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President Gerardine (Ged) Kearney
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Business Tax Working Group Secretariat
The Treasury
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Email: BTWG@treasury.gov.au

Dear Mr Jordan,

The ACTU welcomes the opportunity to provide input to the Business Tax Working Group ('the Group'). Of course, our primary means of engagement has been via my membership of the Group, and the membership of Jeff Lawrence before me. This brief submission is intended to supplement and complement the contribution we have made, and will continue to make, as part of the Group.

The Group's terms of reference are directed towards improving the business tax system to make the most of the challenges and opportunities facing the Australian economy. Particular reference is made to the difficulties arising from the "patchwork economy". We don't believe that an across-the-board cut in the company income tax (CIT) rate would achieve this goal. Instead, a revenue-neutral rebalancing of the business tax system, with an elimination of some existing distortions, could help to protect jobs and help businesses in industries that face difficult conditions.

To reduce the CIT rate without off-setting savings from within the business tax system would reduce the effective tax rate levied on immobile economic rents, including resource rents. This would not be an efficient policy choice. Doing so would entail either reducing public expenditure on vital public services, or shifting the burden directly to consumers and workers via a change in the tax mix. This would not be an equitable policy choice.

Instead of an unfunded across-the-board CIT rate cut, the terms of reference require the Group to identify off-setting budget savings from within the Commonwealth business tax system. We welcome this requirement. This is consistent with our position that policy changes shouldn't result in a reduction in the share of tax revenue paid by business. It is disappointing that some parts of the business community have been unwilling to constructively engage with the process of identifying existing deductions and exemptions that could be removed or modified to fund a cut in the CIT rate.

For the longer term, a broader reconfiguration of the business tax system could improve its efficiency. This reconfiguration could involve taxing immobile economic rents at a higher rate, and taxing normal rates of return to capital at a lower rate. We believe that an Allowance for Corporate Equity (ACE) system is worthy of further detailed examination. We submit that the Group should ask Treasury to complete and release detailed modelling of an ACE system for Australia. This modelling should be done with a range of parameters, including a CIT rate at 30% and one of 40%. The effect of an ACE system on public revenue and economic outcomes should be evaluated. The sensitivity of these estimates to the assumed degree of capital mobility should be noted. While the Group may believe that an ACE is not an appropriate reform option for the short term, it should contribute towards the longer-term policy development process by constructively engaging with the ACE option.

Some of our positions regarding business tax reform are set out in more detail below.

The case against an across-the-board company income tax cut

We support the approach to business tax reform embodied in the Group's terms of reference, specifically the requirement for any cut to be offset by savings from within the business tax system. We would not support a cut to the CIT rate that was not accompanied fully offset in this way, and we do not believe it would result in a net improvement in the economic wellbeing of Australians.

Much of the public debate around business tax has proceeded from the assumption that Australia perfectly resembles the model of a small, open economy with perfect capital mobility, and that the incidence of CIT is borne by labour. The AFTS Review suggests that, if the stringent assumptions of this model held in the real world, then a small open economy should not levy source-based capital taxes at all.

However, the AFTS Review did not accept this conclusion. It found that "economies are not fully open and capital is not perfectly mobile" and that "Australia will continue to exhibit some characteristics of a closed economy". The Review suggested that "the impact of investment taxes on economic outcomes in both open and closed economies needs to be carefully considered in the development of tax policy".[1] This has a number of implications.

The estimates of the marginal excess burden that were included in the AFTS Review and have been referred to in the public debate overstate the real-world economic cost of CIT and the extent to which the economic incidence of CIT is borne by labour. This is because the model from which the estimates of CIT's excess burden are derived use an assumption that capital is perfectly mobile.[2] As the AFTS Review itself notes, this assumption does not hold in practice for the Australian economy.

We accept that some portion of the economic incidence of the company income tax falls on labour in the "very long run," as the AFTS Review put it.[3] However, in an economy in which many firms reap location-specific rents and capital is not perfectly mobile, we do not accept that the entire burden is borne by labour; nor do we accept the proposition that a shift in the tax mix away from CIT and towards consumption or personal income tax bases would be neutral for workers. This would represent a move from a tax base which partly falls on labour in the very long run, towards one which falls completely and immediately on labour.

[1] Australia's Future Tax System Review 2009, *Australia's Future Tax System: Report to the Treasurer,* Commonwealth of Australia, Canberra, Part 2, Chapter B1-1.
[2] KPMG Econtech 2010, 'CGE Analysis of the Current Australian Tax System: Final Report', Report for the Australia's Future Tax System Review, Department of the Treasury, Canberra, p.21.
[3] *Ibid.*

Australia differs from the model of a small, open economy in a number of ways. One of these is that capital markets are imperfect and investors exhibit a preference for investments in their own jurisdictions.[4] This means that the response to a change in CIT rate is likely to be less than that assumed by models that do not account for home bias; "the decrease in investment flows following an increase in the corporate tax rate would be less than predicted by the simple theory of tax incidence, which ignores the existence of a home bias".[5]

Another factor that must be taken into account is that reducing the CIT rate would reduce taxes on immobile rents, including resource rents. This would reduce the tax rate on investments that would happen anyway; it would not result in a net increase in investment in projects that reap pure rents. Participants in the public debate often mention that the AFTS Review recommended a medium-term target of 25% for the CIT rate. It is less often noted that this target was accompanied by the recommendation of a 40% resource rent tax with a broad base. The Minerals Resource Rent Tax, though supported by the ACTU, has a lower rate and a narrower base than the proposed RSPT; a 25% CIT rate with the MRRT would therefore tax immobile resource rents less heavily than recommended by the AFTS Review. This would therefore reduce public revenue without delivering economic benefits.

Many international comparisons of Australia's CIT rate and revenue ignore the fact that the business tax base differs significantly across jurisdictions. CIT rate reductions in other countries, particularly in Europe, have involved significant base-broadening exercises, including the abolition of dividend imputation. In any case, as shown in the Group's discussion paper, Australia's CIT rate remains below the weighted average for OECD countries.

Calls for a reduction in the CIT rate also ignore the vital role that CIT plays as a 'backstop' to the personal income tax system. The larger the gap between the CIT rate and the marginal tax rates faced by individuals, the greater the economic distortions that will ensue as a result of individuals arranging their affairs so as to minimise their tax. Because personal income tax (PIT) is the largest source of both revenue and progressivity in the tax system, we do not believe there is a case for a reduction in marginal PIT rates; if PIT rates remain unchanged then this militates against a reduction in the CIT rate.

Based on the above factors, we do not believe there is a strong case for an across-the-board cut in the CIT rate and we would not support one.

The case for a revenue-neutral broadening of the business tax base

However, we recognise that some industries are faced with difficulties, including those associated with the elevated exchange rate. We are open to policy changes that would assist to preserve employment in these industries. As a result, we have constructively engaged with the Group's processes and are willing to support a revenue-neutral reconfiguration of the business tax system.

The Group has identified a range of ways in which the business tax base could be broadened to facilitate a reduction in the CIT rate. We are not in a position to comment on the practical effect of these recommendations, nor the relative desirability of each measure. We are somewhat disappointed at the unwillingness of some business groups to countenance a reduction in distortions in return for a reduction in the CIT rate.

[4] Chan, K., Covrig, V. and Ng, L. 2005, 'What determine the domestic bias and foreign bias? Evidence from mutual fund equity allocations worldwide', *Journal of Finance,* vol. 60, no. 3, pp.1495-534.

[5] Menezes, F.M. 2012, 'The business tax reform agenda', *Economic Papers,* vol. 31, no.1, March, pp.3-7.

We also submit that the Group should consider recommending the reduction or elimination of those deductions and exemptions that have the least social benefit. It is widely recognised that research and development activities by firms have positive externalities for an industry and an economy; the promotion of such activities by Government is therefore a legitimate and desirable deviation from a pure broad tax base. Other potential offsets identified by the Group do not, on the face of it, appear to possess the same characteristics, in that the tax expenditures may not be justified on the basis of promoting activities with positive social benefits. In our submission, the Group should err towards recommending that Government broaden the tax base in those areas in which the social benefits of exemptions are smallest.

The need for examination of longer-term options

The movement towards a system that taxes economic rents more heavily, and normal rates of return to capital more lightly, may bring substantial economic benefits to Australia. For this reason an Allowance for Corporate Equity should be seriously examined as an option for the medium- and long-term. An ACE would eliminate source-based business taxation for firms making normal rates of return, but could raise more revenue from firms that are making economic rents.

Professor Freebairn made the case well at the 2011 Tax Forum:

> *So the idea of the ACE system is that you would essentially lower the tax rate on the normal rate, which is the stuff that flows around the country, and anything that is above the normal rate of return, whether it is because you're acting as a natural resource, or you've got a new tech breakthrough, you get hit with that. That would be a rate that's much higher than 30 per cent. It might be more towards 40 or 50 per cent.*[6]

Implementing an ACE would involve a number of challenges. We do not pretend that such a reform would be easy, nor that the case for the change to an ACE has been comprehensively made out. It has not. Instead, it is an idea that is meritorious and deserving of further investigation. The Group has come to the view that an ACE would be inconsistent with its terms of reference, as it could not be revenue neutral without increasing the CIT rate. This does not preclude the Group from further developing and examining the case for an ACE, including through requesting additional modelling from the Treasury.

Conclusion

Thank you for the opportunity to provide this brief submission to the Group. I look forward to continuing to work as a member of the Group towards a fairer and more efficient business tax system.

Yours sincerely,

Tim Lyons
Assistant Secretary
ACTU

[6] Transcript, Session 1: Business Tax, http://www.futuretax.gov.au/content/Content.aspx?doc=TaxForum/transcripts/session_1.htm.