1: Challenges for Australia's tax system

Overview

This chapter sets out the major challenges that confront the Australian tax system.

Key points

- Australia's tax system faces challenges from a changing world.
- The tax system needs to support improvements in productivity and encourage workforce participation.
- Tax reform offers one of the biggest opportunities to improve productivity and foster jobs, growth and opportunities.

1.1: Australia's tax system faces challenges from a changing world

In recent decades, changes in the global economy have put strain on tax systems around the world and Australia has been no exception. Key factors include technological change (particularly the rise of the digital economy), highly mobile investment and greater labour mobility. These developments pose two critical issues for tax systems: they can weaken the ability of tax systems to raise revenue from traditional tax bases and they can increase the economic costs of taxation, dampening economic growth.

Technological change is particularly significant for the taxation of income, especially corporate income. Multinational firms operate across many jurisdictions, much of their value is intangible and the location where value is added can be difficult to determine. The digital economy also facilitates greater personal importation of goods and services, placing pressure on the indirect tax bases.

As the mobility of capital increases, Australia's high corporate tax rate can deter investment, ultimately leading to lower wages and prosperity. High effective marginal tax rates (including through the interaction with the transfer system) can also deter workforce participation or lead to tax planning activities as individuals seek to reduce their tax burden.

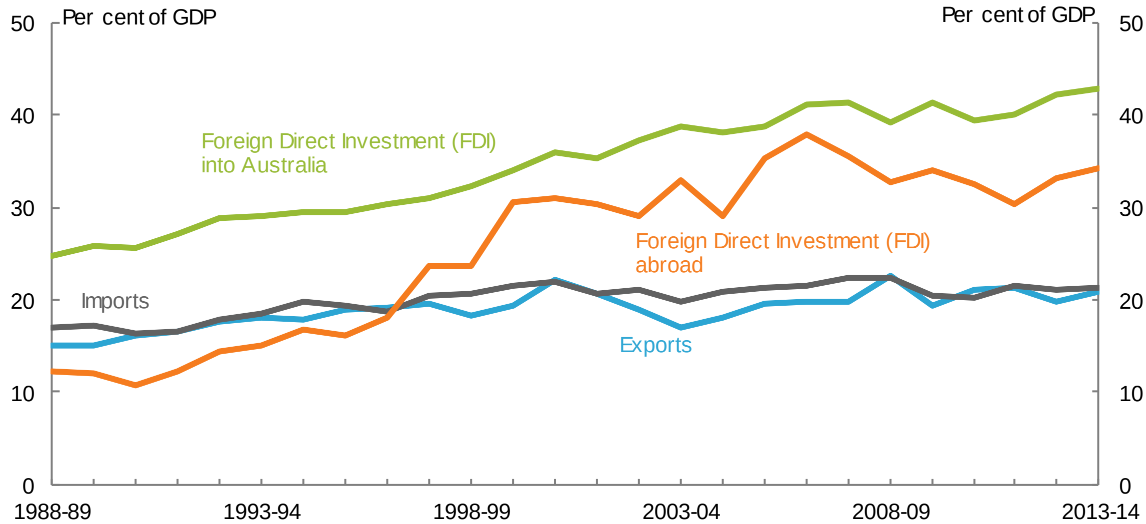
Australia also faces the prospect of a period of below-average income growth as the terms of trade decline and global economic growth remains subdued, relative to the years leading up to the global financial crisis. Tax reform offers an opportunity to significantly improve productivity and foster jobs, growth and opportunities.

Globalisation provides opportunities for a more prosperous future, but also challenges Australia's tax system

Over the past 50 years, the economic environment in which the Australian tax system operates has changed dramatically. In the 1950s, Australia generated substantial income from wool and other agricultural commodities, the economy was encircled by a comprehensive tariff wall, the financial sector and the flow of capital were heavily regulated, and the manufacturing sector was a major employer.

Today, developed economies, including Australia's, have become increasingly open to international trade and investment (see Chart 1.1). Financial deregulation, the growth of multinational companies utilising globally dispersed supply chains and the increasing digitisation of global commerce have opened the Australian economy to the world. This has had an overwhelmingly positive influence by increasing business efficiency and living standards and driving economic growth. However, these changes have also transformed the environment in which tax systems operate, especially for capital importing countries such as Australia.

Chart 1.1 Trade and foreign direct investment as a share of GDP



Source: Australian Bureau of Statistics (ABS) 2014, *Australian System of National Accounts 2013-14*, cat. no. 5204.0, ABS, Canberra.

Historically, large companies tended to be locally based and engaged in production (such as manufacturing) primarily for domestic or regional markets. Now, technology allows large companies to supply global markets using internationally integrated supply chains. This means that production can be located where costs are lowest. It is now normal for multinational companies to: have their investors reside in one country; manufacture products in another; locate their marketing and product development in a third country; and supply customers in a fourth.

A leading indicator of change is that multinationals are investing increasing economic value in intangible assets, such as intellectual property. Investment in intangible assets (such as patents, trademarks, copyrights, goodwill and branding) has been growing at around 1.3 times the rate of tangibles since 1974-75.[1] The inherent difficulty in valuing unique intellectual property and the ease with which intellectual property can be relocated present particular challenges for identifying which jurisdictions have the right to tax the value or 'income' generated by these assets.

Similarly, financial markets are increasingly globally integrated, and the international flow of capital has become less restricted and more mobile. Technology has also allowed new business models to evolve that have substantially changed the way businesses and consumers interact. New ways of transacting, including crypto-currencies such as bitcoin, were not contemplated when the current tax system was designed.

These developments make determining the appropriate tax outcome for a particular company in a specific country difficult and raise concerns about the ability of companies to relocate profits to minimise their tax.

Australia has been active in ensuring companies are taxed appropriately in Australia, including through some of the toughest integrity rules in the world and the compliance efforts of the Australian Taxation Office (ATO) working with counterparts overseas. Australia has also played a leading role with the G20 and the Organisation for Economic Cooperation and Development (OECD) in seeking to reshape global rules to better counter inappropriate multinational tax planning.

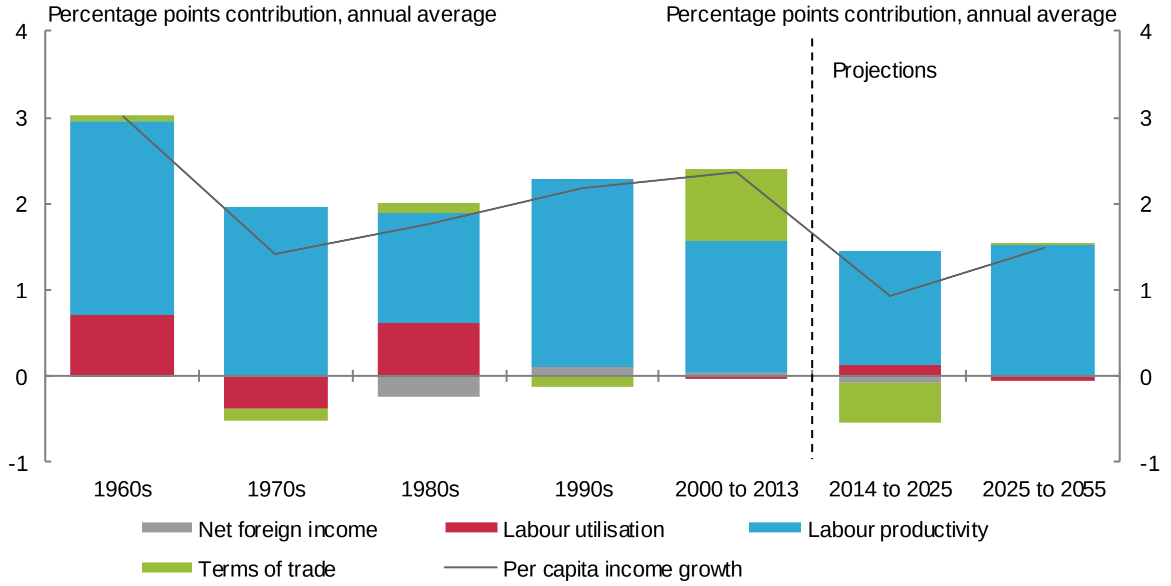
Australia's tax system needs to support higher productivity and encourage workforce participation

Australia's growth over the past decade has been supported by increased demand for commodities, predominantly from Asia. This has resulted in unprecedented investment in the resources sector, the record terms of trade, higher average incomes and improved living standards. The benefits of the mining boom have been spread across the economy as a result of downstream investment, employment growth in industries supporting the mining sector and greater purchasing power for Australian households as a result of record terms of trade.

However, recently slower growth in Asia, falling commodity prices and a lower terms of trade, as well as resource projects shifting from development into production, mean the mining sector is no longer driving national income growth to the same extent as previously. In the absence of improvements in other drivers like labour utilisation and national productivity, annual growth in incomes is likely to fall to around one per cent over the next decade, less than half the rate to which Australians are accustomed (see Chart 1.2).

1 Barnes, P and McClure, A 2009, *Investments in Intangible Assets and Australia's Productivity Growth*, Productivity Commission Staff Working Paper, Canberra.

Chart 1.2 Sources of growth in real national income per person



Source: ABS 2015, *Australian National Accounts*, cat. no. 5206.0, ABS, Canberra and Treasury

Corporate tax rates that are increasingly uncompetitive will make it harder for Australia to continue to attract necessary investment. Ongoing investment in Australia is one of the key drivers of labour productivity and growth. Furthermore, high corporate tax rates increase the incentives for companies to engage in tax planning, such as profit shifting.

Australia's population is also expected to grow and change over the next 40 years. Projections in the recent Intergenerational Report show that the number of Australians aged 65 and over is expected to more than double by 2055. In turn, the number of people aged between 15 and 64 for every person aged 65 and over is projected to fall from an estimated 4.5 people today to a projected 2.7 people in 2055. This change in our demographic structure will have important implications for the tax base, as well as the ability of future governments to deliver services at the standards expected by the community.

The proportion of the population participating in the workforce is expected to decline as a result of population ageing. By 2054-55, the participation rate for Australians aged 15 years and over is projected to fall to 62.4 per cent, compared with 64.6 per cent in 2014-15. The recent Intergenerational Report projects that gradual declines in participation rates will slightly slow the rate of economic growth.

Bracket creep and higher personal income taxes can reduce participation incentives for some people (see chapter 2). Over time, unchecked bracket creep could potentially reduce workforce participation and the opportunities afforded to the community by higher participation rates.

Tax reform offers one of the largest opportunities to improve investment and productivity and help maintain and improve growth in standards of living

The recent Intergenerational Report shows that Australia can continue to build prosperity and improve growth in living standards over the next 40 years. Real growth in GDP is projected to average 2.8 per cent a year going forward, compared to an average of 3.1 per cent a year over the past 40 years.

Continued steps to boost productivity and encourage higher workforce participation will be critical to driving this economic growth. There is a range of measures that governments can pursue to enhance productivity and help position Australian businesses to be flexible, competitive and robust in the face of dynamic global conditions. Some opportunities will be considered as part of the Competition Policy Review and the Productivity Commission's inquiry into Australia's workplace relations framework.

Changes to our tax system could also foster new opportunities for businesses and workers. Indeed, some argue that comprehensive tax reform could promote economic growth more than any other area of government policy.

The potential for productivity enhancing tax reforms exists at all levels of government in Australia. Aligning the processes for the reform of Australia's tax system with the reform of Australia's Federation provides a once-in-a-generation opportunity for change.

Discussion questions:

1. Can we address the challenges that our tax system faces by refining our current tax system? Alternatively, is more fundamental change required, and what might this look like?