NSW Business Chamber

NSW Business Chamber incorporates
- Sydney Business Chamber
- Australian Business Lawyers & Advisors
- Australian Business Recruitment Solutions
- Australian Business Consulting & Solutions
- Australian Business Apprenticeships Centre
- Australian Business Training Solutions
- Australian Business Defence Industry Unit
- Australian Business Industrial

3 June 2015

Tax White Paper Tax Force
The Treasury
Langton Crescent
PARKES ACT 2600

Via email: bettertax@treasury.gov.au

Dear Sir / Madam,

RESPONSE TO THE DISCUSSION PAPER

The NSW Business Chamber welcomes this opportunity to contribute to the development of the Government's Tax White Paper.

About us

The NSW Business Chamber is one of Australia's largest business support groups, with a direct membership of more than 17,000 businesses, providing services to over 30,000 businesses each year.

Tracing its heritage back to the Sydney Chamber of Commerce established in 1826, and the Chamber of Manufactures of NSW established in 1885, the NSW Business Chamber works with thousands of businesses ranging in size from owner operators to large corporations, and spanning all industry sectors from product-based manufacturers to service provider enterprises.

The NSW Business Chamber is NSW's leading business solutions provider and advocacy group with strengths in workplace management, workplace health and safety, industrial relations, human resources, international trade and business performance consulting. Operating throughout a network of offices in metropolitan and regional NSW, the Chamber represents the needs of business at a local, regional, State and Federal level, advocating on behalf of their members to create a better environment for industry.

Summary

Australian Governments collected $450 billion in tax revenue in 2013-14 (27 per cent of GDP) so good tax policy is crucial to continued growth in Australian living standards. At this stage of the White Paper process, the Chamber has largely focused on indicating general directions for tax reform.

This submission is divided into three sections. Section 1 discusses how the Government can build the case for tax reform. Section 2 considers Commonwealth tax reform, particularly in relation to the taxation of capital income at both the individual and entity level. Section 3 focuses on State tax reform and how the Commonwealth can best support reform at the State level.

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Section 1: Building community support for tax reform

Previous reviews of the Australian tax system have identified substantial scope for fundamental tax reform, but the limited success of previous governments in implementing these recommendations demonstrates how difficult it is to build public support for reform.

Recommendation 1.1: The Government's first step towards building greater public support for tax reform should be to refocus the debate on the public interest by starting a community conversation about the basic tax policy trade-offs between economic growth, public services and redistribution.

Recommendation 1.2: The Government should try to establish the overall objectives of tax reform before making any specific policy recommendations. Good principles are usually easier to explain than good policy, and policies are easier to justify if the audience accepts the basic objectives.

Recommendation 1.3: In light of the economic and social challenges facing Australia – including a fragile economy, unsustainable public finances, and concerns about increased inequality – the objective of tax reform should be to create more jobs and higher income growth by reducing the economic costs of raising revenue. In particular:

- If spending continues to grow more quickly than revenue, tax increases will be needed on a regular basis as no one-off tax increase will balance the budget in the long-term. Growing the economy more quickly by making taxes more efficient is a better way of making public finances sustainable than continually increasing taxes as a share of GDP. The *quid pro quo* for business is accepting that making the tax mix more efficient may do more to boost the economy than simply reducing taxes.
- The tax system should not be made more progressive to deal with increased concerns about inequality as Australia has one of the most progressive and redistributive tax systems in the world and increased employment opportunities have been the key to growth in living standards for low-income households in recent decades.
- However, the tax system could be made more efficient and more equitable by eliminating legislative loopholes and poorly targeted taxes or tax concessions that cause individuals with the same living standards to pay different levels of tax, regardless of whether these concessions typically benefit the wealthy or the poor.

Recommendation 1.4: The Government should consider allocating a small proportion of annual revenue into an ongoing fund to support the short-term transitional costs that are often associated with reform in much the same way that an infrastructure fund funds the upfront costs of delivering long-term benefits through infrastructure.

Recommendation 1.5: The Government should manage expectations about what the White Paper can achieve. Building the public case for reform is difficult, and realistically there are likely to be many worthwhile proposals that are set aside because there is only so much that the Government can deal with simultaneously. However, the need to develop a politically manageable reform package to take to the next election should not cause worthwhile reform to be forgotten, and the Government should consider establishing an ongoing process for achieving further tax reform post the White Paper.

Section 2: Commonwealth Tax Reform

Setting aside GST, which is essentially controlled by the States, almost all the revenue the Commonwealth raises comes from income tax, and most of the difficult tax policy issues relate to the taxation of capital income.

Recommendation 2.1: The Government should acknowledge that personal income tax must remain at the core of the Australian tax system because it is the only feasible way to tax capital income progressively. However, serious consideration should be given to whether improving technology may make a progressive consumption tax, such as a personal expenditure tax, a feasible alternative in the long-term.

Recommendation 2.2: The Government should explain to the public that the effective tax rate on investment income increases over time. For example, a 30 per cent headline rate becomes a 50 per cent effective rate for an investment held for 20 years with a 6 per cent annual return.

Recommendation 2.3: The Government should acknowledge that existing tax concessions from savings are poorly targeted and inconsistent which leads to significant distortions in investment decisions. The Government should investigate how these concessions can be made more consistent, including considering:

- A consistent deduction on most types of capital income, including capital gains and recurrent income streams
- Options for providing a similar concession for dividend income
- Removing transition to retirement concessions and applying a discount rather than a flat tax rate to superannuation contributions

Recommendation 2.4: The Government should urgently lower the corporate tax rate to an internationally competitive level, as an uncompetitive corporate tax rate leads to lower investment and ultimately lower incomes for domestic factors of production. It is worth noting that corporate income tax is just a withholding tax for domestic business owners so reducing the corporate income tax provides limited direct benefits to domestic businesses, rather a lower corporate tax rate is a priority because of the benefits that would flow to domestic businesses and workers from additional foreign investment.

Recommendation 2.5: As a *quid pro quo* to lowering the overall corporate tax rate, it will be important for the Government to demonstrate progress on preventing tax avoidance through transfer pricing and thin capitalisation. However, this must be done multilaterally.

Recommendation 2.6: Dividend imputation should be retained as its removal would significantly increase the costs of funds for domestic businesses that cannot access international capital markets. However, the structure of corporate taxation is an issue that warrants further consideration.

Recommendation 2.7: Small business concessions should be maintained in recognition of the fact that low-income small business owners are the group most disadvantaged by the over-taxation of savings because they receive very little benefit from being able to defer earnings in a corporate structure.

Recommendation 2.8: The threshold for small business concessions and GST registration should both be increased in line with inflation. Consideration should be given to phasing in these thresholds to avoid the risk of creating substantial effective marginal tax rates for business growth.

Outside of the taxation of savings, there are several other income tax related reforms.

Recommendation 2.9: Historical bracket creep should be returned and income tax thresholds should be indexed – regardless of whether this occurs the Government should include a statement of the cost of bracket creep to representative workers in the Budget papers.

Recommendation 2.10: The income tax thresholds themselves can be rationalised and simplified without having any significant impact on marginal tax rates, including by incorporating the Medicare Levy and the Low Income Tax Offset into the tax base.

Recommendation 2.11: Fringe Benefits Tax should cease to be a penalty tax and fringe benefits should instead be taxed in the hands of employees at their marginal rate.

Recommendation 2.12: Outside of the income tax system, the main priorities for Commonwealth tax reform should be the abolition of the luxury car tax and the standardisation of alcohol tax to a volumetric rate that genuinely reflects the negative externalities of alcohol consumption.

<u>Section 3: Reforming State taxes</u>

One of the challenges with using a White Paper as the vehicle for tax reform is that it represents the views of the Commonwealth and many of the most significant reform opportunities relate to taxes that are controlled by State Governments.

Recommendation 3.1: While the Commonwealth must be careful not to dictate to States, the Commonwealth can also make observations about State taxes and provide incentives for reform with fewer political constraints than State Governments themselves – this may not generate immediate results, but it helps build momentum for reform over time. An appropriate model is the Asset Recycling Fund, which is much less controversial and politically significant at a national level than the activities that it funds are at a State level.

Recommendation 3.2: At minimum, the Commonwealth should highlight the benefits of abolishing inequitable and inefficient state taxes such as stamp duty on conveyances, general insurance duties and the fire services levy, stamp duty on the transfer of motor vehicle ownership and payroll tax.

Recommendation 3.3: The Commonwealth should also highlight the benefits of reforming other State controlled taxes, including the GST:

- Removing the principal place of residence exemption for land tax and changing the assessment mechanism to a flat rate or a value per square metre rate.
- Making royalties profit based to avoid the unnecessary closing mines in the context of low commodity prices.
- Transforming registration charges into efficient network access charges and combining them with appropriate charges for externalities imposed on other road users
- Broadening the base of the GST itself, even if that means reducing the overall rate.

Recommendation 3.4: As most inefficient state taxes are essentially very narrowly based consumption taxes, the Commonwealth should observe that the most logical replacement for these taxes is a more broad based consumption tax such as the GST.

Recommendation 3.5: However, the Commonwealth should also emphasise that State can pursue reform independently, and arguably the most beneficial reform that State can pursue independently is to follow the ACT in replacing stamp duty on conveyances with a broad based land tax. This has the potential to boost GDP by 1.3 per cent according to modelling by Independent Economics for the Housing Institute of Australia (HIA). Replacing one property-based tax with another would offset any potential price volatility maximise the chances of broad based support for change. The NSW Business Chamber's discussions with other state interest groups suggests that there is broad support for change provided there are appropriate transition arrangements and protections for asset rich income poor.

Section 1: Building community support for tax reform

Australian governments collect around 27 per cent of Australian GDP ($434 billion in 2013-14) as tax revenue, so tax policy has a major impact on Australian living standards. The unprecedented living standards that Australians currently enjoy are based on mutually beneficial exchanges of goods and services. Most taxes cause price distortions that prevent some of these exchanges from occurring, but taxes also fund public services and redistribute economic resources to households where society believes they will be more highly valued.

Accordingly, tax policy is essentially about finding a publicly acceptable balance between the economic costs of raising revenue, the benefits of public services and the arguments for and against greater redistribution. It is worth noting that redistribution and the provision of public services can sometimes be competing considerations, because a tax system that focuses on minimising the economic costs of raising revenue can efficiently fund more public services than a tax system that sacrifices economic efficiency for progressivity. However, the Australian tax system is more a product of history than optimal design, so in practice there are actually various reforms that could support all three of these objectives simultaneously.

Unfortunately, public knowledge of the basic objectives of tax policy is limited, even in the business community. Usually tax policy is treated as a zero sum game where the goal is to make sure other people pay as much as possible. Everyone becomes a caricature, with low-income earners as lazy, welfare cheating burdens on society and high-income earners and business people as rapacious robber barons who are rorting the tax system.

For tax reform to succeed the government needs to refocus the conversation on the public interest and educate the community about the basic trade-offs between economic growth, public services and redistribution.

Recommendation 1.1: The Government's first step towards building greater public support for tax reform should be to refocus the debate on the public interest by starting a community conversation about the basic tax policy trade-offs between economic growth, public services and redistribution.

Recommendation 1.2: The Government should try to establish the overall objectives of tax reform before making any specific policy recommendations. Good principles are usually easier to explain than good policy and policies are easier to justify if the audience accepts the basic objectives.

The major economic and social challenges facing Australia should provide the context for determining the objectives of tax reform. Following a period of unprecedented prosperity, the Australian economy appears increasingly fragile.

- Commodity prices have declined more quickly than expected, and as a result, so has mining related construction activity.
- Strong public infrastructure investment and a buoyant housing market are supporting economic activity in some states.
- However, growth in housing finance is also creating systemic risks for the financial system, and the Reserve Bank is struggling to balance the need for monetary policy that accommodates the need to control these risks with the need to stimulate business investment.
- At present, business confidence is weak, growth is below trend, the unemployment rate is increasing, wage growth is at record lows, and looking forward the participation rate is set to fall as the population ages.

Additionally, government spending is growing more quickly than government revenue.

- In some cases, spending growth is the result of changing values and a conscious commitment to provide services that were not previously available, such as the National Disability Insurance Scheme.
- More generally, expenditure is growing because Australians are consuming more healthcare services and the price of healthcare is rising rapidly.
- The ageing population compounds the growth in healthcare consumption, and adds to social security costs, while reducing the number of working age taxpayers.
- Efforts to mitigate population ageing and address skills shortages through extensive migration have created their own challenges by creating the need for additional infrastructure investment in Australia's major cities.
- Finally, information technology and globalisation have made it easier for foreign investors to locate their operations in low tax jurisdictions rather than high tax global economies.

Finally, while household incomes have grown strongly over the last 20 years, the distribution of household income has also become more unequal, which has led to calls for increased income redistribution. Rapid growth in the price of housing adds another dimension to the debate about inequality, particularly in Sydney, with some concerned that Australia has been divided into those who bought when prices were lower and a growing minority who are either locked out of home ownership or locked in to mortgages that are many multiples of their annual income.

Given this context, the objective of tax reform should be to strengthen the economy, create jobs and increase incomes by making the tax mix more efficient.

Growing the economy more quickly by making taxes more efficient is a better way to increase revenue than making taxes a larger share of GDP. Moreover, a one-off increase in tax revenue can only make the budget sustainable if the problem is only a gap between revenue and expenditure levels. However, Australia's fiscal problems are the result of a gap between revenue and expenditure growth. The only way to address a gap between revenue and expenditure growth through higher taxes would be to keep raising taxes on a regular basis. Similarly, businesses should recognise that reducing the average economic cost of raising revenue may be able to deliver more benefits to the economy than slightly decreasing the overall tax share of GDP. Pragmatically, revenue neutral tax reform is also the most likely approach to receive broad based public support.

Making the tax system more efficient can also address concerns about inequality as stronger growth delivers more employment opportunities, and increased access to work has been one of the key drivers of increased living standards in low-income households. Increasing employment among low-income earners reduces inequality and increases overall living standards. In contrast, greater redistribution increases the living standards of low-income households by transferring income from high-income households, with some sacrifice in overall living standards.

In general, tax reform should not make the tax system redistribute more, as Australia already has one of the most progressive tax systems in the world. On the other hand, the tax system can be much more efficient without being less progressive. In some areas, the tax system may be made more efficient and more equitable by eliminating legislative loopholes and poorly targeted taxes or tax concessions that cause individuals with the same living standards to pay different levels of tax, regardless of whether these concessions typically benefit the wealthy or the poor.

Recommendation 1.3: In light of the economic and social challenges facing Australia – including a fragile economy, unsustainable public finances, and concerns about increased inequality – the objective of tax reform should be to create more jobs and higher income growth by reducing the economic costs of raising revenue. In particular:

- If spending continues to grow more quickly than revenue, tax increases will be needed on a regular basis as no one-off tax increase will balance the budget in the long-term. Growing the economy more quickly by making taxes more efficient is a better way of making public finances sustainable than continually increasing taxes as a share of GDP. The *quid pro quo* for business is accepting that making the tax mix more efficient may do more to boost the economy than simply reducing taxes.
- The tax system should not be made more progressive to deal with increased concerns about inequality as Australia has one of the most progressive and redistributive tax systems in the world and increased employment opportunities have been the key to growth in living standards for low-income households in recent decades.
- However, the tax system could be made more efficient and more equitable by eliminating legislative loopholes and poorly targeted taxes or tax concessions that cause individuals with the same living standards to pay different levels of tax, regardless of whether these concessions typically benefit the wealthy or the poor.

Reform fund

In many areas of tax policy, the policy answers are largely well known, but the barrier to reform is building political support for change. Major tax reform inevitably requires major changes in the allocation of tax liabilities, which always creates losers and sometimes-legitimate concerns about double taxation and sovereign risk. One solution that the Government could consider is to allocate a small proportion of annual revenue to a reform, which can invest in the long-term benefit of reform by funding short-term compensation and transitional arrangements.

Recommendation 1.4: The Government should consider allocating a small proportion of annual revenue into an ongoing fund to support the short-term transitional costs that are often associated with reform in much the same way that an infrastructure fund funds the upfront costs of delivering long-term benefits through infrastructure.

Establishing a process for future reform

The Government should consider using the White Paper to establish an ongoing process for pursuing further tax reform, in addition to making specific tax policy recommendations.

Tax policy is a vast and complex subject that ranges from questions about the fundamental structure of the tax system to minor legislative adjustments. While the Tax White Paper should be ambitious, it must also be realistic and advancing too many reforms simultaneously is likely to make it difficult for the government to build a case for reform. However, the need to develop a politically manageable reform package to take to the next election should not close the door on other beneficial reforms.

Recommendation 1.5: The Government should manage expectations about what the White Paper can achieve. Building the public case for reform is difficult, and realistically there are likely to be many worthwhile proposals that are set aside because there is only so much that the Government can deal with simultaneously. However, the need to develop a politically manageable reform package to take to the next election should not cause worthwhile reform to be forgotten, and the Government should consider establishing an ongoing process for achieving further tax reform post the White Paper.

Section 2: Commonwealth Tax Reform

Setting aside GST, which is essentially controlled by the States, almost all the revenue the Commonwealth raises comes from income tax, and most of the difficult tax policy issues relate to the taxation of capital income.

The basic problem

In Australia, and most other developed countries, personal income tax is the largest source of revenue and almost the only source of progressivity in the tax system. Personal income tax is relatively efficient because the base is very broad and avoiding earning income is difficult. This efficiency combined with the fact that income is a measurable and relatively accurate approximation of ability to pay also means that personal income tax has an almost unique ability to deliver progressivity.

However, applying income tax to income from savings and investment is problematic. The cumulative nature of income tax increases the effective tax rate on savings over time. The Henry Tax Review showed that at a 30 per cent tax rate and a 6 per cent rate of return, someone who chooses to invest their income over 20 years (say for retirement) rather than consuming it immediately, pays an effective rate of tax of 50 per cent. Table 1 illustrates how the cumulative nature of income tax reduces the value of an investment compared to a no tax scenario.

As a result of this cumulative effect, someone who would have earned $600,000 over 10 years from salary of $60,000 per year has after tax income of $420,000, while someone who would have earned $600,000 from investing at 6.4 per cent would have an after tax income of $384,000, implying an effective tax rate of about 36 per cent.

Table 1. The effective rate of income tax on investment income increases over time

Year	Value of investment		Effective tax rate
	No tax $	Post income tax $	 %
0	100	70	30
1	106	73	31
2	112	76	32
3	119	79	34
4	126	83	35
5	134	86	36
10	179	106	41
20	321	159	50

Assumptions: Based on a 30 per cent tax rate and a 6 per cent rate of return.

The difficulties in measuring returns as they accrue means income from gains in the value of capital assets are generally taxed on realisation. This creates additional distortions as investors seek to realise losses early and delay the realisation of gains. Individuals can also defer taxation by retaining income in a company structure, which necessitates company tax as an integrity measure, and there are further opportunities to delay or avoid taxation through borrowing.

Many argue that capital income should be taxed at a lower rate than income from labour, and perhaps exempted from tax altogether. The basic point is that people who save are no better off than people with the same income who choose to consume immediately: savers just have a stronger preference for future consumption, which taxation would distort, and investment returns are just compensation for inflation, the time value of money and risk. People who save may have higher incomes on average, but distributional concerns should be dealt with directly by increasing taxes on those with higher labour incomes rather than distorting the timing of consumption decisions with a further tax on income from savings.

Few dispute that applying personal income tax to savings distorts decisions about the deferral of consumption, but some argue that there are good reasons for at least some additional tax on capital income. Those who save may have had fewer expenses, and those with strong investment returns may be better investors or have access to unique investment opportunities. Additionally, taxing capital income more highly may make it harder for people to live on their savings and investments, rather than working, which partially offsets the participation disincentives created by taxing labour income.

Possible alternatives to income tax

There are alternatives to personal income tax that provide a neutral treatment of income from savings. Both consumption taxes and labour income taxes apply the same effective tax rate regardless of how long savings are invested. One advantage of labour income tax is that it can be progressive because individual labour income is easy to measure. Progressivity is difficult for consumption taxes because it is hard to measure consumption at an individual level. From an equity perspective a transition to consumption taxes has the disadvantage of applying additional taxation to the consumption of those with existing savings that have already been subject to income tax. One disadvantage of a labour income tax is that it requires a distinction between labour and capital income that can be difficult to make in practice, particularly for closely held businesses; this distinction is not required for consumption taxes.

Regardless of these advantages and disadvantages, the main problem with consumption and labour income taxes is that they do not impose a higher tax rate on those with higher capital incomes. Indeed, under a labour income tax the founder of a very successful high growth business could pay basically no tax if they received dividends or sold stock rather than drawing an income.

One attempt to balance the over-taxation of savings under a personal income tax with the desire to tax those with stronger capital income involves taxing capital income at a lower headline rate than labour income – this is called a dual income tax. However, the problem with a dual income tax is the level of taxation applied to savings still depends on how long they are held. Depending on the generosity of the rate, savings held for a long period will still be taxed more heavily than labour income. Additionally, short-term savings may have a lower effective tax rate than labour income. Most crucially, a dual income tax is unlikely to satisfy those who are concerned with redistribution because although savings are taxed at a higher effective rate than labour income, it is still a flat rate.

There are variations to dual income tax that tax capital income at a lower headline rate than labour income, but retain progressivity by either discounting the income itself or providing a discount from an individual's marginal tax rate. The Henry Tax Review's proposal for a 40 per cent discount on almost all types of capital income takes this approach. However, as with a standard dual income tax the effective tax rate still depends on an investment time horizon.

An alternative to a dual income tax and its variations is to provide a capital income allowance based on inflation or even an estimate of the risk free rate of return, and then tax capital income at an individual's marginal rate. This is theoretically appealing because it means investment time horizons are less likely to affect the effective tax rate. However, there are practical difficulties. Any estimate of the risk free rate of return would only be a rough estimate, although this is less of an issue if tax rates on capital income are already arbitrary. The bigger problem seems likely to be measuring the size of an investment so an appropriate capital allowance can be calculated.

Ignoring practical issues, the most attractive option would probably be to eliminate income tax and replace it with a progressive tax on consumption called a consumed income tax (CIT) or a personal expenditure tax (PET). As noted above, a consumption tax eliminates the impact of the investment time horizons on effective rates. The only thing that stops a consumption tax from being progressive is that individual consumption is very difficult to measure. Past proponents of a progressive consumption tax have suggested applying withholding tax to labour income and adjusting taxable income for net savings, including borrowing, using designated investment accounts that are similar to superannuation accounts. However, critics expressed concern that problems with tracking borrowing and investment accurately would create major compliance issues, and making adjustments to labour income would also make tax more complex and administratively burdensome for the average person. The other problem with a major switch between income tax and consumption tax is that it double taxes people with substantial existing savings that have already been subject to income tax, so some form of grandfathering would be required.

Despite all these problems, it may be worth putting a progressive consumption tax back on the table for consideration as a possible long-term direction for tax reform. The last time a progressive consumption tax was seriously considered seems to have been the Unlimited Savings Allowance (USA) proposal in the United States in the late 1990s. Since then technology has drastically improved, particularly with respect to the ability to track funds in the financial system. For example, with modern technology it might be possible to withhold on transfers between designated savings and consumption accounts. Even if a progressive consumption tax cannot be implemented using today's technology, it should not be forgotten as a long-term option.

Recommendation 2.1: The Government should acknowledge that personal income tax must remain at the core of the Australian tax system because it is the only feasible way to tax capital income progressively. However, serious consideration should be given to whether improving technology may make a progressive consumption tax, such as a personal expenditure tax, a feasible alternative in the long-term.

<u>Concessions for capital income in the Australian tax system</u>

In practice, Australia deals with objections to the application of income tax to savings and investment income by providing a variety of pro-savings concessions. As the over-taxation of capital income is most severe for long-term investments, the most generous concessions are provided for long-term savings vehicles, including the CGT exemption for an individual's principal place of residence, superannuation concessions and CGT concessions for small business owners. Concessional treatment also applies to capital gains more generally, but not to ongoing income streams from investment such as rental income, dividends and interest.

The result is inconsistent and incoherent taxation of different asset classes that distorts investment decisions. The Henry Review proposal for a consistent discount for all types of income from savings and investment has merit, though it would not address inconsistency arising from different investment time horizons. As the Henry Review notes, any change to the tax treatment of savings should be phased in gradually so that asset prices have time to adjust. The main problem with the Henry Review from a business perspective is that it recommended excluding dividend income from the general discount. Further work is required on how consistent relief could be provided for dividend income.

With respect to superannuation, the generosity of the concessions is generally justified to offset the substantial over taxation of long-term savings. However, the long-term savings of high-income earners and low-income earners are both overtaxed so there is strong case for changing the concession on contributions to a flat deduction rather than a flat rate. Taxing earnings in the fund at differential rates does not seem administratively feasible, so high income earners will continue to receive a larger concession than low-income earners in the earnings phase – however, this is probably appropriate as low-income earners also receive access to the age pension. An alternative would be to reintroduce some tax to the benefit stage, but this risks being poorly targeted as the value of the concessions received by a superannuant depend on when they invested rather than just how much. The most poorly targeted super concessions are those provided to individuals close to retirement, in particular transition to retirement benefits and concessions on voluntary payments.

Recommendation 2.3: The Government should acknowledge that existing tax concessions from savings are poorly targeted and inconsistent which leads to significant distortions in investment decisions. The Government should investigate how these concessions can be made more consistent, including considering:

- A consistent deduction on most types of capital income, including capital gains and recurrent income streams
- Options for providing a similar concession for dividend income
- Removing transition to retirement concessions and applying a discount rather than a flat tax rate to superannuation contributions

Entity level taxation

As a matter of priority, corporate income tax should be lowered to an internationally competitive rate. Aside from the proportion of corporate income tax that falls on profits produced by geographically fixed economic rents, corporate income tax actually just reduces the income received by domestic households and businesses by reducing investment. Efforts to reduce the capacity of multinational companies to avoid tax should continue, and should be used to help fund the reduction in the corporate tax rate. However, multinational tax avoidance efforts must be undertaken multilaterally lest they just discourage further investment.

Recommendation 2.4: The Government should urgently lower the corporate tax rate to an internationally competitive level, as an uncompetitive corporate tax rate leads to lower investment and ultimately lower incomes for domestic factors of production. It is worth noting that corporate income tax is just a withholding tax for domestic business owners so reducing the corporate income tax provides limited direct benefits to domestic businesses, rather a lower corporate tax rate is a priority because of the benefits that would flow to domestic businesses and workers from additional foreign investment.

Recommendation 2.5: As a *quid pro quo* to lowering the overall corporate tax rate, it will be important for the Government to demonstrate progress on preventing tax avoidance through transfer pricing and thin capitalisation. However, this must be done multilaterally.

Recommendation 2.6: Dividend imputation should be retained as its removal would significantly increase the costs of funds for domestic businesses that cannot access international capital markets. However, the structure of corporate taxation is an issue that warrants further consideration.

Small business

Dividend imputation should be maintained as its removal would substantially disadvantage domestic businesses that cannot access international capital markets.

Small business concessions should also be maintained. The CGT tax concessions that are available to small businesses simply reflect the fact that small business owners save for retirement through their business rather than through a superannuation account. The other concessions help simplify the tax system and offset the disproportionate impact of compliance costs on small businesses. The turnover threshold for small businesses should be lifted to keep pace with inflation, and consideration should be given to whether small business concessions could be phased out gradually rather than all at once. Phase in arrangements should also be considered for the $75,000 GST threshold, which can operate a $7,500 marginal tax rate for low income sole proprietors in industries where there are few taxable inputs.

Recommendation 2.7: Small business concessions should be maintained in recognition of the fact that low-income small business owners are the group most disadvantaged by the over-taxation of savings because they receive very little benefit from being able to defer earnings in a corporate structure.

Recommendation 2.8: The threshold for small business concessions and GST registration should both be increased in line with inflation. Consideration should be given to phasing in these thresholds to avoid the risk of creating substantial effective marginal tax rates for business growth.

Other income tax related issues

Outside of the taxation of savings, there are several other income tax related reforms.

Bracket creep

The most significant income tax policy issue outside of the taxation of capital income is bracket creep. Failure to adjust the personal income tax marginal rate schedule over time means individuals pay steadily higher taxes (at the margin and on average) without any change in their real taxable income. Increases in average tax rates through inflation are inefficient, inequitable and undesirable.

As such, historical bracket creep should be returned as soon as possible and allowances for future bracket creep should also be made over at least the forward estimates.

Ideally, we recommend the introduction of more long-term indexation arrangements. We recognise that this has consequences for revenue growth and the ability of the budget to absorb adverse shocks without the political challenges that may be associated with formal policy changes.

However, these problems are essentially issues of political convenience and they do not outweigh the widely agreed efficiency and equity problems associated with bracket creep. Rather than implicitly increasing taxes every year through bracket creep, the Government should endeavour to implement broadly based taxes that are buoyant enough to keep pace with expenditure growth. If this is not possible, then the public should be given a transparent choice between a steady increase in formal tax rates or measures that reduce expenditure growth.

A practical issue for either introducing indexation or returning historical bracket creep is deciding what the basis should be for making the adjustments. The most conservative approach to returning bracket creep is just maintaining the real value of the marginal tax rate threshold by adjusting them based on inflation. However, adjustments by inflation will still result in a steadily increasing individual tax rates, assuming wages grow more quickly than prices. An alternative would be to index marginal rate thresholds based on some measure of wage growth. Adjusting marginal tax rates based on average or median wage growth means that the marginal tax rate an individual faces will change depending on their relative income, which is how marginal rates should be set anyway.

Recommendation 2.9: Historical bracket creep should be returned and income tax thresholds should be indexed – regardless of whether this occurs the Government should include a statement of the cost of bracket creep to representative workers in the Budget papers.

In terms of incremental reform, the Low Income Tax Offset and the Medicare levy should be incorporated into the tax system. Nearly identical average tax rates can be achieved with a standard system of progressive marginal rates, at least for single income earners. The marginal rates of income tax could also be rationalised without changing any individuals average tax rate by more than 1 per cent.

Recommendation 2.10: The Government should consider rationalising and simplifying the marginal rate schedule for income tax, including incorporating the Medicare Levy and the Low Income Tax Offset, while maintaining roughly equivalent average tax rates for all income earners.

Another relatively incremental reform would be to tax fringe benefits in the hands of employees, rather than taxing fringe benefits in the hands of employers at the top marginal rate. Under the current model, fringe benefits tax is a penalty tax and an integrity measure rather than a genuine income tax on non-financial income.

Recommendation 2.11: Fringe Benefits Tax should cease to be a penalty tax and fringe benefits should instead be taxed in the hands of employees at their marginal rate.

Other Commonwealth tax issues

The Henry Review made a number of other recommendations for reform of Commonwealth taxes. The business community broadly supports these reforms, in particular the Commonwealth should abolish the luxury car tax, which is a very poorly targeted way to achieve progressivity and standardise the taxation of alcohol to a volumetric rate that genuinely reflects the negative externalities of alcohol consumption.

Recommendation 2.12: Outside of the income tax system, the main priorities for Commonwealth tax reform should be the abolition of the luxury car tax and the standardisation of alcohol tax to a volumetric rate that genuinely reflects the negative externalities of alcohol consumption.

Section 3: Reforming State taxes

One of the challenges with using a White Paper as the vehicle for tax reform is that it represents the views of the Commonwealth and many of the most significant reform opportunities relate to taxes that are controlled by State Governments.

Economically, it makes little sense to consider state and federal taxes separately as businesses and households generally care more about how much tax they pay than who collects the revenue. However, substantial political difficulties arise if tax reform requires one level of government to increase taxes so another level of government can make tax cuts. As such, it is useful to consider how reform can be pursued by different levels of Government independently.

The Chamber's observation of the political debate around privatisation is that the Commonwealth's Asset Recycling Fund has provided an important endorsement for reform at a State level that goes beyond the actual funding that it provides. Moreover, Asset Recycling Fund is less controversial federally than either the privatisation initiatives that it funds at a State level or the Commonwealth's own privatisation initiatives.

This suggests that there is a major opportunity for the Commonwealth to build momentum for State tax reform without expending substantial amounts of its own political capital. However, in doing this the Commonwealth should take care to limit itself to highlighting the pathway for reform without actually trying to force the hand of State Governments.

Recommendation 3.1: While the Commonwealth must be careful not to dictate to States, the Commonwealth can also make observations about State taxes and provide incentives for reform with fewer political constraints than State Governments themselves – this may not generate immediate results, but it helps build momentum for reform over time. An appropriate model is the Asset Recycling

Fund, which is much less controversial and politically significant at a national level than the activities that it funds are at a State level.

State taxes that should be abolished

The easy part of making the case for tax reform is outlining which taxes should be abolished. There are a number of inefficient taxes at a state level that should be abolished completely.

Stamp duty on conveyances is a highly inefficient and inequitable. KPMG modelled the average excess burden of stamp duty at 60 cents per dollar for residential stamp duty and 70 cents per dollar for commercial stamp duty (this is probably an underestimate because it does not take into account the progressive rate structure that stamp duties apply). Stamp duty doubles the cost of moving houses and adds substantially to the savings needed by first homebuyers. Stamp duty is unfair because there is no reason why people who move more often should pay more tax. Reduced household mobility also has implications for the labour market. Some workers may decline job offers because of the cost of moving, leading to higher unemployment, as it takes longer to find work, and lower productivity, because employers must settle for less suitable staff. Similarly, workers may choose to take a new job with a longer commute rather than relocating, which adds to congestion and increased strain on transport infrastructure. Stamp duty on the transfer of motor vehicles has similar negative effects.

General insurance duty and the fire services levy are also among the most inefficient and narrowly based taxes. These taxes add substantially to the cost of insurance premiums, and since the net benefit of purchasing insurance is the premiums less payouts, the effective tax rate is extremely high. This discourages people from taking out adequate insurance, which ultimately leads to significant costs for governments whenever a natural disaster occurs. Some see insurance related taxes as a user charge for emergency services, but this argument is hard to sustain given emergency services are provided to everyone regardless of whether they have insurance.

Economists generally regard payroll taxes as relatively efficient because wages are a relatively broad tax base and labour is relatively inelastic. However, as the Henry Review noted, the exemption of small businesses from payroll tax undermines efficiency because it changes the competitive landscape and may discourage businesses from growing above the threshold. More importantly, payroll tax is simply a less efficient and equitable version of a more broadly based consumption tax like the GST. Payroll tax only applies to labour income, so it distorts the allocation of resources towards more capital-intensive industries and applies no additional tax on those with stronger capital incomes – arguably social services groups and unions should be those most opposed to payroll tax. Payroll tax also applies to exports and does not apply to the offshore labour component of imports, which means it disadvantages trade exposed businesses and undermines international competitiveness. Payroll tax is different in different states, which adds administrative costs and distorts business location decisions. Payroll tax increases are also often impossible for businesses to pass on given the highly regulated nature of labour markets.

Recommendation 3.2: At minimum, the Commonwealth should highlight the benefits of abolishing inequitable and inefficient state taxes such as stamp duty on conveyances, general insurance duties and the fire services levy, stamp duty on the transfer of motor vehicle ownership and payroll tax.

State taxes that should be reformed

Reforming other State controlled taxes is likely to be more difficult.

With respect to land tax, the Government should broaden the base and the lower rate by removing the principal place of residence exemption. Making state land taxes more efficient must also involve changing the assessment mechanism to a flat rate or a value per square metre rate, as the current approach in most states based on aggregated land holdings excludes a large proportion of the tax base and discourages large investors from participating in residential property market. An ideal broad based land tax is arguably the most efficient possible tax because it is impossible to avoid. However, the substantial exemptions undermine this efficiency by allowing tax to be avoided by changing the use or ownership of the land. This also allows investors to pass on much of the costs of land tax to renters. A further benefit of a broad based land tax is that it delivers some redistribution, even if levied at a flat *ad valorum* rate because those with more valuable properties pay more tax and property assets are closely correlated with overall wealth for the majority of Australian households.

With falling commodity pricing leading to the closure of many mines and a faster than expected reduction in mining related construction activity, state governments should also give some thought to moving from price based royalties to profit based royalties. Some may argue that royalties are basically payments that states get for selling their resources so they should be based on the sale price of those resources. However, the economic value of resources depends on how much they cost to extract not just how much they sell for. By refusing to take into account the cost of extracting resource in the prices that they charge, States are undermining their own revenue base and sacrificing significant potential economic activity.

There is a strong case for replacing all existing motor vehicle related taxes at the State level with a better-designed registration fee, set as low and efficient charge for access to the road network, and time and location based charges for any negative externalities that arise from road use. User charging for the costs of building roads is generally inefficient and should be avoided – instead the value of new infrastructure construction can be captured automatically through a broad based land tax.

Finally, States should agree to broaden the base of the GST, even if that were to mean reducing the headline rate. The current exclusions for the GST are essentially arbitrary as the recent debate about adding further exclusions demonstrate. Health, education and fresh food are important necessities, but so are many other things, including electricity and transport costs. While these concessions may proportionality benefit low-income earners, the majority of the value of the concession still goes to high-income earners who consume more of these services. If State Governments really want to provide subsidies for particular types of good or services, they can do so by providing direct subsidies on an individual state-by-state basis, without binding the decision of other States.

Recommendation 3.3: The Commonwealth should also highlight the benefits of reforming other State controlled taxes, including the GST:

- Removing the principal place of residence exemption for land tax and changing the assessment mechanism to a flat rate or a value per square metre rate.
- Making royalties profit based to avoid the unnecessary closing mines in the context of low commodity prices.
- Transforming registration charges into efficient network access charges and combining them with appropriate charges for externalities imposed on other road users
- Broadening the base of the GST itself, even if that means reducing the overall rate.

<u>Packaging State tax reform</u>

As most inefficient state taxes are essentially very narrowly based consumption taxes, the Commonwealth should observe that the most logical replacement for these taxes is a more broad based consumption tax such as the GST.

However, Australia already has a very pronounced vertical fiscal imbalance (VFI), which leads to states often passing responsibility for reform to the Commonwealth. It is debatable if the problem is VFI per se or a lack of clear expenditure responsibilities, but either way it is important for States to be able to pursue at least some tax reform independently. In this regard, there is a strong case for States to fund the abolition of stamp duty using a broad based land tax.

Replacing stamp duty with a broad based land tax has the potential to boost GDP by 1.3 per cent according to modelling by Independent Economics for the Housing Institute of Australia (HIA). Replacing one property-based tax with another would offset any potential price volatility maximise the chances of broad based support for change. The NSW Business Chamber's discussions with other state interest groups suggests that there is broad support for change provided there are appropriate transition arrangements and protections for asset rich income poor.

A broader land tax is not the only alternative revenue source that is more efficient and equitable than stamp duty. For example, the Henry Review recommended replacing stamp duty with either a broad based land tax or a higher consumption tax. However, the Henry Review noted that replacing stamp duty with land tax has the benefit of minimising the effect of removing stamp duty on property prices. In contrast, replacing stamp duty with a broad based consumption tax like the GST could lead to significant short-term price increases.

Replacing stamp duty with land tax has other advantages. A broad based land tax is even more efficient than a broad based consumption tax because it directly targets economic rent. Unfortunately, states have structured land taxes in a way that is far from the theoretical ideal. The exemption for owner-occupied housing excludes up to 75 per cent of the land tax base, according to the Henry Review. The progressive rate structure generally based on total land holdings also excludes a significant proportion of investors with low value holdings and discourages large-scale investors from participating in the residential rental market. Broadening the land tax base is likely to be difficult, but it will probably be easier in the context of abolishing stamp duty because it involves one tax on owner-occupied property being replaced with another.

Since land is a scare resource, particularly in major cities, the value of taxable land also seems likely to continue to grow quickly making land tax one of the most buoyant possible tax bases, and, with averaging of land values, land taxes is also likely to be a more stable source of revenue for state governments.

Additionally, while removing the exemption for owner occupied housing will inevitably be politically difficult, replacing stamp duty with a broad based land tax may receive more broadly based political support than an increase in GST. For example, since ownership of land increases with income, those concerned with progressivity may also be more favourable to the replacement or stamp duty with land tax rather than consumption tax.

Redesigning the assessment mechanism for land tax

Broadening the land tax base involves a number of tax design decisions.

All states that levy land tax calculate tax liabilities based on the value of land itself (though there is some variation in how that value is calculated from state to state). In some states, some council rates are based on some method of valuing the land and its improvements, but governments should resist any suggestion that a similar approach should apply to land tax – and ideally, council rates should be reformed to reflect a valuation approach based on the land itself.

All states that levy land tax also use a progressive structure with a substantial tax-free threshold. In most States, the progressive rate is based on the aggregated value of land in all the properties that an individual owns. This effectively prevents larger investors from participating in the residential housing market because they pay much higher land tax rates than small investors. This is particularly problematic because large investors are arguably more able to provide low-cost housing and long-term tenure. Unlike other States, the ACT uses the value of individual properties rather than aggregate land holdings. However, this just creates a different set of distortions by giving landholders an incentive to divide their holdings into smaller parcels.

The most straightforward solution is to simply remove the progressive structure and levy a flat tax. As noted above with respect to stamp duty, land holdings and property values are not necessarily indicative of wealth. However, moving from a progressive stamp duty to a flat rate of land tax may reduce the potential for broad based support from across the political spectrum. A further problem with a flat land tax is that for low value land, it can be difficult to separate the underlying value of land from the value of improvements, and such circumstances land tax may discourage investment rather than simply taxing the unimproved value of land.

The alternative proposed by the Henry Review is to adopt a progressive rate based on the value of land per square metre. Unlike most progressive taxes, a per square metre approach may actually be more efficient than a flat rate, because the value of high value land is likely to contain a higher level of economic rent. A further advantage of a per square metre approach is that if very low value land were excluded from tax, primary production exemptions could also be removed from land tax. Those who argue that a per square metre approach will lead to lower investment in high value areas have their analysis backward. Higher land tax in high value areas will be incorporated into existing prices and will have no effect on new investment. Indeed, there will be a stronger incentive to ensure that land is put to its highest value use.

Protections for asset rich income poor

Opposition to the replacement of stamp duty with owner occupied land often focuses on the circumstances of asset rich income poor households, particularly seniors. Taxpayers understand stamp duty and they can choose not to pay it by not buying property. However, land tax cannot be avoided – which is also why it is much more efficient – and problems arise when individuals who own valuable land do not have enough liquid assets to pay their land tax liabilities. Seniors are particularly vulnerable to the impact of land tax because they have often made long-term retirement income decisions that are difficult to alter.

There is a strong argument for not providing concessions to working age individuals that have difficulty meeting their land tax liability. As with all taxes, hardship provisions should be put in place to ensure that those experiencing short-term difficulties are not forced to sell their home. However, if individuals are unable to pay their land tax bills in the long-term, it seems reasonable for them to adjust their circumstances in the same way as they would have to if they became unable to afford their mortgage repayments. However, it is much more difficult for those at or near retirement to adjust their plans for an unexpected increase in land tax. Moreover, provide exemption for working age landowners based on their income is likely to discourage labour market participation.

Those aged over 65 appear to own between 21 and 25 per cent of owner occupied property depending on which source of data is used – this proportion drops to 16 per cent if property holdings are discounted by the proportion of those aged over 65 who main source of income is not government pensions.

Assuming those aged over 65 own roughly the same proportion of owner-occupied land as they own of owner occupied property, fully exempting all seniors from land tax would create significant foregone revenue. Limiting the exemption to pensioners would reduce the cost, but it would also provide an additional incentive for retirees to reduce their income and assets so they are eligible for the pension.

Another way of limiting the revenue forgone is to allow seniors to defer their land tax liability as a charge against the property (appropriately indexed and capped at the total value of the property) on sale or death. This removes any cash flow problems and means that those receiving the concession may treat land tax in much the same way as stamp duty. As this concession is less generous, it is also likely to be subject to less exploitation by high income seniors. Nevertheless, the short-term impact on the Government's cash flow could be similar granting a full exemption. Another issue that would need to be explored with this alternative is the impact on nursing home arrangements.

The long-term costs of protections for asset rich income poor seniors could be limited by only providing these concessions to people born before a certain date currently living in owner occupied housing. If the transition to land tax occurred gradually over a long period, this may mean that the revenue that is ultimately forgone is minimal.

Transitional arrangements

Appropriate transitional arrangements will be vital to a successful switch from stamp duty to a broad based land tax.

Individuals who pay stamp duty on the purchase of owner-occupied housing in the period shortly before a switch to land tax is announced are likely to feel disadvantaged because they did not anticipate the land tax liability that they will face. Investors in residential housing and buyers of commercial property are less likely to be affected because they already face a land tax liability.

The Henry Review outlines three transition options:

- Grandfathering all owner occupiers,
- a credit for recent payers, or
- a long-term transition.

Grandfathering involves exempting all current owner occupiers from land tax and only applying land tax to those who move. However, any grandfathering arrangement is likely to forego a significant proportion of land tax revenue. As noted above, only around 6 per cent of the housing stock turns over each year and a similar proportion of owner-occupiers move each year. This means that 94 per cent of owner-occupiers would initially be exempt from land tax. Grandfathering arrangements would also discourage people from moving houses in much the same way as the existing stamp duty. One advantage of grandfathering is that it may negate the need to provide protections for asset rich income poor seniors because they are unlikely to move. Grandfathering only seems viable if revenue from stamp duty is largely replaced through some other tax, like GST, and the broadening of the land tax base is ancillary.

A credit for those who recently paid stamp duty is likely to be less costly, but it still likely to involve significant foregone land tax revenue. The available data suggest that around 50 per cent of home-owners have moved in the last 10 years, which means anybody who purchased owner-occupied housing in the last 10 years has paid more stamp duty than average. Providing concessional arrangements for 50 per cent of all owner-occupiers would be difficult to afford, even if the number of people receiving concessional arrangements were to fall by around 5 per cent a year. This is especially true because the 50 per cent of people who bought more recently are also likely to be separate to the 10-20 per cent that receive concessions as asset rich income poor seniors. If those who move following the introduction of stamp duty lose access to the credit the cost will be reduced. However, it is not clear that the reduction in revenue forgone will be significant and this continues at least part of the disincentive that stamp duty provides against mobility.

At present, the most viable way to transition seems to be to gradually reduce stamp duty while land tax is gradually increased. A long-term transition may also negate the effect of and/or need for concessions for asset rich income poor seniors who have already made arrangements for their retirement. However, some further work is required to understand how a gradual shift from stamp duty to land tax could be paired with a change in rate structure of land tax, which must necessarily happen at once. Obviously, the disadvantage of a long-term transition is that the benefits of reform are substantially delayed.

Recommendation 3.4: As most inefficient state taxes are essentially very narrowly based consumption taxes, the Commonwealth should observe that the most logical replacement for these taxes is a more broad based consumption tax such as the GST.

Recommendation 3.5: However, the Commonwealth should also emphasise that State can pursue reform independently, and arguably the most beneficial reform that State can pursue independently is to follow the ACT in replacing stamp duty on conveyances with a broad based land tax. This has the potential to boost GDP by 1.3 per cent according to modelling by Independent Economics for the Housing Institute of Australia (HIA). Replacing one property-based tax with another would offset any potential price volatility maximise the chances of broad based support for change. The NSW Business Chamber’s discussions with other state interest groups suggests that there is broad support for change provided there are appropriate transition arrangements and protections for asset rich income poor.

Contact details

The NSW Business Chamber wishes to thank the Government for the opportunity to provide a submission on these important issues. Should you have any questions, please contact me on 02 9458 7462 or at paul.orton@nswbc.com.au.

Yours Sincerely

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