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Shedding light on the debate
Mythbusting tax reform

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Done well, tax reform is a goal worth fighting for, as it will improve the living standards of our children and grandchildren.

Mythbusting tax reform

I am delighted to launch the first of our two reports on Mythbusting tax reform.

These reports have grown from a desire within our firm to shed light on many of the myths and misconceptions that have grown around tax reform and tax policy.

Our firm, like many of our clients, is fundamentally invested in building the Lucky Country. We know that Australia's future is at a turning point. We believe that our firm – alongside governments and clients – has a responsibility to move the debate forward, to investigate, form views and communicate what 'good' tax reform looks like, and how it will benefit Australia.

Our first report discusses fiscal drag (bracket creep), GST and company tax; and considers some myths and facts that surround these contentious topics.

To produce these insights our economic specialists in Deloitte Access Economics and Deloitte Tax specialists have collaborated, so you have the benefit of their expertise and experience in the one place.

Like our *Building the Lucky Country* series, this is an important national conversation that will affect generations to come. Done well, tax reform is a goal worth fighting for, as it will improve the living standards of our children and grandchildren.

Australia owes itself a mature debate. Let's not delay acting on the imperatives of tax reform; we know that the task will get harder if left till later.

We hope that you will find this publication illuminating and informative.

Cindy Hook
CEO, Deloitte Australia

Let's not delay acting on the imperatives of tax reform; we know that the task will get harder if left till later.

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Executive summary

The easy ride is over. No longer is Australian prosperity able to slipstream on the growth of a fast charging China.

Our living standards have stalled since 2011, and there is a risk this period of stagnation will linger unless and until our nation once more takes charge of its own destiny.

It doesn't need to be this way. 2015 should be a year of opportunity as Australia considers key changes to tax policy.

But the signs aren't encouraging. A better tax system could be a big contributor to building the Lucky Country, a key goal for Deloitte. Yet to date a mix of factors – the political climate, the reactions of vested interests, and the sheer breadth of the reform opportunities being considered – has resulted in a debate that has been confusing, contradictory and inflexible.

Most frustratingly, it has been characterised by a proliferation of myths and misconceptions.

That's why Deloitte is releasing two reports aimed at shedding light where there is currently too much heat.

Our first report covers three contentious areas: fiscal drag, GST and company tax. Reforms to all three are vital. But they are dogged by misconceptions that just won't die.

Take **fiscal drag (or 'bracket creep')**. Over time, rising wages push people into higher tax brackets. That's an ugly and unfair way to raise taxes. And in a few short years workers on average full-time incomes will see their average tax rate back where it was before the GST was introduced:

Myth 1: Despite claims fiscal drag will drive 80% of the total revenue increase over the next four years, the actual figure is closer to 10%. The reason is simple – people can only get pushed into higher tax brackets if wages are rising, yet wage growth is at record lows.

Myth 2: Although this problem doesn't involve the dazzling dollars usually attributed to it, it is still a problem – just not for those you think it is. It's a myth that those on average full-time wages feel the most pain: fiscal drag is actually a bigger problem for low income earners.

The **GST** is widely considered the 'third rail' of Australian politics – touch it, and you get electrocuted. So, few politicians have the courage to mount a case for taking a good tax and making it better. Why is it good? Relatively speaking, it doesn't hurt the economy much when it raises a dollar. How could we make it better? Applying it more widely and raising its rate:

Myth 3: But the response is that the GST hits the poor, and a wider GST base would be a double blow for the poor, as they spend a bigger share of their outlays on 'essentials'. Yet this myth ignores the bleeding obvious: that we can raise pensions and benefits and tweak the personal tax system to keep the less well-off at least no worse off than now.

Then there's **company tax.** The debate about the corporate income tax rate has been dogged with questions about fairness, cost and benefit, the wisdom of tax competition and questions of timing.

Myth 4: It is a myth that it is wrong to push for a lower company tax rate. It isn't; the argument for cutting the company tax is the same as the matching argument applying to a number of other taxes. It's a bad tax. It hurts the economy more than many other types of tax, and all Australians would be better off if we cut the company tax rate and paid for that by raising less economically damaging taxes.

Myth 5: We have to wait for the Budget to heal before company tax can be cut. Yet tax reform is about raising the same dollars in a way that boosts the productive capacity of the economy, so that too is a false objection. And other nations are already taking action, including a number of our Asia Pacific neighbours and key trading partners.

Tax reform is more vital to this nation than ever before

Australia can and should do better

Australian living standards have risen fast over the past three decades, but have now stalled.

The world is paying less for Australian exports, and our baby boomers are retiring. That means two of the three big drivers of our living standards – the share of the population in work, and the prices the world pays us – are in reverse, leaving today's living standards well shy of where past trends would have had them.

In turn, that says this nation needs a sense of urgency about the third and final key potential driver of our living standards – productivity.

Unless and until Australia lifts its productivity performance, we risk a prolonged period of stagnation compared with our past performance on prosperity.

More of the same will not be enough

Australia can lift productivity in a variety of ways, but an important channel to greater prosperity is tax reform.

And, luckily for the Lucky Country, 2015 is a year in which Australia is having a conversation about tax reform. Unluckily however, to date that debate has seen more heat than light.

We'd like to help

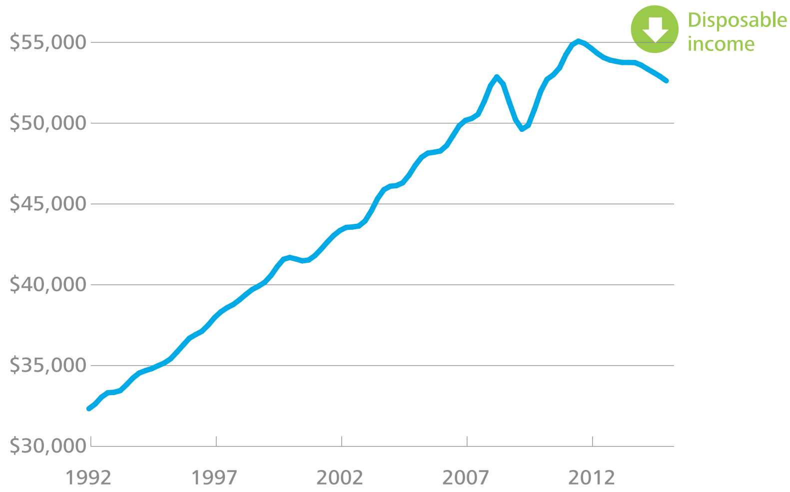
Deloitte Access Economics is the largest group of economists in the private sector. And Deloitte is home to leading tax specialists.

We'd like to shed some light where such illumination is currently lacking.

Cheer up, it's not that bad

Tax reform is a frustrating beast – summit after summit, white paper after white paper, conference after conference, the recommendations economists and tax practitioners make for changes to the tax system that would make Australia more prosperous and fairer don't change much.

Chart 1: Trend real net national disposable income per head (today's dollars, annual rate)



Source: Australian Bureau of Statistics

Equally, our tax system hasn't changed much either. In other words, we know what to do, but the politics of reform is horrendously hard. At any given time the prospects for tax reform are only three banner headlines from defeat.

Yet despite the obstacles, Deloitte is optimistic that 2015 may mark a turning point.

To that end, we have a few observations for you.

Don't count your fairness chickens tax-by-tax

First, remember fairness isn't the end result of individual taxes. It is what happens after *all* government spending and *all* taxes and other interventions have their impact that matters.

Why do we stress that? Sometimes efforts at tax reform flounder because fairness is being measured solely in terms of changes to an individual tax – such as the GST – rather than the impact of an entire reform package, or indeed of an entire tax and transfer system.

That's like measuring how well runners do in a race at the halfway point: interesting to know, but not ultimately what counts.

If you hear someone saying tax reform "just isn't on" because of the fairness impact of one part of a proposed package – instead of all of a tax reform package – then feel free to switch off. That someone is trying to snow you.

Eggs and omelettes

Federal Treasury's estimates of the impact of tax reform are effectively based on a simple assumption: some people can only be better off to the extent that others are worse off.

So if you hear commentators demanding "no one can be worse off" as a result of tax reform, then what you are actually hearing is someone saying "we can never have tax reform."

How then did John Howard succeed when he introduced the GST? He sweetened that tax reform with big tax cuts and lots of compensation, sufficient to turn a Budget surplus in 1999–2000 of 2% of national income into a small deficit by 2001–02.

That option isn't open to Australia today. We already have a Budget doing it tough, so we can't sweeten the tax reform pot by much. Equally, however, Australians shouldn't let that stop good tax reform from going ahead at all.

Besides, even if the Budget were in much better shape, there's a sleight of hand in declaring people are better off when the Budget becomes worse off. Ultimately the Budget has to be in sustainable shape, and so handing out treats today will tend to eventually come at the cost of higher taxes or lower spending some time down the track.

Fairness figures are likely to be better than those you hear

There's another furphy worth calling out here. You will see estimates of the impact of tax reform on different types of households – singles, families with young kids, retirees and the like. Yet such figuring usually assumes an unchanged pie is getting reallocated.

However, that assumption forgets a key aim of tax reform is to increase the size of the pie: to boost national income. When considering the fairness impacts of a tax reform that shifts revenue raising from 'bad taxes' (those with high costs to the economy) to 'good taxes', don't forget such policies generate a growth dividend that makes all Australians better off down the track.

Tax reform is different to tax cuts

There are important arguments as to the appropriate level of spending and taxes in Australia, and you need to consider both spending and taxes – State and Federal – in determining where that balance should lie.

After a decade in which we've voted for everything from family benefits to disability insurance and tax cuts, Australia now spends a lot more than it raises in revenue. So you should be rightly suspicious of tax 'reform' plans that are merely proposals for tax cuts. Only treat them seriously if they come stapled to matchingly detailed proposals to cut spending or to raise other taxes. If they don't, then do yourself a favour and file them cylindrically.

Taxes have a big impact on prosperity

Deloitte often speaks of the Federal Budget as Australia's social compact with itself. The two big aims of any such compact are prosperity (the size of the pie) and fairness (how it is sliced).

Although some taxes have a major bearing on fairness (superannuation and the GST are good examples), most taxes have a bigger bearing on prosperity. That is because some taxes (such as state stamp duties on business and residential conveyancing, insurance taxes and royalties, and federal company taxes) hurt the economy more (have higher 'deadweight losses') than do other taxes (such as the GST or broadly-based land taxes).

Spending has a big impact on fairness

In contrast, and again as a generalisation, spending is a more effective lever for fairness. For example, were the GST base to be widened and/or the rate lifted, prices would rise. To protect the less well-off, the logical response would include raising pensions and benefits.

The tax reform equation

How much prosperity is at stake? The maths is pretty simple. The extent to which tax reform makes Australians better off comes down to:

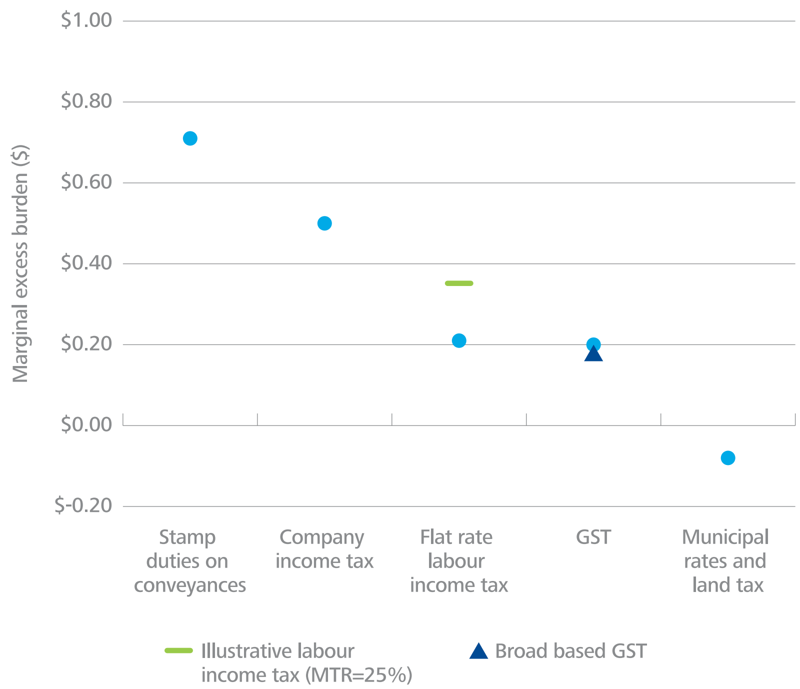
A. The dollars shifted from 'bad taxes' to 'good taxes', multiplied by

B. The gap in economic costs between 'good' and 'bad' taxes.

For example, there is not a huge difference in the 'deadweight losses' generated by raising a dollar of payroll tax versus that generated by raising a dollar of residential conveyancing duty. And if the movement in dollars is also small (only a little extra residential conveyancing duty, and a little less payroll tax), then by definition such a program of tax reform wouldn't raise many cheers from economists.

Alternatively, say the tax reform in question looks to abolish all state stamp duties on business conveyancing (a tax with a high deadweight loss) and replace the lost revenue with higher commercial rates of land tax. That type of reform would generate larger gains – and so garner more applause from economists.

Chart 2: Treasury estimates of tax efficiency ('good taxes' have lower 'excess burdens')



Source: Chart 2.9 in the Tax Discussion Paper, Department of Treasury, March 2015, Page 25

Tax reform is mostly a prosperity story – if you can shift from 'bad taxes' to better ones, then you can make Australia more prosperous.

Tax reform now offers a bigger bang for the buck

And there's some good news for Australia's reformers: both Treasury and Deloitte have estimated growing gaps between 'good' and 'bad' taxes in recent years.

As a simple example, Treasury now sees municipal rates and land taxes as having negative deadweight losses – that is, the economy is actually better off when a dollar of tax is raised from these sources, partly because *"(l)and taxes paid by foreign and domestic landowners are only redistributed to the domestic households, providing a benefit to Australian households and generating a negative marginal excess burden for a broad-based land tax."*[1]

Such changes are part of a longer running trend. For example, the estimates of the efficiency of various taxes has changed notably since 2010: work commissioned for the Henry Review[2] showed the marginal excess burdens of conveyancing stamp duties and municipal rates at 34% and 2%, respectively, whereas the 2015 Treasury Issues Paper (reproduced as Chart 2) seems to show matching estimates of 71% and negative 8%, respectively.

The rising gap between 'good' and 'bad' taxes suggests a substantive tax reform package could add some 2% to national income. If achieved, that would rank among the largest reforms ever implemented in Australia. The matching estimates of tax efficiency from Deloitte Access Economics show less of a spread between the 'best' and 'worst' taxes, but are also consistent with good potential returns from tax reform.

But shouldn't we just leave tax alone, and fix the Budget through spending cuts?

By the way, none of what we talk about in this report lets spending off the hook. Even if tax reform is 'revenue neutral', there's still a big Budget repair task to be done. As Deloitte Access Economics analysis prepared for the Business Council of Australia has shown (see Chapter 4 of the Deloitte Access Economics report available at http://www.bca.com.au/publications/bca-budget-submission-201516-a-10-year-plan-for-growth), policy decisions over the past decade ran at a four-to-one pace of spending increases outpacing tax cuts, indicating a need to seriously address the other side of the ledger.

> Because economists now think the gap between the economic costs arising from 'good' versus 'bad' taxes is higher than they previously estimated, the gains from tax reform are now also larger than previously estimated.

The fact government spending needs work doesn't mean we should ignore taxes. The whole point is we are taxing badly in Australia, and by shifting from 'bad taxes' towards 'good taxes', we can increase national prosperity.

1. Tax Discussion Paper, Department of Treasury, March 2015, Page 25.
2. See Table 5.1 in http://www.taxreview.treasury.gov.au/content/html/commissioned_work/downloads/KPMG_Econtech_Efficiency%20of%20Taxes_Final_Report.pdf

Fiscal drag – is it doing all the heavy lifting?

Fiscal drag (or its more evil sounding pseudonym, 'bracket creep') is the ultimate hands-off approach to Budget repair.

Australia's progressive personal income tax system is based on marginal rate thresholds that are fixed in dollar terms, meaning government revenues benefit from fiscal drag as higher wages gradually drive individual taxpayers into higher marginal tax brackets.

Wage growth means, even when governments do nothing, average rates of personal income tax go up over time, helping to lift the tax take.

Unlike other types of Budget repair, bracket creep doesn't require any action by governments. That makes it a politically attractive choice to raise extra revenue.

However, fiscal drag is also an ugly, ungainly and unfair way to raise taxes. For example, in just a few short years, workers on average full-time incomes will see their average tax rate back where it was before the GST was introduced.

Overall revenue gains from bracket creep can be divided into two components:

- **A nominal component** which occurs as wages rise with price inflation, thereby increasing average tax rates even if real wages are going nowhere
- **A real component,** which occurs when wage rises outpace price inflation, shifting taxpayers even further into higher tax brackets. This type of bracket creep is a natural feature of a progressive income tax system.

The first form of bracket creep generates a cut in real disposable income over time, whereas the second form of bracket creep involves a sharing of real wage growth between taxpayers and governments. Most estimates of fiscal drag typically exclude the real component and focus solely on the impact of price inflation on income taxes over time.

Yet fiscal drag isn't quite the problem it is made out to be

Myth 1: Despite claims fiscal drag drives 80% of the total increase in revenue over the next four years[3], the actual figure is closer to 10%. Yes, you read that right. And the reason is simple – people can only get pushed into higher tax brackets if their wages are rising, yet Australia's wage growth is at a record low.

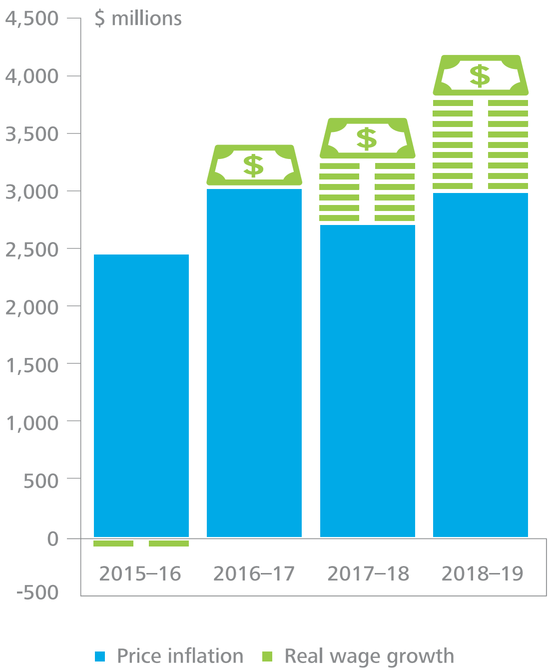
Let's take a look at the numbers

Deloitte Access Economics calculates fiscal drag by comparing forecast receipts for total taxes on individuals on two different bases:

- We start with the 2014–15 personal income tax rates and thresholds, and then factor them up for our forecasts for increases in the consumer price index (CPI), starting in 2014–15. The difference between these forecasts and those arising from actual rates and thresholds over time represent the nominal component of bracket creep (the price inflation component)
- Then we use 2014–15 rates and thresholds, and factor them up for our forecasts for increases in average weekly earnings (AWE), again starting in 2014–15. The difference between these forecasts and those based on CPI indexation alone form the real component of bracket creep.

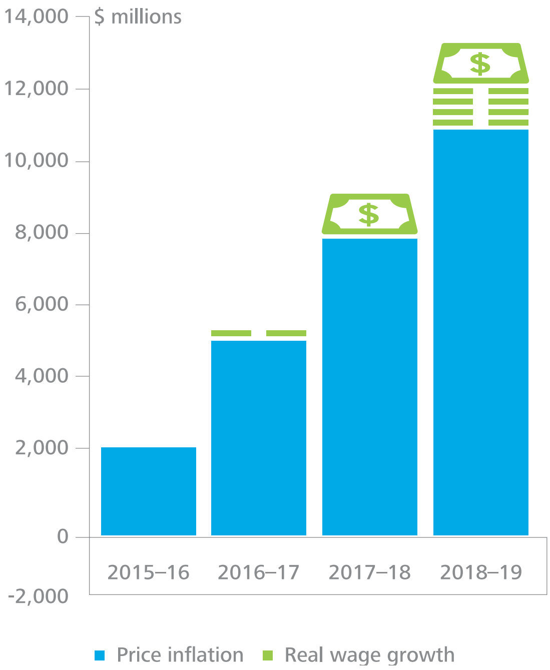
3. A number which even showed up in the Opposition's Budget reply speech (see http://billshorten.com.au/budget-reply-2015).

Chart 3: Single-year effects of bracket creep due to price inflation and real wage growth



Source: Deloitte Access Economics

Chart 4: Cumulative effects of bracket creep



Source: Deloitte Access Economics

Chart 3 shows estimates of the components of bracket creep over the forward estimates period.

The chart shows the role bracket creep plays is important in improving the Budget position, but that it is not the massive contribution many think it is.

You'll note the nominal component (price inflation) – what most people talk about when discussing fiscal drag – averages just $2.7 billion a year over the forward estimates period shown here.

That is a lot. And yet it isn't, or at least it isn't when compared to the Budget's projection of overall growth in revenues. By 2018–19, as Chart 4 shows, the cumulative addition to Budget revenues as a result of nominal fiscal drag is projected to be running at $11 billion.

And although that's a large number, remember the Budget papers (pages 10–12 and 10–13 of the 2015–16 Budget Paper 1) see overall revenue rising from $377 billion in 2014–15 to $488 billion in 2018–19.[4]

So across a period in which total revenues are projected to go up by $111 billion per year, fiscal drag is projected to account for just $11 billion per year – one in every ten dollars.

Contrast that with the current tax debate, which credits fiscal drag not merely with accounting for 80% of the rise in total revenue across that same period, but also with generating locust plagues and taking the life of your first born.

4. By the way, our figuring seems to be in line with Treasury's. Treasury Secretary John Fraser has nominated $25 billion as the cost of fiscal drag over the four years of forward estimates (see http://www.treasury.gov.au/PublicationsAndMedia/Speeches/2015/Australias-budget-pressures). The blue bars in Chart 4 add up to $21 billion across those four years.

Why isn't fiscal drag bigger? Because the engine that drives it is travelling at a very low speed. Chart 5 shows wage growth in Australia, which just hit a record low.

And if wages aren't growing much, then it should come as no surprise fiscal drag is also travelling slowly, as it relies on wage growth to pack its punch.

So what on earth does the heavy lifting to take the overall tax take from $377 billion in 2014–15 to $488 billion in 2018–19?

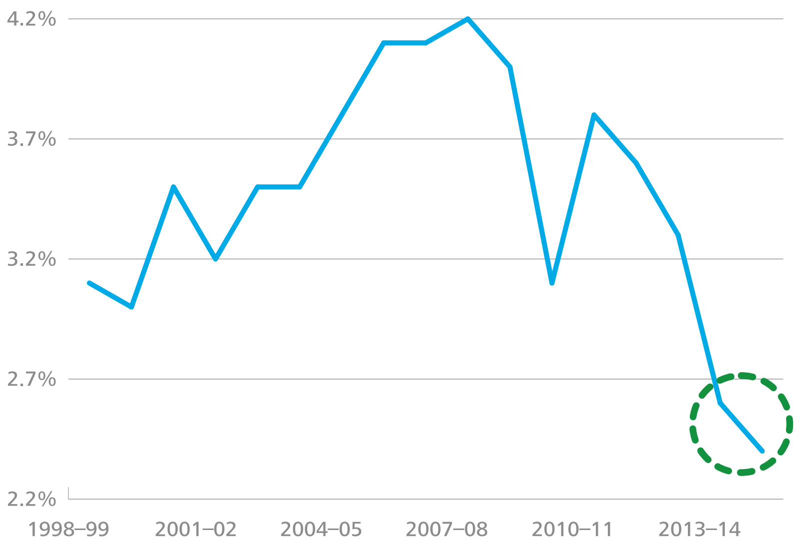
Far and away the biggest contributor is simply a bigger economy. As a result of inflation and continuing growth, $377 billion in 2014–15 would become $456 billion in 2018–19 anyway, with Treasury forecasting the nominal economy will be almost 21% larger across that four year period.

Of the remaining difference of $32 billion ($488 less $456 billion), two big factors stand out: as noted, about $11 billion is fiscal drag, while another $9 billion is Treasury's forecast of a pick-up in the capital gains tax take.

Myth 2: And although those on average full--time wages will feel the pain of bracket creep, there's an even bigger group facing an even larger challenge:

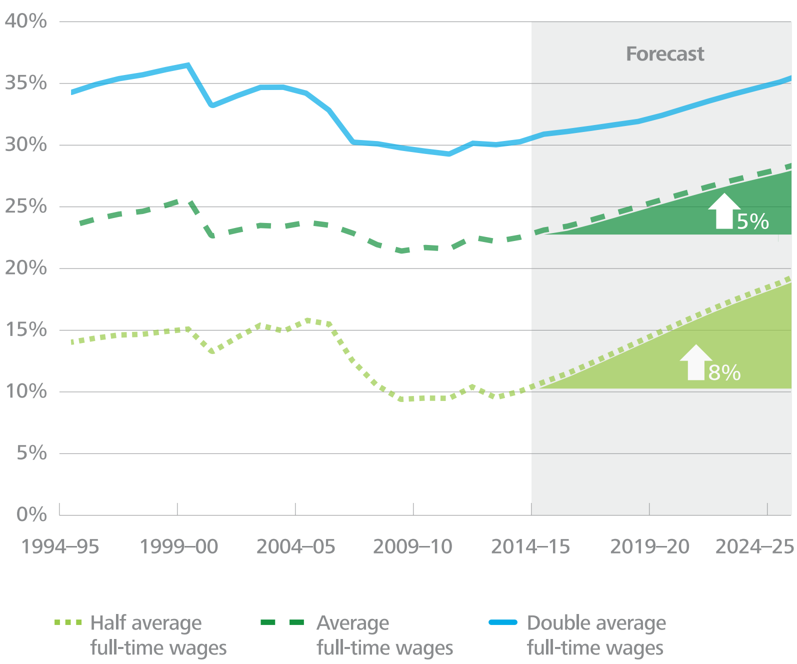
- It is true there are 800,000 taxpayers with incomes between $70,000 and $80,000 (whose marginal tax rate may therefore soon jump 4.5 percentage points)
- Yet there are also 1.3 million taxpayers with incomes between $30,000 and $37,000 (whose marginal tax rate may therefore soon jump by 13.5 percentage points).

Chart 5: Wage growth hits record lows – slowing the pace of fiscal drag



Source: Australian Bureau of Statistics

Chart 6: Average tax paid at different levels of income



Source: Deloitte Access Economics

As Chart 6 shows, the average tax paid by a person earning average weekly ordinary time earnings (AWOTE – the income of full-time workers) is forecast to increase from a rate of around 23.3% in 2014–15 to 28.2% in 2024–25. That's a notable increase of a little less than five percentage points.

Yet a bit of perspective is handy here. For a person earning half this amount, their average tax paid is set to increase by eight percentage points over this period, lifting from 11.0% in 2014–15 to a projected 19.0% in 2024–25.

Yes, you read that right. Although that's not quite a doubling, it is a rather larger increase than that faced by those on average full-time earnings.

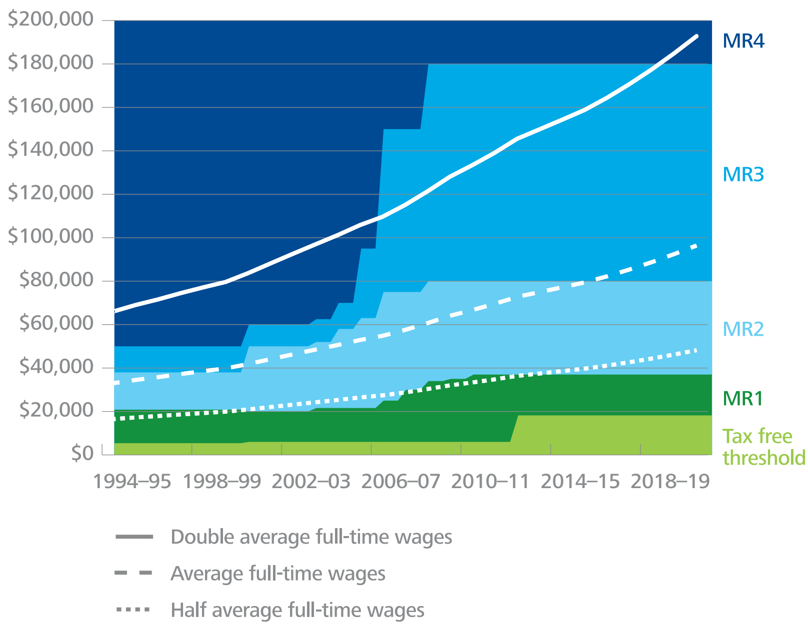
Accordingly, there will be substantial shifts in marginal tax rates faced by typical taxpayers (see Chart 7). In a few short years, a person earning average weekly ordinary time earnings is expected to be in the second top marginal tax bracket for the first time since the turn of the current century. That means they'll be paying over a third of every extra dollar earned in tax.

As more and more people are subject to higher and higher marginal rates of tax, the incentives to work are eroded. But that is particularly true for the less well-off, for whom interactions between the tax and transfer systems can produce substantial changes in take home income – if Mum works extra hours, then not only may her marginal tax rate jump if she gets a pay rise or works extra hours, but the family may also lose some family benefits or rent assistance.

The less well-off are also the same group of people bracket creep is expected to affect the most.

So bracket creep may help to repair the Budget, but by less than people think. However, it does little to repair Australia's social compact. To the extent that it makes the spending promises of the past decade more affordable, it does so by eroding the progressivity in our system of personal income tax.

Chart 7: Marginal tax rate (MR) paid by those at different levels of income



Source: Deloitte Access Economics

Although fiscal drag isn't as big a problem as it is sometimes portrayed, its main victims are the less well-off. And the less well-off are also those most exposed to weak incentives to work.

Simply having tax policy on autopilot is hurting the economy more every year action isn't taken.

That is why bracket creep is a genuine problem: not because its dollars are dazzling, but because the pain it causes for low income workers is unfair, and because the resultant disincentive to work hurts Australia's prosperity prospects.

Can a GST increase be fair?

The Goods and Services Tax (GST) has been a contentious issue in Australia ever since it was first proposed by Paul Keating when he was Treasurer in the mid-1980s.

It is widely considered the 'third rail' of Australian politics – touch it, and you get electrocuted.

As a result, few politicians have the courage to mount a case for taking a good tax and making it even better.

Why is the GST a good tax? Because it doesn't hurt the economy much when it raises a dollar.

And how could we make it better? By applying it more widely and raising its rate.

Myth 3: The Pavlovian response to any reform proposals in this area is the GST hits the poor, and a wider GST base would be a double blow for the poor, as they spend a bigger share of their outlays on 'essentials':

- Yet we can raise pensions and benefits and tweak the personal tax system to keep the less well-off no worse off than they are now
- And even though fresh food accounts for a higher share of the spending of the less well-off, we can ensure in the same way that these families would be no worse off if fresh food was added to the GST base.

What might GST reform look like?

While there are a range of possible alternatives reform could take, we present just two here – a low case and a high case. These are:

- **Scenario 1:** increase the rate to 15%, and broaden the base to include imported digital products and services and low value imports
- **Scenario 2:** increase the rate to 12.5%, and broaden the base to include fresh food, imported digital products and services and low value imports.

These two scenarios are chosen for illustrative purposes, as they cover the breadth of possible reform to the GST, including:

- An increase to the rate of the tax
- A broadening of the base it is applied to
- Already announced changes that will address some of the challenges to the tax base technological changes (such as the rise of the internet) have brought.

For illustrative purposes, these changes are modelled from 1 July 2016 (1 July 2017 has already been flagged as the start date for GST on imported digital products and services and low value goods).

For both these scenarios, we present how much revenue we would expect the government to raise, as well as how much would need to be handed back to households to ensure adequate compensation is provided to low income earners.

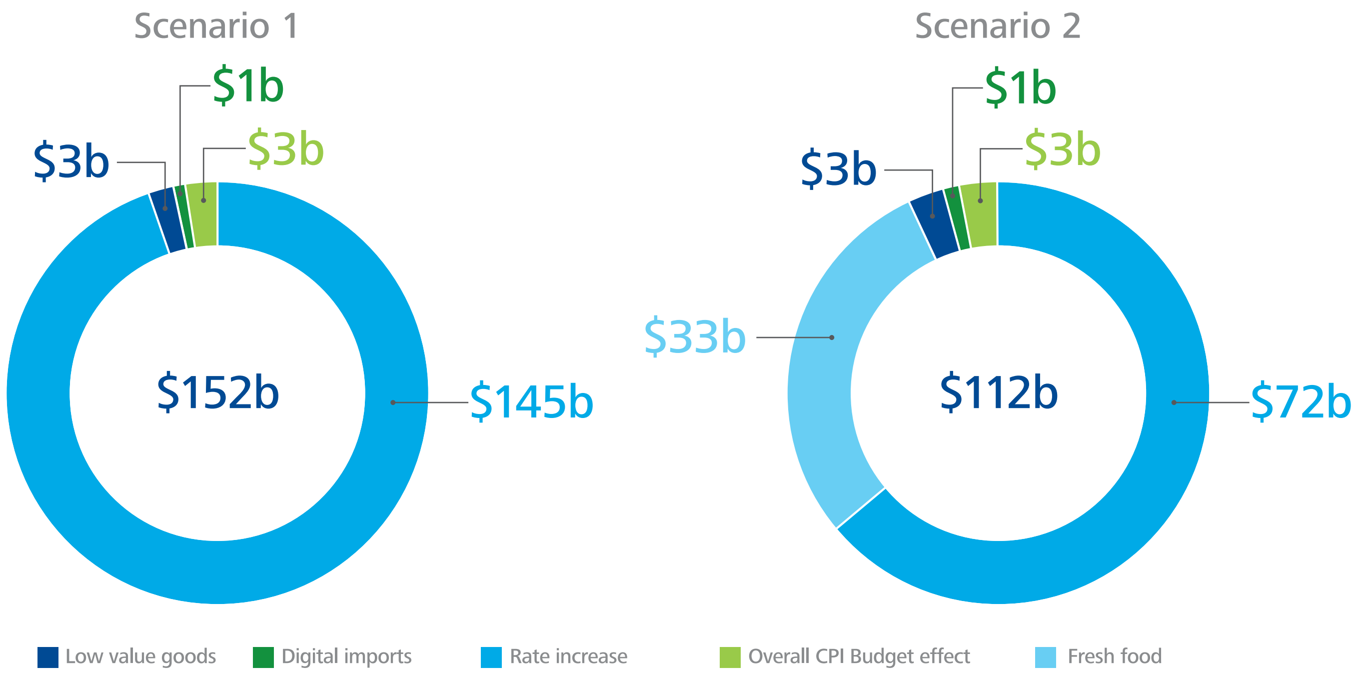
In both cases we show **that the GST can be changed while ensuring low income households are no worse off.**

What would it raise?

Estimates for revenue raised under both scenario 1 and 2 are shown in Chart 8 opposite:

- **Under scenario 1, an additional $152 billion of revenue would be raised over four years**. Nearly all of this comes from an increase in the rate to 15%, while a further small share comes from expanding the base to include low value imported goods, and imported digital products and services. **Such a reform would increase the amount of revenue raised by the GST by roughly half.**
- **Scenario 2 is forecast to raise over $112 billion in revenue over four years.** Around two-thirds of this comes from increasing the rate to 12.5%, with most of the rest coming from expanding the base to include fresh food. A small share comes from the inclusion of low value imported goods, and imported digital products and services.

Chart 8: Estimated additional revenue raised under each GST scenario, 2016–17 to 2019–20



Source: Deloitte Access Economics

So raising extra GST revenue would disproportionately fall on low income earners who are least able to pay. But that's not the end of the story – it is just the start. These households can be compensated.

Who pays?

Determining who pays the most, or who bears the biggest burden, from the increase in tax is important in determining whether or not it is progressive or regressive in nature.

As the blue bars on Chart 9 show, higher income households spend more money per week, so they need to pay the most extra dollars in order to buy the same goods and services when the GST is raised.

But a relative measure of cost (average household expenditure as a proportion of disposable income) shows low income households consume a higher proportion of their income. In fact, average households in the bottom two-fifths among income earners spend more than their income – either by running down what savings they have, or by borrowing or selling assets.

So any increase in the GST would indeed hit low income households harder in relative terms.

In both the scenarios presented here a similar pattern emerges. Chart 10 shows the story for scenario 1 – a bigger GST would cost the well-off more in terms of extra dollars a week (because they spend more than the less well-off), but less as a share of their income (because although they spend more than the less well-off, that gap is even bigger still for their income).

How can low income earners be compensated?

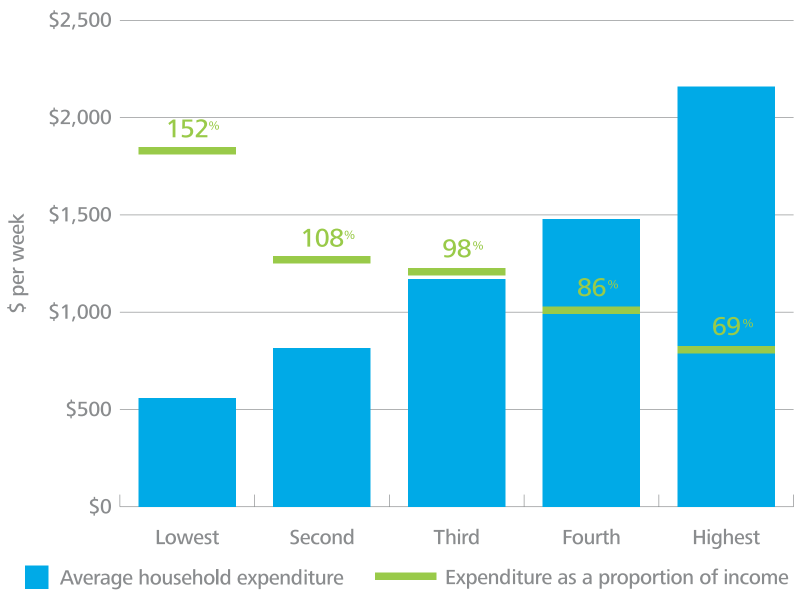
There's more than one way to be doing it tough. Australia's low income households include those on fixed incomes such as pensioners, students, the unemployed and families supported by low paying jobs.

As a result, any reform needs to look at more than one means of compensating low income households for an increase in GST, via a mix of:

- Increasing pension or benefit amounts provided to those on fixed incomes
- Increasing the rates of support payments to families
- Changing the personal income tax system to cut taxes paid by low income earners.

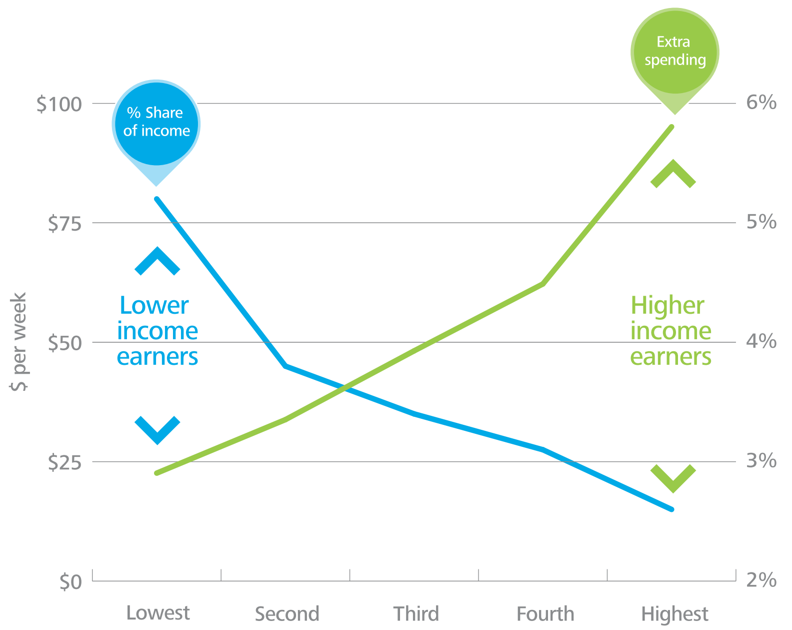
The relative split between these depends on the size of the change to GST, and on the goals of the compensation package.

Chart 9: Household expenditure per week by gross income quintile, 2009–10



Source: Australian Bureau of Statistics; Deloitte Access Economics

Chart 10: Scenario 1 – Different stories on dollars versus income share by gross income quartile



Source: Deloitte Access Economics

Past household compensation schemes which have accompanied other tax changes, such as the introduction of the GST in 2000 or the carbon tax in 2012, have had a similar structure.

In the scenarios here, there is a roughly 50-50 split between compensation provided through the transfer system (higher benefits and pensions) and the personal income tax system.

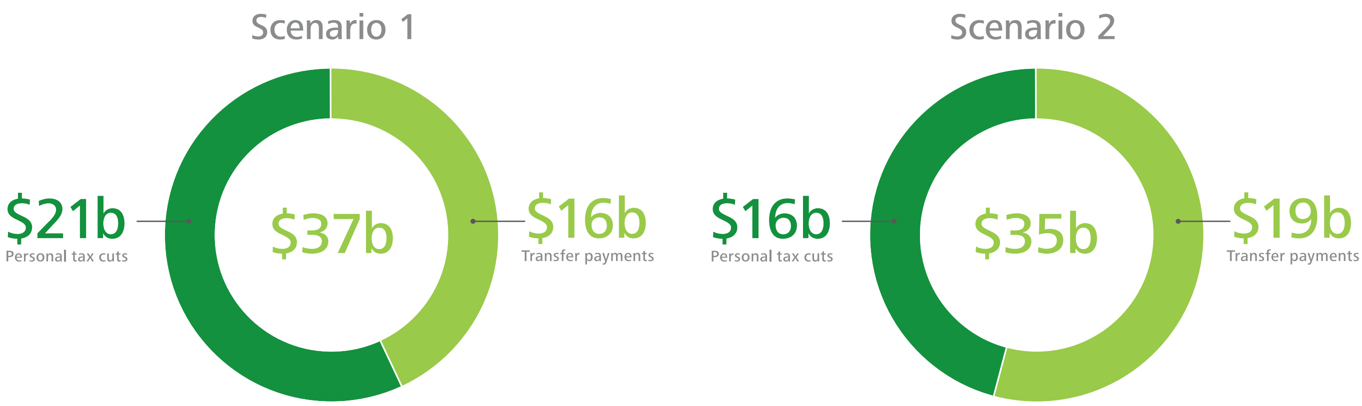
The more even split between tax cuts and increased government payments compared with the package at the time when the GST was introduced is because (1) this package is more focused on low income earners, and (2) that group has largely been taken out of the personal tax system through successive increases to the tax free threshold.

In scenario 1, $21 billion in tax cuts and $16 billion in increased transfer payments would be provided to households to ensure low and middle income households were adequately compensated. **That hands back a quarter of the money raised to ensure less well-off Australian families are, on average, no worse off despite a bigger GST.**

In scenario 2, $16 billion worth of personal tax cuts and $19 billion worth of transfer payments would be provided. Compensation provided in scenario 1 is higher than in scenario 2 due to the increased cost faced by households (the additional GST revenue raised is also higher in scenario 1). **That hands back almost a third of the money raised to ensure less well-off Australian families are, on average, no worse off despite a bigger GST.**

The split between tax cuts and increased transfers (in scenario 1 versus scenario 2) is also different because of slight differences in where the burden lies between scenarios. The proportion of the cost which falls on households in the lowest 20% of income earners is slightly higher in scenario 2 than in scenario 1. This is because fresh food (which is included in the GST base in scenario 2) makes up a higher share of spending for low income households. Because more of these households rely on transfer payments, the compensation in scenario 2 is more skewed to increased transfers rather than lower taxes.

Chart 11: Total proposed household compensation provided, 2016–17 to 2019–20



Source: Deloitte Access Economics

The proportion of compensation a household would receive is shown in Chart 12. The average share of compensation falls as income rises under both scenarios. While average compensation is shown below, different household types such as families with children would receive a higher proportion of compensation.

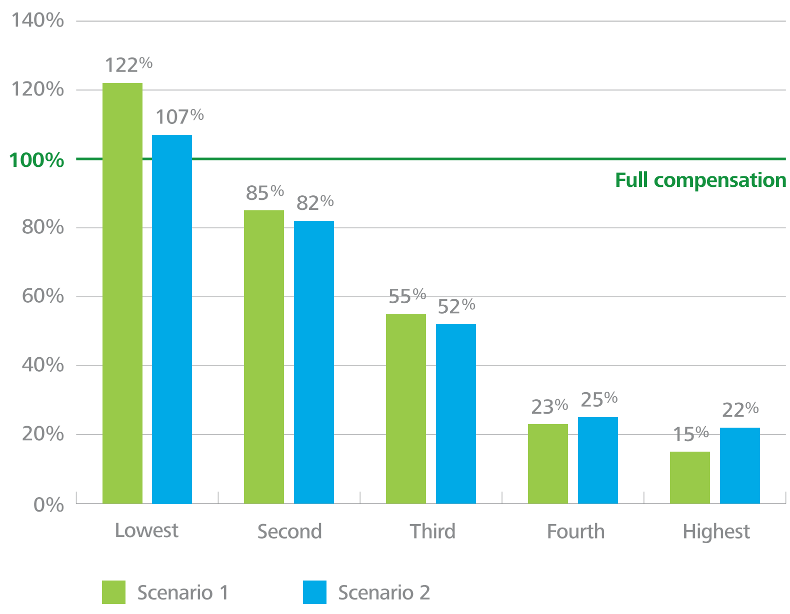
The least well-off in Australia would actually be better off under these reforms, with average compensation greater than the additional cost of the GST reforms (that is, and as the chart shows, the lowest income households would receive more in compensation than the cost to them of the GST reforms).

The personal income tax cuts included as part of the compensation package target low income workers. (A handy side-effect is these are also the same individuals who are most at risk from fiscal drag).

What does this leave us with?

Even after taking into account the cost of providing compensation to low and needier middle income households, there are still big bucks to be gained by expanding the GST. Scenario 1 would raise $115 billion in net terms over four years, while scenario 2 is forecast to raise an additional $77 billion over four years in net terms.

Chart 12: Average amount of compensation provided to households by gross income quintile (100% = full compensation)



Source: Deloitte Access Economics

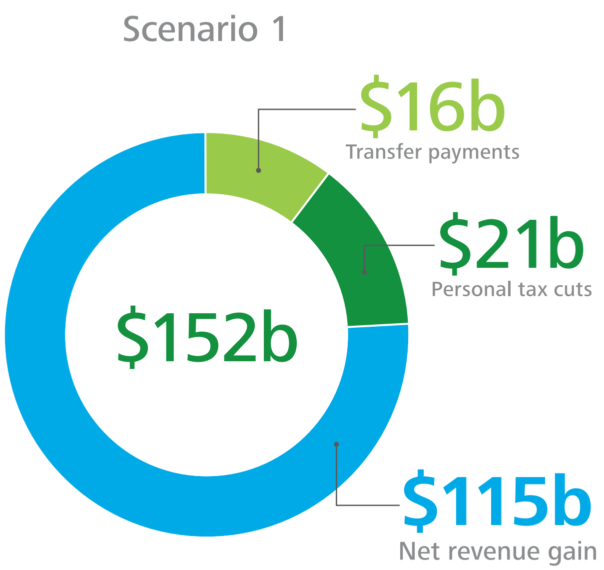
Case study – A pensioner couple

Those on fixed incomes such as pensioners are among the most affected by a change to the GST. This is because they usually spend all their income and their income is fixed.

Under the change in scenario 2, a pensioner couple with no private income and expenditure equal to the average for a couple pensioner household would need to spend an additional $1,070 a year in 2016–17 to maintain their current lifestyle.

Under our household compensation package, this couple would receive increased pension payments equivalent to $1,099 per year which more than covers the yearly cost increase for an average pensioner couple. Some of this happens automatically anyway, because pensions rise alongside the faster growing of prices and wages, and the CPI goes up when the GST does too. The rest would come from a fortnightly supplement to their pension to cover increased ongoing expenses.

Chart 13: Revenue raised split between compensation and net revenue increase, 2016–17 to 2019–20



Source: Deloitte Access Economics

So there you have it. It is possible to (1) raise the rate of GST and (2) broaden its base, while (3) still ensuring the less well-off are protected from the resulting price rises.

The myth that GST reform is necessarily unfair is simply untrue – it's a furphy.

Worse still, that myth risks derailing reform by pretending it's all too hard.

A corporate tax cut should wait… right?

The debate about the corporate tax rate has been dogged with questions about fairness, cost and benefit, the wisdom of tax competition and questions of timing.

Let's cut to the chase here: advocating a company tax cut sounds like welfare for plutocrats. And surely the timing is awful given a national debate over whether some companies are paying their fair share anyway?

- But what if a lower company tax rate benefited Australians by providing growth, employment and higher living standards?
- What if, by pursuing a selfish agenda, the business community also brought the benefits of prosperity to the table?

Let's not ignore a good reform option simply because it may be hard to explain to the voters that they'll be the real beneficiaries.

It's time to explore some of the popular myths and misconceptions around company tax.

Myth 4: It is wrong to push for a lower company tax rate.

No, it isn't welfare for plutocrats. The argument for cutting the company tax is the same as the matching argument applying to a bunch of other taxes.

Quite simply, company tax is a 'bad tax'. It hurts the economy more than many other types of tax, and all Australians would be better off if we cut the company tax rate and paid for that by raising less economically damaging taxes.

It's inefficient

All taxes shrink the economy a bit for every dollar they raise, but company income tax generates economic costs that are well above the average.

Treasury modelling in the Tax Discussion Paper suggests company tax is one of the taxes with the highest marginal excess burden (see Chart 2 earlier). In fact, it has some of the highest economic costs on the living standards of Australian families.

That's because company tax changes the decisions businesses would otherwise make, affecting everything from location, risk, and timing questions through to choice of structure, financing and dividend policy. At its worst, this tax can lead to investment decisions being delayed, abandoned or substantially altered.

Why? Economists have long known taxes create harm when they change the decisions businesses and families would otherwise make, and decisions are more likely to change when the thing being taxed is 'mobile'. That's why various land taxes show up as having low costs to the economy, because land can't move.

But money can move – and it does. Capital is internationally mobile, and that means company taxes that are 'too high' scare off investment in Australia.

That same mobility also means lower company taxes can encourage Australians and the world to invest more in the Australia of tomorrow.

Here's the thing. Mr and Mrs Suburbs think company tax is paid by the top end of town. That makes any cut to company tax a hard sell politically.

Yet economists beg to differ, arguing the burden of company tax ultimately falls on individuals by affecting the wages they earn – meaning the benefits of a rate reduction would also be enjoyed by individuals in the form of higher wages.

Companies actually don't bear the burden of company tax

Treasury has modelled the long-run welfare effect of a cut in company tax[5], showing only around one-third of benefits from a tax cut go to shareholders[6], with two-thirds flowing to families, primarily through higher wages.

The research concluded *'there may be larger welfare gains available from cutting the company tax rate than from other major revenue sources and that in the long run, only a minority of the welfare gains will accrue to the owners of capital, with the majority shared more broadly through the community'*:

- That's why the Henry Review[7] also found *'a shift away from company income tax towards greater reliance on taxing other less mobile factors of production, or on consumption, has the greatest potential to increase GDP and growth'*
- But wait, there's more, with the 2010 OECD study[8] *Tax and Growth* finding taxing consumption appears to have significantly less adverse effects on national income than does corporate income tax.

Company tax cuts create a bigger pie

Foreign shareholders do benefit from a cut to the corporate tax rate. As company tax is a final tax in Australia in respect of foreign shareholders, they are directly better off under a lower corporate tax rate.

But why would we do that? Why drop the corporate tax rate for the benefit of foreigners? Martin Parkinson (former Secretary of the Department of the Treasury)[9] explains:

"*People will think, 'well, why cut the corporate income tax because the benefits will go to the foreigners?' Actually, what you are doing is lowering the hurdle rate of return on future investment and, if you lower the hurdle rate of return in a competitive world, you will get more investment coming in and – depending on the income and price elasticity of the product and how competitive the markets are – the benefits of that will show up in lower prices for the consumers and ... in higher wages and more jobs for workers.*"

In short, lower rates of company tax encourage both Australians and the world to invest in Australia – spending more on everything from computers to mines, roads, shopping malls and office blocks. And the increased investment makes workers more productive, which in turn leads to them earning higher wages:

- In 2012 Treasury undertook preliminary modelling and found that a one percentage point cut in the company tax rate could raise national income and wages by about 0.2%[10]
- Then in 2014, Treasury found a company income tax cut from 30% to 29% would increase the level of national income by between 0.15% and 0.35% in the long-term.[11]

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5. Xavier Rimmer, Jazmine Smith and Sebastian Wende, *The incidence of company tax in Australia*, Economic Roundup, Issue 1, 2014.
6. Foreign shareholders benefit directly through lower taxes on their dividends. Both Australian and foreign shareholders benefit indirectly from the reinvestment of higher profits back into Australia, generating further income on their investments.
7. *Australia's Future Tax System*, Report to the Treasurer, December 2009, at p. 151.
8. OECD, *Tax Policy Reform and Economic Growth*, OECD Tax Policy Studies, 2010, No. 20, OECD Publishing, Paris, Annex B: *The OECD Tax and Growth Study*.
9. See http://www.afr.com/news/politics/tax-system-stuck-in-the-50s-treasury-20141203-11zj8f.
10. Business Tax Working Group Final Report, November 2012, at page iii.
11. Xavier Rimmer, Jazmine Smith and Sebastian Wende, *The incidence of company tax in Australia*, Economic Roundup, Issue 1, 2014.

Myth 5: We have to wait.

There's a view out there we can't afford a company tax cut now – the Budget is too battered, and tax reform takes time.

Cutting the company tax rate isn't an argument to cut the overall tax take. Given Australia's lingering Budget deficit, you should rightly regard any proposals to cut the overall tax take with suspicion. But company tax reform can and should be part of a wider package of tax reforms: one in which Australia would still raise the same amount of tax, but do so in a way less damaging to the economy, and looking after the interests of the poor.

That's how you boost prosperity. And other nations are already taking action, including a number of our Asia Pacific neighbours and key trading partners.

How much does it cost?

A corporate tax rate cut costs less than you think.

Many Australians forget that company tax is part of a bigger tax system.

Why does that matter? If you are a shareholder in a company that has paid tax, that company tax is then offset against your personal income tax.

This 'dividend imputation' means that a cut to company rates has a smaller impact on total tax collections than you might otherwise think: although company tax collections go down, personal income tax collections go up. Individual Australian shareholders will continue to pay tax based on their individual marginal rates of tax, while the offset for company tax paid will be reduced.

Table 1 sets out Deloitte's modelling of costs based on different corporate tax rates. (The current rate is 30% for bigger businesses, and 28.5% for smaller businesses. For simplicity the reforms considered here all include a return to a unified rate.) For illustrative purposes we have compared these costs to the possible revenue that a change to the rate and/or base to GST would raise.

These are, of course, big bucks. But that's exactly what you need them to be if tax reform is going to be a big enough bang to lift national prosperity.

And, by way of comparison, the second GST scenario would, even after all compensation costs, pay for cutting the company tax rate to 25% and still have $47 billion left over across the four year forward estimates period, while the first GST scenario would pay for a company tax rate cut to 25% and still have $85 billion left over.[12]

Table 1: The cost of corporate income tax cuts ($ billion)

New company tax rate of:	2015–16	2016–17	2017–18	2018–19
28.5%	-2.1	-2.2	-2.4	-2.6
28%	-2.7	-2.9	-3.2	-3.4
27%	-4.1	-4.3	-4.8	-5.1
26%	-5.5	-5.8	-6.4	-6.9
25%	-6.9	-7.2	-7.9	-8.6
GST less compensation Scenario 1	25.9	27.9	29.7	31.9
GST less compensation Scenario 2	17.5	18.9	20.1	21.6

12. We have simplified here by allowing the GST revenue to flow one year earlier. The GST estimate in Table 1 for 2015–16 is both (1) net of compensation costs and (2) the figure from our analysis earlier in this report for 2016–17. That helps to make a like-with-like comparison of the net savings from GST reform versus the net cost of company tax reform.

No, that's not to say that tax reform is as simple as 'cut company tax and raise the GST.' At the very least, the funds from the GST currently go to the States.

But it is to say the core of tax reform is to cut taxes that hurt the economy a lot (such as company taxes), and get revenue back through taxes that hurt the economy less (such as the GST).

And if any such set of tax reforms reduces fairness – as changing the GST would – then the final package should fix that.

Others are already acting

Many trading partners have already moved to boost the international attractiveness of their company tax rates, including in parts of Asia and in New Zealand.

There's also more in the pipeline, including announced cuts in the United Kingdom, Japan, and India.

The OECD thinks we should do it now…

In its 2015 report *Going for Growth*[13], the OECD notes Australia has a high headline rate – especially so for a nation that benefits from foreign investment. Its official recommendation is therefore to:

> *'Reduce the corporate tax rate as part of a wider reform that also envisages raising the currently low rate of goods and services tax (GST) and/or widening the base.'*

Choices: A race to the bottom, being competitive, or steadily losing ground?

Tax competition will continue to exist as long as countries seek to attract mobile capital.

Australia's headline corporate tax rate is high by OECD standards. Looking at the headline corporate tax rates for some of our Asia Pacific neighbours, including those we have recently entered into new Trade Agreements, only Japan and India have a similar or greater corporate tax rate than Australia – and both those two countries have already announced of their intention to cut rates.

Australia doesn't need to have the lowest rates to keep business investment here, but we do need to be comparable to our economic and regulatory peers.

What does the ATO say? Deputy Commissioner Mark Konza says, "*Multinational enterprises need to make choices about where they will 'put their feet down' around the world. Tax should be a part of the bundle that companies pick up when they choose a country. A stable society and legal system, high education standards, good infrastructure, hardworking people and a tax rate that is competitive in that context should be a good offering.*"[14]

Australia is already late to the tax reform table.

And when it comes to company tax, most of the OECD and a number of Asia Pacific nations have lower rates and started on this process several years ago.

Australia, on the other hand, is still just starting this conversation.

It's time to recognise the benefits a company tax cut can bring to all Australians.

13. http://www.oecd.org/economy/growth/going-for-growth-australia-2015.pdf.
14. *Global tax avoidance and its effects on Australia's economic prosperity*, 26 August 2014.

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Mythbusting tax reform

Tax reform is more vital than ever before

Taxes affect prosperity = $ shifted from bad taxes to good taxes x gap in economic costs between good taxes and bad taxes

Increase the national pie

We can **look after low income earners**

Fairness = result of all government spending **+ all taxes + other incentives + payments**

Spending policy also needs to be **addressed**

The myths	The facts

Fiscal drag – is it doing all the heavy lifting?

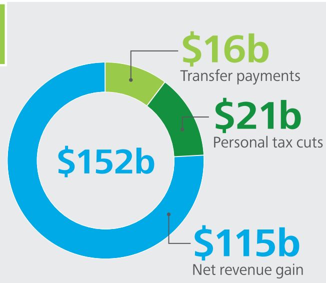
The myths	The facts
Fiscal drag (also known as bracket creep) will drive 80% of the increase in government revenues over the next four years	✓ Fiscal drag (also known as bracket creep) will drive 10% of the increase in government revenues over the next four years
Middle income households will be most affected	✓ Lower income households will be most affected

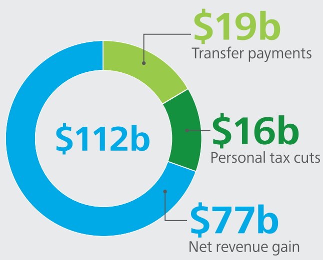
Can a **GST** increase be fair?

The myths	The facts
Any increase to the rate or base of the GST would most harm the poor	✓ **We can raise pensions and benefits** and tweak the personal tax system to keep the less well-off at least no worse than before

SCENARIO 1

Increase the rate to 15%. We can adequately compensate the less well-off and achieve a net revenue gain of $115b





SCENARIO 2

Increase the rate to 12.5%, and undertake base broadening to **fresh food**. We can adequately compensate the less well-off and achieve a net revenue gain of $77b

A **corporate tax** cut should wait… right?

The myths	The facts
It's wrong to push for a lower company tax rate	✓ **It's not wrong** Company tax is inefficient, and companies don't actually bear the burden of it. A lower company tax stimulates investment. That increased investment makes workers more productive and leads to higher wages
We have to wait – the budget is too battered, and tax reform takes time	✓ **Many of our trading partners** have already moved to boost the international attractiveness of their company tax rates ✓ **We need tax reform** on a big scale if we want maximum effect