

Tax Brief

23 December 2008

Ken Henry's "Root and Branch" Christmas Present

The next step in the "root and branch" tax reform currently in progress occurred on 10 December 2008 with the release of a 300 page consultation paper on Australia's future tax system and separately a 50 page paper on retirement income.

The reason for the separation is that the retirement income tax review deadline has been brought forward to the end of March 2009 so that it can be considered along with the review of government pensions. Decisions on these matters could appear as early as the May 2009 Budget. The overall review has a more "leisurely" pace, being due to report by the end of 2009 with government decisions presumably in 2010.

Submissions for the retirement income review are due by 27 February 2009 while submission on the broader tax reform issues are due on 1 May 2009.

The summer holiday period promises once again to be a busy time for those involved in submissions to government on taxation.

Significant shift in the economics of tax reform

While short on specific proposals and more a discussion of possibilities, the consultation papers signal a significant shift in the economic underpinnings of tax reform. The received economic wisdom from at least the 1930s has been the base broadening strategy.

The basic intuition was that if all income or consumption is taxed alike, the outcome will be a level playing field with maximum economic efficiency. This was the economic policy argument that led to fringe benefits and capital gains being included in the income tax base in the 1985 tax reform and the broad based GST being introduced through the 1998 tax reform. A comprehensive tax base was the mantra of tax reform. Treasury still annually produces a Tax Expenditures Statement based on the comprehensive tax base and it has been the first recourse of policymakers whenever tax reform is in the air.

During much of this period the tax rate was essentially seen as a value judgment independent of economics and based on society's preferences for the size of government and for redistribution of wealth through the tax and transfer system.

Since the 1970s there has been a seismic shift in the economic analysis of taxes based on welfare economics. There are several major differences in the new approach. First, the idea that it is possible to tax all income or all

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expenditure is rejected. Household production (work in the household by the members of the household) and certain forms of leisure (such as lying on the beach) cannot be taxed for a variety of reasons. Hence individuals have important untaxed choices available to them and all real world taxes inevitably lead to economic distortions. The level playing field is not possible and tax rates matter to efficiency!

The assumption underlying the comprehensive tax base, that the size of the economic response to taxes is the same across different kinds of consumption or income, is nowadays rejected. Economic distortions depend on how sensitive demand or supply is to taxation. Clearly taxes on necessities produce less economic distortion than taxes on discretionary luxury goods. Our demand for food is less sensitive to tax than our demand for French perfume. While taxing food under the GST was ultimately rejected for equity (fairness) reasons, there are many other areas where this style of argument will be critical in the current tax review.

While the welfare economics analysis initially was focussed on labour income, more recently it has been deployed for business and investment income (income from capital). The chapter on business and investment income in the consultation document in particular reflects this literature.

One important feature of the analysis is the rejection of another important underlying assumption of the comprehensive tax base – that the burden of particular taxes landed in the right spot. Ultimately all taxes are borne by individuals, even though most taxes are collected in the first instance from business entities – as GST, FBT, PAYG etc. The traditional approach was that the GST ended up being borne by the firm's customers, the FBT by the firm's employees and the company tax by the firm's shareholders. Recent literature suggests that taxes paid by firms often do not end being borne where intended. For example, an increase in corporate tax may be borne by employees over time through reduced increases in wages – it all depends on the forces of supply and demand.

The welfare economics approach to taxation means that there no longer are any accepted absolutes in tax policy analysis like the comprehensive tax base. Analysis of tax reform thus requires sophisticated economic and empirical studies to substantiate claims made in relation to proposed measures.

This shift has significant implications for business submissions on tax reform. On the positive side it means that proposals that would be characterised as “concessions” under the comprehensive tax base and likely to be rejected in the past for that reason may receive fuller and more sympathetic consideration. On the other hand business will be expected to provide the supporting economic and empirical analysis for their proposals. The consultation document, in summarising submissions so far, often makes the comment that claims are “unsupported”, meaning unsupported by this kind of analysis.

Criteria for tax reform

The generally accepted criteria for judging tax reform proposals are equity, efficiency and simplicity. To these the current review is adding sustainability and coherence.

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Even for the long accepted criteria, there is a difference this time around. Equity and efficiency are now viewed through the lens of welfare economics. The significant changes that this implies have been noted under the previous heading.

Simplicity is always acknowledged in tax reform exercises but in the past one could not help feeling that this was mere lip-service as the outcome inevitably was a much more complex tax system overall. This time around the aspiration seems to be higher and the canvas broader in a number of respects.

Sustainability is more than the necessary acknowledgment of environmental issues – though the way in which the tax system is often the enemy of the environment is highlighted. It also includes robust legal and administrative frameworks which have community support and a tax-transfer system that can last into the future. The heightened awareness of inter-generational issues arising from demographic changes which has influenced policy in recent years (such as the superannuation changes in 2007) continues to be important to tax reform.

Coherence one would think went without saying in any policy reform exercise but too often it is ignored with different levels of government pulling in different policy directions and even the same level of government pursuing conflicting policies through different arms. The emphasis on coherence signals some important features about the current tax reform exercise. Much more than in the past it is a whole of government approach to tax reform – and especially across tax and government transfers. Moreover, coherence feeds into the greater emphasis on simplicity in tax reform.

Constraints on tax reform

The traditional constraint on tax reform exercises is that the reform be revenue neutral. This time around that constraint, as such, is missing.

The terms of reference were written before the revenue surpluses of recent years disappeared in the maw of the global financial crisis. In the near term there may not be the growth in revenue that has been occurring in the recent past, so that revenue neutrality may well become the order of the day. One other constraint originally imposed on the review, the government's aspirational tax rates (that is, hoped for tax cuts), has since been ditched as a result of recent events.

The government has imposed two specific constraints, that the rate and base of GST not increase and that the exemption of tax-free superannuation payments for the over 60s remain. The consultation paper notes that a cut in the GST rate or even its abolition is "technically" within its terms of reference, but that description sounds like the end of the matter. The GST receives virtually no discussion in the consultation paper apart from input taxing of financial services and GST on non-profits. On the other hand a large focus of the review is the retirement income system and much attention is devoted to it, despite the limit imposed by the terms of reference.

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The consultation paper indicates that tariffs are also off the agenda.

Surprising for a federal tax review but no doubt welcome to business, state taxes are very much part of the agenda. Taxpayers in NSW and Victoria, however, may be disappointed that the formula under which more Commonwealth money per capita goes to residents of other states and territories is regarded as beyond the terms of reference – perhaps an acknowledgment of political realities rather than the terms of reference.

Process of tax reform

This is the third major tax reform process in which Treasury Secretary Ken Henry who is chairing the review panel has been involved. He was there for the Hawke-Keating tax reform in 1985, albeit in a more junior capacity. He was a driving force of the Howard-Costello tax reform of 1998.

The process of these major previous reforms was quite different. Older readers will remember the tax reform cart of 1985 when then Treasurer Keating tried to sell Option C including a broad based consumption tax to the electorate but had to settle with Option A which was a greatly expanded income tax. On this occasion three quite specific options were presented in the Draft White Paper essentially prepared by Treasury. Then a Tax Summit was held in Canberra.

The Howard-Costello tax reform consisted of announcing a plan prepared by Treasury but with heavy political involvement and then holding an election to get it approved. There was one major further process, the Ralph Review of Business Taxation dealing only with one part (but a very important part) of the tax reform. Some of the major proposals of this review were ultimately abandoned by the Howard Government including the unified entity tax regime and the tax value method but the other major elements of the reform on the GST, revenue sharing with the states, tax administration and reform of personal taxation proceeded more or less as announced.

Apparently Dr Henry was not completely taken with either of these approaches as he has reverted to the main elements of the last truly independent review of Australia's tax system, the Asprey process of the 1970s (and the Asprey Report is generally credited with setting the tax reform agenda since 1975 – it was the first to recommend for example the GST and imputation). The Asprey Committee sought submissions on tax reform proposals, commissioned studies on specific topics, held public meetings and produced a final report without any direct political involvement.

The process this time has these elements and has borrowed the Tax Summit idea (scheduled for mid 2009) although it appears this will not be a political but rather a technical meeting. This Review is not independent in the same sense as Asprey. Although there are non-government members, like the Ralph Review this one is essentially driven out of Treasury. The current consultation papers borrow to some degree from the Ralph Review and the Board of Taxation process in setting out specific questions for further submissions and discussing the issues without providing conclusions.

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This approach means that it is not yet possible to provide much guidance on substantive reform proposals. The consultation paper is very much a catalogue of tax reform proposals many of which are familiar from the past.

Business and investment tax reform

The chapter on business and investment income is largely framed as a discussion of international competitiveness and is highly technical in economic terms. The chapter starts by noting that Australia has achieved a high level of investment to GDP compared to other OECD countries and in effect questioning claims about tax competition which simply point to the corporate tax rate or corporate tax base in another country and say that Australia is therefore not competitive. Business will need to deploy a very sophisticated analysis to convince the review of many of the tax reform requests that have been made in the first round of submissions.

A number of specific points can be noted:

- The overall impression is that a combined reduction in both the corporate tax rate and the corporate tax base is unlikely to happen but that some reduction in just the corporate tax rate is more likely. There is some technical discussion of alternative tax bases for business income but it does not suggest any great enthusiasm.
- Imputation seems likely to remain but business will have to mount a strong case for dealing with the current problem that imputation creates for multinational companies and which has led to calls for streaming of foreign income to foreign shareholders. The paper states:

paying foreign tax does not benefit Australians, whereas Australian tax funds public services. The absence of a foreign tax credit then aligns an investor's private return from investing overseas with the national return and provides a counter-balance to incentives for Australian companies to shift investments to low-tax countries. This view is consistent with maximising Australian (rather than global) welfare, but assumes no spillover benefits from offshore investment and disregards any costs of biasing the saving portfolio choices of residents ... Providing a credit for foreign tax paid might also reduce the integrity benefits associated with imputation.

For those familiar with the issue, this is a repetition of a well-worn Treasury line. Similarly, more generous exchange of imputation credits with New Zealand is not enthusiastically received, even though NZ Treasury and Inland Revenue are listed as providing a submission to the Review.

- By contrast submissions on withholding tax changes may get a better run – the paper notes that company and resource taxes account for the bulk of tax on non-residents in Australia and that withholding taxes raise relatively little. The message is that Australia should be taxing economic rents in the case of non-residents and the withholding taxes – apart from royalty withholding tax – do not fit this pattern.
- The general discussion of income measurement for business and investment (as opposed to specific claims in areas such as amortisation of goodwill on international competitiveness grounds) is

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fairly conventional. The usual suspects – use of accounting profit, the problem of inflation, and the treatment of depreciation, capital gains and losses – are mentioned but only the first seems to get much traction.

- The Ralph agenda of the unified entity tax regime only gets passing mention which will be a relief to many. Taxation of collective investment and taxation of offshore income under accruals regimes are it seems mainly being left to the Board of Taxation, though there is a consultation question addressed to making Australia a base for internationally focussed businesses.

Other tax reforms

The coverage of issues in the consultation paper is vast and it will require enormous resources to bring in a final report dealing with all the matters in detail by December 2009.

A selection of some issues to give an idea of the breadth follows:

- A large part of the discussion is devoted to the tax transfer system for individuals. This ranges from discussion of different tax rates for different types of taxpayer to the problem of integrating the tax and transfer system in such a way as to prevent the highest effective tax rates effectively being levied on low and middle income taxpayers. The paper also notes that the family is used as the unit in the transfer system and the individual in the income tax system but does not suggest that any significant change is likely to occur. This discussion flows over into retirement income on which the panel has to report by the end of March 2009. The separate paper on this topic is mainly addressed to the three pillars of the system (old age pension, compulsory superannuation saving and voluntary superannuation saving).
- The consultation paper spends some time discussing the FBT both in relation to cars and shifting the tax liability to the employee. Some changes may be in prospect in this area but as usual it is hard to tell from the discussion.
- All the major state taxes receive discussion. Those hoping for the repeal of the payroll tax may be disappointed by the discussion, but on the other hand there is some hope for dealing with state taxes on businesses and even conveyance duty. The distribution of taxing powers within Australia's federal structure and the use of grants from the Commonwealth to the States are canvassed at some length.
- Tax compliance is seen as a critical issue and receives its own lengthy discussion. Some of the criticism of the ATO in submissions and the idea of an oversight board for the ATO are mentioned as well as the possibility of making the ATO the exclusive revenue collecting agency in Australia, along with other ways of having taxpayers deal with fewer faces of bureaucracy.

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- The not-for-profit and housing sectors, specific taxes on consumption (such as excises), transport and the environment are each given their own separate chapters and lengthy discussion in the consultation paper.

For further information, please contact

Sydney

Andrew Mills

61 2 9225 5966

andrew.mills@gf.com.au

Melbourne

Richard Shaddick

61 3 9288 1412

richard.shaddick@gf.com.au

www.gf.com.au

These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

Greenwoods & Freehills Pty Limited ABN 60 003 146 852
Level 39 MLC Centre Martin Place Sydney NSW 2000 Australia
Facsimile (02) 9221 6516 Telephone (02) 9225 5955

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