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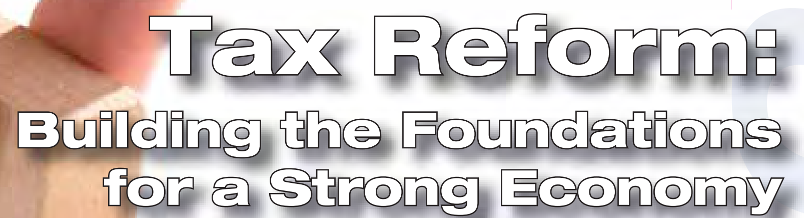

Tax Reform:
Building the Foundations for a Strong Economy

CCI Advocacy
September 2011

Making it easier to do business

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Introduction

CCI is the peak organisation representing business in Western Australia. It is the second largest organisation of its kind in Australia, with a membership of over 6,500 businesses across all sectors of the economy.

In the 2008–09 Budget, the Federal Government announced a "root and branch" review of Australia's taxation system (the Henry Review). The Terms of Reference were to review the taxation system, while taking into account its relationships with transfer payments and social welfare. Notably, not all aspects of the tax and transfer system were considered in the review, with the GST, industry policy, carbon pollution policy, and administration and drafting largely excluded.

The final report of the Henry Tax Review was handed to Government in late 2009, and outlined a long term vision for the nation's tax system, with suggested reforms to be introduced incrementally. The recommendations outlined in the review sought to develop a tax system that will allow Australia to deal with the demographic, economic and environmental challenges facing the nation in the years ahead.

Since then, the Government's initial response to the review has been limited, with even fewer delivering significant business tax reform. The Government's key commitments to date include introducing a 30 per cent Minerals Resource Rent Tax on iron ore, coal, oil and gas resources from July 2012, and expanding the Petroleum Resource Rent Tax.

The revenue from this new tax would be used to:

- fund a reduction in the company tax rate to 29 per cent from 2013–14, with small business having a head start from 2012–13;
- simplify small business capital allowance arrangements; and
- increase the superannuation guarantee from nine to 12 per cent by 2019–20.

However, the Government has indicated that these will be only 'first steps'. As part of the 2010 Federal Election, the Government also committed to hold a Tax Summit before June 2011, to debate and discuss the recommendations of the Henry Tax Review and a new agenda for tax reform. This Forum will now be held on 4 and 5 October 2011.

While the Tax Forum will provide an ideal opportunity to discuss meaningful tax reform, CCI remains concerned that this issue has not been given the priority that it deserves in recent times. The ability of the Tax Forum to deliver real and meaningful reform is limited by the terms of reference, with key issues such as reducing the size of the tax burden, the GST and the MRRT outside of the debate.

Given these concerns, CCI has set out to develop an overarching tax reform agenda that will help reduce the size of the tax burden, remove inefficient taxes, promote workforce participation, boost productivity, and improve international competitiveness. This paper sets out a range of improvements that the Commonwealth and State Governments could make in the short term to reduce the impact of the tax system on the business community. It also outlines a more ambitious agenda which could be achieved over the longer term, aimed at addressing issues with Commonwealth–State financial relations, and eliminating inefficient taxes.

In developing this reform agenda, CCI consulted broadly with its members, and established a Tax Reform Working Group to advise on key tax policy issues. The group consisted of members across a wide range of industries and sizes, including the not-for-profit sector.

Notably, this paper is intended to provide direction on the type and scale of reform that can be achieved, but is not intended to be a complete package for reform. The paper focuses on key taxation issues based upon member feedback, but is not an exhaustive list of all reforms needed to improve the tax system. Further work is also needed to model the impacts of these reforms and to cost the proposals set out in this paper.

Personal services business
determination application
Section A: Ap
T A X E S
What is the tax file number (TFN) of the individual identified
at question 2? (If available)
Other given name
Does 80% or more of your PSI come from one client?
Yes
No
If you do not operate a company, partnership or trust, go to question 7.
is the name of your company, partnership or trust?

Executive Summary

While tax is a necessary part of a modern economy to fund the provision of essential Government services, it also represents a significant cost of doing business, and in turn impacts on investment and employment decisions.

Reform is needed to ensure that the tax system has a minimal impact on business and individuals, assists competition, and promotes employment, investment and economic growth, as well as the nation's social goals. This will also help the nation navigate its way through the many economic and social challenges which lie on the horizon.

Tax reform is particularly important in terms of maintaining our reputation as a competitive place to do business internationally, given that investment is mobile and taxation is a vital issue for investors when considering where to locate or establish operations. As the State and national economies gather pace in coming years, it is critical that our tax system does not act as a disincentive to further investment. An uncompetitive tax system may put at risk more than $767 billion worth of investment projects in the pipeline across the nation, with $263 billion of these projects earmarked for WA (as at June 2011).

The tax system will also be an important way to ensure that Australia has a workforce that is capable of ensuring the nation's continued economic success. With labour more mobile than ever, reform is needed to ensure the tax arrangements do not deter overseas workers from moving to Australia, and prevent people from Australia relocating to other countries. Tax reform is also needed to boost workforce participation among the current population, by improving the incentives to work, and mitigating disincentives to work. The tax system is an important tool to encourage greater participation among those sectors of the community that are underrepresented in the workforce, such as women, people with a disability and Indigenous Australians.

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

Any reform to the tax system must be considered in the context of good taxation policy. Any changes to the system should be assessed against the principles of equity, efficiency, simplicity, transparency, adequacy and certainty.

As a starting point, it is critical to determine the appropriate level of services to be provided by Government. A broad review of Government spending programs at both a Commonwealth and State level is needed to identify areas of waste and inefficiency. This will not only improve the operation of the public sector and ensure that taxpayers get value for money, but it will also reduce the overall size of the tax burden on the community. Any reform of the tax system should not be constrained by the need for revenue neutrality.

The ability to achieve widespread taxation reform is however contingent on treating the Commonwealth and State tax system as one regime. Until the imbalance between the revenue raising capacity and spending responsibilities of the States is addressed, the ability to reform the most inefficient taxes is limited.

However, addressing these imbalances will require a major systemic overhaul, which will take some time if it is to be well planned, and provide taxpayers with sufficient support and assistance throughout the transition process.

In the meantime, there are a range of reforms that could be implemented immediately that will improve the operation of the nation's tax system, and alleviate the burden on businesses and the community more generally. Many of these reforms at both a Commonwealth and State level centre on streamlining the tax system, for example by simplifying tax scales and thresholds, and indexing thresholds to a reasonable measure of price change to address bracket creep. Greater harmonisation of taxes between jurisdictions would also help to simplify the system. A more detailed short-term reform agenda is set out in the following section.

While these reforms will provide some tax relief in the short term, they will not address many of the underlying problems with the tax system. In this regard, it is critical that a more ambitious reform agenda is implemented over the longer term.

The most important area is to address the current imbalance in Commonwealth and State financial relations. The States must be provided with a sustainable source of revenue, which will enable them to fund the abolition of inefficient State taxes.

Given that consumption is one of the most efficient tax bases and provides a stable source of revenue, broadening the base and increasing the rate of the GST should be investigated.

An income tax sharing arrangement may also be a suitable option to provide the States with a sustainable revenue base. This could be achieved by passing the income tax base from the Commonwealth to the States, or for the States to share the income tax base with the Commonwealth (such as through a surcharge).

Such a move would allow for inefficient taxes such as payroll tax and duties to be abolished, without adversely affecting the ability of the States to provide necessary services.

The Short Term Agenda

- Before any reform of the tax system can be undertaken, a broad review of Government spending programs at both a Commonwealth and State level should be undertaken, to identify areas of waste and inefficiency, and reduce the overall size of the tax burden on the community. Eliminating jurisdictional overlap is one key area where reform could be achieved.
- Changes should be made to the personal income tax system to encourage workforce participation, and ensure that Australia can attract and retain workers. In particular, the top marginal tax rate should be progressively cut to equal the company tax rate (currently 30 per cent), adjustments should be made to reduce the number of thresholds for personal income tax, and these should be indexed to wages growth.
- The personal income tax system should be used to encourage greater labour mobility between the States, and further work should be undertaken to determine the best approach. One option may be to increase the value of the zone rebate, ensure that it is representative of average wages, and index this rate to ensure that its value is preserved over time. Establishing Special Economic Zones with preferential tax treatment may also be an option.
- Reform to Capital Gains Tax (CGT) is needed to ensure that Australia can continue to attract investment. The tax rates for CGT should be reduced, to encourage investment. One option may be to introduce a stepped rate, which will see the proportion of capital gains that is taxed diminish over time. Capital gains should also be allowed to be offset against tax losses in previous years, to reduce the amount of complexity and allow businesses to use all of their capital losses.
- Adjustments to Fringe Benefits Tax (FBT) are needed to reduce the cost to business. FBT should be applied to the employee, as all other income is treated, with collection from the employers in the same manner as PAYG. The business premises test should be removed, to allow for childcare to be salary sacrificed. The FBT exemptions for not for profit organisations should be retained. However, the legislation should be simplified to reduce the administrative and compliance burden.
- Depreciation arrangements should be streamlined and simplified, by allowing low valued assets (for example, less than $5,000) to be immediately written off. For small businesses, assets valued less than $10,000 should be allowed to be immediately written off, and all other depreciating assets pooled together, and written off at a single rate. These thresholds should be indexed.
- Any changes to taxation arrangements for resources should be considered as part of a broader reform agenda, and in consultation with the States. CCI opposes the Government's proposed MRRT, as it does not form part of a package of broader reform, and will penalise one of the nation's most successful industries. Further debate on the merits of rent taxes should be undertaken as part of the Tax Forum.
- Simplification of State taxes is a key area where reform should be achieved in the short term. Tax scales and thresholds for a range of State taxes should be simplified, and indexed to a reasonable measure of price change. Payroll tax is a priority area for reform, in that it represents a major burden on business and is effectively a tax on employment.
- The States should also continue to implement harmonisation measures for tax administration to minimise compliance costs and provide a greater degree of certainty for businesses operating across Australia. All aspects of State tax legislation except the rate should be harmonised (including the base, definitions, exemptions etc).
- Measures should be introduced to reduce the complexity of the tax system, and in turn the compliance costs. A priority area for reform would be to align the two Income Tax Acts.
- A starting place for such reform should be to address complexity issues as they arise. The Government should consider adopting measures in assessing the provisions of the Tax Act by introducing a Tax Administration Impact Statement (the TAIS) to be administered for example by the Inspector General of Taxation.
- The administration of personal income tax arrangements should be streamlined by adopting the Henry Review's recommendations to introduce a standard deduction for taxpayers, which would allow taxpayers to lodge a default tax return, or claim actual expenses with full substantiation.
- Commonwealth and State Governments should conduct a review of current exemptions and concessions to ensure they are consistent across States, and remove those where the administration and compliance costs exceed the revenue foregone.
- The Commonwealth and State Governments should implement the Henry Review's recommendation to review all minor nuisance taxes against the principles of good tax policy, and abolish those which do not meet these criteria. Examples of these taxes include the luxury car tax and Perth Parking Levy.

What is needed is an overarching and ambitious reform program to be implemented over the longer term

Longer Term Reforms

While the above reforms have focussed on the design of a number of taxes and will provide some tax relief in the short term, they will not address many of the underlying issues with the tax system. What is needed is an overarching and ambitious reform program to be implemented over the longer term, which will involve fundamental change to the tax mix – either by abolishing the most distortionary taxes altogether or replacing them with more efficient taxes.

- The States must be provided with access to a sustainable source of revenue which will allow the most inefficient taxes to be abolished. Given that consumption is one of the most efficient tax bases and provides a stable source of revenue, broadening the base and increasing the rate of the GST is an option that should be considered. However, this would also require reform to the current methodology by which GST is allocated to the States, given the unsustainable decline in WA's share in recent years. Providing the States access to the income tax base will also help alleviate revenue pressures on the State and is a priority area for reform.
- Inefficient taxes, including payroll tax and duties, should be abolished once the State's have access to a more sustainable revenue stream.
- The Government should impose a fiscal rule to maintain the company tax rate below the OECD average, to improve Australia's international competitiveness and ability to attract investment from overseas.
- Reducing the complexity and compliance costs of the tax system should be a central part of any tax reform agenda. The Government should implement the Henry review's recommendations aimed at making the tax system more responsive and accountable.
- Addressing the complexity of the tax system and associated compliance costs over the longer term will also require new legislation to be carefully assessed, with necessary cost/benefit analyses undertaken to determine the net social benefit of taxation changes for their compliance impact.

The Imperative for Reform

The Australian economy is widely recognised as one of the strongest and most resilient in the world, and has benefited significantly from the ambitious reform agenda that has been undertaken by successive governments since the 1970s.

These reforms have ensured the Australian economy is flexible, resilient, and increasingly integrated with global markets, and have provided the impetus for almost two consecutive decades of growth, and historically low unemployment. It was these reforms that also set the nation up to withstand more difficult times, including the Asian financial crisis, and more recently, the global financial crisis and subsequent economic downturn.

In recent times however, the reform agenda has ground to a halt. While Australia has still recorded a stellar economic performance, this has been driven by the surge in commodity prices from the global boom in mineral and energy markets.

While this has delivered much wealth for the nation, it is not a sustainable way to improve the nation's prosperity and standard of living over the longer term.

Instead, what is needed is a reform agenda that will reverse the slump in productivity growth that has occurred in recent years, and ensure the economy is well prepared for the economic, demographic and social challenges that lie ahead.

There is considerable scope to strengthen and streamline the national and State taxation regimes as part of this reform agenda. Reform is needed to ensure that the tax system has a minimal impact on business and individuals, assists competition, and promotes employment, investment and economic growth, as well as the nation's social goals. Importantly, a new tax reform agenda should not be straight jacketed by the need to remain revenue neutral.

While reform to the tax system is necessary to ensure the nation's ongoing growth and prosperity, the ability to achieve widespread taxation reform is contingent on considering the Commonwealth and State tax system as one regime. Until the imbalance between the revenue raising capacity and spending responsibilities for the States is addressed, the ability to reform the most inefficient taxes is limited.

Any reforms to the tax system should focus on its current high level of complexity and should aim to improve its efficiency and transparency. A consultative approach to reform would help ensure that future tax changes take into account the impact on taxpayers.

The reform proposals highlighted in this submission demonstrate practical and achievable ways in which reform can be delivered in the short term within the existing taxation framework, as well as setting out a more ambitious longer term agenda.

Notably, this paper is intended to provide direction on the type and scale of reform that can be achieved, but is not intended to be a complete package for reform. Further work is needed by the Government to model the impacts of these reforms and to cost the proposals set out in this paper.

Encouraging investment, entrepreneurship and economic growth

The tax system has a significant impact on economic choices, such as firms' decisions to invest and innovate.

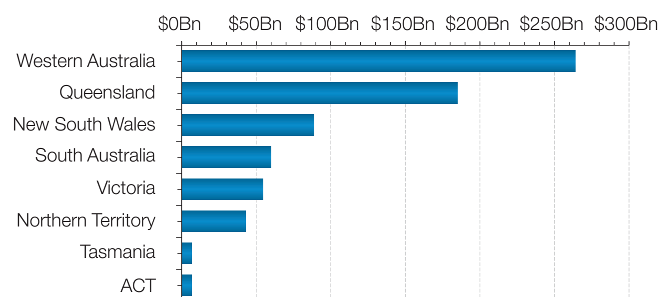
The continued integration of the global economy means that there will be greater competition for capital, and the tax system will be an important factor for businesses and individuals deciding where to invest, and the types of assets to purchase.

Although Australia has successfully attracted high levels of capital, particularly in the resources sector, these levels of investment are not guaranteed over the longer term. Given that many countries have been cutting tax rates on capital and business in recent years, Australia's tax system needs to be further reformed to ensure that the nation remains an attractive location to invest and do business. The ability to attract foreign investment is particularly important to support economic growth, given the nation's traditionally low savings rates, as well as the productivity-enhancing technology, expertise and market links that it brings.

An uncompetitive tax system may mean that Australia loses out on investment opportunities. With more than $767 billion worth of investment projects earmarked for the country (and $225 billion worth of these in WA), a competitive taxation regime will be critical if the nation is to make the most of the many opportunities that are on the horizon (Chart 1).

Ensuring that investment is directed towards its most productive use is also important to ensure the nation's ongoing economic success. The current system taxes different types of investments in different ways, and may prevent capital from being directed to investment that will deliver the greatest benefit to the nation.

Chart 1 – Investment Projects, Australia Value by State, June 2011



Source: Deloitte Access Economics Investment Monitor

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Addressing workforce challenges

Given the severe and widespread labour shortages that already exist, boosting the size of the workforce will be critical to ensure that WA and the nation will be able to take advantage of the many opportunities on the horizon. These workforce challenges will be exacerbated by the demographic changes from the ageing of the population.

The extent of the nation's future workforce requirements is significant. Skills Australia have estimated that 9.3 million jobs will need to be filled over the next 15 years, with 4.8 million due to economic growth, and 4.4 million replacement positions from workers exiting the labour force. Meanwhile, CCI's own estimates show that some 480,000 additional workers will be required in WA by 2020, with an expected shortfall of 210,000 people.

Attracting workers from overseas will be a critical strategy to address the long term challenge of labour shortages. With labour more mobile than ever, reform is needed to ensure the tax arrangements do not deter overseas workers from moving to Australia, and prevent people from Australia relocating to other countries.

As well as encouraging overseas workers to Australia, reform to the tax system is needed to boost workforce participation among the current population, by improving the incentives to work, and removing disincentives to work. Australia's participation rate averaged 65.6 per cent (in June 2011), well below the OECD average of 71.8 per cent.

The tax system is an important tool to encourage greater participation among those sectors of the community that are underrepresented in the workforce, such as women, people with a disability and Indigenous Australians.

The tax system can also be used to encourage labour mobility between States and within States, and provide incentives for people to migrate to, and take up jobs, in areas where labour shortages are more pronounced.

Demographic challenges

The ageing of the population is one of the most critical challenges on the horizon for the nation. With one in four Australians expected to be over the age of 65 by 2056, this will have a significant impact on the demand for Government services, the size of the nation's labour force, and the transfer system.

The ageing of the population will have significant implications for Government finances, with spending in the areas of health and aged care in particular expected to increase substantially in coming years.

It will also reduce the proportion of the population of working age, and exacerbate the workforce challenges already facing the nation, with less than 60 per cent of the population expected to be of working age by 2051 (compared to almost 70 per cent today).

Reform to the tax system will be an important step to prepare the nation for these challenges, by ensuring the Government has access to a sustainable revenue base, encouraging workforce participation and promoting savings.

Imbalances between the Commonwealth and States

In the 110 years since Federation, there has been repeated conflict between the States and Commonwealth over jurisdictional boundaries, and in general, an increase in the power of the central government relative to the States. This has created significant imbalances between the funding and responsibilities of the States and Territories (known as vertical fiscal imbalance). Today, the Commonwealth Government raises about three quarters of all tax revenues collected, but the States are responsible for about half of government expenditure.

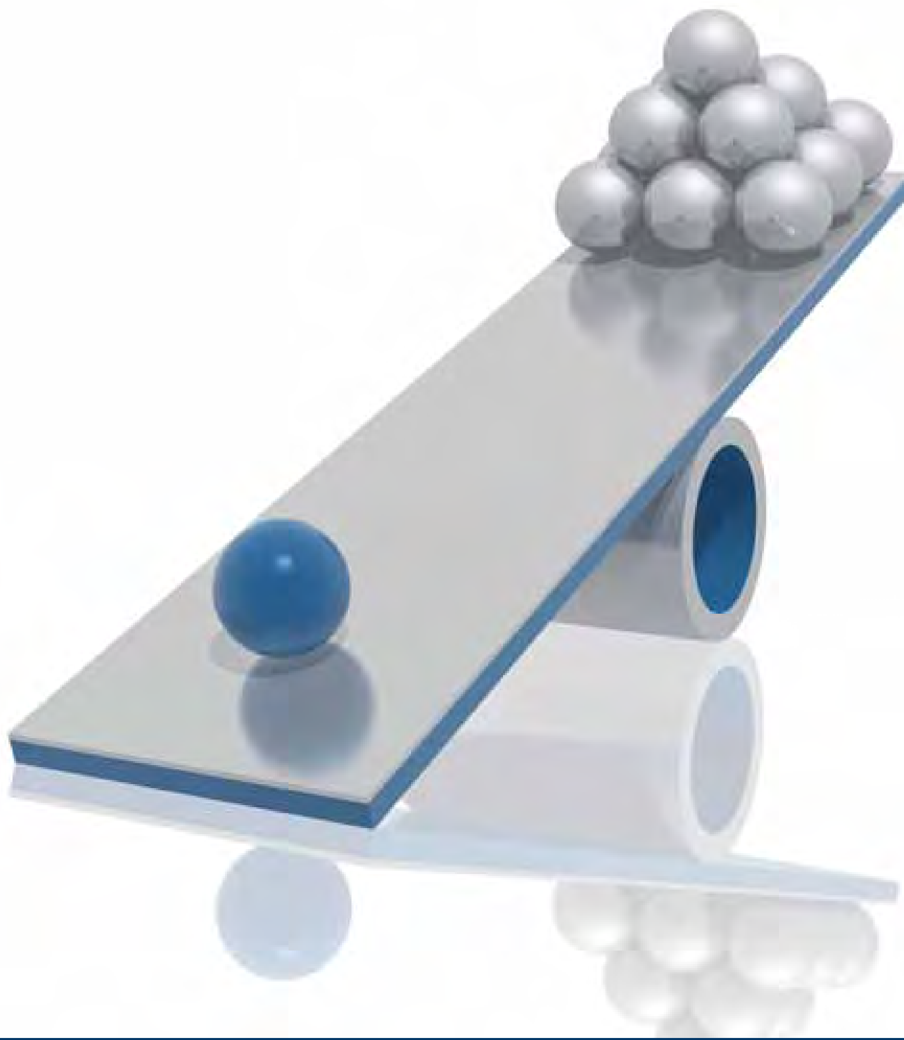
An excessive amount of vertical fiscal imbalance (VFI) can create a range of problems. VFI undermines the autonomy of the financially dependent government, and reduces the accountability of the States.

It also means that the States are reliant on transfers from the Commonwealth, and a number of narrowly based and inefficient taxes to ensure they have sufficient revenue to fund services demanded by the community.

The reliance on transfers from the Commonwealth is of particular concern given the current issues with the process of horizontal fiscal equalisation. There is typically a great source of tension and debate as to what the appropriate distribution of GST revenues should be and the method used by the Commonwealth Grants Commission (CGC), especially by those States that are net losers from the process, namely New South Wales, Victoria, and Western Australia.

Ensuring the States have access to sufficient and sustainable revenue will be critical to the ability to deliver overarching reform to the tax system. These imbalances must be addressed before any meaningful tax reform can be achieved.

Australia's tax system needs to be further reformed to ensure that the nation remains an attractive location to invest and do business



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Reducing complexity and compliance costs

Taxation complexity and compliance represent a major drain on the time and finances of all businesses. A complex tax system reduces transparency, can influence decision making, and lead to errors in tax collection.

While Australia is a low taxing country by OECD standards, the system is highly complex. International comparisons show Australia has a highly complex tax system, being ranked the third worst in 2007 out of the 20 largest economies in the world in terms of the volume of tax legislation according to the Joint Committee of Public Accounts and Audit.

There are currently at least 125 taxes levied in Australia, with 99 of these levied by the Commonwealth, 25 by the States and territories, and one by local Government. Around 90 per cent of the nation's tax revenue is raised through just 10 of these taxes.

For businesses, the tax framework is made even more complex by the lack of uniformity and overlap that exists between jurisdictions. Businesses operating across more than one State are faced with different rules, different tax bases, thresholds and rates in each State and Territory.

The complexity of the system is of particular concern for small businesses. Because of their limited resources, small businesses do not always have the capacity (time, money, and skills) to decipher and comply with all regulation. The effect is that the regulatory compliance cost burden, when compared with dollars per turnover, has a greater, disproportionate impact upon small firms.

Addressing the complexity of the tax system is particularly important in the current environment of rising business costs. Reducing the complexity of the tax system is also an important way to lift productivity, by ensuring that resources are directed towards their best use.

States' reliance on inefficient taxes

The imbalances between the funding and responsibilities of the States and Territories have meant that they are reliant on a number of inefficient taxes to fund Government services.

Analysis undertaken by KPMG as part of the Henry Tax Review assessed the efficiency of a broad range of taxes levied by the Commonwealth and State governments, by considering the marginal welfare loss arising from a small increase in the tax.

The results revealed that the three most inefficient taxes were levied by the States. These included royalties, insurance taxes and payroll tax.

Tax Principles

Tax is a necessary part of a modern economy, to support Government provision of services such as health, education, environmental protection and defence, and investment in economic and social infrastructure.

The ideal tax system has a minimal overall effect on the business sector and incentives of individuals, and promotes an economic environment that creates employment, income and wealth. It should not impede or reduce the economy's productive capacity.

There are a range of taxation principles commonly identified as being necessary to achieve these goals. These are outlined below.

- Equity – this principle ensures that the tax burden is spread fairly across the population. Horizontal equity requires that taxpayers in similar circumstances should face a similar tax burden; while vertical equity requires that those in different circumstances face a different tax burden, with those better able to pay facing a higher tax burden.
- Efficiency – an efficient tax system promotes a strong economy by ensuring that resources are allocated to their most productive use. The system should be administratively efficient so that the costs of managing and complying with a tax are not excessive relative to the revenue raised; and it should be economically efficient so that distortions caused by people changing behaviour because of tax are minimised.
- Transparency – a transparent tax system allows taxpayers to clearly identify how much tax they are paying. A transparent system identifies what is to be taxed and how the liability is calculated.
- Adequacy – the government requires revenue to fund its expenditure. Taxation should raise sufficient revenue to support fiscally–responsible Government spending.
- Competitiveness – the size and structure of the tax burden should encourage people and businesses to locate and do business in Australia rather than in alternative locations.
- Certainty and simplicity – the tax system should be clear and simple to understand, so that taxpayers can anticipate when and how the tax is to be paid, and the amount of the tax.

The key to maintaining a competitive taxation environment is to apply the principles of taxation to minimise the overall effect of the tax system on the business sector and incentives of individuals.

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

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

An efficient tax system promotes a strong economy by ensuring that resources are allocated to their most productive use

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Snapshot of the Australian Tax System

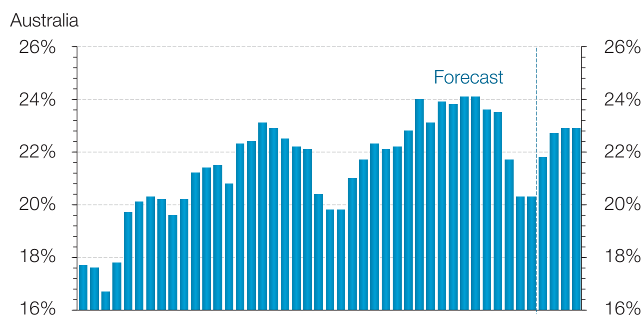
Size of the Burden

Australia's overall tax burden, as measured by taxation revenue as a percentage of Gross Domestic Product (GDP), is relatively low by international standards. At 23.2 per cent, Australia's tax take as a proportion of the economy rates below nations such as the United States of America (24 per cent), Japan (28.1 per cent), New Zealand (31.1 per cent), the United Kingdom (34.3 per cent) and all of the nations in the European Union (which average close to 40 per cent).

However, Australia does not perform quite so well when tax is measured on a per capita basis, rating just below the OECD average in US dollar terms. On this measure, Australia's tax burden sits at a similar level to nations such as the United Kingdom, United States of America and Canada; above developing nations such as Mexico, Poland and the Czech Republic; and below countries such as Sweden, the Netherlands and Denmark.

Australia's relative tax burden has also been increasing over time. According to figures contained in the 2011–12 Commonwealth Budget, Australia's tax to GDP ratio has risen from as low as 16.7 per cent in 1972-73, to the most recent peak of 24.1 per cent in 2005–06. While the tax to GDP ratio has since dropped back slightly, it still remains at a historically high level (Chart 2).

Chart 2 – Tax Revenue as % GDP



Source: Commonwealth Budget 2011-12

CCI Cost of Doing Business Survey

A survey recently conducted by CCI, in partnership with WA Business News, also illustrates the higher tax burden faced by WA businesses, with just over half of respondents describing their taxation costs as 'higher' (46 per cent) or 'much higher' (9.5 per cent) over the past five years.

This could reflect business growth through higher profitability, capital expansion and more labour – although 60 per cent of respondents indicated that higher taxes had impacted their profitability over the past five years, suggesting these costs has not necessarily increased in line with the growth of their business.

Composition of Tax Revenue

A key feature of Australia's tax system compared to other OECD nations is its reliance on direct taxation.

While the reliance on direct taxes was similar in other OECD nations before the 1990s, in recent years other nations have embraced tax reform which has seen a shift towards consumption as a key tax base. As a result, one third of tax revenue in OECD nations on average is raised from consumption taxes, compared to just one quarter in Australia. This overall figure includes taxes such as fuel and cigarette excise, as well as the GST.

Australia's relatively low reliance on indirect taxes is in large part due to the much lower rate of Australia's GST, compared to consumption taxes in other advanced nations. For example, the United Kingdom charges a flat 20 per cent on all sales, with some exemptions; New Zealand's GST is levied at 15 per cent (from 10 per cent when it was introduced); and Denmark's consumption tax is charged at 25 per cent on all goods and services. Just three countries, Switzerland, Canada and Japan, charge a GST-equivalent tax at a lower rate than Australia.

Australia's reliance on direct taxation means that corporate income tax receipts as a percentage of GDP in Australia are among the highest in the OECD. Corporate income tax receipts represented just under six per cent of the tax take in 2008–09, behind only Norway (which levies a 50 per cent rent tax on top of the regular company income tax rate of 28 per cent for excess oil profits).

This reflects the relatively higher rates of corporate income tax in Australia. In 2009–10, Australia's effective corporate tax rate of 30 per cent (i.e. the rate actually paid on each dollar of income when state and local company taxes are also taken into account) ranked 15 out of 23, compared to ninth in 1989–90.

Australia's personal income tax rates are also relatively uncompetitive. Outside of Europe (whose income tax rates are high to fund extensive public welfare systems), Australia's top marginal income tax rate (46.5 per cent) is the second highest behind Japan (50 per cent). However, Japan's top rate doesn't take effect until a worker earns 4.6 times average annual earnings, whereas Australia's top rate kicks in at a multiple of 2.8.

Australia is also amongst the only developed nations to still levy a tax on employer payrolls. At five per cent of GDP, Australia's payroll tax collections rate just behind Sweden and Austria. By contrast, other federations have a much lower reliance on payroll tax such as Canada (2.3 per cent), Belgium (0.1 per cent) and the United States (none) (Charts 3 and 4).

Australia's taxation of property appears to be favourable compared to the OECD, however much of the tax levied on property is on a transactions basis. Of the eight per cent of tax revenue garnered from property, just under 40 per cent is sourced from stamp duty on property transfers, behind just South Korea, Ireland and Greece. The remaining 60 per cent is derived from recurrent land tax, with Australia lagging the United States, United Kingdom, Canada, Japan and New Zealand on this measure; all of which collect over 90 per cent of their property taxation from recurrent land taxes.

Changes to the tax mix

The OECD has conducted research into how tax structures could be best designed to support economic growth, as part of its 2010 paper, Tax Policy Reform and Economic Growth.

The report looked at the economic efficiency impacts of certain taxes, to determine which were the most damaging to economic growth. It found that corporate taxes are the most harmful, followed by personal income tax, and then consumption tax. Taxes on immovable property were found to be the least damaging.

The report noted that a growth-oriented tax reform agenda would shift part of the tax burden away from income, to consumption and property. It also noted that a key aspect of growth oriented reform would be to broaden the tax base, and increase the rate.

Chart 3 – Tax Revenue by Base
Australia, % of Total

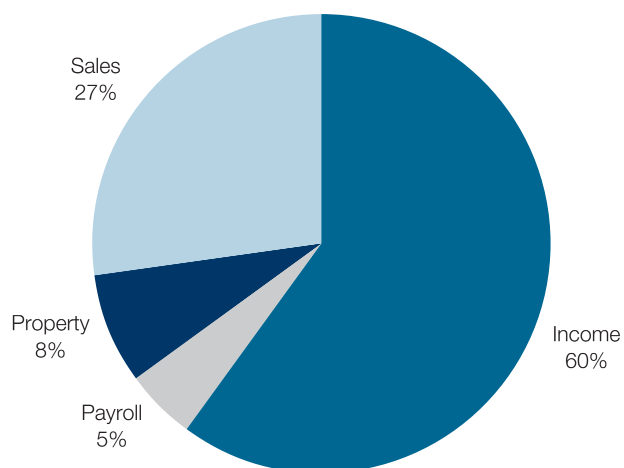
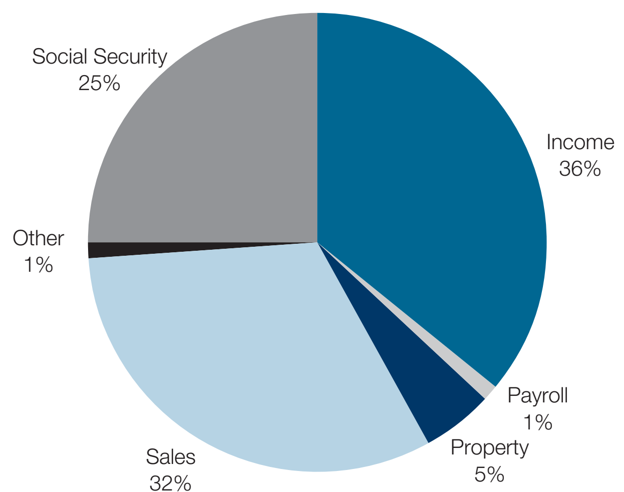


Chart 4 – Tax Revenue by Base
OECD, % of Total



The Reform Agenda

While there have been many reforms to the State and national tax systems over the years, further reform is needed to lift productivity and ensure the system meets the needs of a modern economy.

Ultimately, the tax burden is determined almost entirely by the level of government expenditure. This reinforces the need for Governments to be fiscally responsible and ensure that expenditure growth is kept in check to avoid placing an increasing burden on taxpayers. A lower tax burden is important to encourage investment, job creation, labour force participation and economic growth.

Before any reform of the tax system can be undertaken, it is critical to determine the appropriate level of services to be provided by Government.

As a starting point for reform, a broad review of Government spending programs at both a Commonwealth and State level is needed to identify areas of waste and inefficiency. This will not only improve the operation of the public sector and ensure that taxpayers get value for money, but it will also reduce the overall size of the tax burden on the community.

The review of government spending should be undertaken by an independent party, with an aim to abolish spending programs that do not deliver a benefit to the community, or do not perform a core role of government. The review should also look for options to contract out services that could be provided more efficiently by the private sector, and privatising or consolidating agencies.

A key area where reform could be achieved is in relation to jurisdictional overlap. There is a need to revisit the allocation of responsibilities within the federation more systematically and rationally, with a view to simplifying the system, improving its efficiency and transparency and eliminating duplication. This would require both State and Commonwealth Governments to commit to a genuine review of functions and responsibilities, including a commitment to withdraw from areas deemed to be more appropriately sited in the jurisdiction of another layer of government. It also requires that funding adequacy and autonomy be addressed.

A starting point for such reform might be an independent review of jurisdictional boundaries and their efficiency by a body at arms-length from Government, such as the Productivity Commission. Its first role would be to recommend new and clearly defined allocations of policy, spending and revenue raising responsibilities for funding, policy determination, and policy implementation.

While this is an important starting point for any reform of the tax system, it should not end here. Government spending should be reviewed on a regular basis, with the results published, and programs which are no longer valuable abolished. In addition, Governments should also keep to their self imposed spending targets, given the longer term structural challenges from the ageing of the population.

This budget reform program will provide the scope for the Government to provide a range of short term and longer term taxation reforms.

It is critical that a more ambitious reform agenda is implemented over the longer term, which focuses on addressing imbalances between Commonwealth and State finances, simplifying the system, and abolishing inefficient taxes. Importantly, such a long term agenda should not be constrained by the need to be revenue neutral. While there may be some short term costs in delivering tax reform, these would be recovered over the longer term by the more efficient operation of the tax system.

The following sections outline a range of reforms, to provide direction on the type and scale of reform that can be achieved, but is not intended to be a complete package for reform. Further work is needed by the Government to model the impacts of these reforms and to cost the proposals set out in this paper.

Commonwealth Taxes

Personal Income Tax

Given that labour shortages are expected to be a key challenge for the nation in coming years, there is a pressing need to reform the personal income tax system.

Personal income tax directly impacts on labour, and the nation's ability to attract and retain suitable workers.

With labour markets becoming increasingly global, high marginal tax rates undermine the ability of Australian businesses to attract skilled migrants and also to retain skilled workers in the Australian economy. At the same time, the personal income tax system also impacts upon the incentives of the current population to participate in the labour force.

To ensure that Australia has a workforce capable of supporting our growing economy, measures are needed to lower the marginal income tax rates, reduce the number of thresholds and increase the rates at which they start to apply.

Addressing Australia's high effective marginal tax rates (EMTR) will be a particularly important reform to encourage workforce participation. Because of the highly targeted nature of Australia's welfare system, benefits are clawed back from families as means tests cut in. Once earnings rise over the tax free threshold, the combined effect of tax and the withdrawal of benefits often lead to very high EMTR, well above that paid by many high income earners.

Effective Marginal Tax Rates

Where people receive family payments and face tax on their earnings, the incentives they face are a function not just of the tax they pay but also of the rate at which family payments are "clawed back" from them as their earnings rise.

The EMTR is the sum of these effects, and measures the extent to which people benefit from additional exertion at work. Where a tax rate of 15 per cent is combined with a reduction in their family payments of 50 cents in the dollar, this means that their EMTR is 65 per cent.

While high income earners face a marginal tax rate of 46.5 per cent, there are also a substantial number of families on middle and lower incomes which face higher EMTRs.

Once earnings rise over the tax free threshold, the combined effect of tax and the withdrawal of benefits often produced EMTR of 60 per cent or more.

POLICY

Australia's high EMTR act as a disincentive to move from benefits, into the labour force. A high EMTR can mean that, looking at financial benefits alone, for some it is simply not worth entering the workforce, or working longer hours because the combination of their loss of benefit and/or greater income tax liability diminishes the increase in income they receive from an increase in earnings. Certain groups are more likely to experience high EMTRs – particularly lower income earners, people with dependent children, and married mothers.

The tax system can also be used to encourage older aged Australians to continue to participate in the workforce after retirement age.

There currently exists a mature age worker tax offset, aimed at encouraging older aged Australians to remain in the labour force. The offset phases in at five cents per dollar from the first dollar of net income from working, with the full $500 offset available when net income from working reaches $10,000. The offset is then phased out for higher income earners (with the offset reduced by five cents per dollar between $53,000 and $63,000), with the offset reducing to zero for people earning in excess of $63,000 per annum.

While this offset will provide some incentives for mature aged workers, the current arrangements have the potential to actually discourage workers from taking on additional hours. In March 2011, the average income for Australians (based upon average weekly earnings) was just over $52,200, and even higher in WA, at around $57,543. For full time workers, the average annual income is $69,804 across Australia, and $79,206 in WA.

Personal Income Tax change as part of the Gillard Government's Carbon Tax

As part of the introduction of a Carbon tax, the Government has committed to adjust personal income tax scales.

The tax free threshold will rise to $19,400 by 2015, the low income tax offset will be reduced, and the marginal tax rate for people earning between $37,000 and $80,000 will rise to 33 per cent.

While changes to the tax free threshold will improve incentives to enter the workforce and were recommended by the Henry Tax Review, these changes only go part way to reform the personal income tax system.

Based upon these figures, the mature age worker tax offset is phased out for full time workers on average wages.

In this regard, removing the current scales and applying the $500 offset to all workers over the age of 55 may be a simpler and more effective way to encourage older Australians to remain in the workforce.

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

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

The extent to which the value of the Zone rebate has been eroded was highlighted by the WA Government in its submission to the Henry Tax Review. The submission notes that when it was originally introduced, the fixed Zone A rebate equated to 4.6 weeks average earnings and the Zone B rebate equated to 2.3 weeks average earnings. Today, the Zone A rebate equates to only 0.27 weeks average earnings and the Zone B rebate equates to only 0.04 weeks average earnings.

An important part of this process will also be to re-examine the current locations where this rebate applies, with the view to ensuring that the incentives apply to those areas where workers are most needed. It may be necessary to extend the rebate beyond remote areas, to other locations of severe labour shortage.

Another option to investigate is to designate high growth regions as 'special economic zones' as suggested by a recent poll conducted by the Institute for Public Affairs. This may include measures such as tax breaks and incentives to attract workers to live in critical regional areas, and fuel investment in critical infrastructure. This could alleviate problems associated with skills shortages as well as providing a base to grow the region's economic development.

As well as encouraging workforce participation, reform is needed to align the personal income tax rates with company tax, to reduce the distortions that this creates.

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

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

Reform Priorities

- The top marginal tax rate for personal income tax should progressively be cut to equal the company tax.
- The tax free threshold for personal income tax should be increased, and the number of thresholds reduced and indexed to wages growth.
- Further analysis should be conducted of the rates at which benefits are withdrawn. These rates should also be indexed, to take into account wages growth.
- The tax system should be used to encourage older aged Australians to continue to participate in the workforce after retirement age. Extending the mature age worker offset to higher income earners may be one way to achieve this.

POLICY

- Options to use the personal income tax system to encourage greater labour mobility between the States should be investigated. One option may be to increase the value of the zone rebate ensure that reflects current wage levels and delivers a meaningful benefit, and index this rate to ensure that its value is preserved over time. Designating high growth areas as 'special economic zones' which provide preferential treatment on a range of taxes may be another option.

Company Tax and Asset Allowances

Company tax is an important consideration for businesses, and could be adjusted to promote investment and entrepreneurship.

In recent years, other countries around the globe have been cutting their corporate tax rates. In 2008, the average corporate tax rate in OECD countries stood at 26.6 per cent, down from 32.5 per cent in 2001. As a result, Australia's company tax rate now remains above the OECD average.

With the global economy becoming more integrated and capital becoming increasingly mobile, company tax will be an important consideration in investment decisions. In this regard, cutting the tax rate is a longer term objective that will help improve Australia's international competitiveness, and ability to attract investment from overseas.

However, not all businesses will benefit from such a move, given that many small businesses are not incorporated. In this regard, the personal income tax system should be the first priority (see Personal Income Tax section).

There is scope to improve capital allowance rates for businesses. The current system is complex, and adds to the administrative burden for many businesses. The complexity arises from the different arrangements for different types of assets, while others are provided preferential treatment. Notably, there are 40 different effective lives provided for 3,700 different assets.

The current depreciation arrangements are particularly burdensome for small businesses. As well as the inherent complexity, the threshold for pooling low value assets to be written off remains too low.

The Federal Government has in recent months announced that it will increase the asset write off for small business to $6,500 as part of the carbon pricing scheme. While this is a step in the right direction, the threshold is still too low.

Table 1

Corporate Tax Rates "OECD Nations Ranked by Percentage"	**Corporate Tax Rate (%)**		
	1989-90 Corporate Tax Rate	**2009-10 Corporate Tax Rate**	**2009-10 Ranking (change)"**
Australia	39.0%	30.0%	15 (-6)
Austria	30.0%	25.0%	5 (-4)
Belgium	41.0%	34.0%	20 (-7)
Canada	41.5%	29.5%	14 (0)
Denmark	40.0%	25.0%	5 (+5)
Finland	44.5%	26.0%	8 (+9)
France	42.0%	34.4%	21 (-6)
Germany	54.5%	30.2%	19 (+4)
Greece	46.0%	24.0%	4 (+14)
Hungary	40.0%	19.0%	2 (+8)
Ireland	43.0%	12.5%	1 (+15)
Italy	46.4%	27.5%	11 (+8)
Japan	50.0%	39.5%	23 (-3)
Mexico	36.0%	30.0%	15 (-8)
Netherlands	35.0%	25.5%	7 (-2)
New Zealand	33.0%	30.0%	15 (-12)
Norway	50.8%	28.0%	12 (+9)
Portugal	40.2%	26.5%	10 (+2)
Spain	35.0%	30.0%	15 (-10)
Sweden	53.0%	26.3%	9 (+13)
Switzerland	30.6%	21.2%	3 (-1)
United Kingdom	34.0%	28.0%	12 (-8)
United States	38.7%	39.2%	22 (-14)

Source: OECD Corporate Tax Database

Reform Priorities

- The Federal Government should benchmark the Australian company tax rate against the OECD average as part of the Budget analysis. Over the longer term, the Government should impose a fiscal rule to maintain the company tax rate below the OECD average, to improve Australia's international competitiveness and ability to attract investment from overseas.
- Depreciation arrangements should be streamlined and simplified, by allowing low valued assets (for example, less than $5,000) to be immediately written off. For small businesses, assets valued less than $10,000 should be allowed to be immediately written off, and all other depreciating assets pooled together, and written off at a single rate. These thresholds should be indexed.

Fringe Benefits Tax

Reform to the Fringe Benefits Tax (FBT) is needed to reduce the cost of doing business in Australia, and maintain the nation's international competitiveness and ability to attract investment.

Since its introduction, the FBT has been extended, to the extent that it now encompasses legitimate business expenses rather than fringe benefits to employees. As a result, FBT adds significantly to business compliance costs, which is of particular concern for small businesses.

FBT should be reformed to minimise the confusion and compliance costs imposed on business. The application of FBT to the employee, as all other income is treated, with collection from the employers in the same manner as PAYG, would go some way to minimising the confusion and excess compliance costs which are currently impacting business.

A key reform to FBT would also involve the treatment of childcare, as a strategy to help boost workforce participation, particularly among women. CCI research shows that access to affordable childcare is a major barrier to female workforce participation. Making the cost of childcare able to be salary sacrificed would go some way to address this issue.

Current FBT rules only allow childcare to be salary sacrificed where child care facilities are provided at their business location, while discriminating against employees whose employers do not provide on site child care. This requirement should be removed.

Further, childcare expenses should be made fully tax deductible where the expenses relate to deriving an income. Offering families a tax deduction would acknowledge child care as a legitimate cost of working, and would align government expenditure in this area more closely with workforce participation outcomes. This is consistent with OECD recommendations that Australia's child care assistance be made conditional on employment.

Women in the Workforce Survey

In 2008, CCI conducted a survey of female employees to determine the barriers to workforce participation.

A key theme arising from the results was the difficulties faced by female employees in balancing work and family responsibilities.

Respondents to the survey were asked to identify strategies they believed were important to attracting and retaining female workers.

A range of strategies were identified, with 41 per cent of respondents indicating that salary sacrifice of childcare was a key strategy.

Another important aspect of the current system is the FBT exemptions provided to Not-for-Profit (NFP) organisations. NFPs play an important role in the community, and are expected to play an even greater role in the years ahead, as the ageing of the population sees higher demand for community services.

While as a general rule, exemptions should be kept to a minimum, the current FBT arrangements for NFP deliver considerable benefits and should be retained.

A key challenge faced by NFP organisations is in relation to attracting and retaining workers, as many of these organisations cannot compete on the basis of salaries alone. The current FBT exemptions improve the ability of the sector to compete for workers in an environment of increasingly tight labour market conditions.

The Henry Review recommended replacing these concessions with direct funding from Government, as a way to simplify the system. While simplification is an important objective, CCI believes that tax concessions remain the most appropriate way to support the NFP sector. Replacing the current concessions with direct Government funding would create significant uncertainty for the sector and make long term planning difficult, given that these programs may be affected by changes in policy or the budget position. Maintaining tax concessions would also ensure that Government is not taxing NFP organisations, and then reallocating these taxes back to the same organisations through direct funding.

Abolishing the FBT concessions would also be very costly to Government. For a NFP organisation in WA employing around 85 staff, the cost of abolishing the $30,000 cap for public benevolent institutions would require around $1 million in additional Government funding.

While CCI believes these arrangements should be retained, there is considerable scope to streamline these concessions, and reduce the compliance costs for NFP organisations.

The legislation surrounding FBT exemptions is complex, and creates significant compliance costs for NFP organisations. There are a range of inconsistencies that are currently built into the system for NFPs, particularly in relation to tax exemptions and rebates.

A key area of complexity is in relation to the definition of a NFP organisation. Under the current system, there are three different classifications of NFP organisation (charities, income tax exempt funds, and other NFP organisations), with tax concessions being differentially applied to each type of organisation. However, the definition of each classification of NFP is determined by the ATO using common law, which generates considerable uncertainty for the sector.

At the same time, the current arrangements also require NFPs to deal with a number of Government agencies, operating across jurisdictions. The Productivity Commission estimated that there are 19 entities operating across all levels of Government that are able to determine charitable status.

As part of the 2011–12 Budget, the Government announced a suite of reforms to the NFP sector, including the establishment of the Australian Charities and NFP Commission (ACNC), and work towards a national regulator for the NFP sector through COAG. This acted on the recommendation of the Henry Review to introduce of a National Charities Commission.

To the extent that this is one stop-shop for NFPs, this would deliver significant benefits by reducing the time and costs associated with the administration of tax concessions, and make it easier for organisations operating across jurisdictions. However, it is important that this is not just an additional layer of bureaucracy that adds to the compliance and administration costs for NFP organisations.

In CCI's submission to the Assistant Treasurer's 2011 scoping study into a National NFP Regulator, it noted that the benefit of a national regulator must be balanced against the sector benefiting from local service and influence in determining funding, and other strategic and operational arrangements.

If a national regulator is established, CCI believes that it should be set up under the following principles.

- The regulator should be an independent agency.
- The regulator should have and educative/sector support priority.
- The financial and operational information required by the regulator should be accepted by other Government agencies.
- The financial and operational information required by the regulator should be tiered and proportionate.
- The registration of a charity by a national regulator should be recognised across all other jurisdictions for the purpose of applicable concessions.

As well as establishing the ACNC, the Government has also committed to implement a statutory definition of "charity", which will take effect from 1 July 2013. This definition will initially be based on the 2001 Report of the Inquiry into the Definition of Charities and Related Organisations. The Commissioner of the ACNC will be responsible for determining charitable, public benevolent institution and other NFP status for all Commonwealth purposes.

While such a move will provide some certainty for the sector, it is important that the definition reflects the complexity and diverse nature of the NFP sector. The Government must consult with the NFP sector in finalising this definition. The legislated definition should also be harmonised across States and Territories, to provide greater certainty and reduce compliance issues for the sector.

As well as streamlining the compliance issues for NFP, the current caps for exemptions should be indexed to ensure that value is preserved over time. The current caps have remained unchanged since 2000, and as a result, its value has been eroded by the strong growth in wages over this period.

Reform Priorities

- Apply FBT to the employee, as all other income is treated, with collection from the employers in the same manner as PAYG.
- Remove the business premises test to allow for childcare to be salary sacrificed.
- The FBT exemptions for not for profit organisations should be retained, and the legislation should be simplified to reduce the administrative and compliance burden. The current caps for FBT exemptions should be indexed to average weekly ordinary time earnings, to preserve the value of the concession.
- The benefits of a national NFP regulator must be balanced against the sector benefiting from local service and influence in determining funding, and other strategic and operational arrangements. It is important that this does not add an additional layer of bureaucracy that adds to the compliance and administration costs for NFP organisations.
- The introduction of a statutory definition of charity may be of benefit to the sector, to the extent that it will provide certainty. However, this definition must reflect the complex and diverse nature of the NFP sector, and be harmonised across jurisdictions. The Government must consult with the NFP sector in determining the appropriate definition.

Capital Gains Tax

Given that capital is highly mobile internationally, reform to Capital Gains Tax (CGT) is needed to encourage investment and the promotion of efficient resource allocation to enhance both productivity and international competitiveness.

CGT impedes economic growth and productivity by creating clear disincentives for people to save and invest. It decreases the efficiency of markets as it has a “lock-in” effect, which discourages assets to be sold, decreasing asset turnover and hence liquidity. When an asset or business is sold, CGT detracts from the amount of capital that can be used to re-invest in other more productive assets, generating a much higher return.

Australia is clearly uncompetitive on capital gains tax. While reforms introduced in 1999 substantially reduced the capital gains tax burden, other countries continue to implement capital gains tax reforms to attract greater investment.

In this regard, a reduction in the level of capital gains taxation should be part of any reforms to the nation’s tax system. Reducing capital gains tax and the cost of realising capital gains may actually see the Government increase both the number of transactions and revenue, as increasing market efficiency more than offsets the reduced revenue from a capital gains tax reduction.

A possible improvement on the existing capital gains tax regime would involve introducing a stepped rate tax similar to the system introduced in the UK, where the proportion of the capital gains that is taxed diminishes over time. This would act as an incentive to hold assets longer and reduce the amount of speculation taking place.

Reform to the CGT regime should also look to improve the treatment of losses, to encourage investment and entrepreneurialism.

Under the current CGT arrangements, gains and losses are treated asymmetrically, where gains are taxed as they accrued, while losses are not refunded but can offset against any capital gains in the current tax year. These limitations on the use of tax losses discourage entrepreneurship and risk taking, and disadvantage small businesses and firms engaged in risky investment.

Allowing losses to be carried back would reduce the amount of complexity in the system, and provide greater flexibility for investors to use these losses. For example, capital losses are likely to occur during periods of volatility, but may not be able to be used during the same year.

Instead, capital gains should be allowed to be offset against tax losses in previous years, to reduce the amount of complexity and allow businesses to use all of their capital losses.

Another concern with CGT is that it double-taxes earnings, given that a company’s retained earnings have already been subject to company tax. Shareholders who sell shares before retained earnings are distributed are taxed on the earnings, and again on the capital gain caused by the retained earnings.

Reform Priorities

- The tax rates for CGT should be reduced. One option may be to introduce a stepped rate, which will see the proportion of capital gains that is taxed diminish over time.
- Capital gains should be allowed to be offset against tax losses in previous years, to reduce the amount of complexity and allow businesses to use all of their capital losses.

Other industry taxes

While largely beyond the scope of this paper, there are a range of industry-specific taxes, that could be reformed to improve tax system efficiency and reduce complexity.

For example, taxation of alcohol is a key area for reform identified by the Henry Review. Henry notes that the current system for taxing alcohol is complex, with conflicting policy rationales. He also notes that the current arrangements are not effective in addressing the social harm caused by alcohol abuse.

To improve the system, Henry recommends moving to a volumetric system for all forms of alcohol. This system would be phased in over a long period of time to allow producers and consumers time to adjust to these changes.

He also recommends that the current rebates to small producers (under the wine equalisation tax) be replaced with direct Government funding or other tax concessions, given their role in regional industries and communities.

Taxing Resources

The Henry Review proposed changes to Australia’s taxation arrangements for resources, as part of a shift to a more efficient and sustainable tax base.

Henry recommended that revenue raising be concentrated on four key bases, including personal income, business income, private consumption and economic rents from natural resources and land. Specifically, he recommends that the current resource charging arrangements be replaced with a uniform resource rent-based tax.

In its initial response to the Henry Tax Review, the Government announced that a Resources Super Profit Tax (RSPT) would be levied on the resources sector. The Federal Government made changes to the proposed tax in July 2010. Under the re-named Mineral Resources Rent Tax (MRRT):

- the tax will be restricted to the iron ore, coal, oil and gas sectors;
- the existing Petroleum Resource Rent Tax (PRRT) regime will be significantly expanded to all onshore and offshore oil and gas projects including coal seam methane projects and the North West Shelf;
- the resource exploration rebate is scrapped;
- the uplift factor for tax losses has been increased to the Government bond rate plus seven per cent;
- there have been increases in the depreciation arrangements for existing projects; and
- the company tax rate will be cut to 29 per cent, not 28 per cent as originally promised.

While a shift to a rent-based arrangement may improve the efficiency of the tax system, these benefits will not be achieved by implementing such a change in isolation. Rather, any move to a rent-based arrangement for taxing resources should be part of a broader reform agenda, in consultation with the States.

In this regard, CCI is opposed to the MRRT. The introduction of this new tax on top of State based royalties will penalise one of the nation's most successful industries and damage its international competitiveness. CCI is also concerned about the lack of debate over the merits of the tax itself, and the quality of the policy formulation process adopted by Government.

The public never had an opportunity to properly debate and consider the merits of a rent-based tax prior to the RSPT proposal, which was set out in the 2010–11 Commonwealth Budget just nine days after the public release of the Henry Tax Review.

CCI's concerns also relate to the impact and suitability of rent taxes relative to the universal tax principles of efficiency, equity, transparency, adequacy and competitiveness.

Imposing rent taxes on mining due to its use of non-renewable resources violates the principle of horizontal equity in taxation. Using a nation's natural resources to earn rents is not limited to the mining sector alone. Rents can be found in many sectors which exploit natural resources, and moreover, government policy itself can create rents.

The MRRT is also unlikely to achieve administrative efficiency. There is uncertainty over the Government's forecasts of revenue intake from the tax, while compliance costs are likely to be significant. Some industry analysts reportedly estimate that the tax in its current form might only apply to 50 firms and revenue intake could be as low as $2.5 billion in the first two years compared to Government estimates of $10.5 billion.

It is often assumed that governments can tax economic rents without significantly distorting economic behaviour. However, this assumption ignores the unique aspects of the mining sector where the incentive to earn rents are key to motivating firms to undertake the significant economic risks involved in large capital outlays on exploration, development and research into new technology. A rent tax could therefore distort activity in the sector in the long run, even though activity in the short run might remain firm.

The tax system could also be used to encourage exploration expenditure. CCI has long advocated for a flow through share (FTS) scheme to be established in Australia to achieve this. A FTS scheme essentially enables the transfer of tax deductions of individual exploration companies to individual investors. By doing this, the tax deduction of the exploration expenditure is leveraged in the capital markets in the subject year, attracting external investors rather than being accumulated tax losses, which will only be realisable if the company earns taxable income.

This mechanism has been used with considerable success in Canada, where it was first introduced to allow transfer (or 'flow through') of tax credits between corporations in order to boost investment into resource exploration. However, this was eventually extended to allow Canadian resource companies to transfer certain exploration expenses to investors, who were able to apply these expenses against their income.

At present, Canada's FTS scheme is available to mining, petroleum and certain types of renewable energy companies to facilitate financing exploration and project development activities. Since Canada introduced its FTS scheme there has been strong growth in its equity financing and it has become the world's leading market for raising equity capital for mining.

A FTS regime can be particularly beneficial to junior exploration companies who lack the taxable income to raise sufficient exploration capital for fields on which they hold licences. Having junior firms active in exploration is particularly important to the future of the resources sector. Of course, a key challenge they face is access to capital. As a result, juniors are often required to focus on marginally prospective acreage with consequentially lower success rates.

One of the reasons for this occurrence is the impact of the income tax system. For companies that have a tax liability, the ability to deduct such costs immediately against other income provides an important form of cost relief. Entities that do not have (or have insufficient) income are therefore required to carry forward potential tax benefits for exploration expenditure which may never be used. As a consequence, this inability to obtain a tax deduction significantly reduces the after tax value of exploration activity undertaken by these companies.

Reform Priorities

- Any changes to taxation arrangements for resources should be considered as part of a broader reform agenda, and in consultation with the States. CCI opposes the Government's proposed MRRT, as it does not form part of a package of broader reform, and will penalise one of the nation's most successful industries.
- With such little debate conducted on the merits of rent taxes versus royalty regimes, the Tax Forum is the ideal opportunity to finally conduct this analysis.
- A flow through share (FTS) scheme to be established in Australia to encourage exploration expenditure. This should not be constrained by the need to be revenue neutral.

Tariffs

Significant progress has been made over the years in terms of liberalising international trade and investment, with Australia's average tariff rate falling from 15 per cent to three per cent since 1988. As a result, Australia now has a relatively low import tariffs.

However, tariffs do still exist as a barrier to international trade. Australia currently maintains tariffs on a range of products, with the general rate being five per cent. However, the tariff rate is higher in a number of manufacturing industries, such as textiles and clothing, and automotive components.

Removing existing tariffs will allow resources to be used more effectively, and encourage greater competition and improved productivity.

Reform Priorities

- Further progress is needed on removing barriers to trade, such as tariffs. Australia should continue to engage in multilateral, bilateral and regional frameworks aimed at phasing out current tariff arrangements.

State Taxes

While State taxation remains an area where important developments can be made to produce a more efficient and equitable tax regime, the ability to deliver meaningful reform is limited by the inherent problems associated with Commonwealth-State financial arrangements.

The States' limited capacity to raise revenue and its high dependence on grants from the Commonwealth Government means the States are reluctant to undertake significant tax reforms, particularly if the reforms reduce their revenue base.

If the States are provided with an alternative source of revenue, this would allow the most inefficient taxes to be abolished.

An area of particular concern is the forecast decline in WA's share of GST grants. The fiscal outlook presented in the 2011–12 State budget encapsulates the challenge faced by WA in its declining share of GST grants. The State budget, which is based upon an expected fall in GST grants from the Commonwealth to 33 cents from every dollar (on a per capita basis) by 2014–15, results in a fiscal balance of $471 million and net debt of $22.4 billion by 2014–15. However, under an alternative scenario where a higher return of 75 cents from every dollar of GST revenue is achieved, a significantly improved outcome is evident: a fiscal balance of $3.1 billion and net debt of $18 billion.

In the short term, there is some scope to improve the States' access to revenue by reconfiguring the method by which the Commonwealth Grants Commission redistributes GST grants to the States.

There is significant debate about the appropriate allocation of GST revenue. The objective of the grants allocation process is to provide all State Governments with the capacity to provide the same level and standard of services from the same tax effort, given that the States have different capacities to raise revenue and spending needs. To do this, States with below average revenue-raising capacity or above average spending needs to receive a larger share of funding. This means that resources are redistributed from States with the capacity to provide above-average services to the other States.

There are a number of issues with the current CGC process. In particular:

- it is complex and not transparent;
- it treats different sources of revenue for the States inconsistently. For example, mining royalties are assessed as part of State revenue, but other property income, and gambling taxes are excluded;
- it penalises States with rapid economic and population growth and large infrastructure needs;
- the process is lagged, with States penalised for strong rates of growth in previous years; and
- it creates perverse incentives. The larger States, in particular, gain more funds when they allocate a larger proportion of spending to activities they are not especially good at. Conversely, it dampens incentives to promote economic growth, especially in smaller States like WA, where 90 per cent of any State government gain from growth in its tax base or royalties is clawed back though lower grants.

In recent months, the Commonwealth Government has recognised the issues with this process, and announced that it will be reviewed in 2012. This will be the ideal time to address these concerns and ensure a fairer allocation of GST revenue. CCI believes that a fairer allocation of GST revenues would come as a result of changes to the methodology for distributing GST revenue. CCI's submission to the GST Distribution Review, which will be released in October 2011, will provide further discussion on the current issues with the GST distribution process and Commonwealth State financial relations.

However, a fairer share of GST revenue will only go some way to address the issues with Commonwealth and State financial relations. Any longer term reform agenda will require the States to be given access to a more sustainable revenue base. In this regard, the most important part of any broader reform agenda will be to address the imbalance in Commonwealth and State financial relations.

An important part of this process would also be to review the allocation of responsibilities within the federation to simplify the system, improve its efficiency and transparency, and eliminate duplication and overlap. A review of the allocation of responsibilities within the Federation would require both State and Commonwealth Governments to commit to a genuine review of functions and responsibilities, including a commitment to withdraw from areas deemed to be more appropriately situated in the jurisdiction of another layer of government.

POLICY

A starting point for such reform might be an independent review of jurisdictional boundaries and their efficiency by a body at arms-length from Government, such as the Productivity Commission. Its first role would be to recommend new and clearly defined allocations of policy, spending and revenue raising responsibilities for funding, policy determination, and policy implementation.

There are a number of ways in which greater fiscal balance could be achieved. While one option might be to transfer expenditure responsibility to the Commonwealth or by the Commonwealth providing the States a greater share of its tax revenues, such a centralist approach has its complications. In particular, centralisation of Government services reduces transparency about who is responsible for government services, weakens accountability to the public, and slows responsiveness of governments to communities' needs. In Western Australia, this is of particular concern, given its remoteness from decision makers on the East coast, and the unique economic features of the State.

A better reform process would be to reduce the extent of vertical fiscal imbalance by passing tax powers from the Commonwealth to the States. There are two clear options to achieve this, which are detailed below.

Increasing the State's Revenue

Extending the GST

Given that consumption is one of the most efficient tax bases and provides a stable source of revenue, broadening the base and increasing the rate of the GST is an option to fund the abolition of inefficient State taxes.

The need to reform the GST was most recently highlighted by the OECD, in the 2010 Economic Survey of Australia. The report stated that increasing the weight of the GST in total tax revenues would help simplify and rationalise the States' taxation systems, which rely on many inefficient taxes. At present, the GST is applied to a narrow base, taxing only 57 per cent of consumption. The most notable exemptions to the GST were introduced in an attempt to make the tax fairer, and include food ($5.5 billion), medical and health services ($2.7 billion) and education ($2.6 billion).

Removing these exemptions will not only reduce the complexity of the system, but will also deliver greater revenue to fund the abolition of payroll tax, stamp duties, and other inefficient State taxes.

A further option to increase GST revenue is to raise the rate. Australia's current GST rate of 10 per cent is low compared to consumption taxes in other countries, with the OECD average standing at 17.7 per cent. Imposing a GST rate comparable to that in other OECD countries would be enough to fund the repeal of a large portion of all State taxes, such as payroll tax, insurance taxes, stamp duties on motor vehicles and stamp duties on conveyancing.

It is critical however that any increases in the GST rate or broadening of the base is not used to fund further spending increases, but are put towards income tax cuts and abolishing inefficient State taxes.

Sharing the Income Tax Base

A tax base sharing arrangement may be a further opportunity to provide the States with a sustainable revenue base. Income tax is the obvious candidate for such an arrangement, and was identified in the Henry Review as an option that should be further investigated.

Access to income tax would provide the States with a sustainable revenue base, which will increase automatically as the economy expands. It is also constitutionally possible, given that the States collected income tax prior to World War Two.

There are several options for providing the States with access to the income tax base.

Firstly, control of the income tax base could be passed from the Commonwealth to the States. This could be done without changing the existing range of taxes raised, with the Commonwealth instead using GST revenues to finance its own activities.

The alternative option would be for the States to share the income tax base with the Commonwealth. This option is used in other Federations, such as Canada, and could apply as a surcharge on the Commonwealth personal income tax base. To prevent the system from becoming overly complex, the States should align their income tax bases with the Commonwealth's, and set single tax rates and compete only on those rates. To reduce compliance costs, this should be centrally administered by the Commonwealth.

Further modelling should be undertaken to determine the benefits of such an option.

While income tax would solve the issues associated with the State's narrow revenue base, there would be some practical difficulties associated with such a proposal.

Sharing the income tax base may undermine the Commonwealth's role in redistributing income and its ability to control the degree of progressivity in the income tax system. It could also impede its ability to determine the overall process of redistribution by coordinating the cumulative impacts of progressive income taxes, unemployment and other benefits and social spending.

By aligning the tax base with the Commonwealth, the States' flexibility to design their own revenue-raising mechanisms will be reduced, and may remove the disincentive for the Commonwealth to contract the income tax base over time, or change its structure so that income was generated in activities only taxed by the Commonwealth (eg. by encouraging incorporation).

Reform Priorities

- A fairer allocation of GST revenue would come as a result of changes to the methodology of GST distribution.
- The States must be provided with a sustainable revenue base as a priority, to allow the most narrowly based and inefficient taxes to be abolished. While further modelling is needed to determine the precise changes, Government should expand the GST base by removing the current exemptions and increase the rate. Providing the States access to the income tax base will also help alleviate revenue pressures on the State and is a priority area for reform.

Reform to State Taxes

Despite the issues with Commonwealth-State financial arrangements, State governments do have the capacity to reform their tax systems.

Simplification of State taxes is a key area where reform should be achieved in the short term. Little uniformity exists in the application of many taxes across the States, while the current scales and rates for many taxes are inherently complex.

In order to minimise complexity and improve the fairness of the taxation system, tax scales and thresholds should be simplified. The existence of multiple rate scales for conveyance duty, land tax and motor vehicle duty increase the complexity of these taxes, and introduce the problems associated with bracket creep.

Bracket creep can also be addressed by indexing thresholds to a reasonable measure of price change. The index should reflect price changes in the tax base – for example, average earnings in the case of payroll tax and personal income tax, property prices in the case of conveyance duty. A more specific reform agenda for State taxes is outlined in the following section.

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

The States have made some progress in this area, after agreeing to harmonise payroll tax administration as part of the COAG agenda for business regulation and competition. In 2007, the States committed to overhaul current payroll tax arrangements to achieve greater administrative and legislative alignment. Since then, all jurisdictions have taken some steps towards payroll tax harmonisation, with New South Wales, Victoria, Tasmania, the Northern Territory and South Australia all enacting identical legislation. Queensland and WA have also met their commitments under the National Partnership Agreement to Deliver a Seamless Economy to harmonise payroll tax administration by 1 July 2012.

While this is a positive step, it is only an incremental one and there is scope to harmonise the definitions and administration for a range of other State taxes such as stamp duties, land tax, and motor vehicle duty. The 2005 Inquiry into Legal Systems found that despite the recent rewrite of the various State-based Duties Acts, significant inconsistencies still exist in stamp duty regimes, and recommended the harmonisation of the regulatory framework for stamp duty.

The States should also look to minimise concessions and exemptions, which have further complicated an already complex State tax system. As a policy principle, exemptions and concessions from certain taxes should be kept to a minimum due to the economic distortions they can create. Exemptions narrow the tax base, reduce the number of taxpayers and forego potential tax revenue.

However, exemptions and concessions are valid in some cases, such as when the revenue foregone is less than the administration and compliance costs that would be incurred if the exemption did not apply (e.g. payroll tax exemption threshold for small business). There are also different policy approaches across the States which further complicates tax compliance for business.

Reform Priorities

- The States should continue to implement harmonisation measures for tax administration to minimise compliance costs for businesses operating across Australia. Stamp duties and land tax are clear candidates for harmonisation.
- State Governments should conduct a review of current exemptions and concessions to ensure they are consistent across States, and remove those where the administration and compliance costs exceed the revenue foregone.

Payroll Tax

The abolition of payroll tax remains a key long-term tax policy objective, as it is a tax on employment and represents a major cost of doing business. Businesses of all sizes and sectors have a collective desire to reform payroll tax because it discourages the growth of their enterprises, and is viewed as

a penalty for increasing salaries and employing people.

Payroll tax remains a major concern for businesses. Payroll tax raised $2.3 billion for the State Government in 2009–10, up 2.5 per cent on the previous year, and 155 per cent higher than in 2001–02. The continued growth in the payroll tax take has meant that WA remains the highest payroll taxing State in the nation in per capita terms (Chart 5).

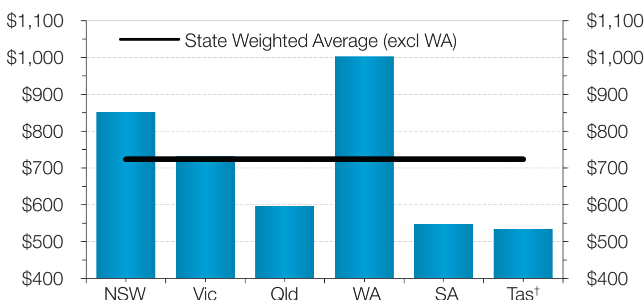
In the short term, there are a number of reforms that could be undertaken to reduce the burden on business.

The significant payroll tax burden on local businesses is due to the higher payroll tax rate in WA, as well as thresholds that have not been adjusted to take account of the strong growth in the local economy in recent years.

The payroll tax rate in WA is the second highest of all States (behind Tasmania) at 5.5 per cent. Other States have been active in providing tax cuts in recent years, despite significantly weaker economic and budget positions.

Despite having the second lowest payroll tax rate in the nation (at 4.9 per cent), the Victorian Government has identified payroll tax relief as a priority, and announced further cuts to the payroll tax rate to 4.85 per cent from 1 July 2011, in an effort to position itself as the most 'business friendly' State in the country.

Chart 5 – Payroll Tax per Capita, 2009-10 WA vs. Other States



Source: State Budget Papers, ABS 3101.0

Business Views on Payroll Tax

"In addition to spending over $1.2m in wages and having created 60 employment opportunities in our small regional town, we are now also hit with payroll tax, the amount of which is greater than our total profit for the year and certainly indicates that the payroll tax system is not indexed to the correct triggers. This is yet another blight on small to medium business, which is struggling at the moment in this State with two extremely different economies in play."
– a medium sized manufacturer.

"Payroll tax shouldn't exist… we pay the government for the 'privilege' of having staff? Absolutely ridiculous!"
– a mid size employer in the recreational services sector.

"Increased staffing levels and salaries pushed us above the payroll tax threshold which has not changed since 2003. Our property manager salaries have about doubled in the last five years."
– a small property and business services firm in Perth.

"The payroll tax threshold has not changed even though pay has gone up considerably. We are paying tradesman $100,000 per annum; if you do the sums it's not very many until you hit the threshold."
– a small manufacturer.

"Due to payroll taxes we have decreased and sold off our interstate division. So even though we took advice from OSR [Office of State Revenue] we still got hit with payroll tax and backdated. It's almost sending us to the wall." ***– a small transport services firm.***

"Payroll tax. Why be penalised for re employing people? We are now having to put people off due to this tax. We refuse to pay it, we do not make the profit to be able to pay it." ***– a mid-size retailer.***

Meanwhile, the NSW Government committed to cut the payroll tax rate from six per cent to 5.45 per cent between 2005 and 2011. South Australia has also made considerable progress on payroll tax reform, with the rate reduced from 5.5 per cent to 4.95 per cent between 2004 and 2009.

A cut to the payroll tax rate of 0.5 per cent would be needed in WA to put it on par with the average rate in other States.

In addition to the relatively higher tax rate, WA's payroll tax exemption threshold also needs to be addressed. Given that the exemption threshold has been unchanged since 2003, many small businesses are now caught in the payroll tax net as a result of the rising wages and strong economic growth which has occurred in the years since.

A business in Western Australia would now only be able to employ nine full time workers on average wages of $75,000 a year before being liable for payroll tax. By contrast, when the exemption threshold was last adjusted in 2003, a business could employ 15 staff before it had to start paying payroll tax. Reform to the payroll tax exemption threshold is needed so that genuine small businesses (with up to 19 employees) are exempt from payroll tax.

Reform Priorities

In the short term, the WA Government should:

- progressively cut the payroll tax rate by at least 0.5 per cent, to align with the average rate of other States;
- raise the payroll tax exemption threshold to $1.4 million, so that genuine small businesses employing up to 20 full time workers are on average exempt from payroll tax.
- index the exemption threshold to address bracket creep as a result of rising wages.

In the longer term, the priority should be for the abolition of payroll tax, once alternative revenue sources are provided to the States (see previous discussion).

Land Tax

Further reforms to land tax are necessary, given that it remains a major burden on local businesses.

Land tax raised $528 million for the State Government in 2009–10 or around 8.3 per cent of total taxation receipts. The WA Government also collects an additional 0.15 per cent on the unimproved value of land which is liable for land tax and located within the metropolitan region, under the Metropolitan Region Improvement Tax (MRIT). WA is the only State to apply such an additional tax on land, which added $78 million in taxation revenue over 2009–10.

Reforms to land tax are needed to reduce the burden on businesses. In particular, the Government should progressively flatten land tax thresholds, and incorporate the Metropolitan Regional Improvement Tax (MRIT) into the land tax base.

The land tax assessment process also remains a concern, with many businesses facing land tax assessments which have increased 10 fold from the previous year. The application of such increases in tax in any one year is likely to put a significant financial strain on many small and medium businesses, particularly given the cost pressures which are continuing to build in the current economic climate.

The methodology that underpins the land tax assessments should reflect the true value of property; mitigate significant increases in any one year; and ensure that the land tax bill does not rise ahead of the rate of increase in the value of the property.

Reform Priorities

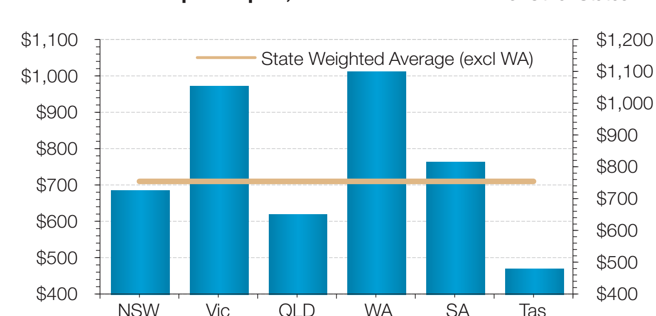
- To simplify current land tax arrangements, thresholds should be flattened, and the Metropolitan Regional Improvement Tax (MRIT) incorporated into the land tax base.
- The WA Government should also review the land tax assessment process to ensure that the land tax bill does not rise ahead of the rate of increase in the value of the property. One option could be the application of a five year moving average, which would average out the land valuations of the most recent five years resulting in less volatile tax bills, preventing the negative impacts on taxpayers of any unexpected large tax increases in any one year.

Duties

The abolition of stamp duties remains a long term priority, as these are highly inefficient, transactions-based taxes that distort economic activity.

In the meantime, reforms to a range of duties are needed to reverse the bracket creep that has occurred in recent years, and reduce the burden on businesses (Chart 6).

Chart 6 – Duties per Capita, 2009-10 WA vs. Other States



Source: State Budget Papers, ABS 3101.0

Conveyance duty is one area where significant reform is needed. Conveyance duty revenues in WA have increased significantly in recent years as a result of the property boom that occurred between 2001 and 2007. Transfer duty revenues have increased from $549 million in 2000–01 to over $1.5 billion in 2009–10 – a total increase of over 170 per cent over this period. WA now collects the highest conveyance duty revenues of all States on a per capita basis at $714.63. Victoria is the next highest, at $649.83.

Although the WA housing market has been flat in recent years, the impact of the property boom is still being felt, given that no adjustments have been made to transfer duty to take into account the period of exceptional growth in house prices. Such is the extent of bracket creep that the median priced home is now just below the top threshold bracket. With Perth's median house price standing at $480,000 in March 2011, as activity in the State's housing market picks up, the average house purchased in Perth will soon be paying the highest rate of transfer duty.

The tax paid as a proportion of the house value has also increased over time. The tax paid on the median priced house in mid 2001 was over $4,600 and represented around 2.8 per cent of the house price. The median priced home today now attracts a duty amounting to $20,200, representing over 3.5 per cent of the total price.

Reforms to transfer duty are necessary to ensure that WA can attract people to the State, given that severe labour shortages are expected to resurface.

Vehicle duty is also a major impost on WA businesses. Stamp duty on motor vehicle licences in WA has more than doubled since the beginning of the decade, rising from $161 million in 2000–01, up to $332 million in 2009–10. WA now collects the highest vehicle duty revenues of all States on a per capita basis of $144.73, followed by Victoria (at $103.26).

WA's rates of duty on motor vehicle licences are now well above other States, particularly for more expensive cars. The top marginal rate for vehicles over $50,000 stands at 6.5 per cent. The next closest is Victoria, where a rate of five per cent is applied to vehicles over $45,000. The top rate for all jurisdictions excluding WA stands at just four per cent.

As well as the relatively higher rates, WA also has one of the most complex vehicle duty regimes, with different rates applying to motor vehicles depending on whether they were new heavy vehicles, used heavy vehicles and other vehicles.

Reform Priorities

In the short term, the WA Government should:

- adjust transfer duty scales to take into account the property boom that occurred in 2001. The top tax rate should take effect at levels equivalent to that before the boom, based upon current property prices.
- index transfer duty thresholds to address any further bracket creep.
- replace the current multitude of rates and scales that apply to different classes of motor vehicles for vehicle duty with a flat tax regime for all classes of motor vehicles.

In the longer term, the priority should be to abolish the range of State-based duties once alternative revenue sources are provided to the States (see previous discussion).

Reforms to transfer duty are necessary to ensure that WA can attract people to the State, given that severe labour shortages are expected to resurface

Complexity, Compliance and Administration

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

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

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

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

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

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

Complexity of the GST

One of the most complex taxes for businesses is the GST.

Businesses are incur significant compliance costs resulting from the GST, including registration requirements, issuing tax invoices, determining different types of supplies, reporting and remitting to the ATO, as well as the costs required with understanding and complying with the legislation.

In 2008, the Board of Taxation conducted a review of the legal framework for administration of the GST. The final report noted that some aspects of the tax imposed high compliance costs on taxpayers, and set out 46 recommendations for reform. The Government has committed to implement 41 of these.

While this is a positive step, the terms of reference for this review were limited. A more comprehensive review of the GST is needed to streamline the current arrangements, and reduce compliance costs for business.

The GST is a particularly burdensome tax for Not for Profit organisations.

Not for Profit organisations are provided with a number of GST concessions, including a higher GST registration threshold, the ability to make supplies GST free, and GST input credits.

However, given the nature of the operations for many of these organisations, significant complexity arises. Some Not for Profits can treat some or all of their separately identifiable branches as separate GST entities. While this means that the organisation may pay less tax (as some entities fall below the $150,000 threshold) it does lead to significant complexity as some services are GST exempt while others are not.

Tax Arrangements for Independent Contractors

A key area of complexity in the tax legislation relates to the treatment of independent contractors.

In 2010, the Board of Taxation's Review into the operation of personal services income laws recommended that changes be made to tax rules to address "sham contractors", which would treat the majority of independent contractors as employees.

While the Government will not make wholesale changes to the tax arrangements for independent contractors, it has announced new reporting requirements for businesses operating in the building and construction industry, which take effect from July 2012.

The changes will add significantly to the administrative burden of tax for many businesses, by way of greater reporting requirements. Under this system, self-employed people and their clients will be required to report to the ATO all invoices and transactions between them. Under this new system, the labour component of each invoice will need to be split out (from goods and other services), with only this component reported on.

These changes will add significant complexity to the current arrangements.

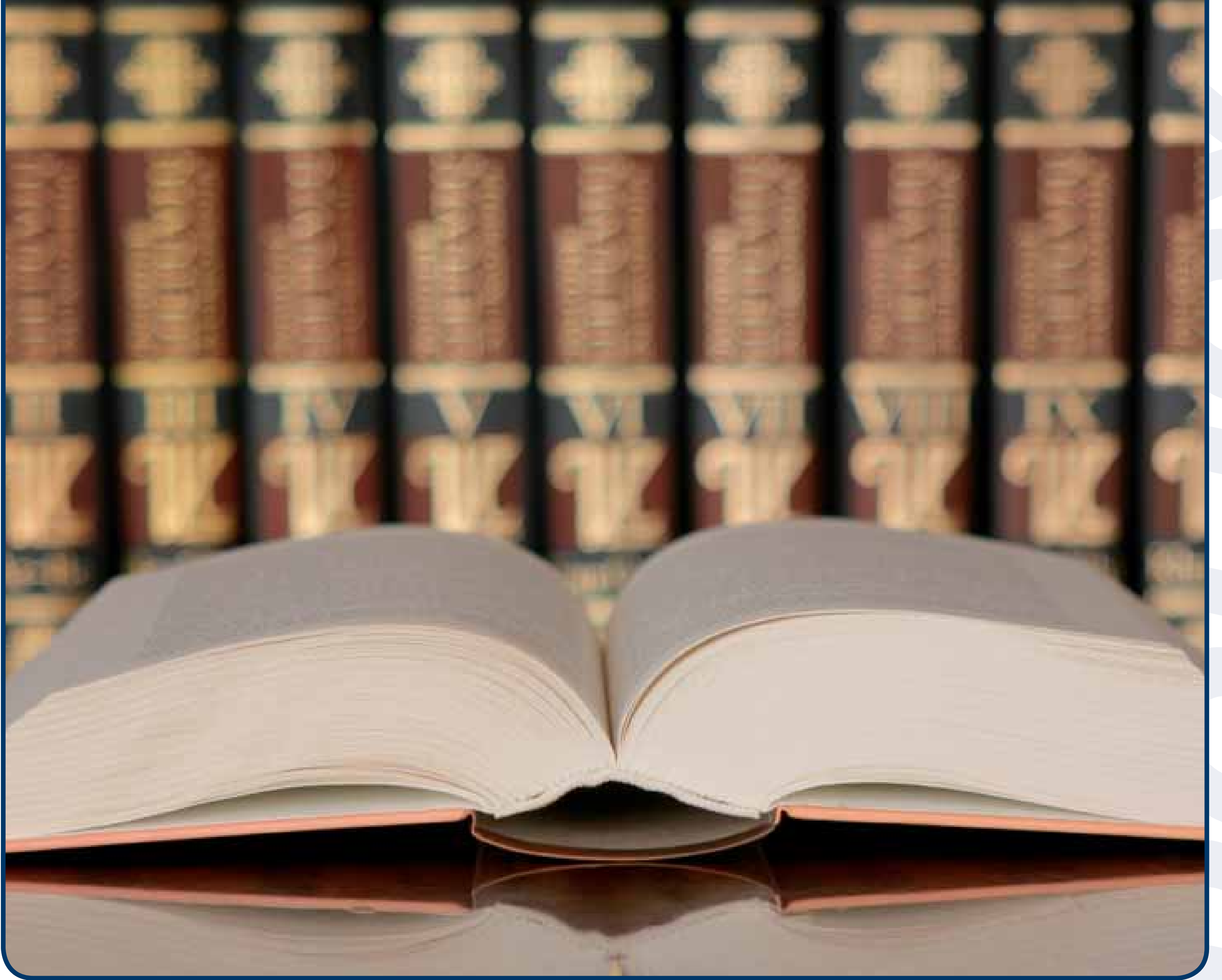
A number of studies have attempted to measure the compliance costs faced by Australian taxpayers. Most recently, the latest PWC Tax Contribution Study revealed that the costs of complying with the tax system for responding businesses represented an effective 1.6 per cent surcharge on top of their actual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

Recently, CCI's Cost of Doing Business survey also revealed that complying with taxation is a major burden for many WA businesses. Nearly 40 per cent of respondents to this survey said that Federal taxation had a high or very high impact on their compliance costs, while more than a quarter indicated a similar result for State taxes.

Reducing the complexity and compliance costs of the tax system should be a central part of any tax reform agenda. Any long-term solution must not only simplify the current system but also recognise that new legislation needs to be carefully assessed, with necessary cost-benefit analyses undertaken to determine the net social benefit of taxation rulings for its compliance impact.

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

- developing open and inclusive processes that allow taxpayers to provide feedback and to raise issues with Government;
- committing to a more principles-based approach to tax law design;
- empowering the Board of Taxation to initiate its own reviews of the operation of tax laws and policy;



POLICY

Table 2				
Tax Complexity Number of Taxes Paid by Hypothetical Company	**Total Taxes Paid (PWC/WB Method)**	**Ranking**	**Ranking on Measure 1***	**Ranking on Measure 2***
Canada	8	1	7	7
New Zealand	8	1	10	9
Portugal	8	1	11	1
United Kingdom	8	1	8	12
Ireland	9	5	9	11
Netherlands	9	5	4	2
Australia	11	7	5	13
Belgium	11	7	6	3
United States	11	7	1	8
Italy	15	10	2	15
Turkey	15	10	14	14
Austria	22	12	3	10
Luxembourg	22	12	15	6
Slovenia	22	12	12	5
Slovak Republic	31	15	13	4

Source: 2011 PWC/WB Doing Business Report

*Ranking includes only nations with full data.

- publicising information used to make determinations about the purpose or policy intent of a tax law;
- establishing a board to advise the Commissioner of Taxation on the management of the ATO;
- clarifying the role of the Inspector General of Taxation to examine systemic tax issues that affect business; and
- ensuring adequate resources are allocated to bodies that are involved in maintaining a fair and efficient tax system.

Reform Priorities

- Reducing the complexity and compliance costs of the tax system should be a central part of any tax reform agenda. The Government should implement the Henry review's recommendations aimed at making the tax system more responsive and accountable.

Pages of Tax Legislation

A study conducted by the World Bank in 2006 revealed that Australia has one of the most complex tax systems when measured by the number of pages of tax legislation.

At approximately 7,750 pages, Australia's tax code rated third largest out of the twenty largest nations, behind just India and the United Kingdom. Australia's tax legislation has more than twice as many pages as the average of these nations, at just over 3,000.

Self Assessment

A key area for reform is in relation to self assessment. While the introduction of self-assessment in 1986-87 was initially welcomed in that it was meant to make tax administration easier by facilitating the internalisation of tax compliance, many businesses do not have the confidence to self assess given the system's complexity.

The system of self assessment has been made all the more difficult for taxpayers given that the tax laws have become increasingly complex and lengthy, with over 8,500 pages of legislation spread over two different Acts (Income Tax Assessment Act 1936, and Income Tax Assessment Act 1997) and many more thousands of pages in general public rulings. In part, the increased amount of detailed income tax legislation has been an attempt to clarify all possible events or circumstances that can arise to increase certainty for taxpayers. However, it has served to make it more difficult to understand and comply with the tax laws.

The pressures on taxpayers and tax advisers to fulfil their tax obligations are compounded due to the uncertainty as to whether they will be audited for incorrectly completing their tax returns (potentially requiring payment of additional tax plus interest), or, worse still, avoiding tax (which can attract large penalties).

Despite the ATO's best efforts and intentions in providing rulings when requested, the practical issues for taxpayers and tax agents means that, for many reasons, the need for an ATO ruling may not be identified or, if it is considered, it may not be sought for any number of valid pragmatic reasons (not to do with minimising tax). By doing this, however, the onus on the taxpayer has now meant the ATO does not have to take a position on a tax matter until after the event.

Table 3

Tax Complexity Percentage of Personal Income Tax Payers Using a Tax Agent for Their Tax Return, 2009	**% Using Tax Agent**	**Ranking**	**Ranking on Measure***
Portugal	2%	1	11
Netherlands	3%	2	4
Belgium	13%	3	6
Slovak Republic	15%	4	13
Slovenia	18%	5	12
Luxembourg	24%	6	15
Canada	39%	7	7
United States	45%	8	1
New Zealand	50%	9	10
Austria	65%	10	3
Ireland	66%	11	9
United Kingdom	67%	12	8
Australia	73%	13	5
Turkey	90%	14	14
Italy	97%	15	2

Source: OECD Tax Administration Report

*Ranking includes only nations with full data.

POLICY

A key area of concern is in relation to personal income tax. The Henry Review noted that 72 per cent of tax filers now seek advice from a tax agent, even though 86 per cent claim no deductions, or only work related expenses, gifts and tax management costs. This proportion is high compared to other OECD countries, and second only to Italy.

The Henry Review sets out a number of recommendations to reduce the complexity and compliance costs associated with personal income tax, including the introduction of a standard deduction to cover work-related expenses and the costs of managing tax affairs, to encourage greater levels of pre-filling. It also recommended that taxpayers be provided with the option to take a standard deduction or claim actual expenses with full substantiation, when they are above the claims threshold. Henry argues that such changes would free most personal taxpayers from preparing a return, and allow them to lodge a default return which requires only minimal additional information.

Reform Priorities

- A mechanism for monitoring the compliance costs of the tax system should be developed.
- The two income tax acts should be aligned as a priority.
- The administration of personal income tax arrangements should be streamlined by adopting the Henry Review's recommendations to introduce a standard deduction for taxpayers, which would allow taxpayers to lodge a default tax return, or claim actual expenses with full substantiation.

Tax Administration Impact Statement

The administration costs imposed on both business and government in attempting to comply with increasingly complex tax legislation needs to be minimised with clearer and simpler legislation.

A starting place for such reform should be a systemic approach, which would deal with issues that arise. The Government should consider adopting measures in assessing the provisions of the Tax Act by introducing a Tax Administration Impact Statement (the TAIS) to be administered by the Inspector General of Taxation.

Reform Priorities

- The Government should introduce a TAIS, which would assess the provisions of the Tax Act. This should include:
  - surveys of the time and money that business spends on complying with the Tax Act;
  - the introduction of a range of initiatives to assist business to identify, understand and implement new and existing taxation requirements. Information programs for small business in particular should involve all components of the small business network;
  - a requirement that quantitative estimates of compliance costs, based on detailed proposals for implementation and administration, be attached to any new tax proposal. Estimates should be based on consistent methodology in line with international best practice;
  - regular reviews of the accuracy of compliance estimates in the TAIS for regulations with a major impact on business; and
  - greater education, skill development, resources and priority within agencies. The Inspector General, in conjunction with the Commissioner of Taxation, could address the corporate culture within the ATO to ensure that the TAIS is carefully constructed when each new tax change is proposed.

Rationalising minor taxes

As well as the taxes outlined earlier in this paper, there are a range of smaller "nuisance" taxes that still exist. These taxes generally have narrow bases, and raise small amounts of revenue, yet add to the complexity and compliance costs of the overall tax system.

While some progress has been made in this area, with a range of taxes abolished as part of the introduction of the GST, there still is still scope to remove a number of small transaction based taxes. The Henry Review recommended that Governments should undertake a review of the existing and potential user charges and minor taxes against the key principles of taxation policy.

A key example of a smaller nuisance tax is the luxury car tax. The luxury car tax applies at a rate of 33 per cent on the GST-exclusive value of domestic or imported cars in excess of the threshold (initially $57,180). In 2008, amendments were made to the tax to raise the threshold to $75,000 for cars that meet minimum efficiency standards, while exemptions were also introduced for farmers and tourist operators purchasing four wheel drives.

This move has opened loopholes for tax avoidance, and meant that the current arrangements are highly complex, and add significantly to compliance costs. At the same time, the tax is narrowly based, and still falls on some vehicles used for business purposes.

The Henry review recommends that the luxury car tax should be abolished, on the basis that it is a narrowly based and inefficient tax, and an ineffective and arbitrary way of redistributing economic resources. CCI supports this view.

At a State level, the Perth Parking Levy is a minor tax that should be abolished. The levy is unfair and contravenes good public policy and good tax policy. It taxes a narrowly-targeted class of citizens in order to meet the cost of providing a particular benefit to another group of narrowly-classed citizens. The tax has an adverse economic impact because it increases the relative costs and diminishes the amenity of doing business in the CBD. Because demand for car parking bays is highly inelastic, it does not act as a deterrent for users of cars, but rather increases costs for businesses, and their customers, in Perth city which increases pressure on businesses to relocate.

There are far more effective ways in which Governments can address car use, with the Henry Review advocating for greater use of congestion charges as a way of addressing this issue.

Reform Priorities

- The Commonwealth and State Government should implement the Henry Review's recommendation to review all minor nuisance taxes against the principles of good tax policy, and abolish those which do not meet these criteria. Examples of these taxes include the luxury car tax and Perth Parking Levy.

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