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EDITORIAL

Australia's tax system stands at a critical crossroads. The Government's revisions to the Stage 3 tax cuts have brought long-overdue attention to fundamental flaws in our tax framework, which, without substantial reform, will continue to hinder productivity, weaken economic growth, and place undue burdens on working Australians. Our current tax structure is overly reliant on income tax, unduly complex, and riddled with outdated mechanisms that fail to meet the demands of our modern economy. Now is the time for a bold reimagining of our tax policy—one that prioritises fairness, efficiency, and economic vitality.

The Australian economy's heavy dependence on income tax, which makes up over 60% of tax revenue, is especially problematic. This reliance, compared to the OECD average of just 34%, distorts incentives to work and invest, holding back productivity. A more balanced approach would involve a shift toward a broader reliance on consumption-based taxes, such as the GST, which can be adjusted to protect low-income earners through targeted compensation measures. Broadening the GST base, while offering protections for those most impacted, would distribute tax burdens more equitably across all Australians and reduce the stifling load on working individuals and businesses. Additionally, the array of complex tax concessions, from negative gearing to capital gains tax discounts, complicates the system, disproportionately benefiting higher earners and distorting investment decisions.

Rationalising these concessions can create a simpler, fairer structure that better aligns with Australians' economic contributions and needs. For instance, modifying capital gains tax treatment to account for inflation, rather than providing a flat discount, could still encourage long-term investment without skewing the system in favour of those with substantial capital.

Our tax system's high level of progressivity, while necessary for equity, could be softened to enhance productivity. With the top 10% of earners shouldering nearly half of the total income tax burden, it risks stifling

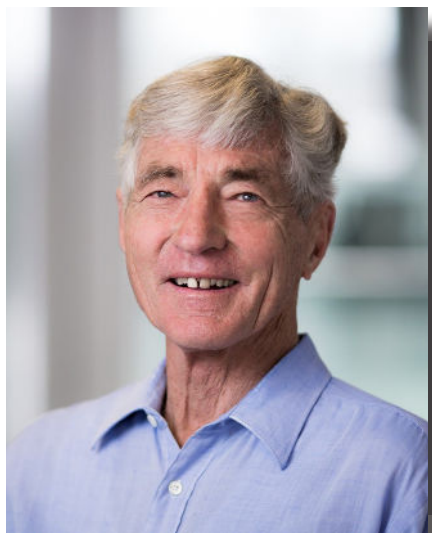
work incentives among Australia's highest-skilled professionals. A moderate easing of top marginal rates, paired with an expanded GST and other broad-based taxes, could stimulate higher productivity and attract international talent, while maintaining Australia's commitment to a fair distribution of tax responsibilities.

Bracket creep, too, must be addressed. When inflation pushes workers into higher tax brackets, their real income falls without any formal change in tax policy. Indexing tax brackets to inflation is a straightforward fix that would protect Australians from stealth tax increases, allowing household incomes to keep pace with the cost of living and ensuring that wage increases translate to real gains.

A comprehensive tax reform agenda would modernise outdated elements of our tax system and align them with the realities of today's economy. Replacing stamp duties with a land tax, adopting road usage charges as fuel excise revenue declines, and reducing payroll tax burdens on businesses would create a fairer, more resilient revenue system that encourages economic mobility and innovation.

Australia deserves a tax system that is both effective and equitable—one that incentivises work, fosters investment, and protects the welfare of future generations. By embracing bold, thoughtful reform, we can unlock significant benefits for all Australians, revitalise our economy, and set a course for sustained growth and prosperity. The time for action is now.

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This paper, written by Professor John Freebairn, Head of the Department of Economics at the University of Melbourne, examines the taxation of residential housing in Australia, highlighting the differences between owner-occupied and landlord/rent properties. It reviews the Henry Review's proposed reforms, including the replacement of stamp duty with an annual land tax, to improve efficiency, equity, and simplicity in the housing tax system.



GST REFORM FOR AUSTRALIA'S PROSPERITY

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Terry Ryan, an economic consultant, examines the need for GST reform in Australia to address shifting consumption patterns and rising service costs. He outlines options such as increasing the GST rate, broadening its base, or combining both to boost revenue. The article also considers compensation measures for low-income households and highlights the potential for economic efficiency and growth through reform, which could reduce reliance on more distortionary taxes.



AUSTRALIA'S TAX SYSTEM: AN URGENT CALL FOR REFORM

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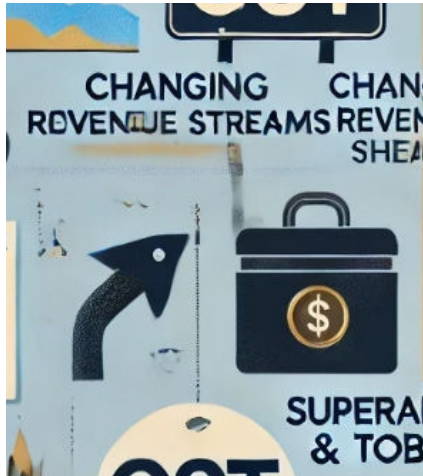
Australia's tax system faces issues like over-reliance on income tax, complex concessions, and outdated mechanisms. Reforms, such as lowering income tax rates, reducing corporate tax, and expanding GST, could address these challenges, boosting productivity and ensuring a fairer, more efficient tax system.



PRODUCTIVITY & SUPERANNUATION

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Allegra Spender highlights a critical issue: Australia's start-ups, key to driving productivity, are struggling to secure capital, despite the country's massive superannuation funds. With venture investment from super funds dropping and productivity growth stagnating, urgent reforms in finance, taxation, and public spending are needed to support innovation and economic resilience. (reproduced from AllegraSpender.com.au)



NAVIGATING AUSTRALIA'S TAX

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Navigating Australia's Tax provides insights from the 2023 Intergenerational Report and examines how demographic shifts, changing consumption patterns, and declining indirect taxes will reshape Australia's revenue system. It highlights the impact of an ageing population, bracket creep, superannuation concessions, and global tax trends while exploring green tax opportunities and policy directions for a sustainable, adaptive future.



FROM CORPORATE TAX TO CASH FLOW TAX

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Ross Garnaut and co-authors propose replacing Australia's corporate income tax with a cash flow tax, allowing immediate deductions for capital expenditures while removing interest deductions. This reform aims to eliminate distortions that favour debt over equity, large firms over small ones, and established businesses over innovative investments. The tax would apply equally to positive and negative cash flows, preventing tax avoidance and closing international loopholes. The authors argue this shift would enhance investment, economic growth, and revenue stability, particularly during a recession.

INTRODUCTION - A TAX SYSTEM FOR THE FUTURE

A Tax System for the Future

Australia's tax system is at a crossroads. With an over-reliance on corporate and income tax, outdated mechanisms, and complex concessions, the current framework is struggling to keep pace with economic shifts and global competition. Without bold reform, productivity will continue to stagnate, investment will be discouraged, and tax burdens will fall unevenly across the economy.

This edition of the Tax Policy Journal brings together leading economic thinkers to explore critical areas of tax reform. Ross Garnaut proposes replacing corporate income tax with a cash flow tax, an alternative designed to eliminate investment distortions, close tax avoidance loopholes, and encourage economic growth. Terry Ryan examines the need for GST reform, outlining options to expand the base or adjust rates to ensure a more sustainable and equitable tax system. Professor John Freebairn provides an in-depth analysis of housing taxation, exploring the impact of existing concessions and assessing proposals such as replacing stamp duty with an annual land tax.

Beyond these major tax shifts, this issue also examines bracket creep, the role of tax policy in boosting productivity, and the importance of financing innovation in Australia's start-up sector. With contributions from leading experts, this journal provides a timely foundation for informed debate.

As governments consider how best to modernise the tax system, the need for a fair, efficient, and growth-oriented framework has never been greater. The insights in this edition offer a roadmap for policymakers seeking to build a stronger and more resilient economy.

Taxation of Housing

Professor John Freebairn

Professor Freebairn is Head of the Department of Economics, at the University of Melbourne, Australia. He is a graduate of the University of New England and the University of California, Davis. His research interests are taxation reform, unemployment, and the pricing of infrastructure.



Owner-occupied and landlord/rent housing face similar consumption, transfer duty and local government taxes, and the former faces lower income and land taxes. The Henry Review proposed to lower income taxation on landlord/rent housing, but no change to the exemption for owner-occupied homes, a shift in the tax mix away from income tax and a larger share for consumption and economic rent taxes and replace transfer duty with an annual land tax. To date, the Henry Review proposals have not been adopted. The efficiency and equity arguments for replacing transfer duty with an annual land tax is provided, and a practical suggestion to follow the ACT reform package.

Introduction

Residential housing in Australia is subject to taxation of income, consumption, asset value and transactions. The tax treatment differs for owner-occupied housing and for landlord/rent housing. Also, the taxation treatment of housing varies with that applied to alternative saving and wealth options, including superannuation, shares and financial assets.

Housing serves two general purposes. One is the provision of accommodation and associated household consumption services. About 70% of homes are owner-occupied and 30% are owned by landlords and rented (ABS, 2022). Two, homes are the dominant savings and investment option for households. Owner-occupied homes account for around 41% of aggregate household wealth, other real estate, including rent property, 16%, superannuation 19%, and financial 17% (ABS, 2022).

Taxation is only a sub-set of government policy interventions to change the quantities, prices and other outcomes of consumption of and investment in housing. Other policy options include subsidies, such as the first home-owner grants and rent subsidies, investment in transport, energy, social and other

assets, and regulations, including those affecting the availability of land and controls on building designs. Often, taxation reform will be a component of a broader package of policy changes.

The Henry Review of taxation in 2010 proposed major changes to the taxation of housing to improve efficiency, equity, simplicity and sustainable revenue (Henry, et. al., 2010). To date, no significant reforms to alter the general structure of taxation, or of housing, have been implemented in response to the Henry Review and other reviews.

The paper is as follows. Section 2 describes the different taxes levied on owner-occupied and landlord/rent housing this twenty-first century. It highlights the concessional treatment for owner-occupied relative to landlord/rent housing. Section 3 offers a summary of key reforms to the taxation of housing provided by the Henry Review. A more detailed discussion of proposals to replace stamp duty on the transfer of property with an annual land tax is provided in Section 4.

Current Taxes on Housing

Table 1 provides a summary of the current set of income, consumption, asset and transaction taxes levied by the Commonwealth, States (and Territory) and Local governments on owner-occupied homes and landlord/rent homes. Aside from adjustments to tax rate schedules, the general structure of taxes and tax bases on housing have not changed this century.

Tax Base and Government	Owner Occupied Housing	Landlord Rent Housing
Income tax (Commonwealth)	Exempt	Net rental income Half rate on realised capital gains
Consumption tax (Commonwealth)	10% GST on new buildings and on repairs and maintenance	10% GST on new buildings and on repairs and maintenance
Land tax (States) Property tax (Local)	Exempt Annual rates	Progressive annual tax Annual rates

Table 1: Income, Consumption, Asset and Transfer Taxes on Owner-occupied and Landlord/Rent Residential Housing

Income tax levied by the Commonwealth on individuals with a progressive rate schedule account for over two-thirds of total government tax revenue. Taxation of income generated by investments in housing receives large concessions relative to a comprehensive nominal income tax. For owner-occupied homes, there is no tax on imputed rent, but also no deductions for expenses, and no tax on capital gains.

For landlords, net rental income (rent receipts less outlays on interest, depreciation, repairs and maintenance, state and local government taxes, and other expenditures) is taxed. Income taxation on capital gains for property held for more than twelve months faces concessions in the form of a half rate on realised capital gains. A progressive personal tax rate schedule applies to the taxable net returns and capital gains.

Some argue that the ability of landlords to deduct negative net rental income from other sources of taxable income, so called negative gearing, is a special concession. The contrary argument is that losses on other

household investments, and negative net income on small businesses and companies, are deductible against labour and other taxable investment income.

The Australian system of income taxation of different forms of saving and investment is a hybrid of different concessions and effective tax rates for the different options. Taxation of nominal (rather than real) income received on savings invested in financial assets and shares in companies distributed as dividends face the highest effective tax rates. Income received from investments in unincorporated businesses is subject to personal income taxation, but with concessions for accelerated depreciation, opportunities to spread incomes via trusts, and the half rate on realised capital gains.

Savings invested in superannuation receive concessional tax rates (namely a flat 15 per cent rate) on initial funds invested, on income received during the holding period, and lower rates for income earned during the withdrawal period. The income tax treatment of owner-occupied housing is at the lowest end of effective tax rates for income taxation of different saving options. For rent

property, income tax is positive but less than that for dividends and financial assets.

Both owner-occupied and landlord/rent housing face the Commonwealth imposed goods and services tax (GST) as a general consumption tax. Rather than tax an annual measure of consumption for imputed rent or actual rent services consumed, the GST tax base is the asset price of new property plus outlays on repairs and maintenance. The chosen base builds on the assumption that the asset price approximates the discounted value of the future stream of consumer products.

This GST purchase price tax model also applies to other consumer durables, including motor vehicles and household appliances. Some, including the Treasury in its tax expenditures measures, argue the GST taxation of housing is concessional in the sense that it exempts the consumer benefits of increases in asset prices over time.

While Australia does not have a general tax on wealth or assets there are several taxes levied on property, both residential and commercial, and on other natural resources, including minerals. Rent property and commercial property are subject to an annual progressive rate land tax; owner-occupied property, primary production property and land in the NT are exempt from land tax. Details of the progressive rate schedule vary from state to state.

Local government rates have been included in the list of asset taxes in Table 1. A flat rate, and in most but not all municipalities a land base, are used. Arguably, local rates are a hypothecated charge for provided services rather than a tax for general revenue purposes. The States collect conveyance duty as a progressive rate tax on the transfer of ownership of owner-occupied homes, rent property, and commercial property. In one

sense the duty operates as an additional consumption tax to the GST. Importantly, and in addition, conveyance adds to the cost of buying and selling property. The extra cost distorts welfare increasing decision response to change location and form of property in response to changes in employment location, family demographics, income, tastes, and other household circumstances.

Stamp duty on insurance, including insurance of property, adds to the insurance premium cost, and this distorts decisions to insure.

Henry Review Housing Tax Reform Proposals
The Henry Review of taxation delivered in 2010 proposed reforms which directly or indirectly would alter the tax treatment of housing (Henry, et. al., 2010). Included in the reform proposals was a general income tax on the real returns to different saving and investment options, expansion of the land tax base as a component of a greater weight on the taxation of wealth, and replacement of stamp duties.

A more neutral system of income taxation of capital income earned on different saving and investment options to replace the hybrid mix of current income tax systems discussed above was proposed. The primary objective of the reform was for a more nationally productive mix of investments. An exception was to maintain the current exemption of income earned on owner-occupied homes from any income taxation.

For all other investment options, a shift to a common real income tax base was proposed. In practice, a 40% discount on nominal income and realised nominal capital gains for investments in rent housing, financial deposits, dividends, other business incomes and realised capital gains (rather than the in place 50% discount) was recommended. Relative to the then current policy, the reform package would

reduce the income tax burden on landlord/rent housing and no change for owner-occupied.

The Henry Review was generally in support of changing the aggregate tax mix to one with less weight on income and more on consumption and economic rent from natural resources and land. A broader base and/or a higher rate GST would affect the two categories of housing about the same. Greater weight on the taxation of land would increase the aggregate tax burden on housing, and more so for owner-occupiers who now face no land tax.

Replacement of conveyance or stamp duty on the transfer of property with an annual land (or improved value) property tax was recommended by the Henry Review. Such a reform has been advocated by many others before and since. Conveyance duty is estimated to be the most distorting and inefficient tax (Australian Treasury, 2015). A replacement comprehensive base land tax has minimal efficiency costs.

The reform proposal also would improve horizontal equity across taxpayers with different frequency of transfer of housing property.

None of the Henry Review reform proposals, including those discussed in this section with a direct effect on housing, were implemented. Aside from relatively minor changes to some tax rates, lack of reform continues through to today.

Land Tax for Conveyance Duty Reform Package

A generally supported reform package among economists, and advocated by the Henry Review, is to replace the current conveyance duty levied on the transfer

of housing (and of commercial and other property) with an annual land tax. Simplicity and limited redistribution effects support a flat rate land tax and an approximate revenue neutral package. A more ambitious reform package could include a future path of higher land tax rates and revenue collected as part of transition to greater weight to the taxation of wealth and less on income. Advantages of the reform package include gains in efficiency and in horizontal equity, and some increase in revenue stability.

Efficiency gains arise from the elimination of conveyance duty tax distortions to change home location or type in response to changes in employment opportunities, family demographics, income and other circumstances. The annual replacement land tax is payable regardless of whether one does or does not transfer to a more suitable property in the event of changes in household circumstances. The reform leads to greater overall value from the housing stock.

In terms of design detail, a land tax base with a highly inelastic land supply results in smaller distortions and efficiency costs than an improved property (land plus building) replacement tax base.

Horizontal equity gains over the longer term with the reform package arise because taxpayers with similar house assets pay the same tax regardless of whether they buy and sell more or less frequently than the average.

Maintenance of vertical equity would support a progressive replacement tax for the current progressive stamp duty tax schedules. Improved value rather than land as the replacement property tax base would reduce redistributive effects, but with some loss of efficiency.

A challenge for the reform is the choice of a transition path. With the cold-turkey or one-off change model option, those who recently paid stamp duty also will pay the replacement land tax and then consider themselves double-taxed.

A second transition option would reduce the magnitude of the double tax concern by providing a partial offset for the land tax for several years for recent payers of conveyance duty. This option incurs a net revenue loss. A third option is the ACT staged reduction of the conveyance duty rate and increase of the land tax rate introduced in 2014. One could follow the ACT 20-year transition, or a shorter period. The gradual transition option avoids a revenue loss and modifies the cold-turkey equity effect, but it delays full realisation of the efficiency gains.

For some property owners, replacement of conveyance duty with an annual land tax can bring liquidity problems. Examples include the asset rich and income poor, and those with short term unemployment or adverse health effects. A supporting part of the reform package would allow carry forward of the land tax indexed by, say, the long term bond rate.

Conclusions

Under current Commonwealth, State and Local government arrangements, and those of the last twenty-five years, taxation of landlord/rent housing bears a higher aggregate tax burden than owner-occupied housing. Both categories face GST, conveyance duty, and local government rates. Landlord/rent housing faces some income taxation, although with concessions, and land tax, both of which are not applied to owner-occupied housing.

The Henry Review of 2010 included reform proposals to change the taxation of housing.

While no change to the exemption of imputed rent and capital gains for owner occupied homes from income taxation was proposed, income taxation of landlord net rent income and capital gains was recommended for a real income tax base, and similar to that proposed for most other forms of household investment income.

A broader general recommendation of the Henry Review to shift the tax mix away from income and to consumption and economic rents would increase the current aggregate tax burden on both owner-occupied and landlord/rent housing, and relatively more so for the former.

The Henry Review, and many others, proposed replacement of State imposed stamp duty on the transfer of property with an annual land tax. Apart from the ACT, this reform to deliver large efficiency gains and greater horizontal equity has not won political or general population support.

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How GST Reform Can Help Reboot Prosperity for Australia

Terry Ryan

Terry Ryan is a seasoned economic consultant with a wealth of expertise in policy formulation and economic analysis. He has authored publications addressing topics such as industry support, taxation, and regulatory frameworks in economics. In this article he summarises the arguments for changing the GST rate.



Australia's Goods and Services Tax (GST) reform is increasingly seen as a cornerstone for revitalising the country's economic stability and sustainability. The 2020 report (Report name and author) delves into the potential impacts and benefits of restructuring GST arrangements to address modern economic challenges. Following is an in-depth analysis of why GST reform is essential, the options available, and how it could reshape Australia's fiscal framework to be more efficient, equitable, and robust.

Understanding the Need for GST Reform

The GST, introduced in 2000 at a flat rate of 10%, was crafted to streamline indirect taxation by providing a broad-based, consumption-based tax on most goods and services. However, the original GST framework included exemptions on essential items such as fresh food, education, and healthcare to lessen the burden on low-income households. While these exemptions served a social purpose, they created complexities in tax collection and limited the GST's revenue potential.

Over the past two decades, the structure of Australia's economy has changed, and so have the demands on its fiscal resources. Consumption patterns have shifted, technological advancements have transformed industries, and the reliance on state-funded services like healthcare has risen sharply. These factors have gradually constrained GST's ability to generate sustainable revenue, leading to increased dependency on other tax sources, particularly personal and corporate income taxes, which can be more volatile.

As GST's share of total tax revenue declines relative to GDP, Australia now faces a pressing need to revisit its tax mix to ensure long-term fiscal resilience. This calls for a well-structured GST reform that could recalibrate

the tax system, making it more responsive to current and future economic conditions, while reducing the economy's vulnerability to external shocks.

Australia's Fiscal Position: The Role of GST in Revenue Collection

GST currently provides about 30% of total state and local government revenue, making it a crucial component of Australia's fiscal structure. In theory, GST is a stable source of revenue that grows in line with consumption. However, the GST's growth in Australia has been slower than expected due to its narrow base and stagnant rate. The rise of exempted goods and services has further limited GST's contribution, even as spending in these areas—particularly health, education, and fresh food—continues to increase.

States and territories, which rely heavily on GST allocations, are feeling the strain as their expenditure responsibilities grow. Unlike income taxes, which can discourage productivity if overly relied upon, consumption taxes like GST are generally less economically distorting. Therefore, bolstering the GST could help reduce dependence on more distortionary taxes like payroll taxes, which often place a disproportionate burden on employers and can discourage job creation.

The pressing issue lies in the inflexibility of the GST framework. Without changes to either the rate or base, Australia risks a widening gap between revenue needs and tax collections. By reforming the GST, Australia could create a more balanced and resilient tax structure that could support essential services and infrastructure without disproportionately increasing the tax burden on working Australians.

“AS GST'S SHARE OF TOTAL TAX REVENUE DECLINES RELATIVE TO GDP, AUSTRALIA NOW FACES A PRESSING NEED TO REVISIT ITS TAX MIX TO ENSURE LONG-TERM FISCAL RESILIENCE”

Pathways for GST Reform: Key Scenarios

Increasing the GST Rate to 12.5%: A moderate rate increase to 12.5% would be straightforward to implement and could provide an additional \$14 billion annually. This measure would spread the tax burden across all households, generating significant revenue. However, it would also increase the cost of goods and services across the board, potentially impacting low-income households the most. Addressing these impacts would require compensation mechanisms to avoid exacerbating economic inequality.

Expanding the GST Base: This approach involves applying GST to currently exempted goods and services, such as fresh food, education, and health. Such a reform could potentially raise an additional \$20 billion per year. Broadening the base without increasing the rate could be more equitable as it aligns tax contributions with actual consumption patterns. However, the inclusion of essentials might still disproportionately affect low-income families, necessitating targeted relief efforts.

Combining Rate and Base Adjustments: A more aggressive option involves both raising the GST rate to 12.5% and expanding its base. This combination could yield up to \$40 billion in additional revenue annually. However, this approach would require a highly coordinated compensation framework to mitigate the significant impact on low- and middle-income households. The potential economic boost from such a reform could be substantial, enabling governments to fund major projects and reduce reliance on personal income tax.

Implementing Tiered GST Rates: In this model, different rates would apply based on the type of goods or services. Essentials like food could remain at a lower rate, while luxury goods could be taxed at a higher rate.

Although administratively complex, a tiered GST rate structure could make the tax system less regressive and align with consumers' ability to pay.

Addressing Regressivity: Ensuring Fairness in GST Reform

GST reform comes with inherent challenges, notably the regressive nature of consumption taxes. Low-income households generally spend a larger portion of their income on essentials, which are precisely the areas that GST reform might target. Any increase in the GST rate or base expansion would likely burden these households unless countered with effective compensation mechanisms.

Compensation measures are crucial to achieving public support and ensuring GST reform does not exacerbate inequality. Some approaches to consider include:

Automatic Adjustments to Social Payments: By indexing social benefits to inflation, welfare payments could be increased in line with higher living costs. This would help offset the additional expenses low-income households face due to a broader GST base or rate hike.

Direct Cash Transfers: Lump-sum payments or regular rebates could be provided to offset GST's impact on low-income households. For example, a quarterly rebate might help ensure families have sufficient funds to cover increased costs on essentials.

Personal Income Tax Adjustments: Lowering income tax rates or increasing tax offsets for low- and middle-income earners would help balance GST impacts. For instance, an increase in the low-income tax offset could reduce tax burdens on those most affected by the GST changes.

By incorporating these adjustments, GST reform can remain socially equitable, aligning with Australia's goal of a fairer, more balanced tax system.

Economic Efficiency and the Potential for Growth

Reforming GST has the potential to enhance the efficiency of Australia's tax system. Income and payroll taxes are generally seen as more economically distorting than consumption taxes, as they can discourage productive activities like working, saving, and investing. A higher reliance on GST could therefore yield economic gains by promoting a more efficient allocation of resources. In particular, a shift from income-based to consumption-based taxation could stimulate economic activity by reducing the tax burden on wages and profits.

The report suggests that moving towards a revenue-neutral tax shift—from income to consumption—could lead to GDP growth of 0.25% to 1% annually. This uplift in growth would result from a more favourable tax structure, one that promotes investment and aligns with Australia's long-term economic goals. By coupling GST reform with reductions in other taxes, Australia could foster a tax environment that supports growth without compromising essential revenue.

Implementation Challenges and Political Considerations

GST reform is complicated by Australia's federal structure. Under the current framework, GST revenue is collected by the Commonwealth but distributed to the states and territories. Any changes to the GST rate or base require unanimous agreement from all states and territories, adding a layer of complexity to the reform process.

Gaining consensus among various jurisdictions is challenging, especially when each has unique economic needs and priorities.

However, the states, which depend heavily on GST revenue, have a vested interest in reform.

Collaborating with the Commonwealth, states and territories could develop a package that distributes benefits and costs equitably across jurisdictions. While this process may be challenging, aligning incentives can facilitate a cooperative approach, increasing the likelihood of successful reform.

Timing and Context for GST Reform

The need for GST reform has become more pressing in the wake of the COVID-19 pandemic, which highlighted the importance of fiscal resilience. Government spending surged during the pandemic to support individuals, businesses, and health systems, resulting in rising debt levels. As Australia transitions from pandemic recovery to long-term growth, restructuring the GST could play a pivotal role in stabilising public finances.

Compared to other OECD countries, Australia's GST rate is relatively low. A modest increase in the rate or a broadening of the base would bring Australia closer to international standards, aligning the country's tax system with global best practices.

Moreover, in a rapidly globalising economy, competitive tax settings are critical to attracting investment and fostering sustainable growth. Aligning GST with broader international practices could help position Australia favourably on the global stage.

Key Considerations for Policymakers

Balancing Revenue and Equity: GST reform should not only increase revenue but also maintain a commitment to fairness. Implementing compensation measures will help ensure that low-income households are shielded from potential adverse effects.

Phasing in Changes Gradually: A gradual rollout of GST reforms would allow households and businesses to adjust. This approach reduces the risk of economic shock, smoothing the transition and making the changes more manageable.

Building Public Confidence: Public understanding and support are essential. Clear communication about GST reform's objectives, coupled with visible compensation for low-income households, can foster trust and mitigate concerns about regressivity.

Collaborating with State and Territory Governments: Ensuring cooperation across jurisdictions is crucial to successful GST reform. A well-coordinated strategy that benefits all states and territories can promote consensus and streamline implementation.

Reforming the Broader Tax Mix: GST reform should ideally be part of a holistic tax reform package that considers income, corporate, and other taxes. By adjusting the overall tax mix, policymakers can create a more balanced system that supports sustainable economic growth.

Moving Forward: A Foundation for Prosperity
GST reform offers an opportunity to modernise Australia's tax system, enhancing its capacity to meet evolving economic demands.

An expanded or higher GST could provide reliable revenue streams that support essential services, reduce economic distortions, and foster fiscal stability. GST reform could lay the groundwork for a prosperous and resilient Australia.

Implementing such reform requires careful planning, robust compensation mechanisms, and political consensus. By addressing these factors, Australia can build a more equitable, sustainable, and prosperous future. GST reform, when done thoughtfully, could indeed be the reboot Australia needs for enduring fiscal health and economic vitality.



AUSTRALIA'S TAX SYSTEM: AN URGENT CALL FOR REFORM



The Australian Government's recent adjustments to the Stage 3 tax cuts have amplified discussions on the necessity for tax reform, especially as Australia grapples with productivity challenges and rising inflation. In an increasingly globalised economy, a streamlined and efficient tax system is crucial to enhancing productivity, maintaining living standards, and addressing fiscal demands across generations.

Australia's tax system, however, faces multiple obstacles, from an over-reliance on income tax to complex tax concessions that often benefit specific demographics disproportionately. This report evaluates these core issues in-depth, underscoring the importance of reform in securing Australia's economic future.

Key Problems in Australia's Tax System

Australia's tax structure exhibits five significant issues:

1. Over-Reliance on Income Tax
2. Complexity Due to Tax Concessions
3. High Progressivity
4. Persistent Bracket Creep
5. Outdated Tax Elements

Each of these factors contributes to inefficiencies and complexities that impede economic growth. To address them, let's dive deeper into each.

Issue #1: Heavy Dependence on Income Tax

Australia's reliance on income tax is notably high, comprising approximately 62% of total tax collections. In contrast, the OECD average for income tax revenue is around 34%. This over-reliance on income tax, whether from individuals or corporations, presents unique challenges. Income tax inherently impacts decisions to work and invest, which can stifle economic productivity. High income taxes also exacerbate intergenerational inequities by placing a rising fiscal burden on younger Australians, who already face steep costs in housing, education, and healthcare.

A shift toward indirect taxes, such as the Goods and Services Tax (GST), could foster a more balanced system. GST, as an indirect tax, is generally less distortionary since it is consumption-based rather than income-based. Moreover, increasing GST's role could alleviate the tax burden on income earners, potentially boosting work incentives and productivity. However, GST can disproportionately impact lower-income earners, so

any GST expansion would require mechanisms to offset these effects on vulnerable populations, such as adjustments in tax credits or direct transfers.

Issue #2: Complexity Created by Tax Concessions

Australia's tax system is notoriously complex due to various concessions, including negative gearing, capital gains tax (CGT) discounts, franking credits, and superannuation incentives. Each concession serves a distinct purpose, yet cumulatively they introduce layers of complexity, distorting investment choices and reducing transparency.

Negative Gearing: This concession allows taxpayers to deduct losses on investment properties against other income. While critics argue it inflates property prices, proponents believe negative gearing encourages investment in rental housing. Eliminating or restricting negative gearing could deter property investment, potentially reducing rental supply. However, selective reforms could be introduced to curb excessive use without entirely eliminating its advantages.

Capital Gains Tax Discount: Currently, capital gains on assets held for over a year receive a 50% discount, an incentive that encourages long-term investment. However, this benefit can be excessive, as it allows high-income individuals to classify income as capital gains and pay lower taxes. A fairer approach might involve adjusting capital gains for inflation, instead of a flat percentage discount, which would more accurately reflect actual gains.

Franking Credits: This concession prevents double taxation of corporate profits by granting investors credits for taxes already paid at the corporate level. Curtailing franking credits could discourage investment in domestic equities, as dividends would be less attractive, but the concession itself does reduce biases against equity investments.

Superannuation Concessions: Tax concessions on superannuation contributions encourage savings for retirement, reducing reliance on the public pension

system. This serves a long-term social benefit by fostering self-funded retirements. Limiting these concessions would likely backfire by increasing future pension obligations, a burden on public resources.

While there may be a case for reforming certain concessions to ensure they are equitable and economically justifiable, outright removal could have unintended consequences. Policymakers should focus on targeted reforms that retain essential benefits but curtail excessive or exploitative use.

Issue #3: High Progressivity and Its Impact on Incentives

Australia's tax system ranks among the most progressive, with the top 10% of income earners contributing close to half of the total income tax collected. The top marginal rate, including Medicare, is 47%—a rate that begins at relatively low multiples of the average weekly earnings compared to other countries.

High progressivity can deter work effort, especially for high-skilled professionals whose marginal return on extra work hours or business investment diminishes as they ascend the tax ladder. Furthermore, this heavy tax burden on a small segment of the population may inadvertently stymie productivity by discouraging the most skilled professionals from taking on additional work or investing in entrepreneurial ventures.

A gradual reduction in reliance on income tax could ease this burden. By diversifying tax revenue sources and reducing the top marginal rates, Australia could create a tax environment that incentivises work, innovation, and investment. However, this would need to be paired with adjustments in indirect taxes or other broad-based revenue sources to offset potential revenue shortfalls.

Issue #4: Bracket Creep – An Unseen Tax Hike

Bracket creep occurs when inflation-driven wage increases push taxpayers into higher tax brackets, leading to unintended tax hikes. This process erodes real disposable incomes, placing a growing strain on households and deterring consumption.

Over the past few years, bracket creep has been a more substantial drag on household incomes than even rising mortgage costs, underscoring its economic impact. Despite its significance, bracket creep often goes unaddressed in public discourse as it doesn't require active policy changes to occur.

A simple yet effective solution would be to index tax brackets to inflation, an approach adopted by various countries. This change would ensure that only real income increases—not inflationary adjustments—result in higher tax rates, maintaining a transparent link between policy intentions and tax outcomes. Moreover, it would prevent governments from relying on bracket creep as an unacknowledged revenue booster.

Issue #5: Outdated Tax Mechanisms

Several components of Australia's tax system have become outdated, reflecting older economic models that no longer align with contemporary needs:

GST on a Shrinking Base: Australia's GST applies to a diminishing share of total consumption, as an increasing proportion of consumer spending shifts toward untaxed services. Expanding GST to cover a broader base would align revenue with evolving consumption patterns.

Stamp Duties on Property: Stamp duties significantly distort property transactions, making housing less affordable and discouraging mobility. A switch from stamp duties to land tax would reduce transaction costs, encourage efficient property use, and alleviate some housing affordability pressures.

Payroll Taxes: State-level payroll taxes act as a disincentive for employment, a direct impediment to growth. Reducing reliance on payroll taxes, potentially by shifting revenue generation toward less distortionary sources, could encourage job creation.

Outdated Vehicle Excises: With electric vehicles and alternative fuels gaining traction, fuel excises increasingly fail to capture road usage equitably. A modern approach would involve a road usage charge, ensuring that road maintenance funding remains sustainable and equitable as vehicle technology evolves.

Updating these elements requires a fundamental shift in how the tax system perceives economic activity, property ownership, and consumption in a digital, service-driven economy.

The Path Forward for Comprehensive Tax Reform

Effective reform must balance the need for fair revenue generation with the goal of minimising economic distortions. The following policy changes could establish a more efficient and sustainable tax system:

Lower Personal Income Tax Rates with Higher Thresholds: Gradually decreasing income tax rates and raising tax brackets can incentivise work and reduce the drag of high marginal tax rates on productivity.

Corporate Tax Reduction: Lowering corporate tax rates would make Australia more competitive internationally, attracting investment and stimulating economic growth.

Expanding GST with Targeted Compensation: Expanding GST's base, combined with measures to protect low-income households, could distribute tax burdens more evenly while encouraging productivity.

Indexing Tax Brackets to Inflation: Adjusting brackets to inflation would counter bracket creep, ensuring that only real income increases push taxpayers into higher brackets.

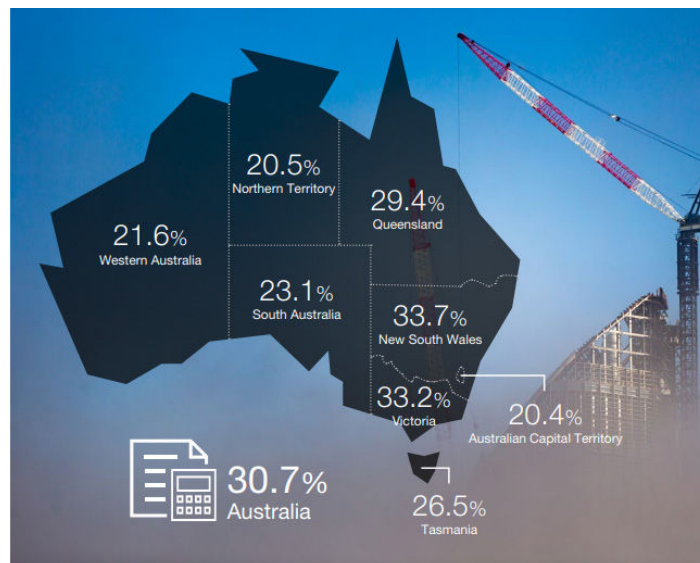
Replacing Stamp Duty with Land Tax: A broad-based land tax, as opposed to transaction-based stamp duty, would reduce distortions in property markets and contribute to more affordable housing.

Reassessing Concessions: Selectively reviewing tax concessions could enhance system fairness without sacrificing key economic incentives. For instance, aligning capital gains treatment more closely with inflation rates would reduce incentives to reclassify income strategically.

Implementing Road Usage Charges: With fuel excise revenue dwindling, transitioning to a road usage charge would provide a more consistent funding stream for infrastructure, aligned with actual road usage.

While these reforms are straightforward conceptually, they require substantial political will, comparable to major tax reforms of past decades. However, failing to implement them may have long-term repercussions for Australia's productivity and living standards.

Australia's tax system, once efficient, now requires significant updates to remain relevant in a changing economy. Addressing the over-reliance on income tax, simplifying concession structures, moderating progressivity, tackling bracket creep, and phasing out outdated mechanisms are essential to creating a fairer, more productive system. Each of these challenges, if unaddressed, risks further productivity decline, greater



Share of State Taxes collected from tax bases with low economic costs

Reforming Australia's tax system is not merely an economic necessity but a strategic imperative to safeguard Australia's economic resilience, equity, and prosperity. As global competitiveness intensifies and domestic challenges evolve, a comprehensive tax overhaul offers a pathway to revitalise productivity and bolster economic security for all Australians.

WHY DWINDLING PRODUCTIVITY IS A BIG DEAL FOR FOR SUPERANNUATION

Allegra Spender - Member for Wentworth

This piece was originally featured in the AFR

Despite having one of the largest pension schemes in the world, the start-ups that can that drive productivity aren't getting the financial support they need.

Australia's lacklustre economic growth grabbed the headlines when recent national accounts were released, but the country's poor productivity performance received a lot less attention.

Output per hour worked – a common measure of Australia's productivity – fell 0.8 per cent last quarter and was only 0.5 per cent for the year. That's less than half the rate that Treasury uses (1.2 per cent) to model the future federal budget position.

Productivity might not grab headlines quite like the theatrics of question time, but it is the measure we can no longer afford to ignore. Dominic Lorrimer

This drop in productivity is a big deal. In a time of high inflation and anaemic growth, the only real way to both lower inflation and grow the economy is productivity. We need to do more with less.

Easier said than done. One place to start is the Productivity Commission's landmark productivity review, *Advancing Prosperity*. It was released over a year ago, with 71 supply-side reforms.

The government hasn't provided a full response to the review. They should urgently. (Frankly, the federal government should be required to respond to such reviews and committee reports in full, as they are in NSW.)

The federal government is taking one step forward and two steps back on productivity. Steps such as improving the skilled migration scheme, increasing apprenticeships and reducing nuisance tariffs are positive, but their IR reforms that have driven wages and complexity without productivity gains are the opposite.

Three areas to focus on

Three areas where we should be focusing are improving access to finance for new businesses, spending public money better, and reforming Australia's tax system.

Research by e61 Institute shows it is young, growing businesses that drive productivity. But times are tough right now for new and small businesses, and access to capital is a major factor.

Angel and venture capital investment per capita in Australia is less than one-third of the levels of the USA, and half that of the UK. Despite having one of the largest pension schemes in the world, start-ups aren't getting the financial support they need – super's share of VC investment has fallen from 60 per cent to 30 per cent over the last decade.

“WE NEED TO CONSIDER HOW “MY FUTURE, MY SUPER” SHOULD FOCUS MORE STRONGLY ON NET RETURNS RATHER THAN FEES”

The picture isn't any better when we look at bank lending. RBA data shows that while lending to large firms is growing, the total value of small business lending has been stagnant since before COVID-19, and unsecured lending is almost invisible.

This is not a quick fix. But we could start by not doing things that make the situation even worse – like the government's push to tax unrealised gains on superannuation.

We need to consider how “My Future, My Super” should focus more strongly on net returns rather than fees; how updates to limits on deal size for venture capital partnership structures could help; and how to remove barriers to business lending.

Assess infrastructure spend

Business productivity is one thing, but with the public sector responsible for an increasing share of Australia's economic activity, it can't be all up to the private sector. One of the best places to start is infrastructure spending. We have had two recent reviews of federal infrastructure that have been scathing, finding that many projects lacked merit and did not meet national investment priorities.

We need a pipeline with rigorous and comparable cost-benefit analyses, and post-implementation reviews to identify why costs blow out. We need to set more realistic budgets up front, and postpone non-urgent spending that is driving construction costs. A more rigorous assessment of infrastructure spending must be part of a stronger culture of bang-for-buck government spending.

Lastly, Australia's tax system needs reform to increase productivity. Outside of the mining sector, capital investment is at historical lows, and we are now a net capital exporter. The tax system can influence this. Stamp duty is a drag on productivity. States need help from the federal government to address this. Tax cannot continue to be ignored.

Productivity might not grab headlines quite like the theatrics of question time, but it is the measure we can't afford to ignore any longer.



Navigating Australia's Tax: Insights from the 2023 Intergenerational Report

Australia's fiscal framework is set to experience profound change in the coming decades, with demographic, technological, and economic shifts challenging traditional revenue models. The 2023 Intergenerational Report underscores that a stable and sustainable tax system will require careful navigation of these evolving forces. From the impact of an ageing population to the rise of renewable energy, here's how the next 40 years might reshape Australia's tax policy landscape—and what steps policymakers can take today to prepare.

The Ageing Population: A Growing Challenge for Income Tax Revenue

Australia's demographic profile is transforming. People are living longer, and the population is skewing older as birth rates decline and life expectancy rises. According to the report, by 2063, people over the age of 65 will make up nearly a quarter of Australia's population, up from around 16% today. This will place substantial pressure on public spending, especially in healthcare, aged care, and pensions. But it will also directly impact tax revenue, particularly in personal income tax, which is the largest source of government revenue.

Currently, Australians over 70 contribute only modestly to the income tax base, with roughly 12% of this demographic paying any income tax at all. As the share of older Australians increases, the pool of taxable income will shrink in proportion to those of working age.

Fewer working-age Australians will need to support a growing dependent population, which is likely to prompt innovative policy adjustments to maintain the revenue base.

Encouraging older Australians to remain in the workforce for longer, for instance, could help offset some of the decline in income tax contributions. Policy options might include incentives for employers to hire and retain older workers, targeted training programs to keep skills current, and potentially reformed retirement age guidelines to reflect longer lifespans. Such measures would aim to maintain income tax stability by increasing workforce participation across all age groups, particularly among those who may wish to work beyond traditional retirement age.

GST: Pressure from Changing Consumption Patterns

The Goods and Services Tax (GST) currently provides a steady revenue stream, but demographic and economic shifts may challenge its sustainability over the coming decades.

Notably, the ageing population is expected to drive demand for GST-exempt services like healthcare and aged care. The growth in these sectors could erode the GST base, reducing its contribution to government revenue even as demand for government services rises.

Considerations for the future might include revisiting the GST base or examining exemptions. Countries worldwide have experimented with various approaches to manage consumption tax sustainability, including broadening tax bases, restructuring rates, or reconsidering sectoral exemptions.

In Australia, broadening the GST base to include more sectors or restructuring the current exemptions could help safeguard revenue.

However, such measures would need to balance revenue objectives with fairness and equity considerations, as increased costs on essential services could have wide-ranging social impacts.

GST adjustments would also need to account for shifts in consumer behaviour as technology and preferences evolve. The increasing digitalisation of commerce, for example, introduces challenges around international services and online purchases, which may require tailored GST policies to capture revenue from the digital economy.

The Decline of Indirect Taxes: Fossil Fuel Excise and Tobacco

Indirect taxes, especially excise taxes on fuel and tobacco, have historically provided significant revenue. However, lifestyle and technological changes are driving declines in these revenue streams, with major implications for Australia's long-term fiscal stability. The transition to electric vehicles (EVs), which Australia is embracing as part of its climate goals, will progressively reduce revenue from fuel excise, one of the government's most significant indirect tax sources. As more Australians shift to EVs, fuel excise could diminish, leaving a substantial gap in the revenue base.

Policymakers may need to consider new tax models that reflect modern transportation patterns. Options under consideration worldwide include road-user charges for EVs, which would apply a fee based on distance traveled rather than fuel consumption. Such measures aim to sustain road infrastructure funding without relying on fossil fuel use, aligning fiscal policy with sustainability goals.

Similarly, as tobacco use declines due to successful public health campaigns, the revenue

from tobacco excise is also decreasing. While a public health success, the decline in tobacco consumption underscores the importance of adaptive tax policies that can accommodate such shifts. The government may need to explore new excise tax opportunities that align with current consumption trends, such as taxes on e-cigarettes or other emerging products, to maintain indirect tax revenue streams.

Bracket Creep and Wage Growth

Bracket creep, a less visible but significant factor, occurs when inflation and nominal wage growth push taxpayers into higher income tax brackets without an increase in real purchasing power. Over time, this phenomenon raises the average effective tax rate, which can help boost revenue but may place an increasing tax burden on middle-income earners.

The report indicates that wage growth and inflation are projected to persist over the coming decades, suggesting bracket creep will remain an issue. Adjusting income tax brackets periodically or indexing them to inflation could help mitigate this effect, ensuring taxpayers are not inadvertently pushed into higher tax rates as their nominal incomes rise. Regular recalibration of brackets would also enhance public perception of the tax system's fairness and responsiveness to economic conditions.

Superannuation Concessions: A Rising Cost Superannuation, designed to provide a secure retirement income and reduce reliance on the public Age Pension, comes with substantial tax concessions. As superannuation balances grow over time, these concessions are projected to expand as a percentage of GDP. According to the Intergenerational Report, superannuation concessions could eventually exceed Age Pension expenditures, potentially impacting Australia's fiscal position.

To address this, policymakers have introduced reforms targeting high-balance superannuation accounts, aiming to contain costs while preserving incentives for retirement savings. This approach reflects a balancing act between ensuring superannuation sustainability and managing the growing cost of concessions. Future reforms may explore additional ways to refine these concessions, potentially focusing on higher-income brackets to alleviate the cost without discouraging average Australians from saving for retirement.

Corporate Tax in a Global Economy: A Shrinking Revenue Stream?

Corporate tax, a critical revenue source, faces unique challenges in a globalised economy. Factors such as digitalisation, international competition, and evolving corporate structures are contributing to a relative decline in corporate tax contributions. With more companies operating across borders and profits increasingly shifting to lower-tax jurisdictions, Australia's reliance on corporate tax could prove precarious.

To counteract these trends, Australia could explore new approaches to corporate taxation, particularly in the digital economy. For instance, many countries are considering or have implemented digital services taxes on large tech corporations to capture revenue from online sales and services delivered across borders. Australia is also engaged in international efforts, such as the OECD's Base Erosion and Profit Shifting (BEPS) project, which seeks to curtail tax avoidance by multinational companies and ensure they pay a fair share of tax based on the economic activity conducted within each jurisdiction.

These efforts could bolster Australia's corporate tax base in the future, but additional measures may still be needed to maintain corporate tax revenue as a reliable funding source. Diversifying the tax base to lessen reliance on corporate tax could provide a more stable fiscal foundation in an era of heightened global competition.

Climate Change, Renewable Energy, and New Tax Opportunities

As Australia moves toward its climate goals, the tax landscape is set to transform in line with a greener economy. Transitioning to renewable energy and meeting net-zero emissions targets may offer new revenue opportunities, but they will also challenge existing tax structures. Traditional tax bases tied to fossil fuel production and consumption will shrink as clean energy grows. Policymakers may need to identify new sources of revenue that align with environmental goals.

Green energy taxes, carbon pricing, or other environmental levies could provide avenues for revenue while encouraging sustainable practices. Additionally, Australia's abundant critical minerals, essential for clean energy technologies like batteries and electric vehicles, represent a potential source of export revenue. If carefully managed, revenue from critical mineral exports could offset some of the declines in fossil fuel-based revenue.

However, a transition to green taxes would require careful planning to avoid overburdening industries critical to the green economy. Policies that incentivise investment in clean technology, coupled with a fair tax regime, could support sustainable growth and help Australia navigate the fiscal implications of a net-zero transition.

Securing Australia's Tax Future: Potential Directions for Policy

The 2023 Intergenerational Report paints a complex picture of Australia's tax future, one that will demand adaptive, forward-thinking strategies to balance revenue needs with a fair and growth-supportive tax environment.

Here are some potential policy directions based on the report's findings:

Encouraging Workforce Participation Across Age Groups: Policies aimed at boosting workforce participation, particularly among older Australians, could sustain personal income tax revenue. Providing incentives for businesses to retain older workers and investing in skills training could keep experienced individuals contributing to the economy.

Modernising GST for a Changing Economy: Revisiting the GST base to adapt to changing consumption patterns and broadening the base to include more goods and services could help maintain this vital revenue stream. Policymakers might consider options that respect equity while ensuring GST keeps pace with the needs of a modern economy.

Adapting Excise Taxes for New Lifestyles: With fuel and tobacco excise revenue projected to decline, alternatives such as road-user charges for electric vehicles or taxes on emerging products may be necessary. These would ensure continued support for public infrastructure and services in line with shifting consumer behaviour.

Managing Bracket Creep: Regularly adjusting income tax brackets could prevent unintentional tax increases due to inflation. Policymakers may consider indexing tax brackets to inflation or implementing periodic adjustments to preserve purchasing power for middle-income Australians.

Refining Superannuation Tax Concessions: Continued review of superannuation concessions, particularly for high-balance accounts, can help manage the growing cost of these incentives. Future reforms may focus on ensuring that concessions remain sustainable and targeted.

Strengthening Corporate Taxation in a Digital Economy: Engaging in global efforts to counteract tax avoidance and adapting corporate tax policies for the digital economy could preserve revenue from multinational corporations. Implementing fair taxation for digital services and e-commerce could help Australia capture revenue from the expanding digital sector.

Exploring Green Taxes: As Australia's economy transitions towards clean energy, green taxes and carbon pricing mechanisms may offer sustainable revenue streams. Balancing these with incentives for green technology investment could support both fiscal stability and environmental goals.

A Future of Fiscal Flexibility

Australia's path to a resilient, adaptive tax system will depend on the policy choices made in the coming years. As the Intergenerational Report underscores, maintaining fiscal stability in the face of demographic and economic transformation will require a careful balance of fairness, innovation, and pragmatism. By proactively addressing these changes, Australia can secure a tax system that not only funds essential services but also supports a prosperous, sustainable economy for generations to come.

For more details, the full report is available on the Australian Treasury website.



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-Alex Harper
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Replacing Corporate Income Tax with a Cash Flow Tax

Ross Garnaut

Ross Garnaut is an economist with a distinguished career in economic policy, development, and international relations across Australia, Asia, and the Pacific. He holds numerous academic and professional roles, including Professor Emeritus at the University of Melbourne, Fellow of the Australian Academy of Sciences, and Distinguished Fellow of the Economic Society of Australia. Ross has been involved in various high-profile institutions, such as the Australian National University, where he played a pivotal role in building research on Southeast Asia, China, and South Asia.

He has authored 48 books and numerous articles on international economics and public finance and has served on editorial boards since 1989. His leadership extends to senior government roles, including as Australian Ambassador to China and principal economic adviser to Prime Minister Bob Hawke. He led the 2008 Garnaut Climate Change Review and has held various positions in prominent Australian and international companies.

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Abstract

We design a parsimonious cash flow tax for Australia and estimate revenue effects. It allows immediate deduction of all capital expenditures, denies deductions of interest payments, and compensates negative cash flows at the same rate and time as it taxes positive cash flows. It allows taxpayer timing choice on implementation over 10 years. It has incentive effects comparable to lowering the corporate income tax rate to zero. It removes distortions that artificially favour debt over equity, short- over long-term investments, rents over competitive returns, large, established over small and new businesses, and conventional over innovative investments. It closes international tax evasion loopholes. Its spur to investment and timing of revenue impacts favours implementation in recession.

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1. Governments have been Cutting Corporate Income Tax Rates

This paper sets out an alternative approach to corporate income taxation that aims to reduce or remove the main weaknesses of the established approach. The authors see it as a change that would generate large benefits for long-term economic growth, and involves relatively small disruption to established administration of the corporate tax laws.

It happens to be useful to the current macro-economic circumstances.

A corporate taxation model for the twenty-first century has to take account of a number of realities: greater mobility of capital, giving rise to an international 'race to the bottom' in taxation rates to attract and retain investment; increasing international payments for management and intellectual property fees in deductions from assessable income; increasing opportunities for tax avoidance and evasion through transactions across international borders; an expansion in the proportion of rent and decline of competitive returns on capital in corporate income; a decline in the competitive position of national against multinational corporations arising out of the former's more limited opportunities for tax avoidance and evasion; a declining national tax compliance culture; and growing resentment of 'globalisation' arising out of multinational enterprises' tax avoidance and evasion.

Public concerns about these matters have contributed to the reaction against 'globalisation' and to growing mistrust of market exchange. Over the last decade or so governments have been cutting their rates of corporate income tax, ostensibly to attract foreign investment to their jurisdictions or to hold onto foreign investment when competitor countries cut their tax rates. The economic justification given is that capital is mobile internationally and will gravitate to countries with low corporate income tax rates. In this competitive race to reduce corporate income tax rates, less emphasis is placed on the base of the corporate income tax, despite its capacity to exert at least as much influence on after-tax returns on competitive investment as the tax rate.

The empirical evidence on the effect of corporate income tax rates on investment decisions is not compelling. The case is often argued from a model that assumes unrealistically that there is perfect competition in all relevant markets.

Even in competitive situations, other considerations are highly influential on investment decisions, including the tax base, sovereign risk, the independence and transparency of regulatory and legal systems, foreign exchange restrictions, work-force skills, and

geographic location. Nevertheless, governments remain under pressure to reduce their corporate income tax rates. This is problematic for financial stability, for the continued supply of public goods that are essential for the efficient operation of the economy, and for equitable income distribution. The rigorous application of economic principles has led us to search for systems of taxation that have low incidence on returns on capital operating in a competitive market, and high incidence on economic rent.

This paper suggests a major change in approach to taxing corporate income. It proposes changing the corporate tax base, from a conventional view of income to cash flow.

This increases the incidence of the tax on economic rent, and reduces the incidence on competitive or ‘normal’ returns on investment. It improves the trade-off between the amount of revenue collected and the amount of welfare-enhancing investment.

Our proposed cash flow tax is relatively simple to administer, applying familiar and well-tested measurements of the taxation base. It has a strongly positive effect on incentives for investment of mobile capital compared to existing corporate income taxation schemes. When applied in a single country, its effect on investment incentives is comparable to that of a corporate income taxation rate of zero—so removing the international ‘race to the bottom’.

It removes an important distortion in traditional approaches to taxation: the artificial promotion of debt over equity, which has adverse consequences for financial efficiency and national economic stability.

By abolishing the distinction between recurrent and capital expenditure, it removes a disincentive to long-lived and capital-intensive

investment that is a feature of the current tax system. It removes and reverses a bias in the current taxation system that favours low-risk investment and does not support innovation. It removes major contemporary avenues for large-scale avoidance and evasion of corporate taxation. It avoids one important source of inequality in the distribution of income in developed countries.

Introduced in a deep recession as it would be in Australia in 2020–21 its revenue impact would be expansionary, with the reduction of revenue withdrawn automatically over time.

Like any change in taxation arrangements, moving to the proposed system would impose some deadweight costs. By allowing tax-payers a choice over a decade of the year of transition from the old to the new system, we would minimise disruption. Second, the proposed denial of deductions for royalties on foreign intellectual property an important feature of our proposal that could be introduced into the conventional corporate tax regime as well might be seen as reducing incentives for global innovation. We judge that this effect will be negligible and more than offset by increased incentives for innovation in Australia.

2. Rent Taxes and the Ideal of Neutrality in Taxation

If the objective is to maximise national income, taxes should not affect investment decisions; that is, taxation should be neutral.

There is a general exception to the neutrality principle where a tax corrects for negative spillovers from an investment decision—such as water pollution and carbon emissions.

In the absence of defined spillovers, taxes that distort investment decisions result in deadweight losses to society.

It is in the nature of economic rent that its taxation does not reduce incentives for investment. The search for neutrality in taxation is in the first instance a search for economic rent as the tax base.

Investors make decisions based on the expected net present value (ENPV) of an investment proposal. The net present value (NPV) of an investment is the value of future positive cash flows minus future negative cash flows discounted to the present at an appropriate interest rate. The ENPV of a possible investment is the weighted average of possible NPVs, with the weights being determined by the probability of each possible outcome.

Tax neutrality is generally achieved when an investment offering a positive ENPV before tax maintains a positive ENPV after tax. Corporate income tax renders sub-marginal any investment that is expected to achieve before tax no more than the normal return on investment obtainable in competitive markets (and some investments with well above normal returns). It does this in two ways. First, it requires investors to deduct their capital expenditures not immediately but over time in accordance with legislated depreciation schedules, ensuring the NPV of those deductions is less than the NPV of the actual expenditures.

Second, it allows only incomplete deductions for losses, which especially disadvantages small, innovative businesses.¹ Corporate income taxation is applied to the normal or competitive return to capital. As a result, an investment that yields a positive ENPV before tax at a discount rate reflecting a normal return may yield a negative ENPV net of the standard corporate income tax.

For an investment to qualify, the ENPV of an investment in a competitive part of the economy

therefore must be expected to earn a before-tax return in excess of that which would support a positive investment decision in the absence of taxation. A higher rate of standard corporate income taxation would make it harder for investors to achieve their 'hurdle' rates of return. A country that applies a higher standard taxation rate will lose out in competition for investment in competitive sectors of the economy with another country applying a lower tax rate to investments that have exactly the same commercial parameters before taxation in the two countries.

In contrast, a two-sided cash flow tax (with negative and positive cash flows being augmented or taxed at the same rate) does not change the sign of the ENPV of an investment; if the proposed investment has a positive ENPV before tax it will maintain a positive ENPV after tax.

There is one significant exception to the rule that a two-sided cash flow tax will not affect decisions on whether to commit to an investment. Different investors have different attitudes to risk and losses. Investors are generally understood to be averse to risk and to loss (Tversky and Kahneman 1991; Hwang and Satchell 2010), and will value an investment with a lower spread in returns more than one with higher spread, even if they have the same ENPV. Investor risk-aversion has long been understood to have negative consequences for overall investment and the severity of downturns (Keynes 1936; Zeira 1990; Castro, Clementi and MacDonald 2004).

The taxation of positive cash flows and compensation of negative cash flows at the same rate compresses the probability distribution of expected after-tax outcomes; that is, it makes investments less risky. A two-sided cash flow tax may therefore affect investment decisions positively, by reducing risk. This particular source of non-neutrality of a two-sided cash flow

tax has the potential to raise incentives to invest and gross national income (GNI) above levels in the absence of taxation.

In some circumstances, rent taxation can reduce economic distortions. To the extent that not all expenditure or money or effort on lobbying for policy change is a deductible expense, it reduces the returns on rent-seeking behaviour. This may raise economic output by reducing the amount of resources dissipated in economically unproductive rent seeking (Tullock 1980; Krueger 1974), or reduce the negative impact of regulatory distortion to protect firms from competition.

Hence an appropriately designed cash flow tax is nearly neutral and to the extent that it is not neutral, it is non-neutral in desirable ways. It is neutral with respect to whether investment ENVP is positive or negative, because its tax base is the economic rent component of corporate income. It is non-neutral in reducing investor risks associated with economically valuable investment, and reducing payoffs for economically unproductive rent-seeking.

Beyond its contribution to economic welfare through increased incentives to productive investment, rent taxation reduces the impact of a rapidly growing and economically unproductive contributor to rising inequality. A large and growing presence of rent tends to increase income and wealth inequality, owing to the narrow ownership of the scarce assets that attract rent. Unlike standard progressive taxation of personal income, rent taxation is progressive without adversely affecting incentives for participation in economically valuable activity.

3. Types of Rent

Economic rent is payment to a factor of production in excess of the minimum required to attract it to, and hold it in, the activity in which it is engaged. In the case of firms, rent is profit above

that which is necessary to attract the economically optimal amount of investment into an activity—returns in excess of the supply price of competitive capital. Rent is the return in excess of ‘normal profits’. Rent persists because competition in the supply of a particular good or service is imperfect or, in some cases, non-existent.

One apparent source of economic rent is the temporary excess profit that occurs following changes in economic equilibria, which takes time for competition to erode—the phenomenon that Marshall called quasi rent (Marshall 1890).

This cannot be taxed away without risking under investment in future productive innovation. It is not accurately described as rent. Investment that generates quasi-rent is not discouraged by the two-sided cash flow tax proposed in this paper. Investments to generate future income are reimbursed at the same rate at which revenues from the innovation are taxed.

Economic rent arises whenever the presence of high profits in an economic activity fails to induce expansion of supply to reduce prices and profits to normal or competitive levels. The restriction on entry may arise because production requires a specific resource, the supply of which cannot be augmented by investment. Examples include urban and agricultural land and mineral resources.

Land and mines that can produce valuable product at lower costs than others, or which are favourably located, cannot be reproduced through investment. The restriction may arise because there are overwhelming economies of scale that make it impossible for a newcomer to compete as in a network, or an economic activity where lowest cost scale of production is very large compared with the size of the market. They may arise because incumbents earn exceptionally high returns because they happen to have established an oligopolistic position in the market and are prepared to invest part of those returns

in predatory behaviour to protect their market power. The restrictions may exist because government law or regulation blocks new entrants. Different sources of rent can interact with and reinforce each other.

Some but not all restrictions that allow rent to persist are economically inefficient. Inefficient rent may be the result of regulatory barriers to competition that serve no public interest. Others arise from privately created monopolies that are in a position to maintain and to exercise market power. It is in the public interest to eliminate these inefficient sources of rent by removing barriers to competitive entry, or by actively promoting competition.

There are several types of rent that emerge from restrictions that increase economic efficiency. One category results from exclusive ownership of a specific land or mineral resource.

There is a sense in which the absence of competitive access to the resource is the result of government action—through the defining and enforcement of private property rights. In the absence of this restriction on competition, private incentives would lead to overall investment in the use of the resource in excess of levels that maximise the value of output. For example, cost-minimising exploitation of an alluvial gold deposit may allow maximisation of economic value with 1,000 workers employed over 10 years, with half of the value of output accruing as mineral rent to the owner of the resource.

A free-for-all in a gold rush may see the same or a lesser quantity of gold being mined and revenue achieved with 4,000 miners working for 5 years. The equivalent of 10,000 worker-years of labour would have been wasted. This is one example of the general phenomenon of ‘the tragedy of the commons’.

Access to urban land is a special case.

Planning regulations are necessary to restrict investment to levels that maximise economic value. In the absence of planning restrictions, there is likely to be over-development of favourable sites, to the point where total economic value is diminished. Here a judicious balance has to be struck between the public interest in full use of the resource, and the public interest in avoiding dissipation of value in overcrowding.

A second category of efficient rent results from government protecting private use of intellectual property resulting from scientific or technological or intellectual or artistic creation. The restriction increases incentives for economically productive investment in innovation, at the same time as it restricts the value generated from access to each creation. As with urban planning, a judicious balance between competing sources of value is necessary for economically optimal outcomes. A third category of efficient rent is ‘natural monopoly’, associated with ownership of a network, or a physical asset with overwhelming economies of scale, or the two together.

Examples of network monopolies are provided by the main information technology and social media platforms. Examples of overwhelmingly large economies of scale include some manufacturing activities (e.g., Diewert and Fox 2008; Angeriz, McCombie and Roberts 2008; Romero and McCombie 2016).

Examples of the two together include electricity transmission, gas pipeline and telecommunications hardware systems. Duplication of investments in a natural monopoly may waste resources while the absence of competition allows the owner of the established assets to maintain high prices and profits at the expense of community welfare.

Some activities generating efficient rent can be subject to regulation of activity or price to increase total economic value. Whatever the source of rent, and however rent may be constrained by regulation,

rent can be subject to taxation without sacrifice of economic value.

4. The Prevalence of Rent

The share of rent in GDP has varied widely in the course of modern economic development.

The rent of agricultural land was at the heart of classical economics (Ricardo 1817) and the economic and political systems from which it grew, with agricultural land comprising around half the wealth in Western Europe in the early nineteenth century (Piketty 2013). The rent of private ownership of slaves contributed a large proportion of US income at that time, and the capital value of slaves constituted about half of all wealth in the southern states by the mid-nineteenth century (Piketty 2013).

Mineral rent has been the main source of income in some resource-rich countries since the beginnings of the modern economy, and was important globally in the immediate aftermath of the oil price leaps in the 1970s. Rent from the concentration of private ownership of business assets was at the centre of the great fortunes of late nineteenth and early twentieth century America, and its reduction the policy focus of President Theodore Roosevelt (Morris 2001).

In the decades from the late twentieth to the early twenty-first century, rent has expanded its share of total income. Rent on urban land has grown in parallel with the populations and economic predominance of large cities.

Its importance in many countries now rivals that of agricultural land in early nineteenth century capitalism. The United States, and increasingly China, have seen growth in rent from monopoly control of new intellectual property and from the natural monopolies of information technology networks. Vast new fortunes in the developing world have come disproportionately from private control of natural monopoly utilities and natural resources. In Australia, a high and, over recent

decades, an increased proportion of incomes has emanated from rent-heavy sectors, notably mining, urban real estate, information technology, financial services and large-scale retailing.

In the United States, where the macro and micro evidence base is developing most rapidly, a range of recent economic analyses has identified an increasing proportion of rent in income from the early 1980s. From 1980 to 2016, returns in excess of normal profits as a share of GDP have grown between four and five fold (De Loecker and Eeckhout 2017, 2018; De Loecker, Eeckhout and Unger 2020). See similar findings in Kurz (2017), Dixon and Lim (2017), Barkai (2016) and Díez et al. (2018). This was the central focus of Olivier Blanchard's Presidential Address to the American Economics Association in 2019 (Blanchard 2019).

The rise in rent accompanies increases in market concentration, especially in banking, healthcare and ICT (US Council of Economic Advisors 2016; Autor et al. 2017). The US economy has bifurcated into an abundance of firms with low returns and a narrow band of firms with super-profits: returns for firms that were in the top 10 per cent by profitability rose from 20 per cent per annum in the mid-1980s to around 100 per cent per annum in recent years. Rent has become more persistent: the odds of a super-profitable firm still being super-profitable 10 years later have doubled since the 1990s to 85 per cent (Furman and Orszag 2015).

The pattern of growing rent is present in many countries. De Loecker and Eeckhout (2018) find that global average mark-ups have increased by 52 percentage points since 1980. The increase in G7 countries ranges from around 30 to almost 150 percentage points.

Ingles and Stewart (2018, p. 20) refer to various Australian and US estimates suggesting the normal return on investment represents between 30 and 60 per cent of the corporate return, with various rents constituting the remainder. Murphy (2018, Table 2, p. 6) estimates that 41 per cent of Australian

corporate income tax revenue is from rent.

5. Cash Flow Taxes as Rent Taxes

An early version of a cash flow tax was proposed by E Cary Brown (Brown 1948). The Brown Tax compensates investors for negative cash flows at the tax rate and taxes positive net cash flows at the same rate. The two-sided Brown Tax cannot change the sign of the ENPV of a potential investment from positive to negative.

In a Brown Tax, financing costs are not deductible expenses. Consequently, the Brown Tax cannot distort financing choices between debt and equity, whereas corporate income tax, which allows for interest deductions, favours debt over equity. The Brown Tax is based on annual cash flows. It allows the immediate deduction of capital expenditures, whereas corporate income tax allows for capital expenditures to be written off over time in accordance with legislated depreciation schedules. In years when cash outflows exceed cash inflows, producing negative cash flows, the government pays to the investing company an amount equal to the negative net cash flow multiplied by the rate of Brown Tax.

This feature makes the Brown Tax a two-sided tax. While the Brown Tax is efficient in its neutrality and elegant in its simplicity, the obligation of the government of the day to make cash payments to companies may not be politically acceptable in some circumstances. An alternative cash flow tax is the Resource Rent Tax (RRT) proposed by Garnaut and Clunies Ross (1975) and further developed by Emerson and Garnaut (1984) and Garnaut and Clunies Ross (1983).

Rather than the government making cash contributions to negative net cash flows as they occur, the RRT provides for them to be carried forward at a risk-adjusted interest rate to be offset against future positive net cash flows.

This accumulation rate is the risk-free long-term government bond rate plus a risk premium designed to raise the accumulation rate to the

investor's hurdle rate or supply price of investment. In taxing jurisdictions where sovereign risk is high, and if the particular investment is considered highly risky, the supply price of investment will be high. The accumulation rate will need to be correspondingly high if the discouragement of investments that would be attractive in the absence of tax is to be avoided. The RRT is, therefore, a one-sided tax; it shares in positive NPVs but not in negative ones. It can change the sign of the ENPV of an investment from positive to negative and therefore is not strictly neutral. However, it is more nearly neutral than corporate income tax and most other taxes in practical application around the world (see Garnaut and Clunies Ross 1983 for comprehensive comparisons).

An operating example of the RRT is the Petroleum Resource Rent Tax (PRRT) introduced by the Australian Government in 1987 for application to offshore petroleum developments. The initially legislated accumulation rates for the PRRT were, for exploration expenditure, the long-term bond rate plus 15 percentage points, and for other expenditure the long-term bond rate plus 5 percentage points. These and other features of the PRRT were reviewed in 2017 and the accumulation rate for exploration was reduced to the long-term bond rate plus 5 percentage points. The rate of the PRRT is 40 per cent.

The data required for assessment of PRRT is essentially the same as that required for application of the corporate income tax. It can therefore rely on established tax law and practice—now augmented by two decades of application of the PRRT itself.

A 2010 review of Australia's tax system chaired by then Treasury Secretary Ken Henry (Australian Treasury 2010) recommended a hybrid of the Brown Tax and the Resource Rent Tax for application to mining income.

Its Resource Super Profits Tax (RSPT) was to apply to all Australian mining income. The RSPT would

allow negative net cash flows to be carried forward at the Commonwealth bond rate for offsetting against future positive net cash flows.

If the investment was abandoned at some time in the future when accumulated cash flows were negative, the government would make a payment to the investor equal to the negative accumulated value multiplied by the tax rate. This payment made the RSPT to some extent two-sided—to the extent that the government's commitment to make the future payment was credible, and that the Commonwealth bond rate corresponded to the opportunity cost of capital during the period in which the negative cash flows were being carried forward.

Following the Australian Government's announcement of the RSPT in the 2010 Budget, the Minerals Council of Australia (MCA) invested heavily in an advertising campaign aimed at defeating the tax. Many of its criticisms did not have an analytic basis. One did. Businesses were being expected to rely on government-legislated assurances that negative net cash flows carried forward would be the subject of a cash refund from a future government. Since this accumulation process could be conducted over decades, rational investors would take account of the risk of these deductions being disallowed through amending legislation. It is reasonable to doubt whether a future government would be certain to honour a distantly preceding government's commitment to provide large cash refunds on unsuccessful investments.

Following the 2010 election, the Australian Government abandoned the RSPT, introducing in its place in 2012 the Minerals Resource Rent Tax (MRRT) at the rate of 22.5 per cent. This took the form of the PRRT, with special arrangements for historical deductions. The coverage of the MRRT was limited to iron ore, coal and natural gas.

An historical cost base for existing projects was negotiated with the mining industry, with the effect of wiping out expected liability for MRRT for a number of years ahead. As deductions from the cost base began to approach exhaustion for some companies, the incoming Australian Government following a 2013 election scrapped the MRRT.

Another approach to rent taxation is the allowance for corporate equity (ACE). It adjusts the normal corporate income tax base by deducting an allowance calculated as a normal, competitive rate of return multiplied by the equity value of the company. In this way, the ACE seeks to exempt from tax the normal, competitive returns on investment, taxing only economic rent. The ACE tax rate would need to be high in order to collect the same amount of revenue as the existing corporate income tax that it would replace.

The ACE is a variant of a general rent tax proposed by Boadway and Bruce (1984), which has become known as the allowance for corporate capital (ACC). Instead of allowing a deduction for a return on equity, as with the ACE, the ACC allows a deduction for a return on debt and equity combined, but interest payments are not deductible.

Recognition of the increasing role of economic rent in corporate income and its perverse effect on economic efficiency and equity in income distribution has led in recent times to the proliferation of suggestions for alternative approaches to taxing rent. For example, Collier (2018) has argued for higher taxation on incomes of large enterprises and of residents in large cities as a way of concentrating taxation more heavily on rent. We see larger gains and smaller losses in seeking an increase in the incidence of taxation on economic rent through an

appropriately designed cash flow tax.

Discussion of and experience with alternatives leads us to favour the efficient and elegant two-sided Brown Tax.

6. Previous Modelling of Rent Taxes

Various efforts have been made to model the fiscal and macro-economic effects of substituting rent taxes for corporate income tax, or of reducing the corporate income tax rate while introducing a rent tax at a low rate. Prominent among these are the computable general equilibrium (CGE) modelling exercises of Murphy (2018) and Dixon and Nassios (2018) in Australia, and Altig et al. (2001) in the United States.

One of Murphy's modelling runs replaces the corporate income tax with the ACC while retaining full dividend imputation. He obtains a gain to consumer welfare of \$18 billion but at a cost to revenue of \$26 billion.

A more modest proposal involves reducing the corporate income tax rate from 30 per cent to 25 per cent and introducing a rent tax at the rate of 8 per cent on the financial sector only. Murphy estimates that, when the effects of the change have fully flowed through the economy, this proposal would collect the same amount of revenue as the established corporate income tax at a rate of 30 per cent, with a welfare gain of \$5.4 billion.

Murphy's estimates of the gains rely on an assumption that there would be substantially less tax avoidance by multinational corporations at lower rates of corporate income tax.

There is no empirical or analytic support for this assumption. More generally, Murphy advocates a corporate income tax rate of 20 per cent, a financial services rent tax and major changes to the dividend imputation system.

While Murphy estimates the impacts at a point in time after economic adjustment to the new regime, Dixon and Nassios track the path of the

adjustment over time. Dixon and Nassios track the effects of reducing the corporate income tax rate to 25 per cent. They take into account the welfare losses to Australian nationals from giving foreign investors a windfall gain on their preexisting Australian investments made in the full expectation of a 30 per cent corporate income tax rate. Dixon and Nassios conclude that the reduction of the tax rate would lead to a fall in national income.

Based on their own tax design analysis and Murphy's modelling, Ingles and Stewart (2018) suggest various options, including combining corporate income tax at a lower rate with a tax that denies interest deductibility and ultimately replacing the corporate income tax with a rent tax.

Altig et al. (2001) simulate five possible cash flow tax reforms in the United States. Some of these variants have properties that are improbable in the Australian and indeed the US context, such as the removal of progressive taxation or the application of the tax to housing wealth.

Each of the five cash flow taxes is expected to raise investment and national income. The variants closest to our model provide the highest national income and wage gains, of three to six percentage points over 13 years, with gains continuing to grow into the future.

By broadening the tax base, they also allow for the lowest capital income taxation rates.

The models lack details appropriate to the contemporary Australian context, including the treatment of intellectual property and services, mechanisms of investment expensing, and international tax arbitrage, and are, of course, modelled using US economic data.

7. Replacing Corporate Income Tax with a Cash Flow Tax

We propose replacing the corporate income tax with a form of cash flow tax that has the two-sided

character of the Brown Tax. The cash flow tax would have as its base net cash flows, being taxable revenues (excluding any interest income) less non-financing cash out-lays (operating costs plus capital expenditure, but with no allowance for interest or other financing costs). The accounting data for revenues and expenditures would be exactly the same as for corporate income tax and the PRRT, so that established case law would apply. No distinction is drawn between capital and recurrent expenditure.

For typical capital-intensive projects, net cash flows in the early years will be negative. Negative cash flows could also arise late in the life of a project when large capital expenditure is required for refurbishments or dismantlement of ageing assets such as oil and gas platforms or, possibly, in years of low prices and sales revenue. In years when negative net cash flows are recorded, we propose that an amount equal to the negative net cash flow multiplied by the tax rate be certified by the Australian Taxation Office (ATO) and rebated to the taxpayer. If political judgements weighed against a straightforward rebate, the certified cash loss could be made available for offset against any cash flow tax payable by any entity. The taxpayer would be permitted to sell the certified amount to another company for offset against its own current cash flow tax liabilities. The private sector, the Australian Securities Exchange (ASX) or the ATO could create a market for such offsets, which would trade at face value minus transaction costs.

8. Specific Design Issues

8.1 Treatment of the Financial Sector

Our analysis of the treatment of financial flows under a cash flow tax follows the structure laid out by the Meade (1978) Committee on UK tax reform, which has since become conventional. The Committee drew a distinction between flows resulting from real transactions and those from purely financial transactions.

Non-financial firms will face incentives to disguise some real flows as financial flows.

As suggested in Auerbach et al. (2017), quasi-financial transactions, such as delayed payment schemes, would be treated as real flows. Non-financial firms engaged in limited but substantial financial activities over a specified threshold may be obliged to submit tax returns

8.2 Countering Base Erosion and Profit (US President's Tax Reform Panel, 2005) but excludes financial flows from its coverage.

We propose avoiding these problems by combining an R-base cash flow tax for all except financial firms, with separate provisions for the taxation of financial firms. For simplicity, we propose taxing financial firms under the existing corporate income tax regime, but with the immediate expensing of investment. Taxable income for financial firms would be interest received minus interest paid, plus fees, minus current costs and capital expenditure. This modified corporate income tax the Financial Sector Income Tax (FSIT) is similar to the Financial Activities Tax, or FAT, proposed by IMF staff (Claessens, Keen and Pazarbasioglu 2010; Keen, Krellove and Norregaard 2016), and the Financial Services Tax proposed by Henry's Future Tax System Review (2010). Our proposal would require no changes in data collection compared to the existing corporate income tax so it can be readily implemented.

The FSIT would be applied at the same rate as the cash flow tax.

Multinational corporations shift profits to tax havens or to lower-tax jurisdictions through inflated related-party interest payments (from artificially high gearing or artificially high interest rates, or both); transfer pricing between related parties for sales (including through dedicated marketing hubs in low-tax jurisdictions); and

inflation of technology and management fees to affiliates. Global digital corporations are famously adept at using technology and management fees to shift profits to low-tax or zero-tax jurisdictions.

A cash flow tax removes tax avoidance problems arising from artificially high gearing and high interest rates for loans from related parties by excluding financial transactions from its base.

We propose removing problems from technology and management fees paid to foreign affiliates by allowing no deduction for imported services, unless the taxpayer demonstrates that they relate to current expenditure on goods and services directly required for the sale to the Australian taxpayer. For foreign investment in research and development, the presumption is that earnings from sales to Australia are an economic rent—except to the extent that they require specific expenditure on adaptation to Australian conditions. This is unlikely to cause any reduction in global research and development, given the small proportion of expected early sales to Australia in the technology firms' plans for investment.

Payments for Australian technology and other services would be deductible as in the current corporate income tax, but with immediate expensing of all expenditure on research and development. Immediate expensing with provision for compensation of negative cash flows at the tax rate would be highly encouraging of Australian investment in research and development. Existing incentives for Australian research and development have their justification in externalities and should not be affected by the changes in taxation.

An anonymous referee has commented that the proposal for denying deductions for imported services that are not directly related to sales to Australia could be introduced into the existing corporate tax system, independently of the shift to the cash flow tax. That would cause the existing

corporate tax to raise more revenue than it does now. While that is true, the treatment that we propose for imported services sits more comfortably within the logic of a rent tax than a standard corporate income tax. However, we have no objection to a reader choosing to see our proposed reform as a package of two reforms: the shift to a cash flow case for corporate taxation; and the proposed treatment of deductions for imported services.

The revenue effects of the proposed reforms are then the revenue effects of the package. Within this package, the denial of the deductions for imported services unless there is a direct link to provision of the services in Australia would account for about \$12 billion of the \$162 billion contributed by the Cash Flow Tax in 2029–30. The denial of the deductions for imported services would account for about \$73 billion of the \$1,180b contributed over the decade 2020–21 to 2029–30.

An anonymous referee has commented that our paper is directed to corporate income alone, and not to business income, and suggested that we should spell out how other business income would be treated. There would be additional efficiency gains in extending the proposal to all business income. That is an appropriate focus of future effort by a government committed to changing the standard corporate income tax to a cash flow tax. We have not included this extension of the proposal in our revenue estimates.

9. Arrangements for Transition and Effects on Revenue

We propose phasing in a cash flow tax while simultaneously phasing out the existing corporate income tax under an 'irrevocable switch' scheme. An irrevocable switch scheme enables any taxpayer to elect in any year in the first 10 years of the new tax system to immediately and fully switch from corporate income tax to cash flow tax. If there has been no prior election, the switch would occur after the 10th year.

We envisage the FSIT applying to financial institutions from the beginning of the transition. The FSIT is more favourable to banks than the established corporate income tax.

For this scenario we model the revenue impact of the reform with a 30 per cent tax rate. We take as the 10-year transition period 2020–21 to 2029–30."

Summary outcomes under each option for the final year of the transition period are presented in Table 2. The results relate to Australian companies with aggregated annual turnover above \$25 million. The methodology underpinning the calculations is provided in the Appendix.

By moving to a cash flow base, taxable income is increased by \$128.2 billion in 2029–30. If the cash flow tax rate were maintained at 30 per cent, the increase in tax collection above the existing corporate income tax is an estimated \$37.5 billion.

The transition path of the estimated tax payable under the irrevocable switch scheme over the period 2020–2021 to 2029–30 is presented in Figure 1. By the year 2029–30 the revenue for the cash flow tax is estimated to be \$179.1 billion and the revenue from corporate tax \$141.6 billion. Our modelling assumes 50 per cent of companies switch in the first year while the rest switch in the 10th year.

In our estimates of additional tax revenue under the cash flow tax, we have endeavoured to use the best available public data. We have sought to overcome the apparent behavioural bias in publicly available data sources collated by the ATO embedded in the ATO's International Dealings Schedule, which experts have told us may tend to understate taxable

Table 2 Estimated Taxable Income and Tax Revenues in 2029–30

<i>Tax scheme</i>	<i>Transition scheme</i>	<i>Taxable income (2029–30) \$ million</i>	<i>Diff. to company tax \$ million</i>	<i>30% Tax rate</i>	
				<i>Tax payable (2029–30) \$ million</i>	<i>Diff. to company tax \$ million</i>
Existing company tax		546,324		141,645	
New cash flow tax with FSIT	Irrevocable switch, immediate CAPEX deduction	674,561	128,237	179,095	37,450

Source: ISA Analysis with data from ATO, ABS, S&P Capital IQ and Ruthven Institute.

income reported in Australia.³ Our approach has also been sense-tested by professionals with deep experience in international dealings. We believe our projections are conservative, since they do not account for second-round efficiency gains that are likely to increase productive investment and other economic activity and hence contribute to larger revenues (as identified in Altig et al. 2001).

Why are the estimated revenues from taxing rent via the cash flow tax larger than from the standard corporate income tax?

Cross-checking of our estimates reveals that most of the estimated revenue gain is attributable to taxable entities with international dealings. These estimated revenue gains come from privately held companies, international branches of foreign owned and Australian-owned enterprises.

The proposed approach reduces revenue leakage associated with transfer pricing surrounding global supply of capital, intellectual property and conventional physical supply chains.

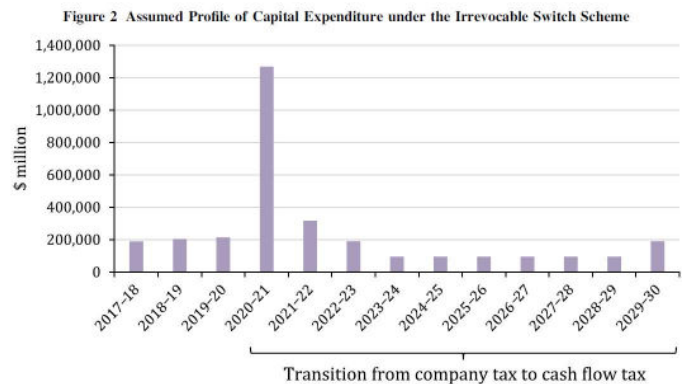
Material problems that arise around transfer pricing by consolidated operations include:

(i) contract production of factory-less goods (for example, Apple does not produce iPhones in Australia but charges the branch office for the intellectual property);

(ii) the creation of special-purpose entities where intellectual property is parked by foreign affiliates (for example, Ireland, a tax shelter, saw GDP jump by 26 per cent in 2015⁴ because of a one-off sale of a special purpose entity);

(iii) use of debt by large capital importers to reduce Australian income.

Figure 2 Assumed Profile of Capital Expenditure under the Irrevocable Switch Scheme



Source: Derived from ABS Cat.5206.0.

(iii) use of debt by large capital importers to reduce Australian income.⁵

10. Preferred Transition Approach

Companies that had incurred large amounts of debt in the period prior to the introduction of the cash flow tax, and have low expectations of capital expenditure in future, are likely to opt to remain in the corporate income tax system for as long as possible, enabling them to claim deductions for interest paid. Companies with big investment plans during the early years of the transition will have an incentive to switch to the cash flow tax, enabling them to immediately expense all eligible capital investment.

Still other companies might opt into the cash flow tax during the middle of the transition, having claimed interest deductions on prior investments for corporate income tax purposes and looking forward to obtaining the benefits of immediate expensing of new capital expenditures under the cash flow tax.

Firms incurring or expecting to incur negative cash flows as a result of recession are likely to opt for immediate transfer to the cash flow tax.

Financial companies would be subject to a FSIT from the beginning. This is the existing corporate income tax regime, but with immediate expensing of investment.

11. Conclusions

We have formed and tested the view that replacing the corporate income tax with a cash flow tax with the design set out in this paper would contribute substantially to efficiency and economic growth, and to a more equitable distribution of the tax burden. It would protect the Australian fiscal system from the contemporary ‘race to the bottom’ in international rates of taxation of corporate income, and it would remove a number of distortions inherent in the current system of corporate income taxation.

The cash flow tax would substantially improve the trade-off between the amount of tax collected

and incentives to invest in activities that would raise Australian output and incomes. It would remove taxation on normal profits the expected income of firms operating in a competitive environment. This would include most small and medium-sized businesses.

The cash flow tax would substantially increase incentives for investment or rather, remove powerful disincentives inherent in the standard corporate income tax for investment in capital-intensive, long-lived and more risky investments.

The cash flow tax would encourage investment in innovation, including, but not only, through research and development. It would do this by compressing the probability distribution of expected outcomes of investments—unsuccessful investments would be compensated at the cash

flow tax rate. The recoupment of ‘tax losses’ at the tax rate from early years of negative cash flows would also support the financing of innovative investments, including those requiring research and development.

The cash flow tax would systematically favour small businesses in comparison with their treatment under the standard corporate income tax. They are much more likely to attract tax losses because of the competitive environment in which they operate and the greater likelihood that their losses will never be recouped under established arrangements.

The cash flow tax would remove incentives to distort financing structures to avoid tax, by artificially inflating reliance on debt. This is likely to contribute positively to efficiency. The removal of artificial encouragement to debt financing would make the economy less vulnerable to financial crises.

The cash flow tax would remove or greatly reduce the main opportunities currently used for avoiding and evading Australian corporate income taxation artificially high interest payments and foreign technology. It would also remove a large, systematic bias in favour of foreign and larger enterprises against Australian-owned and smaller enterprises in the current corporate tax system, through removing opportunities for avoidance and evasion that are generally more readily available to foreign and larger enterprises.

The cash flow tax would be more equitable, because its incidence would be larger on high incomes, as a result of the concentration of ownership of corporations earning large amounts of economic rent.

The cash flow tax would reduce incentives

for rent-seeking pressures on government to introduce laws and regulations that reduce competition. It may therefore contribute to economic efficiency, output and incomes in two ways: by reducing the waste of resources in rent-seeking behaviour; and by reducing deadweight losses from regulatory distortions as a result of rent-seeking pressure on government.

Finally, the introduction of the cash flow tax now would be highly expansionary, at the time when the economy needs stimulus of demand. With taxpayers free to choose when they move to the new tax, those with large investment plans would shift to the new regime and be more likely to make larger and earlier investments. Companies, especially small businesses, incurring losses now in the pandemic recession would receive partial reimbursement for those losses. These sources of loss to the revenue are advantageous now on macro-economic policy grounds. The macro-economic stimulus would be automatically withdrawn as operating losses fall as the economy moves out of recession and early recipients of tax offsets for early investments qualify for smaller deductions in later years than they would have done.

We have designed the proposed cash flow tax to be relatively easy to implement, drawing mainly from concepts and data that are required in assessment of the current corporate income tax and Petroleum Resource Rent Tax. We have introduced transitional arrangements that would avoid sudden and large changes that detract substantially from the expectations of established businesses.

The best publicly available data has shortcomings, and we look forward to our estimates being improved by bodies like the Australian Treasury with the assistance of the ATO, which has access to more up-to-date data and a better understanding of the impact of recent international tax compliance initiatives.

We are confident that the various benefits to economic efficiency and economic growth outlined above would lead to a substantial increase in investment, productivity and incomes. There would be a decisive shift in the tax burden toward enterprises generating income from rent with little new investment, and away from businesses prepared to make large commitments to new investments. The increased incentives for investment would be especially strong in the competitive parts of the economy, where small and medium-sized businesses are dominant.

Endnotes

1. Presently, businesses making losses can carry them forward for seven years at zero interest only. With deductions less than the NPV of expenditures, this is a disincentive for investment. More significantly, small businesses are less likely to survive long enough to benefit from loss deductibility. This inefficiently discourages small business from pursuing positive-ENPV innovations.
2. Murphy (2018), p. 32.
3. The aggregate company tax data presented by the ATO in its Australian Taxation Statistics publication and associated detailed table presents the most detailed, line-by-line, breakdown of the contributions of various revenue and expenditure items to reported company tax payable. However, for international dealings, the summary table which aggregates all information presents only a partial summary of the entirety of all transactions engaged in by entities. This gives taxpayers an opportunity to filter what they report and scope to understate their tax payable from overseas transactions. Also, there is no arithmetic check-sum for the incomplete set of international dealings that are reported by an entity back to the company tax return. Therefore, we believe the international summary reported by the ATO will tend to systematically

understate the tax payable by entities. Evidence for this is the fact that collectively, international corporations have constantly run multi-billion dollar losses year after year. Our projections incorporate an adjustment factor to reflect the recent enhanced enforcement activities by the ATO in international dealings.

4. OECD 2016, Irish GDP up by 26.3% in 2015? viewed 13 November 2018 <<http://www.oecd.org/sdd/na/Irish-GDP-up-in-2015-OECD.pdf>>.

5. While the ATO uses thin capitalisation rules to limit these impacts, the regulations are still quite malleable.

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Appendix: Methodology of Tax Modelling

Our tax modelling is based on publicly available data sources including the ATO's Tax Statistics, S&P's Capital IQ database of Australian listed company data, ABS CAPEX data and Ruthven Institute company data.

The bulk of the modelling was bench-marked on the latest ATO Tax Statistics for the income tax year 2016–17 using Detailed Tables 1a, 6a and 8.

1. We categorised all companies into 3 distinct groups:
 - a. Resident tax status Australian owned;
 - b. Resident tax status foreign owned; and
 - c. Non-resident tax status foreign owned.

2. For the cash flow tax scheme, for companies other than banks, we exclude the following revenue/expense items in

Table 1a—Companies: Selected items, for income year 2016–17:

– Revenue: Gross interest and Unrealised gains on revaluation of assets to fair value.

– Expenditure: Interest expenses within Australia, Interest expense overseas, Royalty expenses overseas, Depreciation expenses and Unrealised losses on revaluation of assets to fair value. All companies are entitled to the immediate expensing of CAPEX.

3. For the cash flow tax scheme, we did not adjust Australian listed banks* for either:

- Gross interest receipts; or
- Interest expenses within Australia.

*Australian listed banks include: ANZ, CBA, NAB, WBC, BOQ, BEN, MQG and ABA. The interest items were obtained from S&P Capital IQ and aggregated. Banks are still entitled to the immediate expensing of CAPEX.

4. To obtain sales revenue and cost of goods sold for foreign companies with resident tax status, we obtained the 5-year average (from 2012–13 to 2016–17) of each revenue and expense items from Table 8—International Dealings before we aggregate them. Under cash flow tax scheme, we exclude the following revenue/expenses items:

– Revenue: Dealings with international related parties; Treasury related services; Management and administration services; Insurance; Reinsurance; Sales and marketing services; Software and information technology services; Technical services; Asset management; Other services; Derivatives; Guarantees; Other financial dealings; and Other revenues.

– Expenditure: Dealings with international related parties; Treasury related services; Management and administration services; Insurance; Reinsurance; Sales and marketing services; Software and information technology services; Technical services; Asset management; Other services; Derivatives; Guarantees; Other financial dealings; and Other revenues.

5. We then adjusted both revenue and expenditure items from international dealings (excluding those items listed above) to account for the enhanced enforcement effects from measures taken by the ATO such as the Diverted Profits Tax (DPT) to ensure significant global entities pay tax given their significant economic activity in Australia. We implement this by adjusting the 5-year average International Dealings Schedule (IDS) net losses by 20 per cent.

6. Certain items in the Reconciliation to tax payable are excluded based on our reading of Tables 1a and 8, and consistent with structure of the tax reforms proposals outlined previously and our subjective line-items assessment of each item contained in the sheets.

7. We select 2020–21 to be the starting year for the cash flow tax transition for the ten-year period to 2029–30. We then match the Treasurer’s estimates of the Commonwealth’s company tax revenues by line item from 2016–17 over the outlook to 2022–23). For subsequent years we project tax revenue forward to 2029–30 by assuming a nominal annual growth rate of revenue and expenditure items of 4.50 per cent on average.

8. For convenience we use tax payable as the measure of tax revenue, not net tax.

9. We sourced our initial CAPEX value for 2016–17 from ABS 5206.0 National Accounts. The value (\$167.9b) includes total non-dwelling construction (excluding net purchases of second-hand assets) and total machinery and equipment. This figure does not include the acquisition of intellectual property products. We’ve also verified with the ABS that this amount does not include the purchase of land.

10. As mentioned previously, CAPEX is fully deductible under all cash flow tax options. Under the irrevocable transition scheme, 50 per cent of companies are assumed to switch immediately to the cash flow tax while the remainder switch in 2029–30 (refer to Figure 1). For companies that elect to switch, their CAPEX is modified so that in aggregate, a significant

portion of CAPEX will take place in the first two years of the transition period. However, the total CAPEX amount from 2020–21 to 2029–30 will be unchanged.

11. We have sought to confirm our primary analysis by comparison with listed company data published by S&P and via consultations with the Australian Taxation Office.

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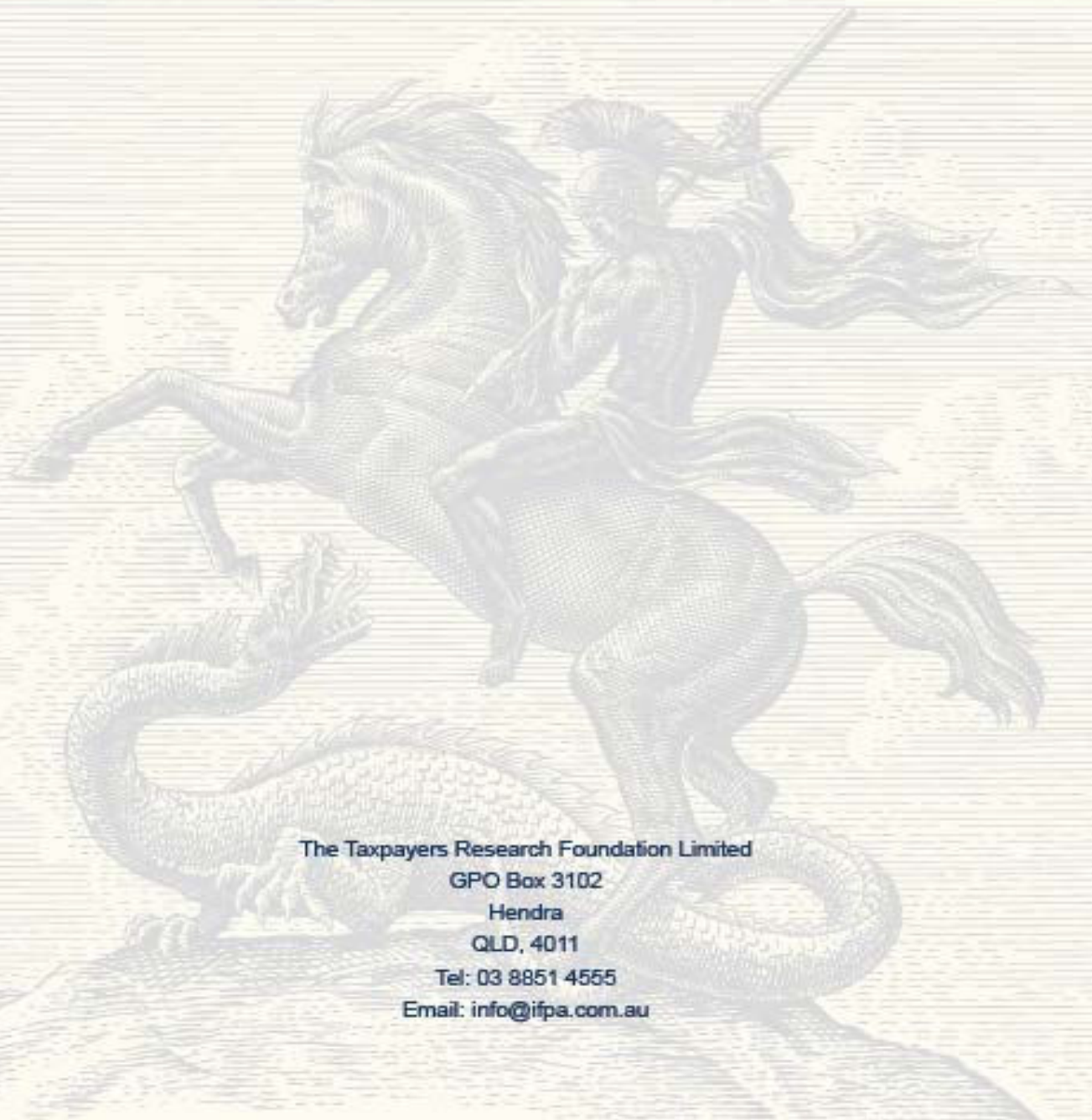
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