AUSTRALIAN INDUSTRY

GROUP

Submission to

The Business Tax Working Group

September 2012

Executive Summary

The Australian Industry Group welcomes the opportunity to comment on the Business Tax Working Group's Discussion Paper. Ai Group recognises the substantial national benefits that can be generated by meaningful tax reform and for several years has argued that priority over all else should be given to reducing the company tax rate to 25 per cent.

We acknowledge the arguments put forward in relation to the Allowance for Corporate Equity (ACE). Nevertheless we remain interested in this approach as a means of substantially improving the efficiency of business taxation in Australia. We suggest that, in its final report, the Business Tax Working Group propose that more work be done on to develop and assess the practicalities of an ACE.

While remaining open to some of the remaining options set out in the Discussion Paper, there has not been a great deal of enthusiasm from Ai Group members for them. This has a number of components.

- Members have expressed very deep opposition to the options put forward to scale back the Research and Development Tax Incentive for larger businesses (options C.1, C.2, C.3 and C.4). These options would change the newly remodelled R&D tax incentive before its effectiveness could be assessed.

  There are very strong grounds on the basis of net national benefits to retain the R&D tax incentive and, notwithstanding some anecdotal reports, there is not any substantial evidence that larger businesses have been less responsive to Australia's R&D tax incentive than businesses in general. In fact, over the past couple of decades the share of R&D accounted for by larger businesses has increased.

- There is a strong wariness of the proposals to limit interest deductibility for all businesses (options A.4 and A.5).

- While revenue estimates are not yet available, members are more receptive to bringing the thin capitalisation rules more closely into line with international practice (options A.1, A.2 and A.3) although there are concerns that the general approach may not be suitable for investors in infrastructure where gearing levels are often relatively high.

- While members remain open to the range of options relating to depreciating assets and capital expenditure (B.1 to B.14), there is a widespread desire for more information on which to make an informed assessment of costs and benefits including the modelling foreshadowed in the Discussion Paper.

Any support for reform options would be predicated on appropriate transition arrangements so that businesses had opportunities to adjust and that where businesses were already committed to existing projects, current write off arrangements would remain in place.

About Ai Group

The Australian Industry Group (Ai Group) is a peak Australian industry association which, along with its affiliates, represents the interests of more than 60,000 businesses in an expanding range of sectors including: manufacturing; engineering; construction; automotive; food; transport and logistics; information technology; telecommunications; call centres; labour hire; printing; defence; mining equipment and supplies; airlines; and other industries. The businesses we represent employ more than 1 million employees.

We are an organisation committed to helping Australian industry and have a focus on building competitive and sustainable industries through global integration, skills development, productive and flexible workplace relations, competitive taxation and regulatory arrangements, infrastructure development and innovation. Our legitimacy comes also from our role in and connection with the broader community.

Ai Group members operate small, medium and large businesses across a range of industries. Ai Group is closely affiliated with more than 50 other employer groups in Australia alone and directly manages a number of those organisations.

Taxation Reform

Ai Group recognises the importance of an efficient and effective taxation system and the very strong scope to improve current taxation arrangements.

While we acknowledge the Business Tax Reform Working Group (BTWG) has a specific terms of reference that limits its considerations to revenue neutral changes within the business taxation system, it is useful to set our response in the context of the broader shortcomings of Australia's tax system.

- At present, Australia has an excessive reliance on income taxation and in particular on the taxation of business income – even after allowing for the operation of the imputation system.
  - Capital is increasingly mobile and the taxation of non-location specific returns to investment is increasingly inefficient.
  - The personal income tax system is also inefficient and in particular its uneven taxation of the returns to saving and its heavy taxation of nominal interest income are problematic.
  - The arrangements for the taxation of superannuation are unstable and, notwithstanding their overall generosity relative to the conventionally-adopted comprehensive income tax benchmark, have a very uneven impact on discretionary saving.
- There is an excessive reliance on selective transaction taxes in the form of the stamp duties and conveyance duties levied by the states and territories. These

are barriers to business restructuring and the mobility of labour and as such are highly inefficient.

- There is significant scope to restructure the taxation of transport fuels and road use charging to remove growing distortions including in relation to congestion.

- We have a relatively low reliance on consumption taxation due to the relatively low rate of the GST and the gaps in its base. The rapid growth of health expenditure is undermining the GST base and is expected to further undermine the tax base in the future.

- Our payroll tax systems are uneven and inefficient and could readily be rolled into an improved approach to consumption taxation with significant improvements in efficiency and administrative and compliance cost savings.

- Our land tax base (not including the taxes on the transfer of real property but allowing for its use by local governments) is relatively underutilised and is characterised by large, distorting exemptions.

- The allocation of taxation between the Commonwealth and the states and territories is severely out of line with spending responsibilities and the systems of intergovernmental grants that address these imbalances, and seek to meet a variety of other objectives, are excessively complex.

As is occurring in other rich countries, demographic forces and rising public-sector health care costs in particular are exerting mounting pressure to lift the share of taxation in GDP. Domestically, a deficit of infrastructure particularly in the context of ongoing population growth add to this pressure and, while there are important opportunities to reduce areas of government expenditure, these underlying factors make it even more important that Australia puts in place the most efficient tax system possible and makes ongoing efforts to improve domestic taxation arrangements. An important step in this process is the work produced by the Review of *Australia's Future Tax System* chaired by Dr Ken Henry.

Clearly there is no shortage of significant avenues for reform with very substantial scope for improving efficiency.

Peter, Paul and the Magic Pudding

For a revenue neutral reform of the tax system to be anything more than a matter of shifting the tax burden between different sets of taxpayers, it needs to improve the efficiency of taxation by more than the costs of changing (and adjusting to changes) in taxation arrangements. Unless there is a discernible improvement in efficiency, tax reform becomes simply a matter of robbing Peter to pay Paul.

In contrast, improvements in efficiency arising from better taxation arrangements create a magic pudding of sorts by permanently raising the level of economic activity on which tax is paid. If allocated to taxpayers the "efficiency dividend" can be revenue neutral but still reduce tax burdens measured as a proportion of the level of economic activity.

Improvements in the efficiency of taxation have associated benefits for the political economy of tax reform by moving from a zero-sum game to one in which the benefits of reform more clearly outweigh the costs borne by individual taxpayers.

There are clearly very strong opportunities to lift the efficiency of Australia's taxation arrangements. The scope of the efficiency gains and the range of reform directions across the tax system means there is, potentially, a very sizable magic pudding that could be used to justify and facilitate meaningful tax reform.

Business Taxation

Ai Group strongly supports the objective of the BTWG of improving the taxation of business income. Our present pattern of business income taxation deters investment, distorts investment and other business decisions and reduces Australia's economic well-being.

Ai Group also welcomed the focus in the terms of reference on the challenge of the "patchwork economy" and the importance of providing tax relief to "struggling businesses".

As indicated above, a fundamental problem with Australia's taxation of business income is our excessive reliance on this source of revenue. As the Discussion Paper recognises, both Australia's company tax rate and the share of company tax in GDP is significantly above those in most other rich countries. This puts Australia at a competitive disadvantage in attracting foreign investment. As also pointed out in the Discussion Paper, it also means that distortions in business taxation weigh more heavily against overall efficiency than would be the case if the business tax burden was proportionally lower.

We note however that addressing the fundamental problem of the excessive reliance on the taxation of business income is all but precluded by the review's terms of reference which limit it to recommending revenue neutral changes to business taxation funded from within the business tax system itself.

Allowance for Corporate Equity

With particular reference to the focus to be given to the patchwork economy and struggling businesses, Ai Group welcomed the direction in the terms of reference that specific attention would be directed to a consideration of an Allowance for Corporate Equity (ACE). The attraction of the ACE is that, in concept, it would remove significant distortions inherent in business taxation by shifting the tax burden from normal returns, where the taxation of business income would deter business investment, to super-normal returns where it would have a much lower distorting impact.

The attraction of the ACE was particularly pertinent given the constraint that changes recommended by the BTWG would be fully funded from within the business tax system itself. It offered scope to remove, or at least to substantially reduce the

inherent bias in the taxation of normal returns to investment and finance it in a way that would not add commensurately to inefficiency.

While we note the arguments put forward in the Discussion Paper in relation to the ACE imply that it cannot be considered as a reform direction in the short-term, we strongly urge that the BTWG recommend that further work be done on the ACE as a means of improving the taxation of business income.

We note also that if the ACE is put off the agenda, there is little in the Discussion Paper that has a *specific* focus on the patchwork economy or on struggling businesses. While the loss carry-back measures put in place by the Government in response to the earlier recommendations of the BTWG do have this focus, Ai Group members in non-mining trade exposed industries in particular are concerned that the BTWG has not given adequate attention to these elements of the terms of reference.

Base-Rate Trade Off

The remaining business tax reform options put forward for consideration by the BTWG involve broadening the business tax base to finance a reduction in the company tax rate.

Ai Group strongly supports the objective of reducing the company tax rate from its present level and for several years has argued that Australia should lower the company tax rate to 25 per cent as a matter of priority. A rate of 25 per cent would make Australia's company tax rate more comparable with those of other small and medium-sized OECD countries.

Our support for the reduction in the company tax rate is, however, conditional on the change making overall sense and in particular taking into account how the reduction in the company tax rate would be financed. Our approach to assessing options takes an economy-wide view rather than a view from the standpoint of particular sectors or activities.

Ai Group has previously supported proposals for revenue neutral reductions in the company tax rate.

- We supported the Ralph Review recommendation to move to a 30 per cent tax rate financed by the removal of accelerated depreciation and a range of integrity measures.

- We also welcomed in concept the reform direction put forward by the Henry Review of a five percentage point company tax rate reduction financed by increased taxation of the location-specific rents generated from the exploitation of Australia's mineral resources.

  Our in-principle support was based on the argument that this alternative form of taxation could be put in place in a way that would not detract from mining investment as it would only apply to returns above a level that would be sufficient to attract the same quantity of investment.

- For the same reasons we supported the modified proposal of a smaller company tax cut being financed from the Mining Resource Rent Tax (MRRT).

  The removal of the smaller company tax rate reduction in the May 2012 Budget was a major disappointment particularly since the MRRT itself remained in place.

Assessing Base-Rate Trade Offs

The diagram below is a stylised representation of the assessment of net economy-wide costs and benefits associated with various base-rate trade-off options (numbered 1 to 16).

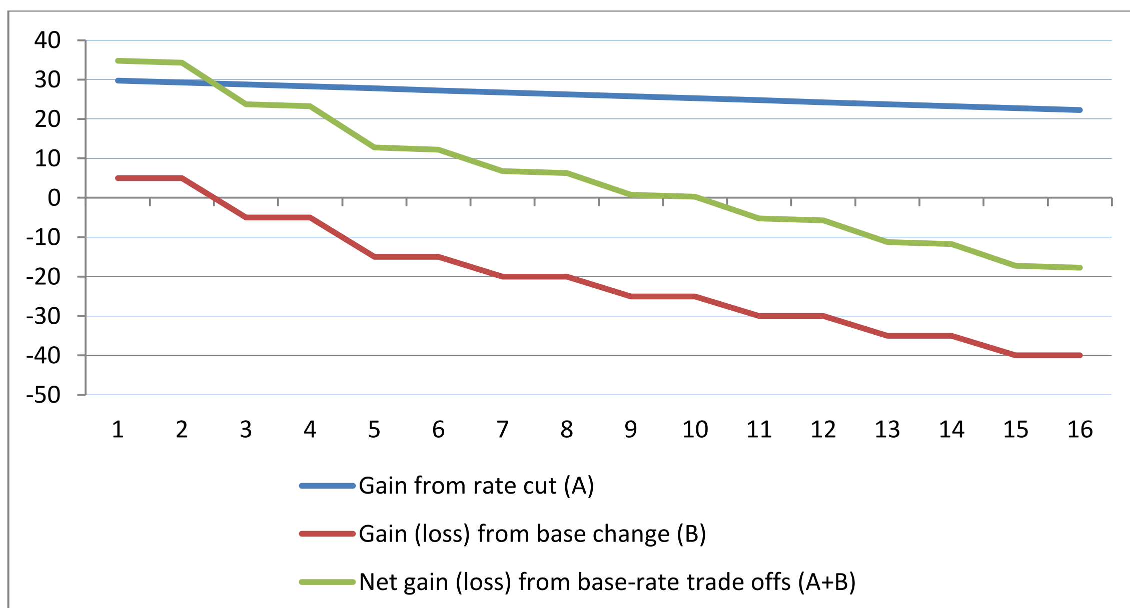
- The incremental gain from reducing the company tax rate (A) falls as the company tax rate is reduced from lower levels.

- In general, base-broadening options (in isolation from a revenue neutral rate reduction) could be expected to reduce economic activity (B) because the reduction in investment due to the removal of the tax incentive will not be matched by increases in investment in other activities (e.g. the supply of capital is not fixed).

- The net impact of a base-rate trade off (A + B) can clearly be positive even if the base-broadening option itself detracts from activity.

- Not all base-rate trade off options will generate net benefits even if the revenue is used to finance a reduction in the company tax rate.

Stylised Assessment of Gains and Losses from Base-Rate Trade-off Options



In this stylised representation, gains to overall efficiency can occur even if some taxpayers adversely affected by base broadening measures do not themselves receive compensating benefits from the company tax rate reduction (for example if they are adversely affected by slower rates of building depreciation but are not taxed as companies). Indeed unless there were very substantial improvements to overall efficiency and the associated gains were distributed to taxpayers, it would generally be the case that there were at least some net losers from a revenue neutral tax reform exercise.

One implication of the stylised assessment is the importance of sequencing of base-broadening options. With incremental gains from reducing income tax rates falling as the rate is further reduced, some reforms that would make sense at higher rates can cease to make sense at lower tax rates. A corollary of this is that at lower company tax rates it could make sense from a cost-benefit point of view to unwind base-broadening measures that generated net benefits at higher company tax rates. Ideally, therefore, reforms that generate higher net benefits should be undertaken ahead of reforms that generate lower net benefits.

This relates more broadly than just to revenue neutral rate reductions financed from within the business tax system and applies to any means of financing tax rate reductions including, for instance, from broadening the consumption tax base. Ideally if larger gains could be generated by financing a reduction in income tax rates by broadening the consumption tax base, this reform should be put in place ahead of options that generated much smaller net benefits.

BTWG Options

While remaining open to some of the options set out in the Discussion Paper, there has not been a great deal of enthusiasm from Ai Group members for the range of options it puts forward. This has a number of components.

- Members have expressed very deep opposition to the options put forward to scale back the Research and Development Tax Incentive (options C.1, C.2, C.3 and C.4).

- There is a strong wariness of the proposals to limit interest deductibility for all businesses (options A.4 and A.5).

- While revenue estimates are not yet available, members are more receptive to bringing the thin capitalisation rules more closely into line with international practice (options A.1, A.2 and A.3) although there are concerns that the general approach may not be suitable for investors in infrastructure where gearing levels are often relatively high.

- While members remain open to the range of options relating to depreciating assets and capital expenditure (B.1 to B.14), there is a widespread desire for more information on which to make an informed assessment and the results of the modelling foreshadowed in the Discussion Paper. Any support for these options would be predicated on appropriate transition arrangements

that ensured that where businesses were committed to existing projects, the current write off arrangements would remain in place.

The general lack of enthusiasm in part reflects a disillusioned view that a large proportion of the base-broadening measures identified by the BTWG Discussion Paper would be financing a reduction in the company tax rate that was only recently withdrawn even though the base-broadening measure (the MRRT) that was to finance it was left in place.

The lack of enthusiasm may also reflect an overall assessment that company tax rate reductions financed from the suite of base-broadening options identified would not generate net benefits or at best would only generate marginal net benefits.

Options to Scale Back the Research and Development Incentive

Ai Group strongly opposes the options put forward to scale back the R&D Tax Incentive. There are three reasons for this opposition.

- Both the feedback from our members and the academic literature provide strong support for the policy arguments behind the retention of the R&D tax incentive.

- The Australian experience with the tax incentive does not provide any support for the presumption behind the Discussion Paper options that the responsiveness of larger businesses to the tax incentive is less pronounced than for businesses in general. Indeed, over the past two decades the share of business R&D spending undertaken by larger businesses has risen.

- The tax incentive has recently undergone a substantial remodelling to make it more effective. Particularly in view of the protracted and at times fraught negotiations involved in this remodelling, it is inappropriate to again change the tax incentive before the effectiveness of the recent changes can be assessed.

The broad thrust of the feedback from members can be summarised as follows:

- While the tax incentive would rarely give rise to new R&D programs that would not otherwise go ahead, it does have a clear positive impact on the amount of domestic expenditure on R&D and the size of R&D projects.

- When the rules governing the tax incentive are stable, businesses can assess the after-tax implications of expenditure plans and the tax incentive has a material impact on the quantity of expenditure undertaken.

- Multinational enterprises take national R&D incentive arrangements into account in deciding where to locate their R&D projects.

- R&D projects often involve collaborative arrangements with other businesses and/or research organisations with external benefits flowing from the hands on experience of individual researchers in projects.

- Businesses undertaking their own R&D typically tune into R&D developments generated by other businesses and the broader research community contributing to and receiving benefits from these developments.

This feedback suggests the R&D Tax Incentive generates additional expenditure on R&D and that business spending on R&D in Australia generates external benefits that are not appropriated by the business undertaking the expenditure and that would not be generated if the R&D was undertaken in other countries.

This feedback receives a good measure of support from a broad cross-section of studies of the effectiveness of R&D tax incentives.[1] While, as the Discussion Paper points out, some studies suggest that smaller businesses may be more responsive than larger businesses to tax incentives, a large proportion of studies find that tax incentives do have a favourable impact on R&D spending by larger businesses.

One quick test of whether tax incentives are less effective for larger businesses in Australia is to look at the share of R&D expenditure undertaken by businesses of different sizes over time. Up until recently the tax incentive has not discriminated between businesses of different sizes and if larger businesses were less responsive to the R&D tax incentive, it would be reasonable to expect that their share of total business expenditure on R&D would fall over time (as the share of smaller, more responsive businesses rose).

The following table summarises ABS data on business expenditure on R&D (BERD) for the largest category identified (over 200 employees) and for all businesses between 1992-3 and 2009-10.

Annual average rates of BERD growth[2]

Number of employees	**1992-3 to 2009-10**
200 or more persons	11.5%
All companies	**10.9%**

The annual average rates of growth of BERD were faster for larger businesses than for businesses as a whole. According to the most recent measures, in 2010-11 businesses with 200 or more employees accounted for around 68 per cent of total expenditure on R&D by Australian businesses.[3] This was noticeably higher than the 63 per cent share of BERD undertaken by larger businesses in 1992-93.

These data lend no support to anecdotal impressions that responsiveness to the R&D tax incentive is less pronounced for larger businesses. If anything they point in the opposite direction.

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[1] HM Revenue and Customs *An evaluation of research and development tax credits*, Research Report 107, UK, 2010; and OECD, *The International Experience with R&D Tax Incentives*, Testimony by the Organization for Economic Cooperation and Development, United States Senate Committee on Finance, 2011.
[2] ABS, 8104.0*, Research and Experimental Development, Businesses*, Australia, various years.
[3] ABS, 8104.0, *Research and Experimental Development, Businesses,* Australia, 2010-11.

There was widespread disbelief among Ai Group members when the BTWG presented options to change the R&D Tax Incentive so soon after it was remodelled.

This remodelling was enacted after a protracted and disruptive process of negotiation around substantial changes that lifted the rate of the tax incentive and narrowed the range of eligible expenditure. The Government's argument at that time was that the new tax incentive would be much more effective and better targeted than the arrangements it replaced.

In introducing the Bill into the House of Representatives in September 2010, the then Assistant Treasurer stated:[4]

> *"The new incentive is the biggest reform to the business R&D landscape in the last decade. It is all about boosting investment in R&D, strengthening Australian companies and supporting jobs. It provides for increased assistance for genuine R&D and redistributes support in favour of small- and medium-sized enterprises—the engine room of our economy.*
>
> *"Our intention is to lift Australia's R&D performance by encouraging many more businesses to benefit from the scheme, ensuring Australia's place as a clever country. R&D activities contribute to innovation by creating new knowledge and technologies—increasing productivity, jobs and economic growth, and allowing Australia to respond to present and future challenges."*

In relation to the more effective targeting of the Tax Incentive, the then Assistant Treasurer stated:

> *"The new R&D tax incentive better focuses public support towards genuine R&D activities"*

and reinforced this point by stating that it:

> *"will deliver much-needed reform to public support for business innovation. It will deliver a substantial incentive for companies to conduct R&D in Australia. It recognises that the innovation dividend for the economy will come from refocusing public support on genuine R&D, not routine business activities."*

It is exceedingly difficult to reconcile these comments with the options put forward in the Discussion Paper to scale back the R&D tax incentive.

[4] Tax Laws Amendment (Research and *Development*) Bill 2010, *Second Reading Speech*, 30 September 2010.