

Ai GROUP SUBMISSION

Economics Legislation Committee
on the Enterprise Tax Plan

SEPTEMBER 2016

The logo for Ai GROUP, featuring the letters 'Ai' in a stylized, bold font above the word 'GROUP' in a smaller, sans-serif font, all in white.

Ai
GROUP

About Australian Industry Group

The Australian Industry Group (Ai Group) is a peak industry association in Australia which along with its affiliates represents the interests of more than 60,000 businesses in an expanding range of sectors including: manufacturing; engineering; construction; automotive; food; transport; information technology; telecommunications; call centres; labour hire; printing; defence; mining equipment and supplies; airlines; and other industries. The businesses which we represent employ more than one million people. Ai Group members operate small, medium and large businesses across a range of industries. Ai Group is closely affiliated with more than 50 other employer groups in Australia alone and directly manages a number of those organisations.

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Executive Summary

Ai Group supports the policy changes proposed in the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016*. In particular Ai Group supports:

- Lifting the small business entity threshold from aggregated turnover of \$2 million per annum to aggregated turnover of \$10 million per annum;
- Increasing the tax discount for unincorporated small businesses entities from its current level of 5 per cent to 8 per cent for the years 2016-17 to 2023-24; to 10 per cent in 2024-25, 13 per cent in 2025-26 and 16 per cent from 2026-27; and,
- Phasing in a reduction in the company tax rate:
 - initially by applying a lower company tax rate of 27.5 per cent to incorporated businesses below an aggregate turnover threshold that would increase in stages from \$10 million in 2016-17 to \$1 billion in 2022-23; and
 - then by reducing the company tax rate applying to all incorporated businesses in steps from 27.5 per cent in 2023-24 to 25 per cent from 2026-27.

In combination these measures would go a considerable way to improving the competitiveness of Australia's tax system; reducing its over-reliance on the comparatively inefficient tax base of business profits; lifting the attractiveness of Australia as a destination for foreign investment; and lifting aggregate business investment, employment, productivity and wages.

We particularly support lifting the threshold below which businesses qualify for small business entity treatment for tax purposes; applying a tax rate of 27.5 per cent to incorporated small businesses entities; and raising the discount for unincorporated small business entity income to 8 per cent. Regardless of the form of business entity involved, these measures will improve the incentives for small business owners to invest in their businesses, to grow and to lift the numbers of people they employ. Raising the small business entity threshold will also reduce compliance costs for close to 100,000 small-to-medium sized businesses.

We also support lowering Australia's comparatively high company tax rate in stages from 30 per cent to 25 per cent. This will improve investment incentives for all incorporated businesses, it will promote greater investment, economic growth, employment and the pace of productivity improvement.

In our view, raising business investment is a leading priority in the current environment in which the Australian economy requires rebalancing in the wake of the mining investment boom. In particular, this rebalancing requires the rejuvenation and re-capitalisation of the non-mining trade exposed sectors that were so adversely impacted by the period of high currency closely associated with the commodity price boom.

While the company tax measures would be phased in over an extended period, the passage of the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016*, would provide a more immediate catalyst for investment because the time horizon over which new investments were assessed would include years in which lower company tax rates applied.

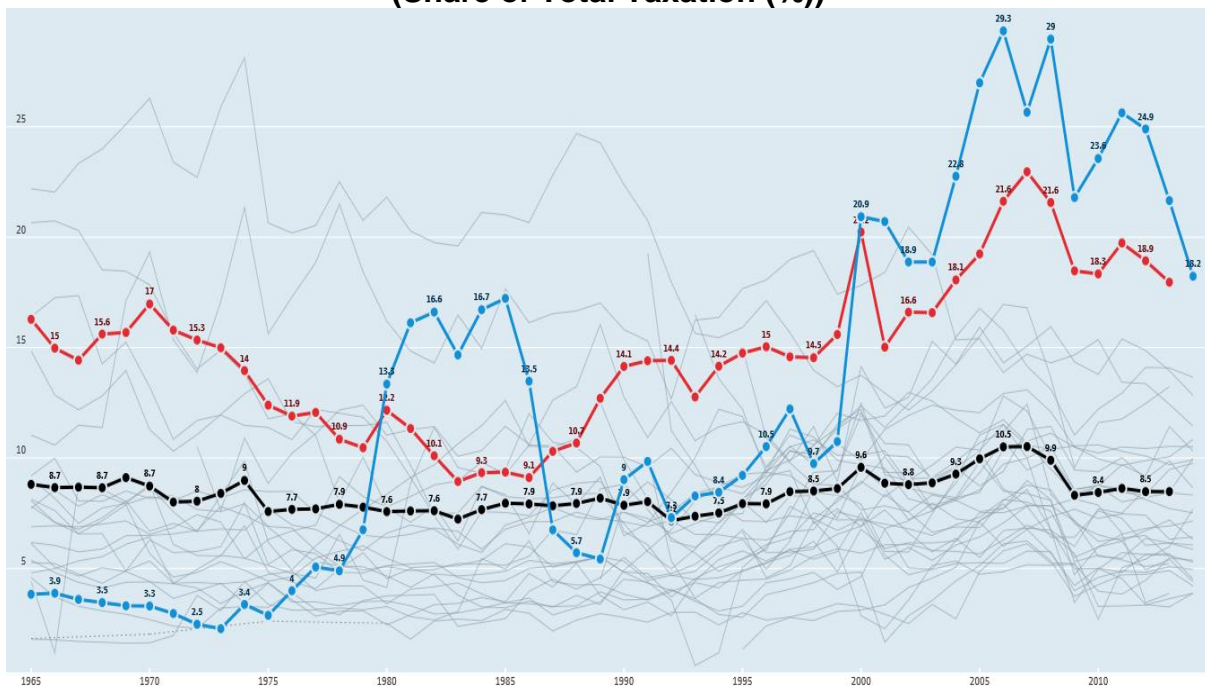
While we maintain very strong support for the phased reduction in the company tax rate, we recognise there is considerable hesitation about this measure. If this hesitation prevents the

passage of *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016*, we would urge that very strong consideration be given to introducing tax measures specifically aimed at lifting business investment over the next few years. Measures such as investment allowances or accelerated depreciation would have this impact.

Australia's High Recourse to Company Taxation

Australia has a high recourse to the taxation of business profits in the form of company taxation. This is shown very clearly in Chart 1 which compares the company tax share of total tax collections for all OECD countries over the period between 1965 and 2014 (which is the latest year for which comparative data are available). In both this and the following Chart, Australian data are highlighted in red, the average of all OECD countries in black and, to emphasise some particular features, Norwegian data are highlighted in blue.

**Chart 1: Taxation of Corporate Profits in OCED Countries 1965 – 2014
(Share of Total Taxation (%))**



Source: <https://data.oecd.org/tax/tax-revenue.htm>

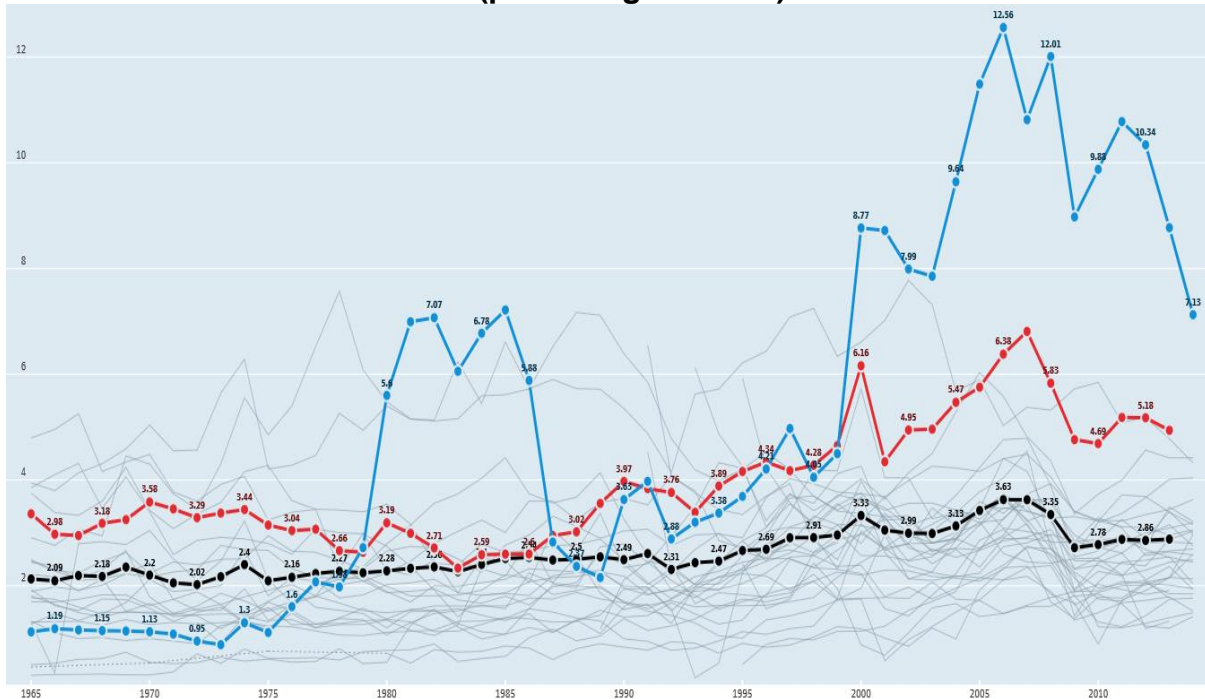
A number of points can be emphasised:

- Over the past half-century, Australia's reliance on company taxation has consistently been above the average for all OECD countries;
- For the second half of this period, coinciding with the major tax reforms of the mid-1980s, both the share of company tax in total tax collections and the gap between the share in Australia and the average share among OECD countries has trended higher;
- For each year since 1990 Australia's share of total taxation contributed by company taxation has ranked in the top three OECD countries and has ranked in the top two OECD countries since 2004;
- Both for Australia and Norway, the reliance on company tax intensified during the recent period of high commodity prices and has since retreated somewhat (in Australia's case

to a level that is broadly consistent with the rising trend since the mid-80s and in Norway's case more dramatically – in line with its particular reliance on resource rent taxation).

Some further features of the relative size of Australia's recourse to company taxation can be made with reference to the Chart 2 below which compares the company tax relative to GDP across the OECD countries, again between 1965 and 2014 (which is the latest year for which comparative data are available).

Chart 2: Taxation of Corporate Profits in OCED Countries 1965 – 2014 (percentage of GDP)



Source: <https://data.oecd.org/tax/tax-revenue.htm>

Before looking at Australia's relative position in relation to the share of company taxation to GDP, it is worth noting that, just prior to the Global Financial Crisis, there were record high levels of company tax collections relative to GDP for the OECD as a whole. This was followed by a sharp fall in the years 2008 and 2009 and a gradual recovery in the ratio of company tax to GDP across the OECD. The most recent years plotted in Chart 2 show a gradual rise in the ratio of company tax to GDP to a point where the ratio of company taxation to GDP for the OECD as a whole is higher than in any year prior to the mid-to-late-1990s.

As is the case with the share of corporate tax to total tax collections, relative to the OECD as a whole Australia stands out having one of the highest company tax to GDP ratios. This is despite Australia's lower-than-average overall tax to GDP ratio. Further, the gap between the Australian experience and the OECD average has tended to widen since the mid-1980s as the share of company tax to GDP in Australia has trended higher (against the more gently rising OECD trend). While it is clearly not the only factor, as is suggested by the Norwegian experience, some of the relative rise in Australia in more recent years is associated with the period of very high commodity prices.

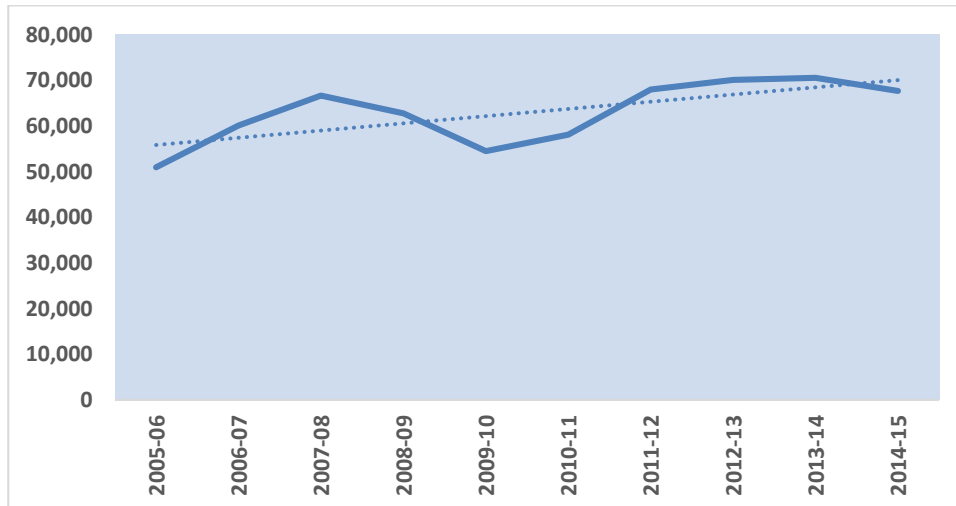
Interestingly the upwards trend in the share of company taxation to GDP across the OECD has occurred alongside the trend of falling headline company tax rates. This points to a progressive broadening of OECD company tax bases. Locally, the fall in the headline company tax rate from 47 per cent before the 1980s reforms and from 36 per cent at the turn of the century to its current

level of 30 per cent, has not been accompanied by a fall in company tax to GDP shares. In fact, the data suggest very strongly that Australia's rate reductions have been more than offset by various base-broadening measures.

What is less readily explained is that alongside the rise in the company tax to GDP ratio there has been an increased perception of profit shifting and tax base erosion both in the OECD and in Australia. At the aggregate level, certainly for Australia, this perception does not match the reality in which recent levels of company tax to GDP are noticeably higher than was the generally case before the commodity price boom. Even for the OECD as a whole, the empirical evidence of a generally rising company tax to GDP ratio is not suggestive of increased profit shifting and tax base erosion (although it is true that for the OECD as a whole, profit shifting between OECD countries would not be reflected in this measure).

To close off this excursion into the facts of company tax in Australia, and to address questions that might arise from the fact that the latest OECD comparisons lag by a couple of years, Chart 3 below plots Australian Bureau of Statistics data on company tax paid in Australia.

**Chart 3: Australian Company Tax Collections (\$million)
2005-6 to 2014-15**



Source: ABS, 5506.0 - Taxation Revenue, Australia, 2014-15, 26/04/2016.

This decade-worth of data from the ABS, plotted here along with a linear trend line, suggest that Australian company tax collections continue to be high (even though they reflect the GFC and, more recently, falling commodity prices). There is certainly no collapse of company tax collections from their high levels relative both to the OECD as a whole or, to Australia's historical experience.

It is therefore clear that Australia has a relatively heavy recourse to taxes on company profits.

While it is true that across the OECD there has been something of an increase in both the relative reliance on company taxation and the ratio of company tax to GDP, the Australian experience has seen:

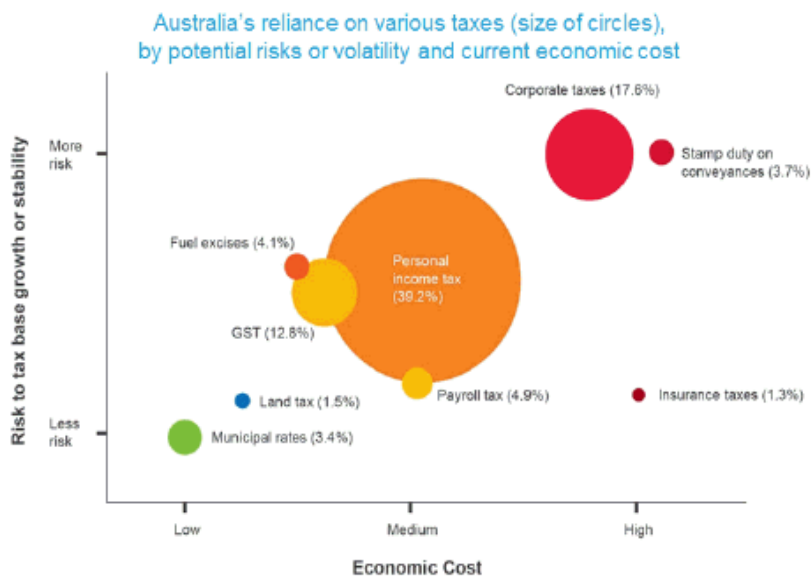
- a higher than average reliance and a higher growth in this reliance on company tax; and
- a higher than average ratio of company tax to GDP and a faster than average growth of the ratio of company tax to GDP.

The Benefits of a Lower Company Tax Rate

Capital is relatively mobile and taxes on the returns to capital are therefore more impactful than taxes levied on less mobile tax bases. As a result, there is a greater loss of efficiency and larger negative economic impacts arising from the taxation of corporate income than is the case with most tax bases. This is shown in Chart 4 drawn from a Treasury presentation showing the risks and costs of different tax bases. Australia's corporate taxes have a high economic cost and are assessed as potentially highly variable or unstable.

Chart 4: Relative Inefficiency of Company Taxation

Australia currently relies on taxes that have high economic costs and with risks to growth



Source: ABS, Taxation revenue 2013-14 for data on the share of tax revenue for each source. Note: Percentages do not sum to 100 per cent because some taxes have been excluded from this chart (e.g. tariffs, motor vehicle taxes, gambling taxes). The ABS captures income tax paid by superannuation funds in 'Corporate taxes' and fringe benefits tax and Medicare levy in 'Personal income tax'.

Source: Roger Brake, Australian Treasury, 8 October 2015, *An Inside Perspective on the Tax White Paper*.

Reducing the rate of company tax can be expected to have a positive impact on the health of the economy. Lowering the company tax rate can be expected to lift investment in Australia with the following ramifications:

- Higher quantities of capital per employee;
- More rapid modernisation of the capital stock;
- Increased labour productivity; and
- Higher real wage rates and higher living standards.

The impacts of imputation and double tax relief

It is true that Australia's system of full dividend imputation for domestic shareholders will dilute the net benefits of the reduction in the company tax rate. This occurs because, other things being equal, the value of franking credits available to domestic shareholders per dollar of after-tax profit will fall and the lower quantity of tax paid at the corporate level will be associated with

the distribution and use of correspondingly fewer imputation credits. Thus a dollar of pre-tax domestic profits company income distributed to domestic shareholders will bear the same level of tax both before and after the company tax reduction. Of course, the corollary to this is that there is no revenue cost in respect of domestic profits distributed to domestic shareholders.

That said, the company tax reduction still has decisive benefits:

- First, in respect of capital provided by domestic shareholders, there is both an improved capacity to retain taxed profits in the company for reinvestment and also a higher incentive to retain and reinvest the profits. Thus, in respect of capital provided domestic shareholders, the impact of the cut in the company tax rate is targeted very closely to the objective of reinvestment.
- Second, overseas shareholders cannot use Australia's imputation credits. The lower company tax rate therefore lifts incentives to invest both in respect of retained and distributed profits. As it is inherently more mobile than domestically-sourced capital on average, this additional impact on the incentive to invest from abroad is another dimension of the effective targeting of the company tax rate reduction.

Another argument that has been used to challenge the claims that the company tax cut will have a large positive impact on the domestic economy relates to provisions in the tax arrangements in other countries that recognise Australian company tax paid and provide shareholder relief from additional home-country taxation.

However, for the vast majority of foreign investors in Australia, double tax relief in their home countries will not be brought into effect by a reduction in company tax in Australia from 30 per cent to 25 per cent. First, for most investor-countries with which Australia has a double tax treaty, the home country tax rate is currently already below the level at which a reduction in company tax to 25 per cent would have an impact. Secondly, even in the few instances where, as a result of the lower Australian company tax rate additional home country tax could arise on profits repatriated from Australia, there is an additional incentive to retain and reinvest in Australia rather than pay the additional tax in the source country. This is analogous to the situation in respect to imputation.

In short, Australia stands to derive considerable benefits from the reduction in the company tax rate from 30 per cent to 25 per cent. These benefits in summary are higher levels of investment, improved incentives to retain and reinvest profits, a faster pace of modernisation of the capital stock and an increased level of capital per worker. These impacts on investment will lift labour productivity and therefore real wage rates and living standards.

The importance of lifting incentives to invest, of raising productivity and income growth should not be taken lightly. Australia is undergoing a difficult and still-patchy rebalancing in the wake of the mining investment boom and is still rejuvenating from the difficulties created in trade-exposed sectors during the period of the very high currency. Reducing the company tax rate and introducing the other measures in the Enterprise Tax Plan are aimed firmly at the lift in business investment that the economy so clearly requires.

Priorities and Second Best Options

While Ai Group attaches a very high priority to each of the elements in Government's Enterprise Tax Plan, we also understand that there is considerable hesitation about some of the measures.

If this hesitation were to prevent the passage of the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016* in its entirety, despite it being very much a second best option, we would urge:

- The measures scheduled to take effect from 1 July 2016 namely the lifting of the small business entity threshold to \$10 million; the reduction in the company tax rate to 27.5 per cent applying to companies of this size; and raising the discount for unincorporated small business entities from 5 per cent to 8 per cent be given priority; and
- Very strong consideration be given to introducing tax measures specifically aimed at lifting business investment over the next few years. Measures such as investment allowances or accelerated depreciation would have this impact.



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