STATEMENT OF REFORM PRIORITIES

PARTICIPANT NAME AND POSITION

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ORGANISATION

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STATEMENT OF PRIORITIES

Objectives of Tax Reform

The tax system impacts directly on business decisions and touches on many aspects of everyday life. Tax reform should aim to lift the tax system's capacity to support economic and social development whilst integrating effectively with the range of government policies designed for this purpose.

The benefits of tax reform should be measured against the benchmark of objectives such as:

- Improving productivity of labour and capital;
- Efficiently allocating and effectively utilising scarce economic resources;
- Supporting entrepreneurship and innovation in business;
- Enhancing economic efficiency and supporting competition;
- Promoting an equitable distribution of income and wealth;
- Minimising the regulatory burden on business; and
- Improving Australia's international competitiveness.

Tax reform can offer real benefits in this sense. For instance, addressing high effective marginal tax rates could have the benefit of lifting workforce participation rates in some areas. Future tax reform must build on previous reforms that have improved our economic capacity. We can learn from past experience; for example, the 'New Tax System' enabled the abolition of financial institutions duty which was a very inefficient transactions tax that was increasingly impractical to operate in an era of technology and global markets and impaired our international competitiveness.

The Significance of Financial Intermediation

Financial institutions and markets play a central role in economic growth and development by intermediating credit and enabling management of financial risk. They provide valuable investment avenues for investors and a pool of resources which support the growth of Australian businesses. Care must be taken to avoid tax measures that 'put sand in the wheels' of the financial system, as making it less effectual would impose a high cost on the economy. However, well-designed tax reform can reinforce other government policies, such as promoting competition in banking, developing a retail bond market and enhancing Australia's competitiveness as a financial centre.

Tax Reform Measures

1. *Supporting competition within the financial sector and our international competitiveness*

Australia relies on foreign capital inflows to finance balance of payments deficits and to support economic growth. Financial institutions raise funds overseas to on-lend to business and facilitate capital raising by Australian companies in overseas markets. The tax system should support the cost effective financing of Australia's capital requirement and our financial system's competitiveness. Thus, AFMA supports full implementation of the Johnson Report's tax recommendations.

Interest withholding tax

Interest withholding tax introduces friction and distorts the free flow of overseas funds to Australian business. It places an additional cost on, and is an impediment to, overseas funding by financial intermediaries with flow-on effects to their customers. It restricts the ability of domestic banks to broaden their funding mix by expanding their overseas deposit base. It presents particular problems for foreign banks in Australia who wish to draw on parent resources to fund their lending in Australia (which has fallen sharply since 2008). Both the Johnson and Henry Reports recommended removal of the withholding tax liability placed on financial institutions in respect of interest paid to non-residents. Whilst the Government announced a partial and phased implementation of this reform, full implementation should be accelerated to help contain the cost of debt finance and to promote competition in the financial system. The cost of this reform would be small in the context of the tax system and would be more than offset by the economic benefits it would generate.

Cross-border GST

The Government is consulting on the GST rules for cross-border transactions. Reform could reduce the cost of regulation for Australian companies that have significant offshore business transactions.

Tax system care and maintenance eg the LIBOR cap

The tax system regularly fails to deal with minor or technical deficiencies in the law. Collectively, these are a drag on economic growth and competitiveness. The 'LIBOR cap' is an example of this. It restricts the tax deductibility of interest paid by a foreign bank branch on funding from its parent. It is an anomalous and out-dated piece of law that deters the commitment of funds by foreign banks to Australian business. The Johnson Report recommended removal of the LIBOR cap but it remains in place, despite compelling evidence on the need for change. The tax revenue cost of change is minimal if any but the benefits through enhanced competition and availability of finance are large.

2. *Promoting promote efficient savings and investment*

The tax system can better promote national savings and the efficient use of capital in the Australian economy. Individuals have greater responsibility to manage their financial affairs and accumulate wealth to provide for their retirement. Investors need a range of financial products from issuers to grow their savings in accordance with their personal profile and risk preference.

The public expects to be able to make investment and risk management decisions within a set of tax rules that are certain and reasonable. The current tax system does not always deliver this and tax rules for some financial products are uncertain and complex. Both tax policy and its administration need to be examined to better provide the level of certainty and balance required in this area.

AFMA supports the policy direction set by the Government by providing a tax discount for interest income. This will provide a more tax neutral environment for savings, encourage investors to diversify their investments and ultimately assist the allocation and effective use of capital within the economy. It complements important policy initiatives to reduce risk in the financial system by assisting banks to meet the stringent Basel III liquidity requirements in a cost-effective way for the economy. The scale of the tax discount on interest income should be broadened over time.

3. *Refrom inefficient State taxes*

Analysis by Deloitte Access Economics for the Finance Industry Council of Australia confirms that State transaction taxes are among the least efficient of all taxes levied in Australia. Economic gains from State tax reform would be significant and the alternatives for a more rational set of State taxes should be considered. With proper grandfathering and transition arrangements there is the potential for reforms of State taxes to result in a steadier, less volatile income stream for the States coupled with improvements in economic efficiency and positive social outcomes.

4. *Improved governance of the tax system*

Innovation in business structures and practices driven by changing economic and market conditions present significant challenges to tax authorities. Companies need to be confident that the Australian Taxation Office (ATO) understands their business and has the technical capability and resources to meet their tax compliance needs in a timely and informed way. Experience points to potential for improvement in this area. The Henry Report recommended that an advisory board be established and the Government has consulted on the design of a Tax System Advisory Board. An independent and well-resourced advisory board would help ATO's senior management to develop and operate policies and promote behaviours that deliver a transparent and accountable tax system in the manner envisaged by the Henry review. This could be accompanied by measures to improve the operation of the self-assessment system in keeping with the changing administration of tax. Tax revenue benefits should flow from the positive effects on compliance costs and business activity.

Managing the Tax Reform Process Going Forward

A significant amount of effort was invested in creating a road map for reform with the Henry Review. The challenge now is to package the implementation of the accepted measures over time by tasking an independent body to work through community concerns and implementation difficulties in order to create a series of well-worked incremental steps. The Government should establish an advisory body tasked to promote and support the tax reform process, such that momentum will be maintained and properly analysed reforms are implemented on a well-ordered basis. The body should make recommendations to the Government on tax reform and the design of the measures to implement change, within the framework of the Government's broad policy objectives. To proceed without creating such a body would be to deny the scale and difficulty of the tax reform task.

Funding Tax Reform

As outlined above, many tax reforms would not impose a cost on revenue. The cost of specific tax reforms should be assessed as part of the broad package of reforms, the metrics of which should be determined by the proposed independent body after public consultation. For example, tax reform could include a GST component subject to the inclusion of measures to address the policy inefficiency and cost to business of input taxation.

Notes: Johnson Report - Australian Financial Centre Forum's report on *Australia as a Financial Centre (2009.*
Henry Report - *Australia's Future Tax System* Report (2010).

LIST OF ATTACHMENTS