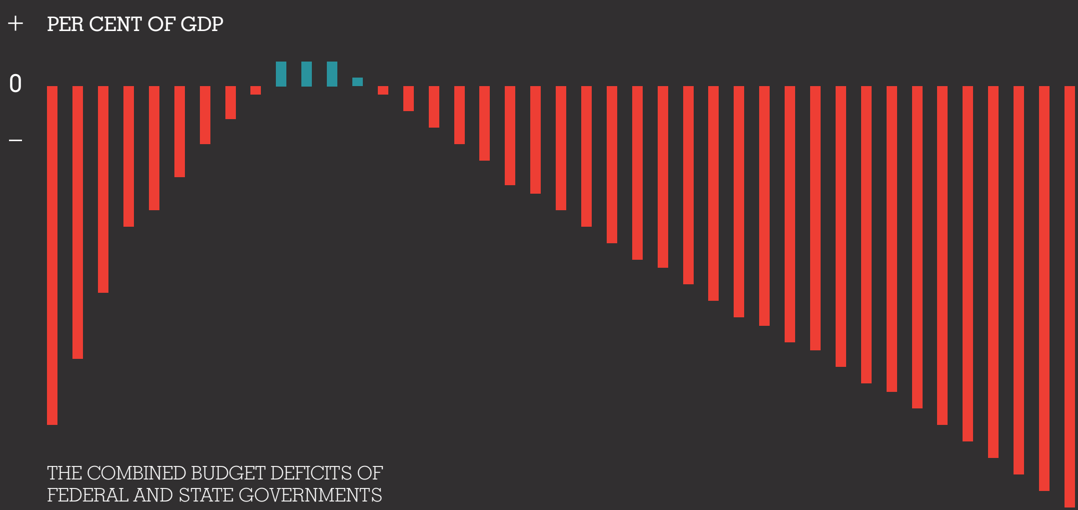
Preparing for a Better Future

Progressing Comprehensive Tax Reform in Australia

» SUBMISSION TO THE 2011 TAX FORUM



THE COMBINED BUDGET DEFICITS OF
FEDERAL AND STATE GOVERNMENTS
2010–2050

Business Council of Australia

→ OVERVIEW AND EXECUTIVE SUMMARY

ABOUT THIS PUBLICATION

This is an overview and an executive summary of the Business Council of Australia's submission to the Australian Government's 2011 tax forum. The submission, which includes a report by Deloitte Access Economics titled 'An Intergenerational Report for the States', can be downloaded from www.bca.com.au.

While the submission has been written for the tax forum, its findings and recommendations stretch well beyond the scope of the forum.

ABOUT THE BUSINESS COUNCIL OF AUSTRALIA

Members of the Business Council of Australia (BCA) are the chief executives of 100 of Australia's largest and most successful businesses. They apply their skills and experience to develop, explain and promote policies for achieving economic, social and environmental goals that will benefit Australians now and into the future. Our aspiration is for Australia to become the best place in the world in which to live, learn, work and do business.

OVERVIEW

As part of its submission to the Australian Government's 2011 tax forum, the Business Council of Australia is calling for comprehensive changes to the tax system and a more efficient approach to government spending.

OVERVIEW CONTINUED

These changes are necessary because:

- Australia faces an unfolding fiscal challenge which, if not addressed, has the potential to bring on a severe fiscal crisis within the next 40 years. This will threaten the capacity of future Commonwealth and state governments to fund the services Australians will need.
  - » While the reality is that the Australian economy will continue to grow and the tax base will grow with it, actions can be taken to accelerate this growth and this will give Australia a better chance of meeting future challenges.
- The tax system is not as efficient as it could be and it is not keeping pace with the rest of the world. This undermines Australia's productivity and in turn, its competitiveness and its capacity to grow the economy.
- There are major problems with the way the finances are organised between the states and the Commonwealth, whereby the states have accountability for delivering high-demand services, but have little of their own revenue.
  - » This creates confusion but more importantly, forces the states to rely on their own relatively inefficient taxes. Some of these taxes, like stamp duties and insurance taxes, are among the worst and most productivity-damaging in the system.
- The tax system is too complicated for individuals, families and businesses to use. That complexity adds to business and household costs and impacts on our productivity.

If Australia is to remain competitive, prosperous and productive, the Australian Government and the Australian Parliament must embark on a 10-year reform of the tax system and improve the efficiency of government expenditure.

Fixing the tax system and improving the efficiency of government spending requires leadership and sound policy principles

This approach would involve four key actions:

- Improving the efficiency and sustainability of Australia's future government expenditure.
- Beginning a process of comprehensively overhauling the tax system, which could be staged over 10 years. This should begin with a focus on removing the most inefficient state taxes and identifying options for replacing that revenue. The other platform for improving the tax system is to improve the overall tax mix, rather than introduce new taxes. That tax mix should gradually reduce the reliance on direct taxes such as personal tax and company tax and increase the reliance on indirect taxes such as consumption tax and land tax.
- Action should be taken to resolve accountabilities for expenditure between the states and the Commonwealth, and consideration should be given to providing the states with a more predictable share of revenue (such as personal income tax) in return for a removal of the most inefficient state taxes.
- Action should be taken to immediately simplify the tax system, using the recommendations of the Henry review as a starting point.

The Business Council of Australia is calling for the government and the parliament to map out a process beyond the forum for well-managed, gradual improvements to the tax system and actions to improve the efficiency of state and Commonwealth spending.

We recognise that these are challenging and demanding issues that need to be resolved. The process will be assisted, however, through a program of reform with an emphasis on consultation and by building stronger institutional arrangements.

Consideration should be given to the potential role of independent bodies which may have a greater capacity for dealing with options and issues that are potentially 'off limits' for Australia's political parties. No option should be removed from debate or consideration.

This long-term approach to fixing the tax system and improving the efficiency of government spending requires leadership and adherence to sound policy principles, not political expediency.

Unless action is taken now to begin the process of properly changing the tax system, Australia will face declining productivity, reduced growth and an inability to pay for the vital services such as health, social security, education and infrastructure required by future generations.

EXECUTIVE SUMMARY

The Business Council of Australia is calling for a 10-year plan to bring comprehensive improvements to the tax system, coupled with a more efficient and accountable approach to government spending and to Commonwealth–state financial arrangements.

The process of improving the system will take 10 years to complete and it is essential we start that process now

This submission seeks to address the fundamental role of the tax system, which is to raise sufficient revenue to pay for the services properly expected from government. A good tax system must also be designed in a way that provides incentives for savings and investment and drives productivity and competitiveness in the economy.

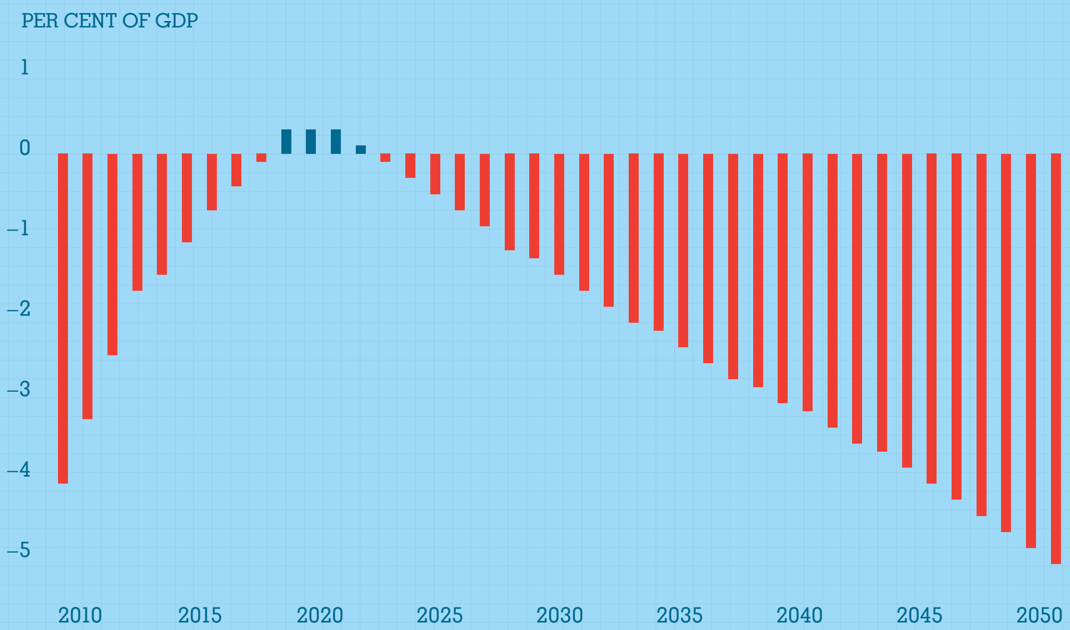
The sooner Australia gets its tax system right, the more likely we will be to generate the economic growth that will support the necessary revenue generation in the years ahead.

At the outset, however, we recognise that governments must ultimately have an overarching objective of improving the wellbeing of all Australians. This includes maintaining appropriate economic, environmental and social conditions including the provision of the acceptable social safety net on which the Australian social compact is predicated. It should continue to feature as a central element of the society we live in – but we need to make sure it is affordable and sustainable.

The capacity of future governments to improve the wellbeing of future generations will be hampered by the following factors.

Australia faces an unfolding fiscal crisis. In simple terms, the states and the Commonwealth Government will not have enough money over the next 40 years to pay for the services future Australians will need.

To assist in the consideration of issues around the fiscal challenges for Australia over the coming decades, the Business Council of Australia engaged Deloitte Access Economics to undertake an analysis of the long-term fiscal outlook and sustainability of government finances at the Commonwealth, state and territory levels. When the state and territory projected fiscal positions are added to the Commonwealth's, it is estimated that by 2050 Australia will face a combined fiscal deficit of 5 per cent of GDP. Today, a budget deficit of this size would be equivalent to around $70 billion. The current tax arrangements and the current approach to government spending will not be able to sustain deficits of this size.



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PROJECTED FISCAL BALANCE –
ALL GOVERNMENTS

SOURCE: DELOITTE ACCESS ECONOMICS,
'AN INTERGENERATIONAL REPORT FOR THE STATES'.

Unless we act to change this outlook, future governments will be forced to either reduce services – such as health and social security – or raise existing taxes significantly and thereby impose an unsustainable tax burden on companies, on individuals and on families.

The tax system is inefficient and uncompetitive. It does not sufficiently reward hard work or provide incentives for companies, individuals and families to save and invest. Nor does it create the right incentives for workforce participation for many citizens. Inefficient and uncompetitive taxes hurt our national productivity, damaging our long-term economic growth and improvements in real household incomes.

Government policies that best support productivity should focus on creating the right economic incentives. These include fostering competition and achieving the right balance of tax rates and tax structures.

In 2010, Australia's effective corporate tax rate on new investments was 26 per cent compared with an average among competitor countries of 18 per cent, making it one of the highest among relevant competitor nations. Our top marginal personal income tax rate is also uncompetitive within our region.

The tax system is overly complicated. A good tax system should be simple for companies and individuals to use. Few people would disagree that we need a smaller number of taxes. As the Henry review points out, 90 per cent of national revenue is raised through only 10 taxes, but there are 125 different taxes imposed across the federation.

There is a mismatch between the service delivery responsibilities of the states and their revenue raising capacity. State governments are not able to raise sufficient revenue to meet the costs of the basic health, education and transport services they provide. In 2010–11, the states and territories were responsible for around $200 billion of spending. Barely half of this was funded through their own tax revenue sources and the GST. Yet, state governments must meet growing and more costly demands across all these areas. As a result, they have been forced to rely on a range of mostly inefficient taxes to raise revenue – taxes that hamper productivity and increase costs for households and businesses.

For all these reasons, Australia can no longer continue with a piecemeal and short-term approach to improving the tax system.

Australia cannot embark on improving the tax system without also examining the size and efficiency of government spending. Taxpayers – families, individuals and small and large businesses – cannot be expected to carry the burden of poorly planned, poorly targeted and inefficient government spending.

If Australia is to address lagging national productivity, create a better and fairer tax system, and position ourselves to become one of the more prosperous of nations, then four actions are essential.

Committed leadership is needed to start the process of improving the tax system and strengthening Australia's long-term budget position

ACTION 1:
Control and limit government spending

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ACTION 2:
Comprehensively overhaul the tax system

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ACTION 3:
Redesign the spending accountabilities

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ACTION 4:
Simplify the tax system significantly

ACTION 1

Control and limit government spending

A first step must be for all levels of government to improve the efficiency and effectiveness of expenditure and stop committing to services and entitlement programs that cannot be afforded in the medium to long term.

The Business Council of Australia is calling for the establishment of a Commission of Budget Integrity to look at government activities and public sector performance to help inform the community about which programs are meeting their objectives and are delivering value for money. The commission would prepare regular independent reports on the sustainability of Australia's fiscal position, and look at longer-term budget pressures across all governments (including in areas that might otherwise be considered 'off limits') and ways of dealing with them.

A Commission of Budget Integrity would ensure the full and ongoing costs of new services and entitlement programs are independently reviewed. This would help Australia avoid the cumulative burden of future taxes and debts that now confront the governments of the United States and many states in Europe.

It could also progress analysis to identify the most intelligent options for improving the tax system in tandem with more efficient spending by all levels of government.

ACTION 2

Comprehensively overhaul the tax system

Comprehensive improvements to the tax system, while difficult, should be staged over 10 years to minimise the impact on families, individuals and businesses.

This overhaul should focus on abolishing the worst productivity-sapping taxes and improving the mix of taxes (rather than inventing new ones). Improving the tax mix would raise revenue, improve productivity and competitiveness and provide incentives for savings and investment back into the economy.

A first step towards a better tax system is the abolition of the most inefficient state taxes, beginning with stamp duties and insurance taxes, with revenues replaced from other, more efficient sources. These taxes are simply taxes on transactions, which limit the mobility of labour and capital and harm innovation and productivity.

Improving the total tax mix is also vital. Continuing to look at individual taxes in isolation (e.g. personal tax or business taxes) is not the best approach to improving the tax system.

Focusing on one set of taxes alone has the potential to create revenue shortfalls in other areas. It is critical that governments look at the tax mix as a whole.

A fundamental principle that should be used to guide tax policy formulation is to make the tax base as broad as possible in order to support lower tax rates.

Australia should aim to move progressively to a tax system less reliant on personal income tax and company tax (taxes on mobile factors) and more reliant on more efficient, less mobile, indirect taxes such as consumption and land tax. This will raise necessary revenue while supporting growth and investment.

Discussions about options to achieve a better tax mix across the four taxes could include personal tax, company tax, indirect taxes and social and environmental taxes.

Personal tax

We recognise the steps that the government has taken to address workforce disincentives that arise from the interaction of the tax and transfer system, particularly at lower income levels. The fact remains, however, that marginal personal income tax rates at middle and higher incomes are high and uncompetitive and risk discouraging work effort from those with relatively high skills and high productivity. That outcome is wrong at a time when we are striving to improve our national productivity performance.

Further steps are needed to simplify the personal tax system and improve the rate structure to improve incentives and competitiveness, including at higher incomes. This should be done in a way that retains an element of progressivity in the tax system.

Company tax

The growing mobility of investment and increasing sensitivity of capital flows to tax settings have important implications for Australia's long-term growth prospects. We strongly support the recommendation of the Henry review that company tax rates should be reduced to 25 per cent. But we need to recognise that a reduction of that magnitude will make us barely competitive within the region today. We should aim to reduce corporate tax even lower as and when we can.

There are some other important corporate tax reform directions set out in the Henry review, including around capital allowance arrangements and loss carry-backs. These issues warrant further consideration. However, they will need to be considered in the context of a goal of moving towards a simpler tax system, predicated on a broad tax base with lower rates.

Indirect taxes

The architecture of a reformed tax system should also recognise that a system freed from the most inefficient state taxes has the potential to deliver significant increases in productivity.

To abolish transaction taxes to improve efficiency and productivity, alternative revenue sources will be needed, ideally from more efficient taxes such as greater taxation of consumption, the taxation of land and potentially a more efficient payroll tax system.

We acknowledge that changes to consumption tax will be controversial. Modelling by many commentators for the tax forum shows that only modest increases in the GST rate, or changes aimed at broadening the GST base, could raise substantial revenue, allowing other taxes to be abolished.

Consistent with our view that Australia should increase reliance on indirect taxes and reduce reliance on personal and company taxes, it is important to set in place some principles for adjusting consumption taxes. Any future increases in GST should be applied solely to the reduction or removal of other taxes, not to raise more revenue. That is, there must be explicit offsets associated with any increase to the GST. Another critical principle is the need for a staged approach with transitional arrangements and appropriate compensation for vulnerable groups.

Increasing the GST is not the only possible solution. There is scope for the states to better utilise existing payroll or land taxes. Thought needs to be given to reconsidering land and payroll tax rates, thresholds, exemptions and concessions with a view to improving overall efficiency. A future tax system could incorporate a combination of revenue sources as a means of replacing existing inefficient state transactions taxes.

In order to improve the tax system, consideration of consumption tax issues should not be taken off the table.

Social and environmental taxes

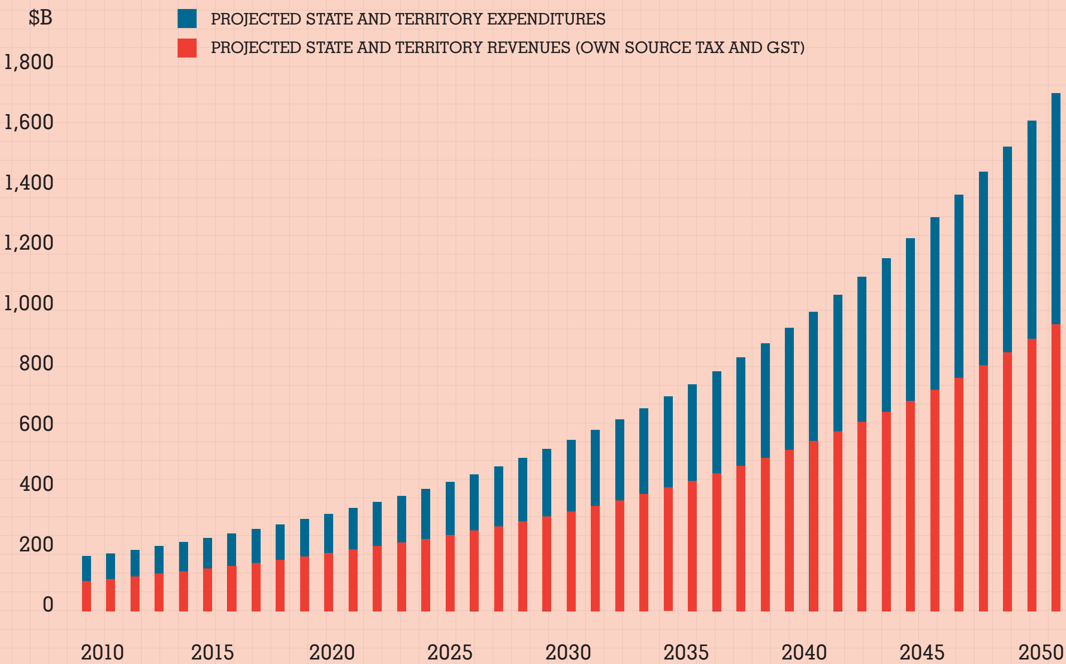
The social and environmental dimensions of human activity also have significant implications for future tax design and the application of tax principles. Narrowly based taxes specifically designed to change behaviour can have a legitimate role. In considering such taxes it is important to be explicit about their purpose. Taxes directed at addressing social and environmental issues need to bring about actual changes in behaviour. They should not have general revenue raising or income redistribution as their main objective.

ACTION 3

Redesign the spending accountabilities and revenue raising capacities of the states and the Commonwealth Government

If inefficient, unproductive state taxes are to be removed, then states will need to find other sources of revenue.

The states will bear a significant responsibility for delivering high-demand services, such as health care, and so they will need more predictable and growing sources of funding. While there are opportunities for the states to raise revenue more efficiently from their own taxes, consideration should also be given to sharing personal income tax revenue with the states.



The Commonwealth and the states must resolve these tensions over the next five years.

SOURCE: DELOITTE ACCESS ECONOMICS, 'AN INTERGENERATIONAL REPORT FOR THE STATES'.

ACTION 4

Simplify the tax system significantly

Reforms to reduce the cost and complexity of the community's interface with the tax system should also be a high priority. A commitment from government to implement administrative reforms recommended by the Henry review – including simplifying personal income tax returns and reducing paperwork for businesses – is an important first step.

A pathway for progressing reform

It is important that the 2011 tax forum not finish with one or two piecemeal changes.

Instead, it is essential that we start the process now of improving the system – a process that will take 10 years to complete.

The long-term program of tax reforms required in Australia will therefore need to be:

- progressed at all levels of government
- coordinated with broader government program developments
- linked to fiscal policy developments
- multi-disciplinary and multi-layered, addressing issues of policy, legislation, administration and compliance.

The key steps to do this would be as follows:

- The Commonwealth Government should, in conjunction with the states, set out the projected fiscal challenge by extending the Intergenerational Report-type analysis across all levels of government.
- The Commonwealth and states should prepare a prioritised list of inefficient state taxes and an approximate timetable for their removal, including identification of potential options to replace that revenue.
- The most useful way of dealing with such comprehensive change would be to progress analysis to identify the most intelligent options for improving the tax system in tandem with more efficient spending by all levels of government. Tax reform options would form the basis of an extensive consultation with the community. Such analysis would identify the impact of changes on families, individuals and companies, possible transitional and compensation arrangements and projected budget implications.
- The government should consider what is the best institutional arrangement to progress tax reform.

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It is important to note that our submission does not deal in detail with the so-called carbon tax and the Minerals Resource Rent Tax (MRRT). In respect of the Clean Energy Future Package and carbon price, if the legislation is passed after three years, this scheme will become an emissions trading scheme and will not form part of the tax system. Notwithstanding this, we remain of the view that the cumulative effect of the carbon price and MRRT will be to compromise the long-term competitiveness of our resources sectors. Given Australia's reliance on those sectors to underpin economic growth, actions taken by governments that impact on that competitiveness impede the strength of the very sectors that Australia needs to position it for long-term economic growth.

A principled way forward

Committed leadership is needed to start a process of improving the tax system and strengthening Australia's long-term budget position.

Australia should begin improving the tax system now, while the economy is in relatively good shape, rather than be forced to make major changes during more difficult economic circumstances, as is now the case with many other economies across the world (particularly in Europe and North America).

Changes to the tax system must be based on good public policy principles. No options should be taken off the table, even if they are politically difficult.

Inevitably, elements of a tax system will reflect political realities, but taking a principles-based approach can limit the potential for bad policy outcomes arising from short-term political expediency. We recommend a number of important principles in our submission.

Finally, and importantly, we must recognise that major changes in taxation will require a mandate from the Australian people. If Australia gets this wrong, or governments are prepared to make only piecemeal changes, it is inevitable that future growth and therefore tax revenue will be weaker, leaving a larger problem to future generations of Australians. Comprehensive, growth-oriented tax reform will, by contrast, support Australia's capacity to deliver on governments' social compact to improve the wellbeing of all Australians.

Australians deserve honest, bipartisan leadership on the challenges we face, on the options we have to create a better tax system and what a better system means for individuals and businesses.

More short-term fixes, more politically motivated tax changes and more promises that can't be kept are simply not in Australia's long-term national interest.

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