Submission to the Federal Government's Tax Discussion Paper

CCI Advocacy | June 2015

Chamber of Commerce and Industry of Western Australia (Inc)

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About CCI

CCI was founded on the belief that the existence of a diverse and thriving business community is an essential ingredient to building a vibrant and prosperous society.

For more than 120 years, we have advocated on behalf of the Western Australian business community and in doing so we have proudly built a strong membership base which represents businesses of all sizes and in all parts of the economy.

CCI remains dedicated to the pursuit of a competitive and responsible free enterprise economy for the benefit of all individuals in society.

Executive Summary

Australia has experienced an extended period of economic success in recent times. Our economy has expanded for a record 24 consecutive years, and has fared well during a number of major global shocks, including the Asian Financial Crisis, and most recently the Global Financial Crisis.

However, our economy is changing and as we look to the future we need to look at ways that we can leverage new and emerging opportunities. Ensuring that Australia has tax system that meets the needs of a modern economy will be an important way to ensure our ongoing prosperity. The nation's two most pressing challenges, an aging population and declining competitiveness, can only effectively be met through wholesale changes to Australia's tax mix.

CCI believes the development of a Tax White Paper, in conjunction with the development of a White Paper on the Future of the Federation, is a rare opportunity to recast the tax and government spending systems of the nation. To be most effective both processes must run in tandem, and this is the approach CCI has taken to this submission regarding the Tax White Paper.

In reforming Australia's tax system, the Federal Government should give regard to the following basic objectives.

Reform objectives

- Reform to government and reform to the tax system must occur in harmony, and there should be no net increase in Australia's tax burden.
- Australia should aspire to have an internationally competitive tax framework to attract business investment and reduce incentive for tax minimisation strategies.
- There must be rigorous application of sound tax principles when designing Australia's tax framework.
- Australia must reduce its reliance on direct taxation and increase its reliance on indirect taxes in-line with international standards.
- Fundamental state tax reform is both possible and necessary.

Consolidated list of recommendations

- Vertical Fiscal Imbalance, the gap between Federal and State Government revenue and expenditure powers and responsibilities, should be addressed in this process and the Federal Government's Reform of the Federation White Paper.

- The base of the Goods and Services Tax (GST) should be broadened to apply to all consumer spending to improve efficiency and gives the States access to a larger share of total tax revenue. At this stage, the rate of GST applicable should be left at 10 per cent.

- The GST should be distributed to the States using a "Point of Collection" methodology that would return GST revenue to the state in which the spending took place. This would make the GST a more stable, predictable and fair source of revenue for the States. Specific funding for States and Territories left worse-off should be provided by the Commonwealth Government outside of the GST pool, noting that the GST is a state tax. These payments should be tied to economic reform and be temporary.

- State Governments should be given provision to charge an independent surcharge on Federal personal income tax rates at thresholds that align with the Federal Government. States should only compete on rates, and not be given power to set exemptions, deductions or thresholds. This should coincide with a significant reduction in personal income tax rates and a flattening of the personal income tax scale at a Federal level (see Package Three: Reducing Personal and Business Income Taxation).

- State Governments should agree to abolish all remaining transfer duties, including on housing-related transactions, with replacement revenue to be generated by a broad-based land tax. Existing exemptions on land tax applicability, including the principal place of residence exemption, should be removed. This should be subject to a long transition period to ensure minimum distortion in the market.

- The land tax thresholds should be significantly flattened, to improve the efficiency of the tax and reduce the incentive to increase rates of tax on higher valued properties.

- The States should, subject to adequate replacement revenue, reduce and gradually eliminate payroll tax, which acts as a barrier to employment and income growth and reduces economic growth.

- With new, efficient sources of revenue, Western Australia should eliminate nuisance taxes, including the Metropolitan Region Improvement Tax (by incorporating it in to the land tax base, particularly now that it applies to the vast majority of taxable land in Western Australia), Perth Parking Levy and Landfill Levy.

- The Federal Government should significantly reduce personal income tax rates at all levels and particularly at the top marginal rate, which is amongst the highest in the world once temporary levies are taken into consideration. This is also to make room in the personal income tax base for the introduction of a state-based personal income tax surcharge.

- The Federal Government should take immediate action to reduce personal income tax and simplify the system by removing the $80,001 to $180,000 threshold and broaden the current 32.5 per cent rate threshold to $180,000.

- The Federal Government's Zone Tax Rebate should be rebased, to reflect its original policy intent and value, or abolished. There may be a reduced need for this rebate should the Federal Government allow provision for States to surcharge personal income tax (see Package One: Reducing Vertical Fiscal Imbalance).

- There should be a review of the tax treatment of savings and the rationale for taxing different modes of saving at vastly disparate rates, given the role this plays in the allocation of capital across the economy.

- There is merit in exploring the introduction of a standard deduction for work-related expenses incurred by income tax payers to reduce administration and compliance costs and reduce reliance on the provision of tax advice for relatively simply tax affairs.

- The Federal Government should immediately reduce the headline company tax rate for all businesses regardless of turnover to 25 per cent to return Australia to the OECD average for headline company tax rates.

- The headline company tax rate should be indexed to the OECD average to maintain Australia's competitiveness over time.

- Australia's rules relating to capital allowances should be significantly streamlined and simplified through the adoption of fewer asset types and allowable depreciation schedules. The rates of allowable depreciation should be increased and the depreciation windows shortened. This should improve the incentive for businesses to invest, lead to reduce administration and compliance costs and bring a significant part of Australia's company tax system into line with regional competitors.

- The scope of the Research and Development Tax Incentive (R&D Tax Incentive) should be broadened and the rates of offset increased, in-line with international standards.

- A formal policy of tax threshold indexation should be introduced and applied to all relevant Federal, State and Local taxes to ensure bracket creep ceases.

- State Governments should seek to have harmonised tax legislation where possible and compete only on rates and, where applicable, thresholds.

- As a rule, tax design should dictate that taxes have as few thresholds and exemptions as possible to ensure simplicity and effectiveness.

- Most of the Henry Tax Review's recommendations regarding tax system governance should be adopted within existing funding arrangements and bureaucratic structures. These relate to transparency, access to justice and elevating the role of tax policy design above political influence.

- The Australian Tax Office should be tasked with the development of Tax Administration Impact Statements (TAIS) in a similar manner to the application of Regulatory Impact Statements (RIS) for other regulatory instruments.

- The small business turnover test threshold should be immediately increased to $3 million, and progressively to $5 million, in-line with recommendations of other government and non-government inquiries.

The Reform Imperative

Australia has experienced an extended period of economic success in recent times. Our economy has expanded for a record 24 consecutive years and has fared well during a number of major global shocks, including the Asian Financial Crisis and most recently the Global Financial Crisis.

Much of Australia's recent success has been driven by the unprecedented period of investment that has occurred in the resources sector, in response to the surge in demand for developing Asia. This drove a period of sharp increases in commodities prices and our terms of trade, and created much wealth for the nation.

By any measure, Australians enjoy one of the highest standards of living in the world. However, the extent to which this has been driven by a rapid rise in our terms of trade has been made clear in recent years. Since the peak in the price of key commodities like iron ore and coal in 2011, real net national disposable income per capita has declined by 3.5 per cent in what has been the first sustained decline in this measure since the 1990s recession.

Our economy is changing as this period of investment has peaked and started to decline. It has become clear that we cannot rely on the same drivers of growth to deliver prosperity for current and future generations. As we look to the future, we need to look at ways to leverage new and emerging opportunities.

Ensuring that Australia has a tax system that meets the needs of a modern economy will be an important way to ensure our ongoing prosperity.

Tax reform will be critical to maintaining our reputation as a competitive place to do business internationally, given that investment is mobile and taxation is a vital issue when considering where to set up operations. Australia's competitiveness has been sliding for some time. The World Economic Forum's Global Competitiveness Index finds Australia's competitiveness ranking has slipped from fifth in 2001-02 to 22nd in 2014-15, having been surpassed by many countries in our immediate region[1]. One of Australia's most significant competitiveness issues is the burden of taxation, with poor ratings for the effect of the tax system on incentives to invest (74th in the world), total tax rate on company profits (104th) and the effect of taxation on incentives to work (80th).

Reform to the tax system will also help to ensure that the nation is capable of dealing with the challenges of an ageing population by ensuring the Government has access to a sustainable revenue base and encouraging workforce participation and savings.

The Federal Government's 2015 Intergenerational Report shows there will be significant pressure on public finances to cope with the additional demands for services from an ageing population, with these overwhelmingly concentrated in the health, disability support and social services sectors[2]. As well as the demand for additional funding, this will also further tensions within the Federation which are created by the high level of vertical fiscal imbalance which currently exists. ,

Reform to the tax system will be an important way to ensure Australia has a workforce capable of delivering our continued economic success. With labour more mobile than ever, reform is needed to ensure that tax arrangements do not deter overseas workers moving to Australia, and prevent people from Australia relocating to other countries. It can also boost workforce participation among the existing population by creating incentives to work and mitigating disincentives to work.

An important starting point for any review of the tax system should be to consider the size and role of Government in today's economy and society, which will ultimately determine the tax burden. An important aim should be to reduce the size of the tax burden on the community. Reviewing the allocation of responsibilities within the Federation will be an important part of this process and it is critical that any changes to the tax system as part of the Tax White Paper process are considered in tandem with the Federation White Paper.

The need for a more efficient tax system has been recognised by successive governments over many decades, and there have been countless reviews conducted in this area of public policy. Some of these led to significant reforms, such as the 1998 Australia's New Tax System review, which saw the introduction of the GST. Others, such as the 2008 Australia's Future Tax System review (the Henry Review), have been largely ignored.

With no substantial changes to the tax system for more than a decade*, Re:think* provides yet another opportunity to examine comprehensive changes to the tax system. It is important that we don't pass up this opportunity. To deliver a genuine and ambitious tax reform agenda will require the Federal Government to work collaboratively with the States, given that many of the most inefficient taxes are state taxes.

Our Tax System Today

Compared to other nations, Australia's overall tax burden is relatively low, although it has been increasing.

As highlighted in the *Re:Think* Discussion Paper, Australia's tax to GDP ratio is 27.3 per cent and considered favourable by international standards. Australia's burden is the seventh lowest of the 34 OECD members, and lower than countries such as the United Kingdom (32.9 per cent), New Zealand (32.1 per cent) and Canada (30.6 per cent). The average OECD tax burden is 34.1 per cent.

Within our region, Australia's tax to GDP ratio is high, with regional neighbours including China, Malaysia, India, Singapore, Hong Kong and Indonesia all having lower ratios than Australia.

Despite a competitive ranking, Australia's tax burden has been increasing over recent years. This is reflected in Australian tax revenue per capita (measured in US dollars) having tripled between 2000 and 2012. Most other OECD countries have only doubled in this measure over the same period.

While the tax burden is relatively low by international standards, a key feature of Australia's tax system is its reliance on direct taxation

Australia's 30 per cent corporate income tax generates a substantial 18.9 per cent of total taxation revenue, the second highest of OECD countries. Personal income tax brings in a total of 39.19 per cent of revenue, and is also the second highest of OECD countries. Combined, these two direct taxes make up nearly 60 per cent of total revenues, which is the highest of the OECD. In comparison, the equivalent taxes make up 47.8 per cent of total tax revenue in the United States, 35.6 per cent in the United Kingdom, and 33 per cent across the OECD. Within our region, Australia's direct tax take is lower than Malaysia (which levies high rates of direct tax on its energy and petrochemicals industries) but higher than Singapore, Indonesia, India and China.

By contrast, indirect taxes on the consumption of goods and services make up only 28.1 per cent of Australia's tax revenue, compared to the OECD average of 32.8 per cent. This can largely be explained by Australia's Goods and Services Tax (GST) having a narrow base and low rate when compared to other countries. Australia's GST rate of 10 per cent compares to an OECD-average of 22.5 per cent, with only Canada's Federal-level (five per cent), Japan (five per cent) and Switzerland (eight per cent) having a lower rate than Australia. In comparison, New Zealand has a wider base and a rate of 15 per cent, up from 10 per cent when it was first introduced.

Australia also generates 8.6 per cent of its taxation revenue from property, compared to the OECD average of 5.5 per cent. Some 60 per cent of this is revenue derived from recurrent land taxes, while stamp duty and transfer taxes make up a further 40 per cent. The United States, United Kingdom, Canada and New Zealand all collect over 80 per cent through these recurrent measures, whilst Australia's 40 per cent collected from stamp duty is the highest in the OECD behind just South Korea and Turkey. The most significant difference is in relation to Australia's lack of recurrent land tax on principal places of residence, with rates of land tax comparable.

Australia is also one of the few nations to still levy a tax on employer payrolls. Only Sweden and Austria have higher rates, whilst the United Kingdom, United States, New Zealand and Japan do not levy a payroll tax at all.

Collection and distribution imbalances

The federal, state and local levels of government continue to become more imbalanced in their collection of taxation revenues. Federal revenue collections now make up 81.4 per cent of all Australian taxes, substantially greater than the 54.5 per cent average across the eight federated governments in the OECD. In spite of this, state and territory governments still maintain a significant range of responsibilities, including: public education, hospitals, government housing and transport.

State governments' revenue sources only fund around half of their budgets with the remainder made up through federal transfer payments. The trend of the Australian system becoming more centralised means states are increasingly reliant on federal transfers to fund their programs.

The key problem with vertical fiscal imbalance is 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.

Separation of revenue raising authority from expenditure authority weakens accountability – in particular, it is claimed to have encouraged inefficiencies in the delivery of State services as States do not bear the political cost of raising the money they spend. This is compounded by the fact most current state taxing powers are applicable to businesses, not households, while many government services are primarily delivered to households.

Existing State taxes tend to be volatile, opaque, inefficient and regressive, and severely limit the revenue raising capacity of the States.

Complete vertical balance is neither realistic nor desirable if the Commonwealth is to continue to provide the mechanism for fiscal equalisation between the States. All federal systems undertake some income transfers between their various levels of government. However, *Re:think* finds that Australia's imbalance is larger than comparable countries and CCI believes closing the gap should be a central objective of this process.

Tax Principles

A tax system for a modern economy should have a minimal overall effect on the business sector and incentives of individuals while promoting an economic environment that creates employment, income and wealth.

It should ensure Australia remains a competitive place to invest, with the size and structure of the tax burden encouraging people and businesses to locate to, and do business in, Australia rather than alternative locations.

It is also important the tax system is suited to modern business practises and takes into account the increasingly globalised economy, new technologies and new industries.

In designing the tax system, there are a range of taxation principles commonly identified as being necessary to achieve these goals.

- **Equity**: this principle ensures the tax burden is spread fairly across the population. Horizontal equity requires taxpayers in similar circumstances should face a similar tax burden; while vertical equity requires those in different circumstances face a different tax burden, with those better able to pay facing a higher tax burden.

- **Efficiency:** an efficient tax system promotes a strong economy by ensuring resources are allocated to their most productive use. The system should be administratively efficient so the costs of managing and complying with a tax are not excessive relative to the revenue raised, and it should be economically efficient so distortions caused by people changing their behaviour because of tax are minimised.

- **Transparency:** a transparent tax system allows taxpayers to clearly identify how much tax they are paying. A transparent system identifies what is to be taxed, and how the liability is calculated.

- **Adequacy:** the government requires revenue to fund its expenditure. Taxation should raise sufficient revenue to support fiscally-responsible Government spending.

- **Certainty and simplicity**: the tax system should be clear and simple to understand so taxpayers can anticipate when and how the tax is to be paid, and the amount of the tax.

As well adhering to these principles, good tax design is also predicated on broad tax bases (with minimal concessions and exemptions) and low tax rates.

Any fundamental reform of the taxation system should be consistent with the objectives outlined above. The options for reform presented in this submission are framed in the context of these taxation policy principles.

Reform Packages

Package One: Reduce Vertical Fiscal Imbalance

A priority area for reform is to reduce the level of imbalance between the funding and the spending responsibilities of the Commonwealth and the States. This is an important consideration for the Federalism White Paper, as well as the Tax White Paper.

The ability for States to reform inefficient taxes is currently limited by the imbalance between the revenue raising and expenditure responsibilities of the States and Territories, known as Vertical Fiscal Imbalance (VFI). The revenue raising capacity is disproportionately vested in the Commonwealth, while the States have primary responsibility for delivering core community services, such as health and education. The States are heavily reliant on grants from the Commonwealth, in particular GST grants, to ensure they have sufficient revenue to fund services and infrastructure.

The system also reduces the incentive for recipient states to reform their economies and improve productivity. Excessive reliance on federal funding has the potential to reduce the appetite for reform and innovation among the recipient states as it will likely lead to lower grant revenue.

Projected decline in the state's GST revenue has the potential to put the break on growth by limiting the State Government's ability to adequately invest in infrastructure and services, and to undertake reforms to maximise the opportunities that lie ahead.

The State's reliance on GST revenue means Horizontal Fiscal Equalisation (HFE) can provide a disincentive for tax reform. Any reduction in GST revenue as a result of the HFE process would limit the ability of the state to undertake any significant tax reforms that would further reduce their revenue base.

Removing this disincentive by ensuring the states have access to sufficient and sustainable revenue will be critical to their ability to deliver overarching reform to the tax system, and allow the least efficient taxes to be abolished.

There are a number of ways that greater fiscal balance can be achieved, however this will require a collaborative approach between the States and the Commonwealth, take into consideration all taxes and not be constrained by the need to be revenue neutral.

Transferring expenditure responsibility to the Commonwealth is not a preferred option as it leads to complications about responsibility for service delivery, weakens accountability to the public and slows the responsiveness of Government to the community's needs.

A better option is to pass taxing powers from the Commonwealth to the States.

Sharing the income tax base

Income tax is the obvious candidate for such an arrangement, and was identified in the Henry Tax Review and National Commission of Audit as an option that should be further investigated[3]. Access to income tax would provide the States with a sustainable revenue base that would increase automatically as the economy expanded and improve the States' ability to abolish inefficient taxes. It is also constitutionally possible given the States collected income tax prior to World War Two.

Canada has a federal income tax rate and a provincial, or territorial, tax rate. The federal tax rate is the same for all providences and states, and the provincial and territorial (apart from in Quebec) income tax rates are calculated in the same way as the federal income tax. However, provincial and territorial income tax rates and thresholds can (and do) differ. This adds to the complexity of the Canadian income tax system. At both levels of government, Federal and Provincial/Territorial, income tax credits are offered and tax credits can (and do) vary from province and territory.

Under such an arrangement in Australia, the Commonwealth would retain the right to set thresholds and brackets for the income tax system. This arrangement would reduce the complexity seen in the Canadian income tax system. The Commonwealth would reduce its income tax rates, which would allow room for the State to levy its own tax rate on income without increasing the overall tax burden. The lower revenue forgone by the Commonwealth would lead to a corresponding reduction in financial assistance to States. The Commonwealth would also be the only level of government to offer tax credits, a power taken from the States.

To ensure the overall income tax burden does not increase for workers, the Federal Government should set a rate band that the States can levy, for example zero to five per cent. This would mean States could set their levy depending on the economic environment for that State. For example, if there are high levels of economic growth which has impacted on the labour market causing labour shortages, and there is a need to attract workers to the State, a lower income tax could be levied. This would increase competition between the States and also could be used as a way to increase labour mobility. If workers prefer a lower income tax rate they have the option to move to a state which offers a lower income tax rate.

An important consideration under this proposal is to ensure compliance costs on taxpayers do not increase. This can be best achieved by the Australian Taxation Office (ATO) continuing to collect all income taxes, including those levied by the State. The States' levies would then be hypothecated to each State.

Commonwealth – Current rates for 2014-15	
Taxable Income	**Tax on this income**
0 - $18,200	Nil
$18,201 - $37,000	19c for each $1 over $18,200
$37,001 - $80,000	$3,572 plus 32.5c for each $1 over $37,000
$80,001 - $180,000	$17,547 plus 37c for each $1 over $80,000
$180,001 and over	$54,547 plus 45c for each $1 over $180,000

Example of Sharing of the Income Tax base

Commonwealth adjusted 2014-15 rates		*State (based on 5 per cent levy)*	
Taxable Income	**Tax on this income**	**Taxable Income**	**Tax on this income**
0 - $18,200	Nil	0 - $18,200	Nil
$18,201 - $37,000	14c for each $1 over $18,200	$18,201 - $37,000	5c for each $1 over $18,200
$37,001 - $80,000	$2,632 plus 27.5c for each $1 over $37,000	$37,001 - $80,000	$940 plus 5c for each $1 over $37,000
$80,001 - $180,000	$14,847.46 plus 32c for each $1 over $80,000	$80,001 - $180,000	$2,699.54 plus 5c for each $1 over $80,000
$180,001 and over	$47,175.78 plus 40c for each $1 over $180,000	$180,001 and over	$7,371.22 plus 5c for each $1 over $180,000

To prevent the system from becoming overly complex, the States should align their income tax bases with the Commonwealth and set a single tax rate then compete only on that rate. To reduce compliance costs, this should be centrally administered by the Commonwealth.

The National Commission of Audit identified that providing the state's with access to the income tax base is an option to reduce the degree of vertical fiscal imbalance in the Federation. This proposal would mean the Commonwealth would make room for a new state surcharge and reduce its personal income tax rate by the equivalent percentage point to ensure taxes do not rise overall. The revenue raised would be hypothecated to the States. The States would be provided with the capacity to periodically vary the surcharge they impose as a means of injecting further competition into the Federation[4].

With States receiving a share of income tax based on incomes in their own states this incentivises states to increase the level of income for people of that State. The key activity to ensure the State's income increases is to ensure the State has strong economic growth.

Further, an important part of this process would be to review the allocation of responsibilities within the federation to simplify the system, improve its efficiency and transparency and eliminate duplication and overlap. The Commission of Audit report recommended a comprehensive review of the roles and responsibilities between the Commonwealth and State governments, noting the principle of subsidiarity so that policy and service delivery is, as far as is practicable, delivered by the level of government closest to the people receiving those services[5].

As part of the Federalism paper to be released, a review of the allocation of responsibilities within the Federation is needed as part of this tax reform agenda. If the States are given a more sustainable revenue base, more responsibilities should be given to the States. A more centralist approach, where expenditure responsibility sits with the Commonwealth, can lead to a situation where transparency is reduced, accountability to the public is weakened and government responsiveness is slowed. In WA, this is a particular concern due to the distance of the state from decision makers on the east coast.

Feature Box: Jurisdictional comparison

Evidence from Canada suggests lowering the corporate tax rate does not result in a loss of revenue for government over the long run. Canada has been through a long period of corporate tax cuts, starting in the 1980s and continuing into the 2000s.

The effective corporate tax rate in Ontario is 26.5 per cent. This comprises of a 15 per cent federal tax component and an 11.5 per cent province tax component[6]. Depending on the province tax rate, the effective corporate tax rate in Canada varies from 25 per cent to 31 per cent.

Chart 1[7] shows Canada's federal corporate tax revenue has increased since 1980, as a percentage of GDP. However, Canada's corporate tax rate has decreased from 38 per cent to 15 per cent. Taxation revenue is correlated with economic growth (even corporate profits) and not the tax rate — this can be seen in Chart 1, with a significant decline in revenue following the GFC in 2008[8].

Corporate taxation revenue shows reducing the corporate tax rate does not result in a loss to corporate tax revenue, because the taxation base expands as a lower corporate tax rate can entice corporations to set up operations and benefit from a lower tax rate, resulting in the government losing no revenue over the long run.

The United States of America has a system of Dual Federalism where power is divided between the State and Federal Governments in clearly defined terms, with state governments exercising those powers accorded to them without interference from the federal government.

The corporate tax rate in the United States is approximately 40 per cent. The Federal government is responsible for approximately 35 per cent of this, while the states and local governments can impose an income of between zero per cent and 12 per cent. Nine states in the US have a zero income rate, eight states have a flat income rate and the remainder of the states use a progressive tax rate. The average state and local marginal tax rate is approximately 7.5 per cent, however corporations can deduct its state and local income tax expense when computing its federal taxable income. This results in a net effective corporate tax rate of approximately 40 per cent[9].

GST reform

A further option to provide revenue to the states is to broaden the base of the GST.

As noted in the tax discussion paper, the GST is relatively efficient compared with other taxes because of the broad tax base, however the current exemptions increase complexity and reduce its efficiency as a broad based tax[10]. Only 47 per cent of private consumption is subject to GST, which is lower than the OECD average of 55 per cent. This VAT coverage ratio has continued to declined, where it was 56 per cent of consumption in 2005-06[11].

The Henry Tax Review found that total household consumption as a percentage of GDP has been relatively stable for a long time, which suggests that a tax on consumption would provide a relatively sustainable revenue base that grows in line with the broader economy. However, GST is slightly less robust because it does not cover the full consumption base[12].

The base of the GST should be broadened to include the main exemptions such as fresh food, education, health, child care, water sewerage and drainage, residential rent and financial services. Most imported services and intangibles purchased by consumers, primarily purchased online, such as multimedia downloads, were not subject to GST, however in the 2015-16 Commonwealth Budget the government said it would apply GST to cross-border supplies of digital products and services imported by consumers from 1 July 2017[13].

Increasing the GST base would alleviate the need to increase the rate of GST from 10 per cent, as a broader base would increase GST revenue. Should an increase in revenue be required to fund a decrease in less efficient taxes, like income tax or state-based transfer duties, the rate of GST could be increased.

Broadening the base of GST collection will result in an increase in GST revenue of approximately $36.7 billion[14] (See Table 1), using 2013-14 figures.

Table 1

	NSW	VIC	QLD	SA	WA	NT	TAS	ACT	TOTAL
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Modelled GST Revenue	$27,202	$19,751	$18,848	$7,984	$4,290	$4,864	$3,131	$1,769	$87,839
Actual GST Revenue	$15,850	$11,508	$10,982	$4,652	$2,500	$2,834	$1,824	$1,031	$51,180
Difference	$11,352	$8,243	$7,866	$3,332	$1,791	$2,030	$1,307	$738	$36,659
Source	Australian Bureau of Statistics, 2013-14, *Expenditure Components of GSP: Current Prices* , Cat. no. 5220.0, Canberra & Commonwealth Treasury, 2014, *Final Budget Outcomes 2013-14* , p. 62, http://budget.gov.au/2013-14/content/fbo/download/Consolidated.pdf								

The Productivity Commission found that by 2044-45 GST revenues may decline slightly as a share of GDP because tax-exempt consumption, such as healthcare, is expected to grow[15]. The Commission estimated that tax-exempt spending will rise from 18.7 per cent of GDP in 2003-04 to 21.4 per cent of GDP by 2044-45. The increase in private health expenditures will be partly offset by a reduction in tax-exempt consumption in education and housing. Broadening the base by including these exemptions would ensure these structural changes in consumption behaviour are captured in the tax base.

Reform to GST distribution

Broadening the GST base in isolation is an option to increase the revenue provided to the states. However, there should also be change to the GST distribution methodology to ensure the full benefits of such a reform are realised.

The current methodology for determining the relativities which inform the GST distribution process is complex and technical which limits public discourse regarding the impact that horizontal fiscal equalisation has on the broader Australian economy; this includes the treatment of revenue, particularly own-source revenue.

While the current methodology of GST distribution focuses on improving equity across the states and territories, it is achieved to the detriment of efficiency, as funds are not necessarily allocated to activities that will deliver the greatest benefit to the nation. While this helps smaller states and territories supply services, the opportunity cost of this allocation is potentially significant as it directs funds away from further industry infrastructure development in stronger states which could build the productive capacity and growth prospects for the nation over the longer term.

The asymmetric treatment of revenue can create distortions because not all states collect revenue from the same sources. For example, gambling taxes are not included in the equalisation process, despite representing a large amount of revenue for some jurisdictions, but mining royalties are, which represent just under 20 per cent of WA's revenue. The Commonwealth Grants Commission has not been able to develop a methodology that it believes can adequately reflect revenue effort in gambling taxes. The effect of this is WA is penalised for not having a significant gambling presence in the state, while simultaneously being penalised for the development of a strong minerals and resource industry simply due to a methodology issue.

There has been much debate around the GST methodology, including the 2015 Review which recommended WA receive a lower GST relativity due to WA's capacity to raise mining royalties compared with other states and territories. The Commonwealth Treasurer ordered the Commission to provide options to give WA special treatment, the Commission presented four options but recommended none be pursued.

One option, which is yet to be examined in detail, is for GST to be distributed based on the point of collection. This approach would incentivise states to increase economic activity in their states which would lead to an increase in consumption and therefore an increase in the collection of GST.

This approach differs from the current reform proposal of distributing on the basis of population. While this would likely improve Australia's economic prospects by distributing a greater proportion of scarce resources to areas of the nation where it can be put to productive use, it results in some equalisation occurring to states that may not have high levels of economic activity. By directly linking GST allocations to consumer spending activity through a point of collection system, the GST becomes a true State tax as GST revenue (minus some administrative cost) is put back into the hands of those who are spending and thus paying the tax.

This contrasts to the current GST system which provides disincentives for economic development and increasing capacity to pursue economic development opportunities. If States fail to improve their economic activity and implement reforms they will be remunerated from the GST grants process due to their lower revenue raising capacity. This penalises states, such as WA, which have high levels of economic activity and population growth which require a corresponding increase in expenditure for economic infrastructure, such as ports and rail, as well as services provided to the community (health and education).

Below are CCI's estimates of two scenarios, the first being GST at the point of collection using the current base, which includes exemptions on fresh food, health and education. The second scenario is GST at the point of collection using the broadened base, which taxes almost all consumption in the Australian economy.

Scenario 1: GST at the point of collection with current collection base

Using 2013-14 figures and the current GST revenue collection methodology (collection on only select components of Household Final Consumption Expenditure as calculated by the Australian Bureau of Statistics), the approximated results from distributing GST revenue at the point of collection is displayed in Table 2[16].

Table 2

	NSW	VIC	QLD	SA	WA	NT	TAS	ACT	TOTAL
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Modelled GST Revenue	$17,341	$12,608	$9,956	$3,386	$5,331	$545	$1,044	$878	$50,926
Actual GST Revenue	$15,850	$11,508	$10,982	$4,652	$2,500	$2,834	$1,824	$1,031	$51,180
Difference	$1,492	$1,100	-$1,026	-$1,266	$2,831	-$2,289	-$780	-$153	-$254
Source	Australian Bureau of Statistics, 2013-14, *Expenditure Components of GSP: Current Prices*, Cat. no. 5220.0, Canberra & Commonwealth Treasury, 2014, *Final Budget Outcomes 2013-14*, p. 62, http://budget.gov.au/2013-14/content/fbo/download/Consolidated.pdf								

Table 2 demonstrates the states and territories of QLD, SA, NT, TAS and the ACT would be worse off.

The net loss for these state and territories is $5.4 billion, or 1.5 per cent of total government revenue[17].

Scenario 2: GST at the point of collection and broadening the collection base

Using the same methodology of keeping GST at the point of collection but broadening the collection base, the GST revenue and distribution are displayed in Table 3.

The results demonstrate that the NT and TAS would be the only states or territories worse off. The net loss for these states and territories totals $2 billion, or 0.5 per cent of total government revenue[18].

Table 3

	NSW	VIC	QLD	SA	WA	NT	TAS	ACT	TOTAL
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Modelled GST Revenue	$29,217	$21,646	$17,275	$5,787	$9,672	$970	$1,685	$1,588	$87,839
Actual GST Revenue	$15,850	$11,508	$10,982	$4,652	$2,500	$2,834	$1,824	$1,031	$51,180
Difference	$13,368	$10,138	$6,293	$1,135	$7,172	-$1,864	-$139	$557	$36,659
Source	Australian Bureau of Statistics, 2013-14, *Expenditure Components of GSP: Current Prices*, Cat. no. 5220.0, Canberra & Commonwealth Treasury, 2014, *Final Budget Outcomes 2013-14*, p. 62, http://budget.gov.au/2013-14/content/fbo/download/Consolidated.pdf								

To address these shortfalls, the Northern Territory and Tasmania could be topped up with payments from the Commonwealth, separate to the GST system, as a way to reduce complexity of the system and ensure that no states are worse off. These top up payments should be contingent on economic reform goals, to ensure these states reduce their excessive reliance on federal funding and increase their productive capacity to further contribute to the growth prospects of the nation over the longer term.

Payments from the Commonwealth to Tasmania would help the state transition to improve their taxing capacity and economic growth. The Northern Territory should acquire separate payments from the Commonwealth as the Territories in Australia are not independent states, and therefore fall under the responsibility of the Commonwealth.

Feature Box: Taxation in other federations

Like Australia, Canada is divided into many states (provinces) and territories. However, unlike Australia, Canada is a decentralised federation. The provinces of Canada compete with one another regarding fiscal and economic matters[19]. This has resulted in a non-symmetric relationship between the provinces as some provinces have more power (fiscal and economic) than others.

As a percentage of total government spending, Federal Government spending in the United States is much higher than Canada. This is because local (province) government spending in Canada is (as a percentage of total government spending) much higher than Federal Government spending[20]. For example, there is no federal department of education in Canada, school funding is left to the provinces.

A similar swing in Canada has occurred regarding revenue sources at federal and provinces levels. However, revenue has not decentralised to the same extent as spending. As a result of this, specific purpose grants are still in place in Canada but over time they have decreased. Furthermore, they are flexible in that provinces can opt out of any particular federal program and still receive compensation from the Federal Government[21].

To further enhance the competition between provinces and territories in Canada, province and territory taxes are not deductable on federal individual tax returns[22]. This creates further competition between provinces and territories regarding tax compensations.

However, issues from a decentralised federation do occur. Difficult national issues are harder for the Federal Government to deal with. The Federal Government does not have the power to introduce policies to affect national issues, such as the labour force, as this power is given to the states. In addition, the provinces of Canada were given certain taxation powers. The provinces were only given direct taxation powers, issues defining a direct tax has become a major issue and been reviewed a number of times by the Canadian judiciary[23].

Recommendations:

- Vertical Fiscal Imbalance (VFI), the gap between Federal and State Government revenue and expenditure powers and responsibilities should be addressed in this process and the Federal Government's Reform of the Federation White Paper.

- The base of the Goods and Services Tax (GST) should be broadened to apply to all consumer spending to improve efficiency and give the States access to a larger share of total tax revenue. At this stage, the rate of GST applicable should be left at 10 per cent.

- The GST should be distributed to the states using a "Point of Collection" methodology that would return GST revenue to the state in which the spending took place. This would make the GST a more stable, predictable and fair source of revenue for the states. Specific funding for states and territories left worse-off should be provided by the Commonwealth Government outside of the GST pool, noting the GST is a state tax. These payments should be tied to economic reform and be temporary.

- State Governments should be given provision to charge an independent surcharge on federal personal income tax rates at thresholds that align with the Federal Government. States should only compete on rates and not be given power to set exemptions, deductions or thresholds. This should coincide with a significant reduction in personal income tax rates, and a flattening of the personal income tax scale, at a federal level (see Package Three: Reducing Personal and Business Income Taxation).

Package Two: State tax reform

The state tax system is an area where there is scope to achieve the biggest gains in terms of efficiency, given that the states are reliant on a small number of inefficient taxes.

However, the ability of the states to reform their tax systems is limited by their revenue raising capacity (see VFI section above).

The scope is even more limited in WA given that royalty revenue has become a much larger share of state revenue, rising from just five per cent of total revenue in 2003-04 to over 20 per cent over the last decade. This large source of revenue is highly volatile due to significant swings in commodity prices. WA's declining share of GST receipts has further added to the state's revenue challenges.

While reforms that will address VFI (as outlined above) will be an important way to provide the states with addition revenue to reform their tax systems, in the short term, there is scope to improve the efficiency of the state tax system by shifting from a reliance on transaction taxes to more efficient taxes such as on property and consumption.

The WA Economic Regulatory Authority (ERA) recommended in its inquiry into Microeconomic Reform in Western Australia the State Government should consider options for reforming payroll tax, residential transfer duty and land tax by broadening the base and lowering the rate of all three taxes to increase their efficiency; or increasing reliance on efficient taxes (land tax and payroll tax) and reducing or abolishing the inefficient taxes (residential transfer duty).

The ERA also noted there are strong advantages of proceeding with the reform of State taxes because of significant efficiency gains that are expected to accrue from reform.

Land tax reform

One of the most efficient tax bases the state has access to is immovable property, such as land. Due to the immobility of land, land tax has the ability to be a highly efficient tax base and makes tax avoidance harder for individuals.

The land tax base in WA should be broadened, which would include the removal of existing land tax exemptions on residential property and other exemptions which are not provided for social purposes. The land tax rates should also be lowered, particularly at higher property values, which combined with a broadened tax base, would ensure the state has an efficient and reliable revenue source.

Land tax is payable on the taxable value of the land on a step rate scale which increases as the value of the land increases. Rather than the six point scale currently used in WA to assess land tax, which is more than other states and territories, a simpler single rate and threshold system for land should be used to simplify the system. However, it should incorporate an exemption threshold that is low enough to ensure the vast majority of owned land in WA is subject to land tax, while not too low as to be administratively inefficient.

Land tax raised $596 million in revenue for 2013-14 and is projected to raise over $1 billion in 2017-18[24]. The government has also increased the land tax rate, in 2013-14 all marginal tax rates were increased by around 12.5 per cent and in 2014-15, all marginal tax rates were increased by another 10 percent. In the State's recent 2015-16 budget, there were further changes to land tax which included a flat rate charge and also an increase in land tax rates (excluding the top rate). Rather than continuously increasing land tax rates, especially in a challenging fiscal environment, broadening the base would increase revenue while spreading the tax burden more equitably across the community, rather than targeting a small group.

For example, the ERA in its *Inquiry into Microeconomic Reform* projected that if the State Government removed all concession and exemptions on land tax and raised the rate, while retaining the progressive scale, this would significantly increase the amount of revenue raised by land tax. Pre-change, the current land tax system would raise about $560 million in 2012-13 figures (or around 6.8 per cent of total revenue). Post-change, land tax would broadly tax more people and lead to revenue of around $1.3 billion (or around 16 per cent of total revenue)[25].

The land tax assessment process also remains a concern with many businesses facing land tax assessments which have increased 10 fold from the previous year. While the process of determining the taxable value of land (utilising the Valuer-General's "Unimproved Value" assessment, including the ability for taxpayers to dispute the assessment) is sound, particularly when compared to other states and territories, reforms that seek to make land tax liabilities more predictable for tax payers are desirable. The current valuation methodology applied to determine a land tax liability is subject to significant volatility on a year-to-year basis, which can lead to volatility for the entity liable to pay land tax.

Once the land tax base is broadened there should be more flexibility for the states to abolish inefficient taxes that make up a large proportion of their revenue raising abilities.

Abolition of duties-based taxes

The abolition of stamp duties should be a key long-term priority for State Governments, as these taxes are highly inefficient, transactions-based taxes that distort economic activity. They lead to inefficient outcomes as businesses and households change their behaviour to avoid the tax, which may mean that resources are not allocated to their most efficient or productive use. Duties are a large proportion of State revenue, for instance, WA raised approximately $2.5 billion on stamp duties in 2013-14[26]. States will not be compelled to abolish these duty based taxes unless an appropriate revenue substitute is found.

The tax is paid by the buyer of the particular item or property, with the rate determined by the value of the item or property on a step rate scale. The Western Australian Government levies duties on residential and commercial property transactions (transfer duty); on the value of the premium of most kinds of insurance (insurance duty); on land transfers by commercial entities or trusts (landholder duty); and on the licensing of a new or transfer of a used vehicle (vehicle duty).

Duties are also charged on insurance where the duty increases with the level of insurance cover. This can create adverse consequences of under insurance and less than optimal production of insurance products. It also penalises people who obtain insurance to cover their property and assets, with the people in the community who do not purchase insurance relying on the government in the event of a major catastrophe occurring.

Transfer duty in property is one area where significant reform is needed. The Henry Review highlighted that transfer duty on property discourages transactions of commercial and residential property and through this, its allocation to its most valuable use. Transfer duty can also discourage people from changing their place of residence as their personal circumstances change or discourage people from making lifestyle changes that involve a change in residence. It is also inequitable, as people who need to move more frequently bear more tax, irrespective of their income or wealth[27].

The abolition of stamp duty on property needs to be phased out slowly to ensure there are no adverse impacts on the property market. The Australian Capital Territory Government has commenced phasing out transfer duties on conveyance over a 20 year period and adopting general rates as revenue replacement.

Feature box: ACT state tax reform

The ACT Government began abolishing transaction taxes in the 2012-13 Budget with the intention of phasing these taxes out over five to 20 years. The tax reform implemented by the ACT Government is intended to be revenue neutral overall, with general rates expected to replace inefficient and volatile state taxes. The main measures are:

- abolishing duty on insurance taxes over five years;
- phasing out Conveyance Duty over 20 years; abolishing commercial Land Tax and combining it with commercial general rates;
- making general rates more progressive;
- making residential Land Tax more progressive;
- reducing the amount of Payroll Tax paid by businesses; and
- legislative changes, including aligning the landholder provision with NSW.

From July 2012, a new flat fixed charge of $555 for all households was implemented. Three thresholds or four tax brackets are being implemented in order to introduce progressivity into the system. According to the ACT Treasury's forecast, around 24 per cent of properties will incur a decrease in rates payable, with 76 per cent incurring an increase.

To assist low income earners that may be impacted severely by the flat fixed charge, the ACT Government has implemented a Rates Deferral Scheme, allowing eligible households to defer payments of their General Rates, expanding this to the non-pensioners over 65 years of age. This allows eligible households to defer payments of their general rates on which a relatively low rate of simple interest is charged and can be paid out of the sale proceeds of that property once it is sold[28].

Abolition of Payroll Tax

The abolition of Payroll Tax remains a key long-term tax policy objective, as it is a tax on employment and represents a major cost of doing business. It also affects business decisions and penalises businesses for expanding. Businesses of all sizes and sectors have a collective desire to reform payroll tax because it discourages the growth of their enterprises and is viewed as a penalty for increasing salaries and employing people.

The biggest impact on business decisions from payroll tax is when the total payroll approaches the exemption threshold, with the effective marginal cost of employing additional labour increasing once the employer moves through the exemption threshold and becomes liable for payroll tax. The WA Government's recently announced increase in payroll tax payable illustrates this, with a survey of CCI's members indicating more than 80 per cent were less likely to increase staff wages or create new jobs as a result of the move[29].

An employer is currently liable for payroll tax on wages paid or payable in WA when its total Australia-wide wages exceed $800,000 per year (or $66,667 per month)[30]. There are a range of temporary rebates and exemptions, including for employers employing Indigenous persons and people with a disability.

Payroll tax is a major contribution to state revenue in WA where it raised $3.4 billion for the State Government in 2013–14, up 2.5 per cent on the previous year and over 200 per cent higher than in 2003–04[31]. The continued growth in the payroll tax take has meant that WA remains one of the highest payroll taxing states in the nation in per capita terms.

The Payroll Tax rate in WA is the third highest of all states (behind ACT and Tasmania, equal third to NT) at 5.5 per cent, while having the fourth lowest exemption threshold[32]. Other states have been active in providing tax cuts in recent years.

Subject to adequate replacement revenue, the State Governments should seek to progressively pare back and abolish Payroll Tax to reduce business cost and reduce the disincentives associated with this tax on employment.

Other state tax reform

The major state taxes that raise the largest proportion of tax revenue for WA have been discussed above, however there are a range of minor taxes or levies that raise lower amounts of revenue for but are also inefficient in their operation. Some examples of these types of taxes are discussed below.

Metropolitan Region Improvement Tax

The Metropolitan Region Improvement Tax (MRIT) is levied at 0.14 per cent upon the aggregated unimproved value of all land in excess of $300,000, which is both liable for land tax and located within the boundaries of the metropolitan region. These collections are hypothecated to a trust fund for expenditure by the Western Australia Planning Commission on road reserves, parks and recreation areas.

In the 2014-15 Mid-year Review it was announced the MRIT would be expanded state-wide from 1 July 2015. However the government decided the MRIT will instead be expanded from 1 July 2016 only to regional areas where a region scheme is in place. This will impact a further 11,000 land owners and raise a further $21 million over the forward estimates. The MRIT is a narrowly based tax as it applies to business in particular local government areas and the notional revenue raised by this funds infrastructure and other developments which benefit both MRIT payers and non-MRIT payers.

Perth Parking Levy

Another state tax that should be abolished is the Perth Parking Levy, which is a charge administered to all non-residential parking bays within the Perth Parking Management Area to allow a non-resident to park their vehicle in this area. The intention is to provide the State Government with funds to develop policies to decrease the use of cars in the Perth parking management area. Currently the levy funds the free Central Area Transit (CAT) bus system.

The levy contravenes good tax policy and taxes a narrowly targeted class of citizens in order to meet the cost of providing a particular benefit another group of narrowly classed citizens. The tax has an adverse economic impact because it increases the relative costs and diminishes the amenity of doing business in the CBD. With the demand for car parking bays highly inelastic, it does not act as a deterrent for users of cars, but rather increases costs for businesses and their customers in the CBD.

Landfill Levy

The Landfill Levy is imposed on waste that originates from or is disposed of in the Perth Metropolitan area. These funds are used for the management, reduction, reuse, recycling, monitoring or measurement of waste. It is levied at $55 per tonne of putrescible waste[33] and $40 per tonne of inert waste[34]. For 2013-14, this levy raised around $46 million for the State Government[35].

Instead, the government should concentrate on ensuring environmental regulation reduces externalities from landfill and waste recovery facilities to acceptable levels. Under an economically efficient framework for the management of landfill, government regulation would ensure that all the externalities of landfill were factored into the cost of landfill and markets would determine the level of waste recovery.

Recommendations:

- State Governments should agree to abolish all remaining transfer duties, including on housing-related transactions, with replacement revenue to be generated by a broad based land tax. Existing exemptions on land tax applicability, including the principal place of residence exemption, should be removed. This should be subject to a long transition period to ensure minimum distortion in the market.
- The land tax thresholds should be significantly flattened, to improve the efficiency of the tax and reduce the incentive to increase rates of tax on higher valued properties.
- The states should, subject to adequate replacement revenue, reduce and gradually eliminate payroll tax, which acts as a barrier to employment and income growth and reduces economic growth.
- With new, efficient sources of revenue, Western Australia should eliminate nuisance taxes, including the Metropolitan Region Improvement Tax (by incorporating it in to the land tax base, particularly now that it applies to the vast majority taxable land in Western Australia), Perth Parking Levy and Landfill Levy.

Package Three: Reforming personal and business income taxation

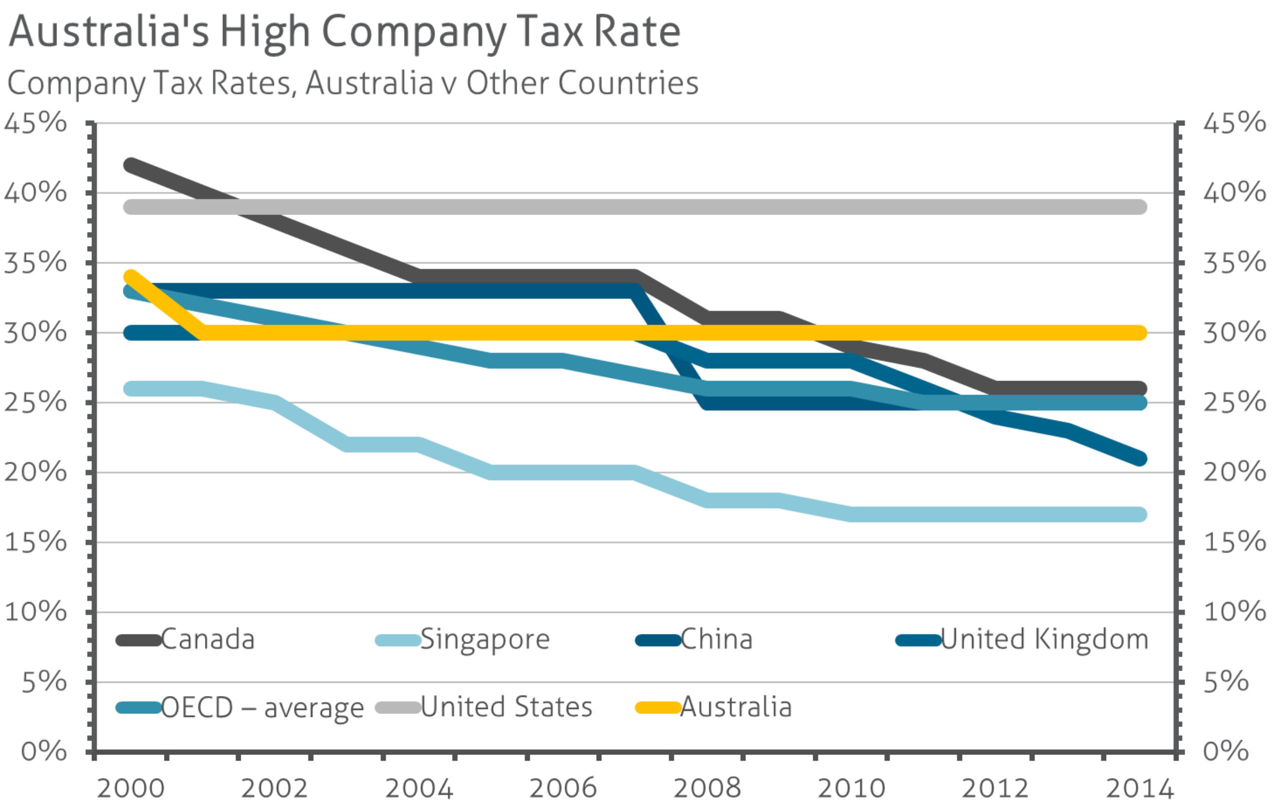
Australia’s reliance on taxation from personal and business income has been highlighted as a key weakness of the tax system, according to the discussion paper. Taxing income reduces the incentive to work for households and to invest for businesses, by reducing the after-tax returns on work done or investments made.

This is put into focus by the Discussion Paper, which finds Australia’s company tax system involves a marginal excess burden – which represents the deadweight loss of a tax – of almost 60 cents in the dollar. This is because capital and labour are relatively mobile tax bases, which can be adjusted to avoid taxation, particularly compared to more immobile tax bases such as land or mineral resources.

Australia’s high rate of company tax reduces the level of investment in the economy as a whole by reducing the supply of investment opportunities that produce an after-tax rate of return that justifies the risk of a project. This leads to a disequilibrium in the number of investment projects which proceed.

For a capital-poor country like Australia, which relies significantly on foreign investment to make up a shortfall in capital, this effect is amplified.

According to the Discussion Paper, this issue is gaining prevalence in other open economies like the United Kingdom, Canada, New Zealand and Singapore, all of whom have reduced their company tax rates in recent years.



Source: CCI Economics, Tax Discussion Paper

High rates of personal income tax have the same effect, particularly at high incomes where unincorporated businesses face very high effective marginal tax rates. More broadly, personal income tax directly impacts on labour and the nation’s ability to attract and retain suitable workers.

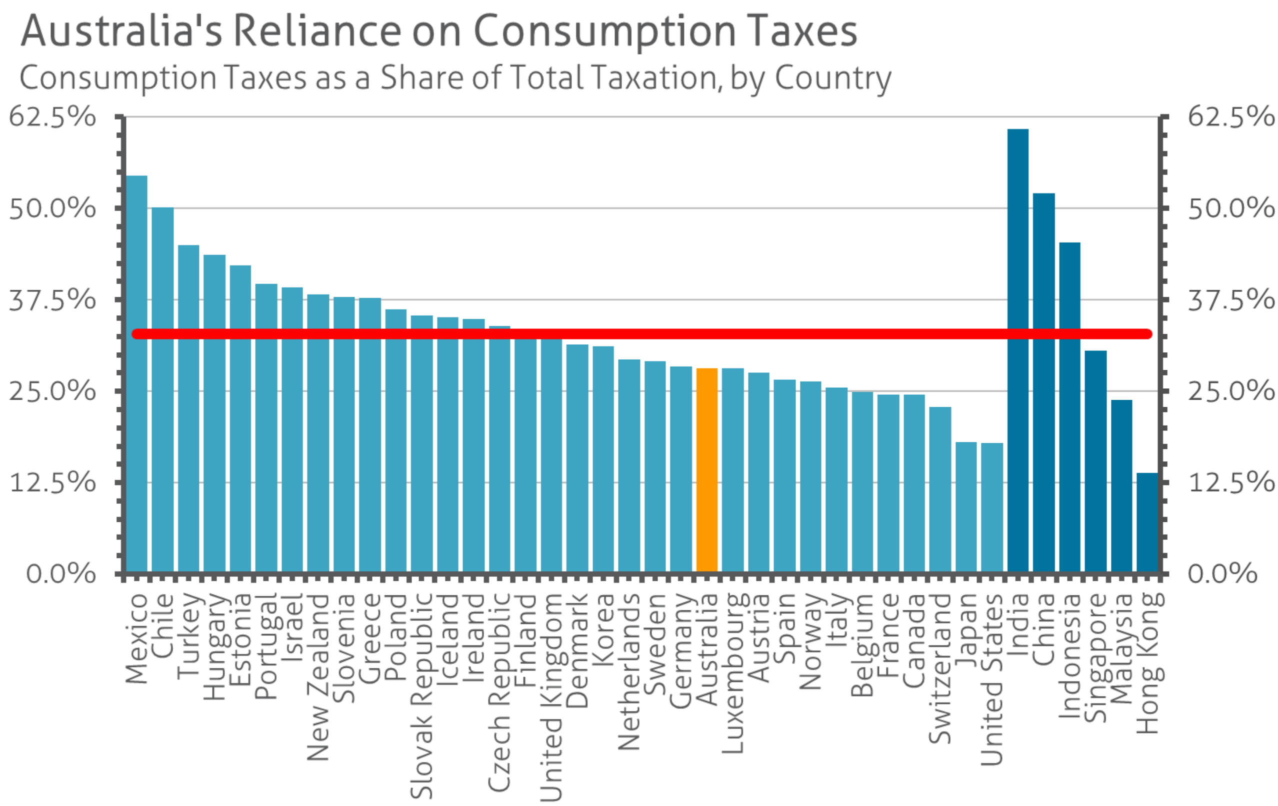
With labour markets becoming increasingly global, high marginal tax rates undermine the ability of Australian businesses to attract skilled migrants and also to retain skilled workers in the Australian economy. At the same time, the personal income tax system also impacts upon the incentives of the current population to participate in the labour force. The complex interaction between the taxation and government transfer payment system also produces perverse outcomes, as highlighted in the Discussion Paper.

Reform to reduce VFI and giving the states access to a share of the personal income tax base will allow the Commonwealth Government to embark on a holistic package of income tax reform, aimed at reducing income tax payable for both households and businesses.

The Federal Government should take action to reduce both personal and business income taxation.

Household taxation

Australia's system of personal income taxation compares unfavourably to competitor countries, and countries in Australia's immediate region.



Source: CCI Economics, Tax Discussion Paper

Australia's system of household taxation, which includes personal income tax and taxes on savings, impacts on the Australian economy in a number of ways:

- **Workforce participation:** direct income tax reduces the incentive for people to work, by reducing the after-tax income of additional hours worked. A progressive rate scale means this effect increases as income levels increase, while interactions with income-tested government payments can produce perverse outcomes at particular thresholds of income earned. Meanwhile, the uniform application of income tax across state boundaries, excluding the Zone Tax Rebate, means the flexibility available to other countries like the United States when it comes to enabling labour to move to where the jobs are, is not available.

- **Attraction and retention of skilled workers:** with labour increasingly internationally mobile – enabled by air travel and the internet – the household taxation system can impact on where skilled workers choose to locate and work.

- **Patterns of savings:** the differential treatment of savings classes in the tax system is potentially leading to a misallocation of resources across the economy and leading to increased investment in dwellings at the expense of at-call deposits.

Addressing Australia's high effective marginal tax rates (EMTR) will be a particularly important reform to encourage workforce participation. 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 lead to very high EMTR, well above that paid by many high income earners.

Australia's high EMTR act as a disincentive to move from benefits, into the labour force. 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. According to the Review Certain groups are more likely to experience high EMTRs – particularly lower income earners, people with dependent children, and married mothers. These are somewhat beyond the scope of the Tax Reform White Paper process, as they are largely an issue relating to the interaction of the tax system with the transfer payments system.

Zone Tax Rebate

The personal income tax system can also be used to encourage people to move to areas of labour shortages. While there does currently exist an income tax rebate for people living in specific remote areas, further research is needed into the most appropriate way to use the tax system to encourage increased labour mobility between states.

If it is deemed that the current rebate is the most appropriate method, the value of the zone rebate needs to be reviewed, so that it provides a meaningful incentive to relocate. Since the introduction of the rebate, its value has been eroded by the strong growth in the economy and wages.

The extent to which the value of the Zone rebate has been eroded was highlighted by the WA Government in its submission to the Henry Tax Review. The submission notes that when it was originally introduced, the fixed Zone A rebate equated to 4.6 weeks average earnings and the Zone B rebate equated to 2.3 weeks average earnings. Today, the Zone A rebate equates to only 0.27 weeks average earnings and the Zone B rebate equates to only 0.04 weeks average earnings. The Federal Government tightened the eligibility criteria of the Rebate in the 2015-16 Budget, stripping those who worked but did not have a physical address in the regions of the concession.

The rebate's value has been eroded to such an extent that it is now unlikely to be acting as an incentive for people to live in remote areas where labour is required. In light of this, the rebate should be reviewed, and either rebased to a higher level or abolished.

CCI's proposal to introduce a state-based income tax surcharge may also reduce the need for the rebate, as states will have the flexibility to reduce income tax rates at times of labour shortage in order to attract labour to areas of need (see Proposal One).

However, workforce participation and mobility issues are not limited to certain cohorts of the population.

Reducing Australia's income tax rates

Looking ahead, as human capital becomes a more important way for countries to generate higher living standards, ensuring a much of Australia's human capital is retained on our shores as possible will be a vital way of ensuring the economy is positioned for future economic growth. Meanwhile, an aging population and decline in Australia's dependency ratio – the number of workers per head of population that is outside of working age – will fall sharply, meaning income tax receipts will likely fall unless rates are increased to damaging levels.

This is of particular concern at higher income levels, where Australia's marginal rate of income tax is no longer competitive.

Australia's top marginal income tax rate in the 2014-15 financial year is effectively 51 per cent, after accounting for the 2.5 per cent Medicare Levy and two per cent temporary Budget Repair levy, introduced in the 2014-15 Federal Budget. This compares unfavourably with other countries in the OECD, with Australia's top marginal tax rate kicking in at a lower level than the United States, Canada, New Zealand and the United Kingdom on a percentage of average earnings basis (see Chart x).

According to Ernst and Young, Australia is just one of three OECD countries that will see an increase in their top marginal income tax rate this year[36].

This is of particular concern for highly skilled workers, who have higher average incomes and are increasingly internationally mobile. High marginal tax rates at high levels of income may encourage skilled workers to locate in countries with lower income tax burdens. At a time where international tax competition is increasing, according to the Discussion Paper, ensuring highly skilled, highly mobile workers are encouraged to live in Australia is becoming increasingly crucial.

One option could be to reduce the number of income tax thresholds, to maintain progressivity but reduce the overall level of tax paid on income. CCI supports the Australian Chamber of Commerce and Industry's suggestion to remove the $80,001 to $180,000 income bracket, and extend the income band with which the current 32.5 per cent tax rate applies from $37,001 to $180,000.

This would likely necessitate a reduction in the tax rate applied to marginal income earned over $180,001, as the marginal increase in taxation at this income level would become a substantial workforce disincentive.

Meanwhile, reform is needed to align the personal income tax rates with company tax, to reduce the distortions that this creates.

The large difference between the top personal and company tax rate gives rise to tax avoidance and minimisation opportunities. The current arrangements create incentives for taxpayers to minimise personal income tax by holding assets in a private company and withdrawing funds as needed. This gap also adds complexity to the system, as the government is required to introduce legislation to address these avoidance issues.

To remove the incentive for tax avoidance, the gap between the top marginal rate for personal and company income tax should be closed.

Treatment of savings

For Australian residents, the tax treatment of savings is an important issue and potentially an important area of macroeconomic reform for the Tax White Paper process.

As noted in the Discussion Paper, Australia's tax treatment of household savings options differs significantly by the class of savings, with relatively high levels of taxation on at-call deposits contrasting with possible tax benefits obtained by investing in non-family home housing stock. This can create distortions in the allocation of savings at the individual level, and may lead to a misallocation of resources in the economy at large. In fact, the two largest tax expenditures afforded by the Federal Government in 2013-14 are related to the way households allocate their capital: superannuation ($29.7 billion) and the exemption of the family home from capital gains tax ($44.5 billion).

Potentially the most significant issue pertaining to household savings is the ability for households to obtain a tax concession for losses incurred from investments made in rental housing stock, otherwise known as negatively gearing an investment property. Negative gearing was introduced as a policy to encourage the creation of new rental housing stock, but has become a method by which taxpayers can reduce their taxable income by making a net loss on rental property income (which occurs when the borrowing cost of the funding for an investment property exceeds the rental income generated). According to the Australian Tax Office, Australian tax payers lost a collective $7.8 billion on rental properties in 2011-12 [cite]. Households that choose to allocate a portion of their savings to invest in a negatively geared property can effectively earn a tax credit for doing so.

Meanwhile, savings invested in at-call deposits are taxed at a household's effective marginal tax rate, given the interest earned on them counts towards a household's taxable income; compulsory superannuation contributions are tax-free, while contributions made over and above the compulsory level are taxed at a concessional rate.

While CCI does not have a view on the way forward, the treatment of savings is an issue worthy of consideration by the Tax White Paper process, and CCI looks forward to responding to proposals put forward in the Green Paper.

Standard deduction for work-related expenses

Administration and compliance costs are an issue often identified in the business taxation system. However, for households, there are a range of complex administrative issues in the personal income tax system that result in a high compliance burden. The OECD's 2013 Tax Administration study found that the overall administration cost of Australia's tax system was equal to 0.18 per cent of GDP, ranked 17th of 33 OECD countries, and significantly higher than countries in our region such as Singapore (0.09 per cent), Indonesia (0.05 per cent) and South Korea (0.11 per cent)[37].

The Henry Tax Review found that over 72 per cent of individuals utilised tax agents to compile their tax returns, despite 86 per cent of individual tax payers claiming only simple work-related deductions as part of their return[38].

The Discussion Paper's suggestion of introducing a standard $1,000 deduction, to replace the range of minor deductions available to individual income tax payers, is worth exploration as a way of reducing the compliance burden on individual taxpayers, and reducing the cost of the tax system.

Business income tax system

The business taxation system is a key determinant of Australia's overall competitiveness, and provides the framework under which business make decisions relating to growth and investment.

Company tax rate

In recent years, other countries around the globe have been cutting their corporate tax rates. In 2014, the average corporate tax rate in OECD countries stood at 25 per cent, down from 32.5 per cent in 2001. As a result, Australia's company tax rate is now well above the OECD average.

With the global economy becoming more integrated and capital becoming increasingly mobile, company tax will be an important consideration in investment decisions. In this regard, cutting the tax rate is a longer-term objective that will help improve Australia's international competitiveness, and ability to attract investment from overseas. For a capital-poor country like Australia, which relies heavily on global financial flows to help fund investment in both public and private sectors, ensuring the ability to earn an adequate rate of return is maintained must be a paramount goal of all government policy.

As a first order of business, Australia's headline company tax rate must be reduced to the OECD average, and progressively lowered in line with the OECD average, to preserve Australia's attractiveness as a destination for international investors.

The OECD recommends to member countries that when they strive for low-rate, broad-based corporate tax regimes. In a tax outlook survey of 32 countries (which combined account for 85 per cent of world GDP), undertaken by accounting firm EY, it was found that seven of these 32 have announced (or are expected to announce) reductions in the rate of corporate tax in 2015[39]. This includes Australia, Denmark, Japan, Portugal, Spain, the UK and Greece.

The Federal Government's reduction in the headline company tax rate for businesses that meet the small business turnover test (a turnover of less than $2 million in a given year) to 28.5 per cent is a welcome first step – however according to the Discussion Paper it will only apply to 10.8 per cent of the company tax base (2011-12 figures). The forward estimates reveal that the Federal Government will still raise some $83 billion in company tax revenue in 2018-19, foregoing just $1 billion as a result of this measure.

Meanwhile, not all businesses will benefit from such a move, given that many small businesses are not incorporated. In this regard, reform to the personal income tax system will also help address the level of tax payable by business. Over time, the top headline rate of personal income tax should be aligned to the company tax rate, to guard against tax planning and reduce the complexities of the income tax system for business.

Capital allowances for small, medium and large businesses

Business pay company tax on their income minus their expenditure. One of the major lines of expenditure for business is capital equipment and machinery, which are bought to book from an expenditure perspective over a number of years through depreciation allowances. The current system used to bring capital expenditure to book is complex, and adds to the administrative burden for many businesses. The complexity arises from the different arrangements for different types of assets, while others are provided preferential treatment. Notably, there are 40 different effective lives provided for 3,700 different assets.

There is scope to improve capital allowance rates for businesses, and particularly for small businesses that often require external expertise to manage their assets.

For small businesses with an aggregate annual turnover of $2 million or less, there are capital allowance concessions that are intended to simplify the management of capital items for SMEs.

Small businesses can combine the value of assets in a single pool, and depreciate those at a rate of 15 per cent in the first year and 30 per cent in subsequent years. The standard instant asset write-off threshold currently stands at $1,000, meaning small businesses can claim an immediate deduction to the value of all assets worth less than $1,000 purchased in a particular year. The Federal Government's 2015-16 Budget saw the introduction of a temporary $20,000 asset value limit, allowing businesses with a turnover of less than $2 million to immediately write off the value of these assets in the year they are purchased.

While these are positive measures, the turnover test applied to determine what constitutes a small business is too low and has not been adjusted since its introduction in 2006-07. The Board of Taxation's Inquiry into the Tax Impediments Facing Small Business found the turnover test should be increased to $3 million immediately, to $5 million over time, and as a minimum measure the threshold should be indexed to maintain its real value[40]. Extending the small business turnover test to a larger portion of the tax base would make a meaningful difference to tax compliance costs for small and medium sized businesses, and improve the incentives to invest in assets.

For larger businesses, there is merit in exploring international examples of asset depreciation rules, particularly in our immediate region.

For example, Singapore's rates of asset depreciation are much simpler and much more generous for medium and large companies. The Inland Revenue Authority of Singapore provides four options for asset depreciation: one year, two year, three year or over the life of an asset, and applies a single rate of depreciation based on the time period selected by the business[41].

As part of the Discussion Paper, Australia's system of asset depreciation and capital allowances should be significantly streamlined and simplified, to reduce compliance costs and improve the ability for businesses to invest in capital equipment.

Research and development tax incentive

Another type of investment that has company tax implications is the Research and Development Tax Incentive (R&D Tax Incentive).

Research shows that the most effective way to encourage industry-led innovation is through use of the tax system. The return on investment generated by tax credits – which place the onus on industry to develop solutions – is much higher than the return generated by grants, the conditions of which are dictated by government. This was reinforced by the Commission of Audit Report, which recommended that the Federal Government's approach to innovation be rooted firmly in an economy-wide, industry-driven approach as opposed to the ad-hoc, grant-based approach which that has characterised past government industry policy.

The R&D Tax Incentive allows for a 45 per cent refundable tax offset for small companies (less than $20 million in annual turnover) and a non-refundable tax offset for all other companies. The Federal Budget saw the introduction of a $100 million expenditure cap for claims, with expenditure above this threshold to be treated in the same way as other types of investment.

According to the annual report of AusIndustry, the R&D Tax Incentive in Australia has a "multiplier effect" of 11 to 1, with $16.8 billion worth of research, development and commercialisation supported through just $1.4 billion worth of foregone tax revenue on the part of the Federal Government. This multiplier is much more significant than grant programs administered by AusIndustry (which range between 1.5 and 2.5), and indeed other grant programs that have been offered by the Federal Government in the past.

The Federal Government should also consider expanding the current R&D Tax Incentive, in both its scale and scope of activities. Consideration should be given to increasing the income offset granted to companies accessing the incentive, which would provide further incentive for businesses to invest in R&D. Other developed nations, such as Canada and the United Kingdom, provide more generous tax offsets for R&D activity, with some items of expenditure granted a 150 per cent or more offset on expenditure.

In this respect, the Federal Government should seek to increase the rate of credit/offset to 100 per cent of eligible expenditure, in line with the practices of other developed countries and countries within our region. This should be a long-term goal, and could be funded from the savings generated by redirecting funding away from inefficient programs.

For businesses that can access the incentive, there can be significant compliance costs to justify and document the allowable tax credits. The scheme requires significant levels of paperwork and record keeping in order to auditors to determine whether a claim is “genuine”, while the ambiguous and intangible nature of research and development activities means record record-keeping requirements cannot be made uniform or easy to define. Businesses are required to log and report on each research and development activity they are conducting, including details of how the activity was conducted, what it was aiming to achieve, and how the research activity specifically relates to a business outcome that was achieved. Records must be kept for five years, while three separate agencies (the Australian Tax Office, AusIndustry, and Innovation Australia) have the power of audit.

This is particularly problematic for smaller businesses, which have limited resources to devote to compliance activities. This not only adds to business costs, but also discourages small businesses from using the incentive to invest in R&D activities. As part of reform to the R&D Tax Incentive, the Federal Government should investigate ways to streamline the application process and record-keeping requirements, to ensure the administrative requirements of the scheme are not acting as a disincentive. A poignant example of this is Singapore, where a series of defined “tests” regarding research and development activity are either passed or failed at the time of the claim.

Recommendations:

Personal income tax

- The Federal Government should significantly reduce personal income tax rates at all levels, but particularly at the top marginal rate, which is amongst the highest in the world once temporary levies are taken into consideration. This is also to make room in the personal income tax base for the introduction of a state-based personal income tax surcharge.

- The Federal Government should take immediate action to reduce personal income tax and simplify the system by removing the $80,001 to $180,000 threshold, and broaden the current 32.5 per cent rate threshold to $180,000.

- The Federal Government’s Zone Tax Rebate should be rebased to reflect its original policy intent and value, or abolished. There may be a reduced need for this rebate should the Federal Government allow provision for states to surcharge personal income tax (see Package One: Reducing Vertical Fiscal Imbalance).

- There should be a review of the tax treatment of savings, and the rationale for taxing different modes of saving at vastly disparate rates, given the role this plays in the allocation of capital across the economy.

- There is merit in exploring the introduction of a standard deduction for work-related expenses incurred by income tax payers, to reduce administration and compliance costs and reduce reliance on the provision of tax advice for relatively simply tax affairs.

Business income tax

- The Federal Government should immediately reduce the headline company tax rate for all businesses [regardless of turnover] to 25 per cent, to return Australia to the OECD average for headline company tax rates.

- The headline company tax rate should be indexed to the OECD average, to maintain Australia's competitiveness over time.

- Australia's rules relating to capital allowances should be significantly streamlined and simplified, through the adoption of fewer asset types and allowable depreciation schedules. The rates of allowable depreciation should be increased, and the depreciation windows shortened. This should improve the incentive for businesses to invest, lead to reduced administration and compliance costs, and bring a significant part of Australia's company tax system into line with regional competitors.

- The scope of the Research and Development Tax Incentive (R&D Tax Incentive) should be broadened, and the rates of offset increased, in line with international standards.

System Wide Issues

Indexation

One of the most insidious elements of Australia's current tax regime is the lack of indexation of the key thresholds that taxes apply to. Over time, this results in an increase in the taxation burden faced by businesses and individuals, and weakens the link between government spending decisions and revenue raising responsibilities. The effect is that the real value of particular thresholds is eroded over time, as inflation and price rises increase tax liabilities.

One such example of this is in relation to personal income tax. The Grattan Institute's analysis of the 2014-15 Federal Budget found that "bracket creep" in the personal income tax system was responsible for the "lion's share" of the narrowing of the Federal Budget deficit by 2018-19[42]. Western Australia's payroll tax exemption threshold was left unchanged for 15 years, which resulted in the average number of employees a business could employ before becoming liable for the tax falling from 15 to nine[43].

The Discussion Paper should recommend the introduction of a formal policy of tax threshold indexation, linked to appropriate benchmarks. For example, income tax thresholds should be indexed to the Australian Wage Price Index, to ensure they increase in line with the broadest measure of wages inflation.

Administration and compliance

It is not just the direct tax payable that adds to business costs. Taxation complexity and compliance also represent a major drain on business finances, and are borne disproportionately by small businesses.

The complexity of the tax environment is directly influenced by a number of factors.

Much taxation complexity is driven by attempts to make the system more equitable or efficient. In developing new taxes, Government is required to balance these objectives against maintaining the simplicity of the system. Similarly, incremental changes, exemptions and policy decisions that have been made to existing legislation in an attempt to make the system more equitable or efficient, have made the system overly complex and cumbersome.

The drafting of tax legislation can also add to overall complexity. The excessive use of legal terms and technical language in tax legislation can force taxpayers to seek professional help in interpreting the legislation.

The need to introduce measures to mitigate tax avoidance and close loopholes has also added to the complexity of the system.

While the complexity of the tax system is recognised as a problem, there is no commonly accepted measure of tax system complexity. A range of measures are commonly used as proxies, including the number of pages of legislation, the number of taxes, and use of tax agents, to name a few.

A number of studies have attempted to measure the compliance costs faced by Australian taxpayers. Most recently, the latest PWC Tax Contribution Study revealed that the costs of complying with the tax system for responding businesses represented an effective 1.6 per cent surcharge on top of their actual taxes – an average cost of $2.1 million per respondent. The report also showed that Australian businesses incurred high administrative costs when collecting a range of taxes on behalf of the Commonwealth, such as GST, excise and PAYG on employee remuneration. The report noted that for every $1 of taxes survey participants paid, they collected an additional $1.78 on behalf of government.

Reducing the complexity and compliance costs of the tax system should be a central part of any tax reform agenda. Any long-term solution must 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.

The states should also look to harmonise legislation where possible, to reduce the burden on businesses operating across multiple jurisdictions. A more consistent approach to tax legislation would provide a greater degree of certainty for taxpayers, and reduce the administrative costs for Government. Harmonisation provides the opportunity for changes to be made which adopt the best elements of legislation in different jurisdictions, and in doing so, greatly reduce the administrative costs for small business. All aspects of state tax legislation [except the rate] should be harmonised (including the base, definitions, exemptions etc).

In order to minimise complexity and improve the fairness of the taxation system, tax scales and thresholds should be simplified. 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.

The Henry Review set out a range of recommendations aimed at improving the complexity and compliance issues associated with the tax system. These recommendations focus on making the tax system and processes more open and transparent, and providing greater accountability for governance and administration. These recommendations include:

- developing open and inclusive processes that allow taxpayers to provide feedback and to raise issues with government;
- committing to a more principles-based approach to tax law design;
- empowering the Board of Taxation to initiate its own reviews of the operation of tax laws and policy;
- publicising information used to make determinations about the purpose or policy intent of a tax law; and
- clarifying the role of the Inspector General of Taxation to examine systemic tax issues that affect business.

This could be achieved within existing government structures and with existing resources, including the Board of Taxation, the Inspector-General of Taxation, Parliamentary Budget Office and government agencies that set tax policy.

Measures to improve the governance of tax administration should form part of this process. 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.

A starting place for such reform should be a systemic approach, which would deal with issues that arise. 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 an appropriate government agent, such as the Commissioner of Taxation or independent Board of Taxation.

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

Compliance and administration is also a significant issue facing small businesses. Small businesses with an annual turnover of $2 million or less have access to a range of administrative concessions, designed to reduce compliance costs.

The Board of Taxation's Inquiry into Tax Impediments Facing Small Business found that as a result of no indexation since 2006-07, the current threshold was too low, and meant many businesses that the measure was intended to assist were not receiving the benefit. The Board recommended that the turnover test be immediately increased to $3 million, and progressively to $5 million, in order to extend the benefits to a wider range of small businesses.

Recommendations:

- A formal policy of tax threshold indexation should be introduced, and applied to all relevant Federal, State and Local taxes to ensure bracket creep ceases.
- State Governments should seek to have harmonised tax legislation where possible, and compete only on rates and, where applicable, thresholds.
- As a rule, tax design should dictate that taxes have as few thresholds and exemptions as possible, to ensure simplicity and effectiveness.
- Most of the Henry Tax Review's recommendations regarding tax system governance should be adopted, within existing funding arrangements and bureaucratic structures. These relate to transparency, access to justice, and elevating the role of tax policy design above political influence.
- The Australian Tax Office should be tasked with the development of Tax Administration Impact Statements (TAIS), in a similar manner to the application of Regulatory Impact Statements (RIS) for other regulatory instruments.
- The small business turnover test threshold should be immediately increased to $3 million, and progressively to $5 million, in line with recommendations of other government and non-government inquiries.

End Notes

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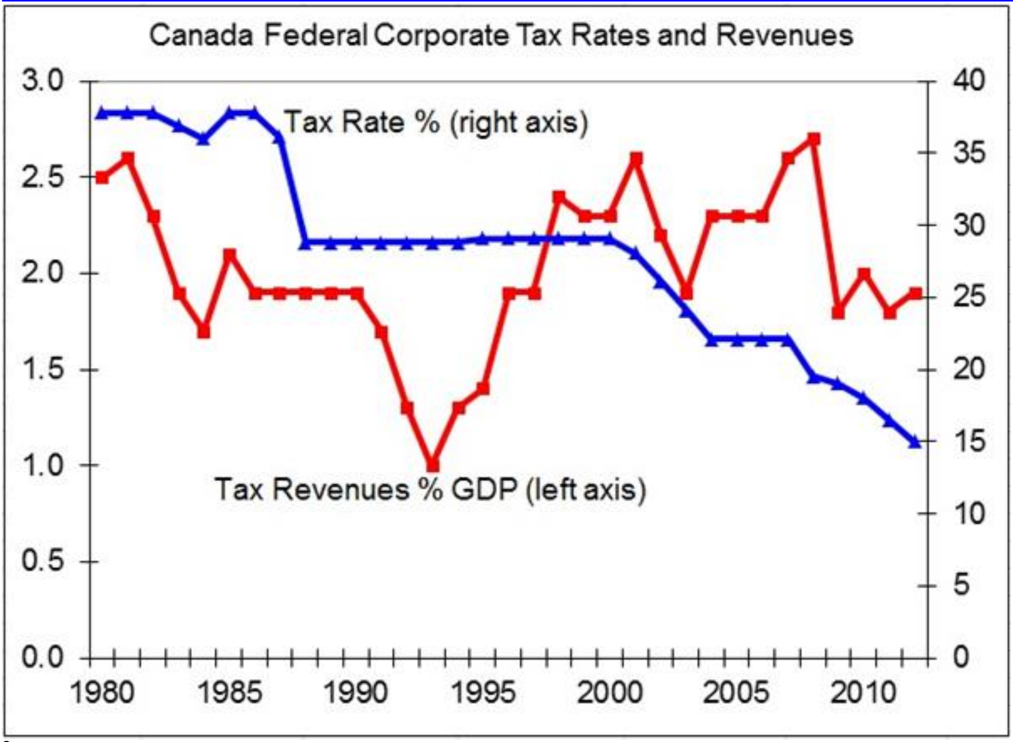

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[13] Commonwealth Budget 2015-16, Budget Paper 1: Budget Strategy and Outlook, pg. 14, http://www.budget.gov.au/2015-16/content/bp1/download/Budget_Paper_No_1.pdf

[14]Methodology: determining each states share of actual GST distribution and then multiplying each states share by the total GST revenue on a broad base of components of HFCE from 2013-14 GSP (all components of HFCE, current prices, excluding net expenditure interstate). To see the full definition for the components of HFCE, refer to the ASB Cat. 5220.0.

[15] Productivity Commission, *Economic Implications of an Ageing Australia,* 2005, pg. 265, http://www.pc.gov.au/inquiries/completed/ageing/report/ageing.pdf

[16] Methodology: the percentage each state contributes to total GST revenue is calculated by multiplying select components of HFCE (all components of HFCE excluding food, rent and other dwelling services, health services, education services and net expenditure interstate), for each state, by the GST rate, and then dividing this number, for each state, by the sum of all states calculated GST revenue. Each states contribution is then multiplying by the actual GST revenue, to determine the amount each state would receive if GST revenue was distributed back to the point of collection. To see the full definition for the components of HFCE, refer to the ASB Cat. 5220.0.

[17] Methodology: net loss divided by total government revenue ($373.9 billion). Commonwealth Treasury, 2014, *Final Budget Outcomes 2013-14*, p. 8, http://budget.gov.au/2013-14/content/fbo/download/Consolidated.pdf

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[33] Putrescible waster includes household food waste, green waste and certain commercial and industrial wastes that easily decompose.

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