Murray-Darling basin. Better signals, both to encourage less demand and more efficient supply (both urban and rural) are long overdue. This and other such problems also draw attention to an institutional problem with which the Henry Review must grapple: different levels of government, different responsibilities of each level, and different financial situations of each level. In turn, these draw attention to the failure, even post-National Competition Policy, to secure a truly national market where that is needed to deliver efficient resource allocation. That challenge is (still) firmly on the COAG agenda.

IV. **Climate Change**: Both externally and internally, climate change is widely regarded as both a serious and inherently intractable problem. Is this relevant to the Henry Review? The short answer is 'yes' – see paragraph 3.6 in the Review's Terms of Reference. The longer answer is also 'yes'. The roadblock to dealing with this problem is 'market failure', private and public sector, national and global. Any solution must involve (cooperative) government action both nationally and internationally, and tax-like instruments will be important in broad-based policy responses.

How can design features of the tax-transfer system help deal with these really ‘big picture’ problems?

5.2 Tax And transfer system features needed to respond to these challenges

The appropriate responses to these challenges cannot be confined to Australia’s tax and transfer system. But the tax and transfer system can and should play an important role in Australia’s response.

There is a common response that is needed in respect of all four challenges noted above:

- In relation to the first challenge (Development of the BRIC Economies), efficiency and flexibility/mobility of resource use is crucial. This means, in general, allowing market-generated price signals to be felt, and removing impediments to demand and supply responses to those signals. These requirements are needed to optimise productivity and to enhance workforce participation (as well as fostering labour mobility and flexibility). Signals fostering strong saving and investment are also needed to boost capacity over time to meet strong demand growth.
- In relation to the second challenge (Ageing Population), again, ensuring strong (price) signals favouring productivity growth and increased workforce participation are crucial. At the very least, anything blunting such signals should be removed. At the margin, some gains may be had via changes in net immigration, but if sustainable growth in *living standards* is the ‘main game’, then applying more resources, more productively, should be the main response.
- The role of the price mechanism, and removal of impediments to demand and supply-side responses to prices, is an obvious response to the third challenge (the Efficient Allocation of Resources). Long standing institutional and *government* governance impediments are the structural problem here. The roles and financing of different levels of government is a central issue.
- In addressing the forth challenge (Climate Change) Australia must ‘do its bit’ to have credibility in international negotiations towards a truly global policy response. At the same time the nation’s volume of emissions are small as a proportion of global emissions. A sound response is based on the alignment of three pillars: a simple and transparent Emissions Trading System, a comprehensive and credible international agreement on reducing emissions and the development of low-emissions technologies. Without the alignment of these three pillars distortions will arise and Australian international competitiveness will be undermined.

So the common theme is: allow price signals to influence demand and supply, and remove impediments blocking price signals and/or blocking demand and supply responses to them in order to boost growth, investment, workforce participation and national living standards.

The tax and transfer system has a central role in addressing this common theme:

- Taxes and ‘abatement rates’ of means-tested transfer payments have direct effects on prices, returns on saving and investment, and returns for effort. They directly affect incentives.
- These effects, by definition, are entirely within the control of governments.
- The design of the tax and transfer system in Australia therefore is strategically central to Australia’s response to the four challenges listed above.

How does this translate into the standard design features – efficiency, equity and simplicity/clarity – noted earlier? In the MCA’s opinion, it reinforces the relevance of each, but adds weight to the following emphasis between them. In particular:

- ***Economic efficiency*** – minimising 'deadweight' efficiency losses – is a very high priority. In this context, greater medium- and longer-term certainty about system requirements also has important efficiency-enhancing and risk-minimising (including sovereign risk-minimising) benefits.
- Promoting ***system simplicity and clarity*** – and therefore minimising the required allocation of resources to administer and comply with the system – is also a very high priority.
- As regards equity, ***horizontal and intergenerational equity*** also must be given strong emphasis. In turn, delivering these can also support broader system neutrality and simplicity.

In general, promotion of these three objectives *together* can be achieved by ensuring Australia's tax system works off broad, reasonably stable and robust tax bases, to which reasonably uniform tax rate structures apply.

5.3 Problems with the current tax &transfer system: some general observations

In the MCA's opinion, at the broadest level, the problems with Australia's current tax and transfer system can be summarised as follows:

- ***Uncoordinated, overlapping and often-inefficient tax bases***. The current tax system inconsistently utilises a variety of tax bases: income, expenditure, consumption, turnover, asset values, specific products, etc. The utilisation of these uncoordinated tax bases can often result in anomalies, inefficiency and complexity.
- ***Inconsistent tax bases*** Tax bases under the current tax system are rarely comprehensive and include inconsistencies such as taxing business inputs.
- ***Non-uniform tax rate structures***. The rate structures applied to the relevant tax bases are also rarely uniform. Non-uniformity usually means rising rate scales and intensifying disincentive effects at the margin.
- ***Effective Marginal Tax Rate (EMTR) disincentives***. The tax-transfer interface has grown in an uncoordinated, ad hoc way, resulting in high EMTRs.
- ***High complexity, and high administrative and compliance costs***. The sheer complexity of Australia's tax and transfer system results in an inappropriately disproportionate resource diversion to administration and compliance.

Economic reform is an ongoing challenge for a competitive economy. The issues raised above provide compelling reasons, if any were needed, to further improve the nation's taxation system.

In the final adjudication of these issues the watchword for policy makers must be to guard against sovereign risk. In a global environment where capital is highly mobile and competition, particularly among producers of commodities, is intense; there is no room for complacency. A combination of poor decisions could create a dangerous environment in a nation that is looking to the mining industry to be a bulwark against a global and domestic slowdown in the short term, and a reliable base for expansion in the long term. Taxation is a key factor that influences the decisions of investors.

That said, the focus of the tax and transfer system reform will be on securing the most sustainably efficient allocation of Australia's *own* scarce resources. That focus optimises Australia's international competitiveness in the most comprehensive and durable way, and in the process secures the highest attainable – and sustainable – living standards for Australians. Among others this will require attracting international investment to ensure the growth of the economy and the improvement of national living standards. As the nation's leading export industry, the minerals sector will play a key part in this. For this reason ensuring there is not an increase in sovereign risk is vital for the nation.

5.4 Reforms needed to address these problems: a 'big picture' view

The foregoing summary of the current problems with Australia's tax and transfer system, in the light of the major challenges the MCA sees confronting Australia in the period ahead, points to the following general reform framework:

I. ***Determine which tax bases should be used for the tax and transfer system, and move as quickly as possible to discard the rest.***

II. ***Make those tax bases as comprehensive as possible***.

III. ***Make tax rate structures applied to those tax bases as uniform as possible***.

IV. ***Allocate the Government tax revenue via a new Intergovernmental Agreement (IGA) between Commonwealth, state and local government levels in a way that more closely reflects the spending responsibilities of each level of government***.

6. MORE SPECIFIC PROPOSED REFORMS

The analysis above gives rise to a variety of policy responses which may directly affect the minerals sector, its companies, employees and the communities in which they operate. The MCA offers the discussion in the following sections in the interest of furthering the national debate on an appropriate tax and transfer system.

The specific areas of proposed reform discussed in detail below include:

- A Review of mining royalties, but only on a prospective basis;
- Reduction in the corporate tax rate;
- Statutory Caps for tax Depreciation rates for long-lived assets;
- Move the Tax Consolidation Regime to a pure asset based model;
- Review of Commonwealth Customs Duties exemptions;
- Removal of Stamp Duties on business conveyancing and on the transfer of shares in land rich companies.
- A reduction of High EMTRs to encourage further workforce participation.
- Indigenous Tax Reforms.
- An improved Tax Policy Development framework; and
- A range of ways of reducing tax complexity.

Each of these is separately outlined in the following sections.

7. MINING ROYALTIES

Mining is a joint venture with the State where undiscovered resources are converted into societal capital. Historically, royalties have been seen as a rental charge for exploiting a non renewable asset. The Commonwealth Grants Commission noted, in a staff paper accompanying a review of funding formulas in 2006, that:

Economic theory suggests that royalties should be based on economic rent, which equals the economic value of the right to exploit publicly owned mineral resources. While this suggests that measures of profitability might underlie the way States think about royalties, and could serve as the revenue base, the actual royalty regimes did not reflect this in practice. The royalty regimes are usually based on outputs – value of production (an ad valorem tax), volume of production (a specific tax) or a combination of the two – rather than economic rent.

More recently the focus has been on profits-based royalties – concomitant with a view that is a tax on additional value created from the "joint venture'' between the company and the State. This "joint venture" creates value in what otherwise would be unrealised without exploration and development. As the MCA noted in a submission to the Ministerial Council on Mining and Petroleum Resources in 2005:

… the Commonwealth Grants Commission has argued that there is another way of viewing royalties. That is, that they may also be seen as a return on a joint venture where the State brings the resources to the joint venture and the minerals company the expertise to convert it to a saleable product.
This view suggests that the concept of a royalty is based on the sharing of the profits that arise from a saleable product. Under this view the State would try to extract a share of the joint venture rents. Royalty rates would relate to the expected rent of a project, so that rates could differ for individual projects. There would be greater reliance on profit-based royalties as a means of sharing rent. If a project was unprofitable/unsuccessful over the year, the State would not be entitled to a return/royalty.

Under either view, the MCA argued, the fundamental principle was the same:

A royalty is charge, not a tax: that is, royalties are payment to the owners of minerals for the right to 'exploit' them. A fundamental fact that must be acknowledged is that the Crown owns nothing of value until it is discovered and developed.

Long experience in collecting and paying royalties by the State and the minerals sector means that in practice the system work efficiently from an administrative perspective. Yet no States (including the Northern Territory) have a similar rate for the 42 mineral products.

A comparison of mineral royalty arrangements across States reveals:

- the method of levying royalties for the same mineral differs across States;
- rates differ for the same mineral across States;
- rates differ for different minerals in the same State;
- in some cases, rates differ for different mines extracting the same mineral in the same State;
- volume royalties are usually imposed on low value minerals; and
- there is no uniformity in the legislative base adopted by the States.

In general, there are four main types of royalties for minerals and petroleum:

- a specific rate royalty (a fixed dollar amount per unit of mass);
- an ad valorem royalty (a fixed percentage of the value of production);
- a profit related royalty (also known a resource rent tax); or
- a hybrid royalty with a flat ad valorem combined with a profit component.

Federal and State Governments have considered reforms of the royalty systems in the past. The former Department of Industry now Department of Resources Energy and Tourism, has stated that:

Consideration is being given to introducing nationally consistent hybrid ad valorem net income royalty systems which use a low first tier ad valorem royalty accompanied by a second tier profit based royalty. The first tier provides a regular royalty cash-flow which begins when mineral sales start, and the second tier royalty is paid in addition to the first tier, if and when the project becomes profitable.

Nonetheless, there has been considerable resistance to the idea of change from the forum that considered the plan, the Ministerial Council on Mining and Petroleum Resources – made up of Federal, State and Territory portfolio ministers – it rejected an MCA suggestion for a review of royalty regimes in 2005:

> *… the MCMPR does not believe that a comprehensive, independent review of fiscal regimes is necessary or justified. No single type of resource tax is likely to be ideal for all circumstances and a range of resource tax regimes is probably unavoidable.*

While acknowledging there are complexities and inefficiencies in the current royalties arrangements, the MCA argues that sudden and retrospective actions are likely to increase uncertainty about government policy settings and the investment climate, and raise concerns about sovereign risk. Such concerns influence the longer-term investment climate in Australia.

There is a strong argument to reform the basis of determining royalty payments to a profits based criteria from a revenue one. Royalties define the revenue sharing arrangements in the joint venture between the State and the company in the conversion of natural capital to societal capital. Thus a profits based system with an appropriate rate and base better takes account of the sharing of the risk in the joint venture arrangement. Royalties are a charge on cost of doing business, hence could be struck on a capacity to pay basis as a share of profits, thereby taking account of all of the matters affecting the profitability of the business.

The Architecture Paper invites discussion on whether there should be reform of the royalties system. As a matter of principle the MCA is strongly inclined to national consistency/national uniformity in taxation and regulation where that improves efficiency, simplicity/clarity and equity and does not compromise equity.

Further, any discussion the Review may wish to have on changes to the current system should only be pursued if they improve investment incentives, equity, and the simplicity and transparency of the royalties system, and do so without increasing sovereign risk.

7.1 Mining Royalty Reform

The MCA enters the debate on tax reform in the spirit of contributing to genuine reform against the criteria of good tax system design: simplicity, transparency, clarity, certainty, efficiency, fairness and equity.

It would be a misconception to examine taxation on the minerals sector on the false premise that it has not been paying its way at a time of improving prices and rising production volumes.

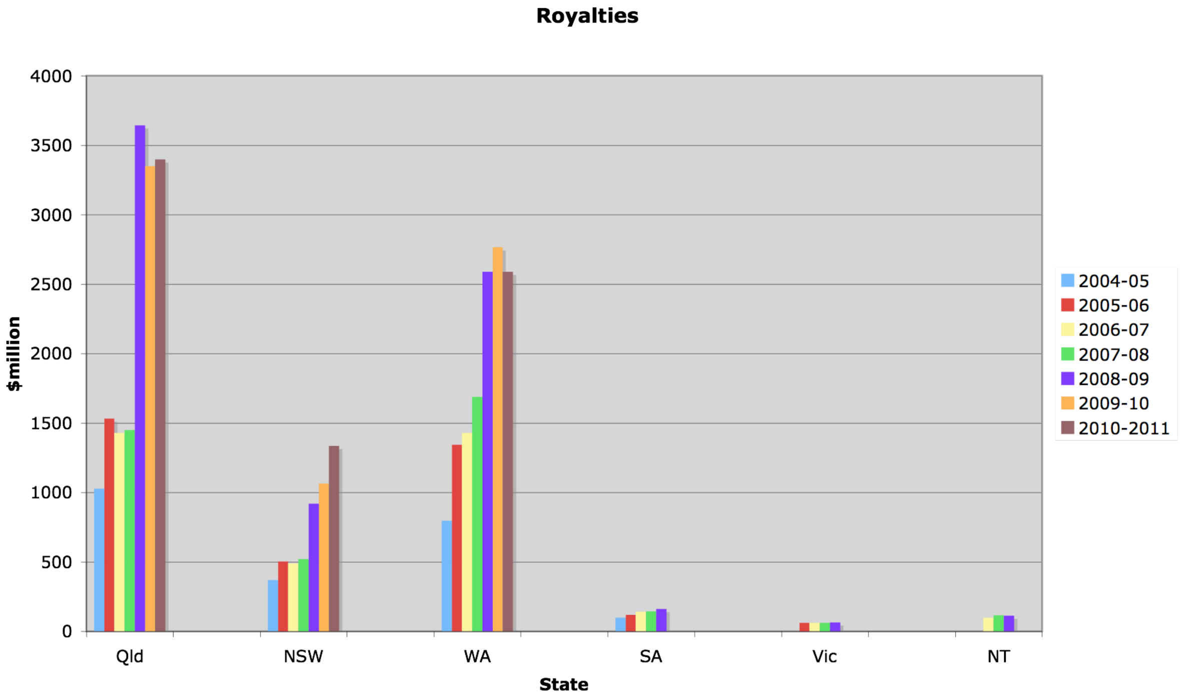
Work commissioned by Access Economics for the MCA examining the mining sectors contribution to both State and Federal Budgets shows tax and other revenues (direct and indirect, corporate and individual) are accelerating. The total tax paid by companies (in royalties, income tax, payroll tax and fringe benefits tax) and individuals working the mining sector is expected to be $18.489 billion in 2008/9. This is a 49 per cent rise over the previous financial year ($12.443 billion). The 2007/8 result was 9 per cent higher than 2006/7 ($11.370 billion) which in turn was 10 per cent higher than 2005/6 ($10.344 billion). From 2005/6 to 2008/9 this is an increase of 79 per cent.

Growth in royalties in particular has accelerated from 2005/6 to 2008/9, up 13.4 per cent, 13.1 per cent and 70 per cent respectively.

(These calculations, October 2008, are based on projections of global and Australian demand and supply, with royalties revenue estimated at $6.911 billion in 2008/9. Estimates in the State budget papers released at the beginning of the year initially predicted an even higher result, $7.4 billion.)

	2005-06 $m	2006-07 $m	2007-08 $m Estimate	2008-09 $m Forecast
Direct taxes on corporates				
Mineral royalties, licence fees, etc	3,159	3,583	4,054	6,911
Income tax, of which	5,173	5,665	5,670	8,029
- Companies	5,021	5,504	5,458	7,748
- Superannuation funds	152	160	212	281
Total	8,332	9,248	9,724	14,940
Indirect taxes on corporates				
- Payroll tax	310	328	440	594
- FBT	179	179	236	314
Total	489	507	676	908
Total tax expenses by companies - total	8,821	9,754	10,400	15,848
Total tax expenses by companies - State	3,469	3,911	4,494	7,505
Total tax expenses by companies - Federal	5,352	5,844	5,907	8,343
	2005-06 $m	**2006-07** $m	**2007-08** $m Estimate	**2008-09** $m Forecast
Direct taxes on individuals				
Income tax, of which				
- Gross PAYG withholding (by individuals)	101	106	140	186
- 'Other individuals' tax	25	27	35	47
- (less) Refunds	-13	-14	-18	-24
Total	113	119	157	209
Indirect taxes on individuals				
- GST	782	825	1,090	1,447
- Fuel excise and other	593	634	746	921
- Other	35	37	49	65
Total	1,410	1,497	1,886	2,433
Total tax expenses by individuals - total	1,523	1,616	2,043	2,641
Total tax expenses by individuals - State	0	0	0	0
Total tax expenses by individuals - Federal	1,523	1,616	2,043	2,641
Total tax expenses	10,344	11,370	12,443	18,489

Source: Access Economics, Tax contribution of the minerals industry, October 2008.



Sources: MCA, Commonwealth and State Budget Papers

Any move to reform the mining royalty regime must not be an unwarranted, short-term or unfair revenue grab on an industry that has been paying much more in tax as it has experienced recent increases in profitability following difficult times earlier in the decade.

As recent developments show investment confidence cannot be taken for granted. In the face of other threats to the mining operations – such as tight capital markets, the right to operate private export infrastructure and an emissions trading system out of step with international agreements and technological developments – a poorly judged shift in taxation policy would send a bad signal.

Accordingly, the MCA wishes to initially propose four broad principles to focus debate on potential reforms to the current mining royalty regime within Australia.

These are set out in the following Box.

Box 7.1. Mining Royalties - Taxing the joint venture between the State and minerals companies in converting resources into societal capital in Australia

1. Assuming an equitable base and rate has been agreed by all stakeholders any new royalty regime should be based on profit rather than income or ad valorem base.

2. Mining royalty reform should recognise that the rate and base of any new regime must vary across commodities and give equitable outcomes for both the State and minerals companies (having regard to risk and expenditure) across the commodity cycle.

3. Any reforms should be prospective in nature. Existing royalty systems should be allowed to be retained for existing projects, with any new regimes only applying to new projects for which the implications of any changes can be factored into the investment decision.

4. To provide administrative ease and allow for combinations or expansions of existing operations, there should be an option available to the minerals company to adopt the new regime for existing projects. Care will need to be taken in design to ensure equitable outcomes on transition (rate, base etc) for both the State and minerals companies.

8. DIRECT BUSINESS TAXATION REFORM

8.1 Decreased Company Tax Rate

It is widely accepted that a number of factors impact on a country's international competitiveness. The tax system is one of these factors and within the tax system "headline" rates of corporate tax are often presented as the touchstone for international comparisons. While such headlines rates do not tell the full story, the MCA recognises that they nonetheless can be important in a consideration of the attractiveness of a country to foreign capital holders. At a time of both highly mobile global capital and tightening credit markets the whole issue of the competitiveness of Australia as an attractive destination to invest and operate takes on even greater significance.

The MCA notes the Architecture paper itself recognises that "it is a surprising result in a globalising world with increasingly mobile capital flows for a small open economy to have the highest weight given to the taxation of capital income." The paper also acknowledges the "relatively high contribution of company tax to total tax compared with other OECD countries."

Australia's corporate tax rate at 30 per cent is well above the OECD average (26.6 per cent). This reflects the fact that since Australia's last downwards adjustment to its corporate tax rate in 2001 many other OECD members have continued with reductions and the unweighted average OECD corporate rate has fallen by six percentage points.

There is a case for Australia restoring its competitive position on this headline rate of corporate tax as part of overall reform of the tax and transfer system. Lowering the relative tax burden on capital in Australia through a reduction in the corporate tax rate could contribute to stronger growth and increased productivity.

8.2 A Competitive Tax System for Capital Investment

The Australian Government's current approach of providing an acceleration of depreciation for some long-lived assets, but not others, is a cause for concern from an equity point of view.

In certain circumstances a "capped life" can apply to a depreciating asset that is shorter than the "safe-harbour" effective life the taxpayer may elect to have determined by the Commissioner of Taxation. This Statutory Cap, however, is only applied to a small selection of typically long-lived assets. Many mining and infrastructure assets, which have no access to these lower caps have tax effective lives of 40 years or more, far longer than the commercial time horizon for capital budgeting.

An essential element of income measurement is the ability to deduct expenses consumed in the course of deriving gains.
To ensure expenditure in capital intensive, long-lived assets will be deductible over the period in which identifiable benefits are received from the expenditure, the MCA calls for all long-lived assets to have a maximum effective capped life for tax depreciation purposes of 20 years.

8.3 Tax Consolidation

The MCA was a strong advocate for the introduction of the Tax Consolidation regime recommended by the Ralph Review, and implemented by the Government with effect from 1 July 2002. The original premise for the tax consolidation regime was to increase efficiency in the tax system by eliminating the tax distortion that arises from having different tax implications for transactions involving the acquisition and sale of companies and businesses. The aim of the tax consolidation rules was to have the same tax implications whether a company or its underlying assets were bought or sold.

Unfortunately, the implementation of the tax consolidation regime was unduly focussed on the transition phase of the new law. Accordingly, many compromises were made which resulted in the 'asset based model' (which was originally proposed) not being appropriately implemented. A consequence of this is that a significant difference in tax outcomes can still exist between the sale/purchase of a company when compared to the sale/purchase of the underlying assets/business of that company. It has also resulted in the tax consolidation legislation being unnecessarily complex which materially adds to the compliance costs of undertaking business transactions.

The MCA submits that the tax consolidation rules should be rewritten and simplified on a prospective basis, to give effect to a 'pure' asset based model as originally recommended by the Ralph Review.

9. PERSONAL TAXATION REFORM

There would be considerable merit in reducing marginal tax rates under Australia's personal income tax.

By definition, such taxes inherently bias choices away from saving towards present consumption, compared with an equal-revenue expenditure or consumption tax.[3]

[3] See, for example, Australia's future tax system: Architecture of Australia's tax and transfer system, the Treasury, August 2008, Appendix B, pages 334-337.

High marginal income tax rates – especially when caused by the interaction between the income tax system and targeted transfers, generating very high EMTRs – can adversely affect incentives to work, weakening participation rates just when Australia faces a longer term need for higher participation rates (see also further discussion below).

Short of more radical reforms to the personal income tax system the main choice for reducing the disincentive effect noted above is between:

- Lowering marginal income tax rates.
- Increasing tax bracket thresholds.

If applied across the board, personal income tax rate reductions reduce the disincentive effects noted above for almost all taxpayers (those below the tax-free threshold, and those in the pension phase of their superannuation fund investments aside, because they already face a zero income tax rate). That said, in general, it may be more expensive, in terms of tax revenue foregone, to deliver across the board income tax cuts than tax threshold increases.

Tax threshold increases provide *marginal* tax rate benefits only to a sub-set of taxpayers.

In general, the MCA believes that reform choices between these options should reflect the following principles:

Box 9.1. Broad principles for personal tax reform

1. In general, personal income tax reform should involve lowering marginal income tax rates. This maximises the spread of improved incentives to save and to work, albeit at higher cost.

2. In general, adjustments to tax bracket thresholds should be used to offset 'tax bracket creep'. Even if undertaken on an 'ad hoc' and discretionary basis, the MCA believes that threshold increases should be determined primarily by the need to offset 'tax bracket creep'.

10. INDIRECT TAXATION REFORM

It is submitted by the MCA that indirect tax reform is needed at both the Commonwealth and State levels. Each is addressed in turn.

10.1 Commonwealth indirect tax reform: customs duties

The Customs Tariff Act 1995 imposes duties on certain goods imported into Australia. The rates applied vary with the goods imported but are typically in the order of 5% for many goods used by the minerals industry. These represent a tax on business inputs, decreasing Australia's competitive position for large capital goods importers like the mining industry.

In addition to the Free Trade Agreements Australia has in place with such countries as Thailand, New Zealand, Singapore and the USA, customs duties are able to be removed at times by:

- obtaining Tariff Concession Orders from the Australian Customs Service; and
- utilising Determinations issued under the Enhanced Project By-law Scheme ("EPBS") administered by AusIndustry.

The broad basis for obtaining the concessions available under the above two regimes is that the goods must not be available from local industry. For the purposes of the minerals industry the availability of these concessions can have the effect of lowering input costs associated with greenfield and brownfield projects.

However, whilst for instance the EPBS has served its purpose to a degree in the past, it has not kept pace with economic change or been updated since the programme's inception in 2002 and is in need of review. In addition, Tariff Concession Orders issued for various goods do not allow for associated spare parts to also be exempt, and also suffers from a number of other inhibitors, such as having to import the goods in one shipment to qualify. As a result the extent to which mineral projects are assisted by the above two concessionary schemes is limited, and hence so is the ability to decrease these taxes on business inputs.

This remains in contrast with other competitive countries such as Canada where the recognition of the importance of the minerals industry is reflected in the nature of the concessionary schemes available.

The MCA calls for a full review of these concessionary schemes.

10.2 State indirect tax reform

Reviews of state taxes and assessments of their efficiency or otherwise are numerous.[4]

The inefficiency rankings across existing state taxes are reasonably settled. Some inroads into these were achieved by the abolition of a number of transactions taxes (stamp duties) in exchange for state access to the GST revenue as part of the *New Tax System*.

However, a number of inefficient State indirect taxes remain. These include:

- stamp duty on non-residential conveyancing.
- stamp duties on the acquisition of shares in land rich companies.
- stamp duty on general insurance.
- fire services levies on general insurance.
- other stamp duties (eg, on motor vehicle purchases).

The most "inefficient'' of these taxes for the mining industry are the stamp duties on non-residential real property, and land-rich share acquisitions.

In the MCA's opinion, the direction for reform in this area is clear-cut. The main problems are (i) financing the revenue foregone, given increasing state budget stress, and (ii) the Commonwealth-State financial relations aspects of possible financing options.

Subject to resolution of these problems, the MCA considers the reform agenda here is straightforward:

Box 10.1. Reforming state indirect taxation

1. The most inefficient state taxes should be abolished as soon as possible.
2. In particular, stamp duties (especially those on business transactions and land rich share transfers should be abolished.

[4] See, for example, *Review of State Business Taxes* Full Report, February 2001, by the State Business Tax review Committee, Victoria (the Harvey Review), and *Review of State Taxation*, (NSW) Report to the Treasurer, Independent Pricing and Regulatory Tribunal of New South Wales, June 2008 (the Mike Keating Review).

11. REFORM OF TAX-TRANSFER INTERFACE

The tax-transfer interface is a complex morass of high and very non-uniform EMTRs that has grown in a fairly uncoordinated fashion over a long period of time. Reform of this area is important for the MCA, because high EMTRs discourage workforce participation at the margin. At times of record low unemployment, and in an industry which already has trouble attracting employees to work in remote areas, we see a pressing need for elimination of any blockers to increased workforce participation. Accordingly, EMTRs are a focus for the MCA.

Only a thorough whole-of-government review of the problem in all its many dimensions will allow a fundamental 'root and branch' reform of this major area of work disincentives.

There are a range of reasons why EMTRs are difficult to deal with, including:

- Transfer payments or other benefits can be universally available, or targeted via being subject to means tests.
- Universally available concessions (eg, the 'standard' tax free threshold under the personal income tax rate scale) can be expensive and/or low in value, but do not give rise to EMTR problems.
- Targeted concessions allow more substantial benefits to be delivered to a smaller cohort of recipients for a lower Budget cost, but contribute to high EMTRs across the own-income range where the benefits are withdrawn.
- By definition, the EMTR is the sum of the applicable marginal income tax rate(s) plus the relevant transfer payment abatement rate(s) across the relevant own-income range
- In some cases, EMTRs can be the result of a 'stacking' of a number of abatement rates on top of the 'standard' income tax rate.

Reducing EMTRs is a difficult area. Empirical evidence about the labour force participation responses to reductions in EMTRs at various own-income levels will be a crucial policy input.

In general, the MCA sees merit in reforms in this area in line with the following principles:

Box 11.1. Dealing with EMTRs

1. An empirical assessment of which EMTRs have the largest disincentive effects on workforce participation should be undertaken, to determine where reductions in EMTRs might deliver the strongest labour supply response.

2. Any Budget cost allocated for easing current EMTRs should be concentrated on the own-income ranges, and the transfer benefits involved, identified as a result of step 1.

3. More generally, to the extent that it is feasible after step 2., a process of 'unstacking' current EMTRs and moving towards more uniform maximum EMTRs should be considered.

4. In some cases, where the additional costs to the Budget are small, moving to universally available concessions should be considered.

12. REFORM OF INDIGENOUS TAXATION

Australia has at present an opportunity to enhance institutional and economic capacity by which Indigenous people may become long-term contributors to, and drivers of, regional and community development. There are however a number of impediments in Australia's social, economic and tax policy frameworks impeding progress and attainment of these objectives.

The tax-transfer system has a direct affect on participation in employment and investment from Indigenous people and their communities. This occurs in two ways. First, the high effective marginal tax rates that can be applied to individuals as they move from welfare to work, or change their work arrangements from supported employment programs to private sector – including the increasing number of Indigenous-owned corporations. The concerns here are similar to those expressed above on the interaction of the tax and transfer system. This is vitally important with the renewed effort by mining companies to boost Indigenous employment both as a sensible business proposition – the need for more labour – and part of the industry's commitment to sustainable development which flows from its social licence to operate.
The second issue is the taxation treatment of payments under native title agreements paid into community-administered trusts. This system is under review by the Federal Government, through its Native Title Payments Working Group, whose membership has included the MCA.

The tax treatment of Native Title payments (for both the payer and payee) is very complicated and needs to be streamlined and simplified. Under current arrangements, an array of different GST and Income Tax consequences are possible and dependent upon such things as whether Native Title is extinguished or not; whether the payments are of a capital or revenue nature (thereby determining whether payments are deductible or not); and/or whether payments are 'compensation' or some other type of payment. Depending on the specific circumstances of particular cases, the tax consequences can be radically different and can greatly affect the material value of the agreement.

For instance, in attempting to maximise the value of compensation and other related payments under the Native Title Act, parties to Indigenous land Use Agreements (ILUA) often utilise the provisions of the Charity Tax Law.

These provisions are confusing and inadequate as they do not provide enough flexibility to tailor agreements that are both tax effective and consistent with the terms of the ILUA (i.e. mainly to provide for, and accommodate, intergenerational benefits). Charitable trusts if structured to conduit compensation payments from mining companies to Traditional Owners for example, cannot usually accumulate for more than 10-12 years. This is a major impediment as compensation payments should provide compensation for current and future Traditional Owners in recognition that they are holders of a perpetual life estate.

In relation to these, the MCA advocates for:

- an extension on the current ten-year limit; and
- broadening the definition of a Deductible gift recipient – because at present the rules are narrow and an organisation must be a recognised conservation, health or early childhood care provider. The MCA would seek a new category for Indigenous Economic Development.

Another proposal for dealing with the broad issue of maximising indigenous opportunities from Native Title is to allow the development of a superannuation fund-style stream of funds management. Recipients of native title payments (either directly or indirectly) would have the right to make non-concessional contributions to a recognised superannuation provider up to the CGT Cap amount (or even a lower CGT Cap Amount, if necessary, say $300,000).

The approach is in similar terms, from a taxation perspective, to the rules that apply to any individuals receiving compensation for personal injury claims or the recipients of Capital proceeds on the sale of small businesses.

The MCA suggest this initiative would provide an incentive for native title holders to direct payment to their respective superannuation funds without the complications that arise for employers and employees in making superannuation contributions.

Other matters which have been proposed to the Federal Government include:

- economic development. The MCA will propose a new initiative called Aboriginal Community Development Corporations – a new form of trust structure available on an opt-in basis with special tax treatment, such as full exemption on expenditure that is classed as capacity building in Indigenous communities.

- venture capital – Establish a system for Indigenous start up businesses with full flow through to shareholders. Minimum Indigenous equity arrangements. This could be revenue neutral with a change to the rules of Indigenous Business Australia.

13. TAX ADMINISTRATION & TAX COMPLIANCE

If Australia can move to a tax system comprising fewer, more robust, tax bases, with more proportional (and on average lower) tax rates, the cause of a more simple tax system, with lower compliance and administration costs, will have been well served. Some ideas for how to achieve that are now discussed.

13.1 Improved tax certainty & policy development

The world has entered a period of uncertainty unprecedented in this generation, and arguably since before WWII. In order to foster a strong investment climate, Australia needs *policy certainty* now more than ever before.

In this respect:

- Certainty about general tax system rules and regulations – free of 'sovereign risk' concerns – is crucial.

- Reasonable certainty about new policy areas, of which broad-based policies intended to deal with climate change are central, is just as important.

These ingredients are absolutely essential for promoting a climate for investment, in a capital-importing country like Australia, that ensures we can finance the investment needed to underpin solid, non-inflationary, growth in living standards.

There is scope to significantly improve the process for tax policy development in Australia. Currently there is only ad hoc involvement of the Australian business community in the development of tax policy. The MCA advocates that the scope of the existing Board of Taxation be formally and statutorily expanded so that it has a role in the provision of formal input into the Australian Government and Federal Treasury on all material tax policy developments in Australia.

13.2 Reducing Tax Complexity

The existing State and Commonwealth tax legislation is excessively complex. The MCA supports a reduction in this complexity to enhance economic efficiency, and offers the following ideas for further discussion with the Panel.

Box 13.1 Ideas for Reducing Tax Complexity

- **Increased Use of Audited Financial Statements – the Panel should investigate the possibility of allowing some taxpayers the ability to lodge tax returns based on audited financial statements, with a minimum of adjustments thereto;**
- **dation of Commonwealth Tax legislation – the existing 1997 and 1936 Tax Acts should be consolidated into one Act, with all unnecessary provisions being removed;**
- **Harmonisation of various State and Commonwealth Taxes – a range of State taxes which apply across States should be harmonised into one Act per tax – eg Payroll Tax. Different rates in different States can be dealt with by having schedules of rates, but with the main legislation being one Act for each tax.**
- **Single Revenue Collection Agency – following a harmonisation of the State taxation legislation, a review should be undertaken of the possibility of establishing a single revenue collection agency with responsibility for all State and Commonwealth taxes.**

14. CONCLUDING OBSERVATIONS

As noted at the outset, the MCA is providing this submission to the Henry Review as a broad statement of issues and principles that, in the MCA's opinion, are important given the Review's Terms of Reference.

The MCA intends to provide more detailed submissions, concentrating on a more limited range of specific issues of concern to its members, in response to the findings to be presented in the expected Consultation Paper[5] to be released by the Review Panel.

[5] Review Panel press release No. 2008/01, 19 August 2008, *Tax review calls for submissions and sets out consultation process*, paragraph six.

APPENDIX 1 – CRITERIA FOR EVALUATING TAX POLICIES

Economic efficiency and economic growth

In simple terms, a completely efficient tax system is one in which the imposition of tax does not get in the way of – that is, distort – decisions made by businesses and individuals. If the tax system were perfectly efficient, decisions would not be affected by tax considerations at all. An investment that would proceed based on its before-tax rate of return would also proceed on the basis of its after-tax rate of return.

In the real world, all general revenue-raising taxes are more or less inefficient, although, as discussed below, there is sometimes a case for imposing *specific* taxes to improve efficiency where social costs of production or consumption diverge from private costs (such as climate change, where external diseconomies result in significant 'market failure').

Sometimes economists and policymakers fall into the trap of thinking that improved economic efficiency is an end in its own right. In fact, improvements in efficiency are a *means* to an end; a means to stronger economic growth. That, too, is not really an end in itself, but rather a means to generate higher living standards (ie, economic growth *per capita*).

Even *that* is not an end in its own right, as is increasingly understood these days:

- higher living standards should be *sustainable*, and
- the corollary is that they should not be at the expense of future generations.

In essence, improved efficiency is the same as improved (sustainable) productivity: that is, bringing together a given amount of investment and of labour in a way that produces more than would otherwise be the case – sustainably.

The critical link between efficiency and economic growth was recognised by the 1998 Review of Business Taxation[6]:

> *In raising revenue for the Commonwealth the business tax system should interfere to the least extent possible with the best use of existing national resources, with the efficient allocation of risk and with national economic growth in the longer term.*

The rationale for this objective springs from broader social goals. Irrespective of taxation arrangements, Australia's economy and resources – including its market structures and its complementary institutional arrangements – need to be marshalled with the objective of ensuring that investment funds are allocated in such a way as to optimise economic growth.

Equity or fairness

Equity or fairness is a seemingly simple concept, but there are different types of equity. Horizontal equity is defined as treating taxpayers in similar circumstances in a similar way.

Vertical equity accepts that those who earn more pay higher *rates* of tax. The Commonwealth personal tax system and targeted welfare systems operate under this principle. It can, however, be partly in conflict with efficiency concerns.

Intergenerational equity – requiring fair treatment between current and future generations – is increasingly recognised as an important issue, especially with ageing populations.

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6 Review of Business Taxation (1998) *A Strong Foundation*, Discussion Paper, AGPS, Canberra, November, p.61.

Administrative and transitional equity – the fair application of the tax law, including in terms of transitions related to tax changes – are also important objectives. However, there is often a trade-off between this type of equity and both efficiency and simplicity.

Simplicity

Simplicity is a straightforward concept. It includes *administrative* simplicity (minimising the taxation authority's costs of running the tax system) and ease of *compliance* with the tax system by taxpayers, minimising their time and money costs as well.

In complex financial systems, simplicity may be more difficult to achieve and so clarity becomes an important, related policy objective.

A simple and clear tax system is a laudable objective and – to the extent that it aids the understanding and administration of the tax system – can help to improve economic efficiency (and hence economic growth).