TAX WHITE PAPER SUBMISSION

Tax White Paper Task Force

The Treasury

Langton Crescent

PARKES ACT 2600

To Whom It May Concern:

Submission on the Tax White Paper – Discussion Paper Phase

The Financial Services Council (FSC) welcomes the opportunity to make submissions on the tax discussion paper.

The FSC represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, licensed trustee companies and public trustees.

The Council has over 120 members who are responsible for investing more than $2.5 trillion on behalf of 11 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the third largest pool of managed funds in the world.

The Financial Services Council promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

Please contact me on (02) 9299 3022 to discuss this submission.

Yours sincerely

ANDREW BRAGG

Director of Policy & Global Markets

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Overview: The economic and fiscal context for taxation reform

This outline provides a rationale for tax reform and explains the package of tax reform we seek.

A good tax system meets the needs and challenges of current and future generations.

A good tax system ensures medium term fiscal sustainability by collecting enough revenue to fund government expenditure in a way that is economically efficient and internationally competitive after taking into account considered societal choices about priorities for government expenditure.

The economic and fiscal challenges facing the tax system suggest that it is not on track to meet these objectives.

The current long run trajectory of the fiscal position, if left uncorrected, is unsustainable.

- **Revenues are expected to be weaker due to slower economic growth than previous decades, increasing global tax competition, and changing consumer and business behaviour.**
- **Expenses are expected to increase for every major spending category bar one as a proportion of GDP, as a result shifting demographics of an aging population and increased community demand for services, particularly in areas such as health and ageing.**

The design of the current tax system is also slowing economic growth unnecessarily.

- **The mix of taxation is inefficient, with too heavy a reliance on direct taxes such as corporate income tax and stamp duties to raise revenues across both the Commonwealth, State and Territory levels of government.**
- **States and Territories, under increasing fiscal pressure due to the vertical fiscal imbalance, are increasingly adopting a piecemeal approach to taxation by raising taxes in the budget cycle – often those that are the most inefficient.**

In order to solve these challenges, business, the community and all levels of government need to assess the options to get the economy back on track, ensure medium term fiscal sustainability, and design a tax system that meets the needs and challenges of the community both now and in the future. This involves considering:

- **fixing the mix of taxation;**
- **considering the aggregate level of tax collected by all levels of government; and**
- **reducing the aggregate level of expenditure made by all level of governments.**

We believe that the primary focus of tax reform should be to fix the mix of taxation so that it improves economic growth, improves our international competitiveness, promotes investment and hard work, and raises the productivity of the country.

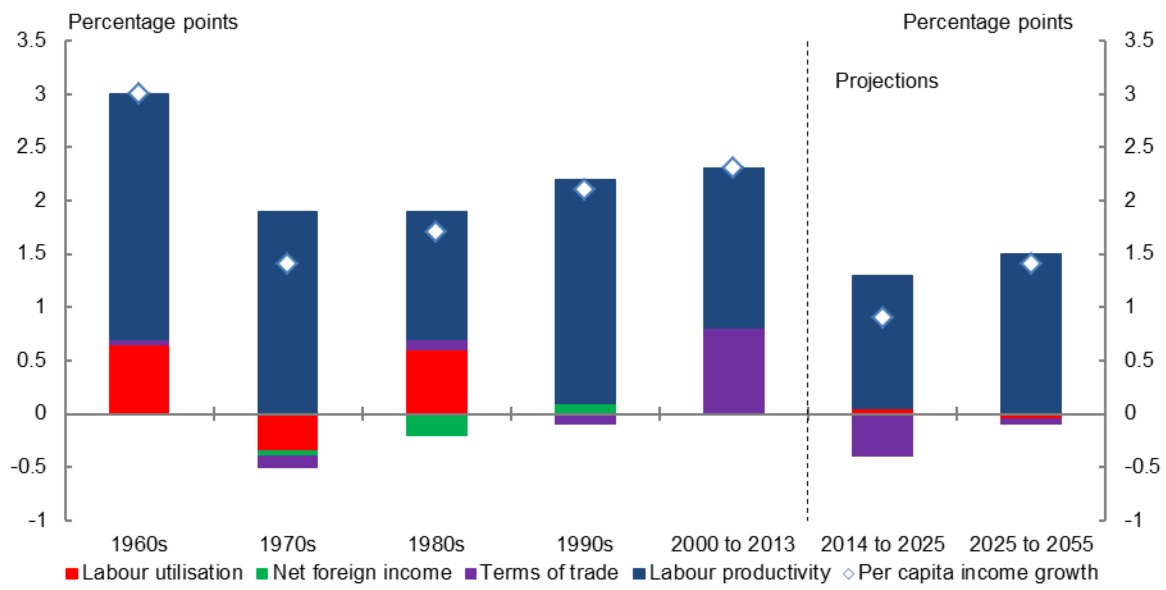
Such a package of tax reform could be revenue neutral and still improve the medium term fiscal sustainability of budgets of all levels of government.

This package would need to be complimented by continued examination of government expenditure at all levels of government.

The economic and fiscal context for taxation reform

The Australian economy has experienced 25 years of uninterrupted economic growth. This growth was first driven by a substantial productivity surge in the 1990s following substantial microeconomic reforms in the 1980s, and then by a commodities boom in the 2000s (see Figure 1). Over the last two decades real national income per capita grew at its fastest pace since the 1960s, growing at an annual average rate 2.1 per cent in the 1990s and 2.3 per cent in the 2000s.

Figure 1: Sources of growth in real national income per capita (Annual average percentage point)



Source: IGR (2015), ABS Cat No.5206.0 and FSC estimates.

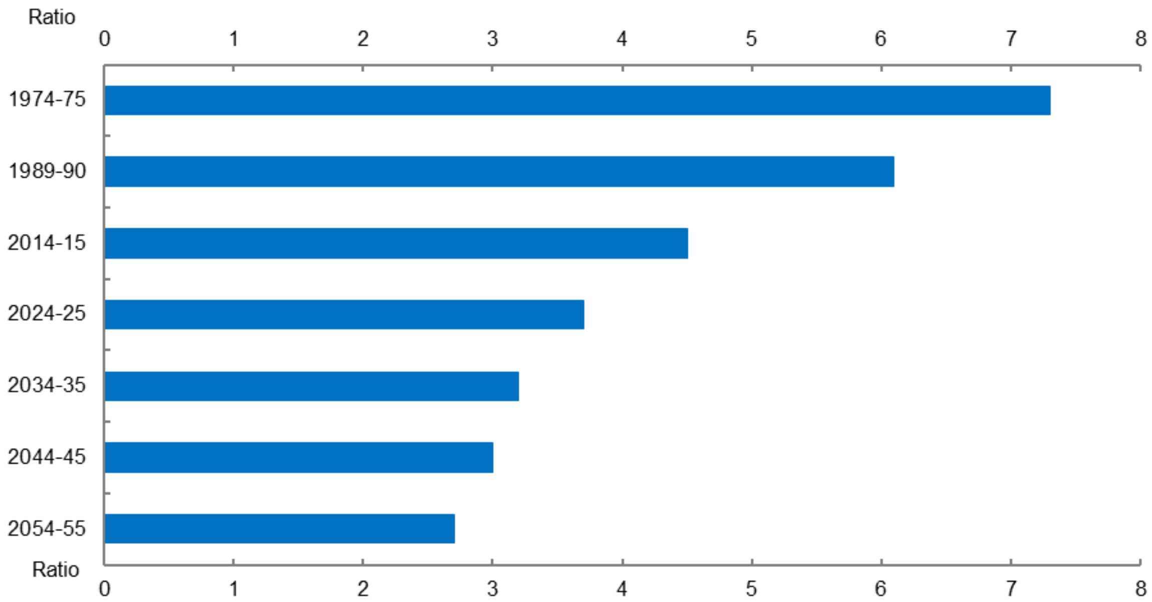
However, over the next 40 years the sources of economic growth for the Australian economy are uncertain. Two major macroeconomic trends over the next 40 years will have far reaching implications for the ability of the government to capture revenue from the existing taxation system.

First, growth in real national income per capita, that is average incomes, are expected to decline from 2.3 percent per annum in the 2000s to 0.9 percent per annum over the next decade to 2025.

Second, we will go from having 4.5 workers for every person aged over 65 to 2.7 workers which will have significant implications for how well the tax system can fund existing spending arrangements (see Figure 2).

This is because people aged 65 and over tend to scale down their participation in the workforce reducing taxation revenue available to government and at the same time, increase their demand for government–provided services and payments such as the Age Pension and aged care. Overall public spending per person is highest beyond age 65, with a substantial increase for people aged 80 and over.

Figure 2: Number of people aged from 15 to 64 relative to the number of people aged 65 and over



Source: IGR (2015)

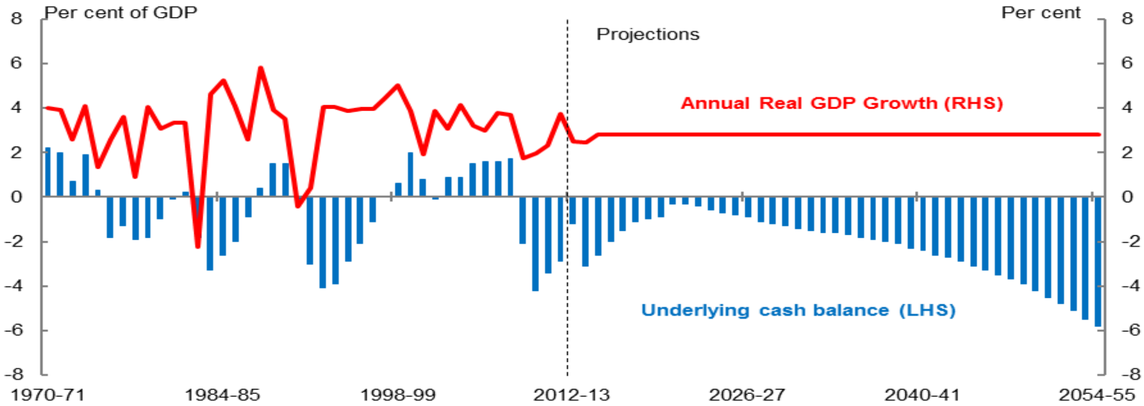
Failing reform of both the taxation system and the range and depth of government expenditure, a declining income growth rate in combination with an aging population will result in a significant fiscal gap that will grow over time.

Understanding the pressures on the budget

Under current policy assumptions, the government expects the underlying cash balance to reach a deficit of 5.8 percent of GDP by 2054-55 (Figure 3). This would result in a fiscal gap of approximately 6.8 percent of GDP after taking into account the government's objective maintaining a surplus of 1 percent of GDP over the economic cycle.

This fiscal gap arises in spite of an assumption continued, uninterrupted economic growth, a highly unlikely eventuality. It also occurs despite Commonwealth tax receipts increasing from 21.9 percent in 2014-15 to 23.9 percent by 2020-21. This increase in the tax receipts to GDP ratio is largely driven by bracket creep whereby wage and salary earners pay higher effective rates of tax on income as their nominal incomes grow over time.

Figure 3: Underlying cash balance (current policy scenario) and annual growth in real GDP



Source: IGR (2015) and FSC estimates.

The 2015 Intergenerational Report assumes that once tax receipts-to-GDP reaches 23.9 percent any excess tax receipts will be returned to individuals through income tax cuts to reduce the negative impacts of bracket creep. However, this level of bracket-creep would arguably result in significant costs on the economy. Under current Treasury projections it would see the percentage of taxpayers in the top two tax brackets (that is, with taxable income in excess of $80,000) increase from around 27 percent to 43 percent.

Further, if no changes were made to payment levels under this scenario, taxes would need to rise to and remain at a sustained level of around 26 percent of GDP to balance the Commonwealth budget.

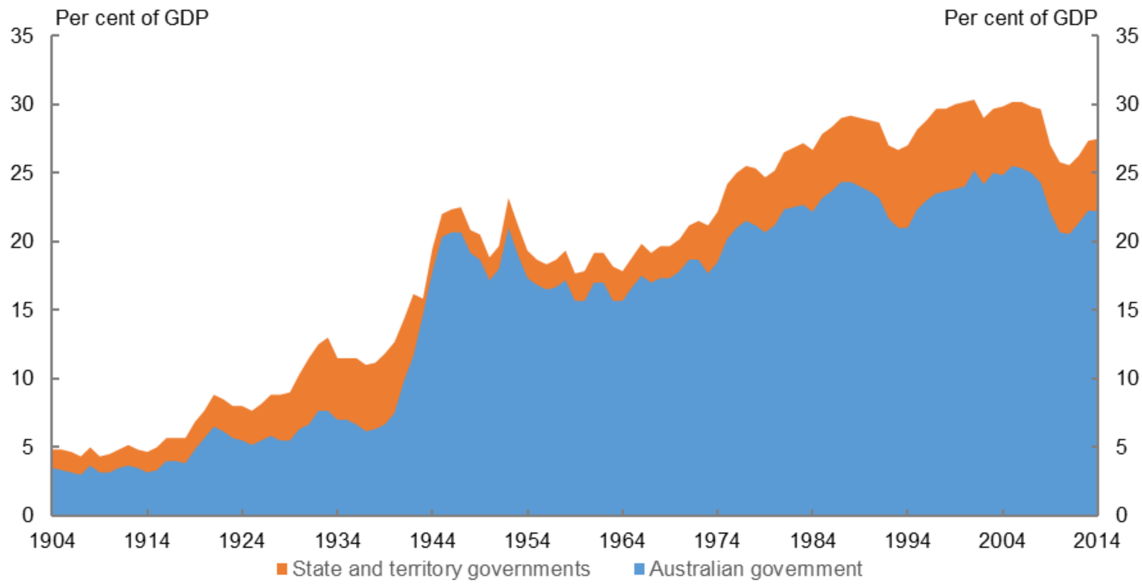
This level of taxation would significantly reduce the real rewards for effort over time by tax payers — discouraging workforce participation and investment, and depressing economic growth.

Key Revenue Trends

Consistent with most industrialised countries, Australia's tax take (measured as the tax to GDP ratio) grew significantly over the twentieth century, in line with the expanding role of government (see Chart 4). At the time of Federation, Australia's tax to GDP ratio was around 5 percent. This ratio remained reasonably constant until the introduction of the federal income tax in 1915. By the beginning of the Second World War, Australia's tax take was over 11 percent of GDP.

However, between 1915 and 1942, income taxes were levied at both the state and federal level. In 1942, income taxation was consolidated by the federal government to increase revenue and as a result, the states' tax base was reduced, replaced by federal government grants. The states' tax base was supplemented in 1971, when the then federal government ceded control of payroll taxes to the states.

Figure 4: Tax revenue (per cent of GDP) – Federal and state and territory government



Source: Treasury, ABS Cat No. 5506.0 and FSC estimates

Tax revenues increased significantly between 1973 and 1975, largely as a result of increased funding for social programmes. Subsequently the tax revenue rose modestly, before declining sharply as a result of the GFC - similar to the experience of many other OECD countries.

However, for Australia, the impacts on revenue following the financial crisis have been more pronounced for federal taxation arrangements, which have fallen from 25.8 percent of GDP in 2006-07 to 22.2 percent of GDP as at 2013-14. Over the same period, state and territory taxes as a percent of GDP have gone from 4.8 percent to 5.3 percent.

Compounding these near term issues has been a gradual erosion of traditional tax bases. Approximately 83 percent of total federal government tax revenue in 2013-14 was from 3 taxes – individuals' income tax, company tax, and the GST. However, over time the base of each of these three federal taxes has gradually eroded.

Notwithstanding a reduction in average inflation due to inflation targeting in the 1990s, the growth in compensation of employees (a common proxy for the individual income tax base) has slowly declined in line with structural changes in the economy from an annual average growth rate of 11.6 percent from 1960 to 1980, to an annual average growth rate of 6.2 percent from 2000 to 2014 (Figure 5).

The corporate tax base, as proxied by corporate gross operating surplus, has also experienced a decline in its growth rate from 11.0 percent (1960 to 1980) to 6.2 percent (2000 to 2014). Of more interest is that the corporate tax base has experienced negative growth rates in more recent history, shrinking by 1.9 percent in 2009-10 and 3.9 percent in 2012-13 (Figure 6).

Figure 5: Growth in Compensation of Employees

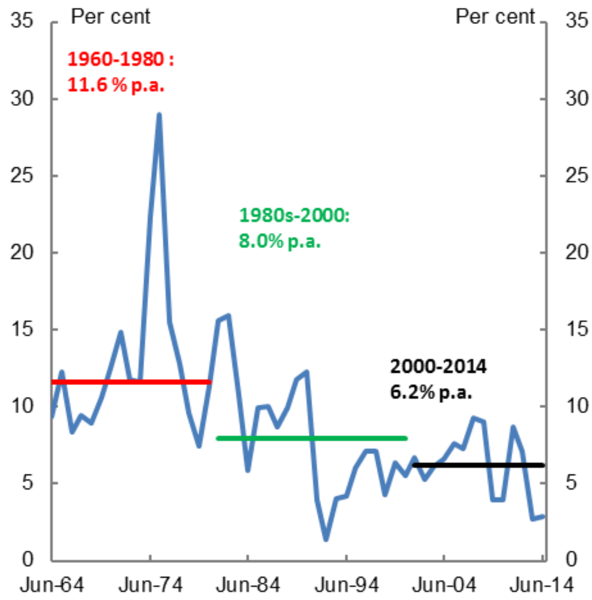
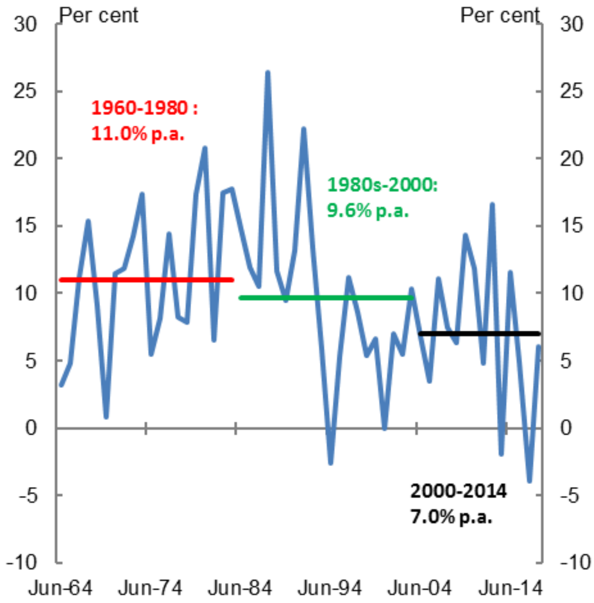


Figure 6: Growth in Corporate Gross Operating Surplus

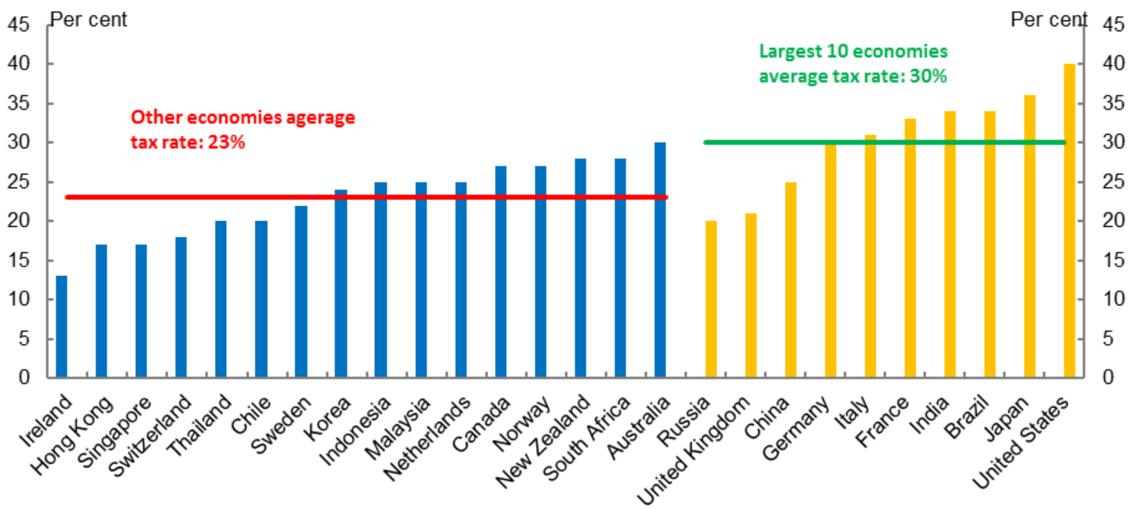


Source: ABS Cat No. 5206.0 and FSC estimates

Another significant strain on the corporate income tax base is due to international base erosion and profit shifting trends. Company tax arrangements are becoming increasingly important as competition for foreign investment intensifies and businesses become more mobile.

Australia's corporate tax rate is high compared to many countries we compete with for investment (Figure 7). This trend is increasingly seeing companies move operations offshore to lower tax jurisdictions and adopt aggressive tax structures which ultimately erode the corporate tax base of Australia.

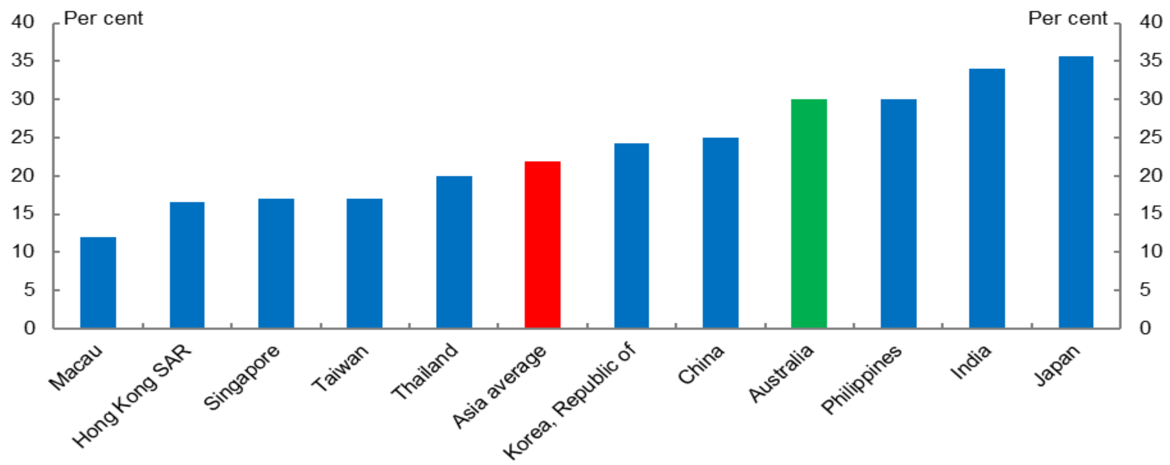
Figure 7: Corporate tax rates – selected



Source: Treasury Tax Discussion Paper (2015)

The lack of competitiveness imposed on the Australian economy as a result of our corporate tax arrangements becomes increasingly apparent when compared to our Asian neighbours, who have an average tax rate across the region of 22 per cent (Figure 8). Advanced Asian economies like Japan have already started making moves to reduce their corporate tax base in order to increase investment and raise wages of employees. Current plans are to cut the corporate tax rate in Japan from 35 percent to 32 percent over the next two years, with a 5 year goal of reaching 30 percent. However, economists have noted that in order to compete in Asia for investment, Japan would need to go further.[1] Research supporting recent company tax cuts in the UK also demonstrates that the long run economic benefits are substantial, the gains flow onto workers in the economy, and the fiscal impacts are muted in the long run (see Box 1).

Figure 8: Corporate tax rates – selected Asian economies



Source: KPMG (2015)

Base erosion is also occurring with the GST. Households now spend a lower proportion of their income on goods which are covered by the GST than they did when the GST was introduced.

Box 1: Case Study – UK Tax reform – the long run fiscal and economic benefits for the economy and workers of cutting the company tax rate

In the UK the largest round of company tax cuts since the 1980s began in 2010. Company tax reductions announced in 2010 and subsequent budgets will see the company tax rate fall from 28 per cent in 2010 to 20 per cent by 2015-16.

HM Treasury modelling suggests the tax reductions will increase investment by up to 4.5 per cent and GDP by up to 0.8 per cent. HM Treasury also found that lower corporation tax will also increase the demand for labour which in turn raises wages and increases consumption. HM Treasury modelling also suggests that increased profits, wages and consumption all add to higher tax revenues. As a result, the cost of the policy falls by between 45 per cent and 60 per cent in the long term.[2] Similar Computable General Equilibrium (CGE) modelling has been calibrated for the Australian economy by Treasury as part of its work for the Business Tax Working group in 2012.

Work by the Treasury found that reducing Australia's corporate tax rate from 30 per cent to 28 per cent would increase GDP by approximately 0.4 per cent. This increase in GDP is driven mainly by greater foreign investment flows into Australia to fund additional projects that are made viable by the reduction in the tax rate. The modelling also suggests that Australian workers benefit from the company tax cut in the long run as the productivity of labour increases with the increase in the size of the capital stock and this flow through to an increase in after-tax real wages.

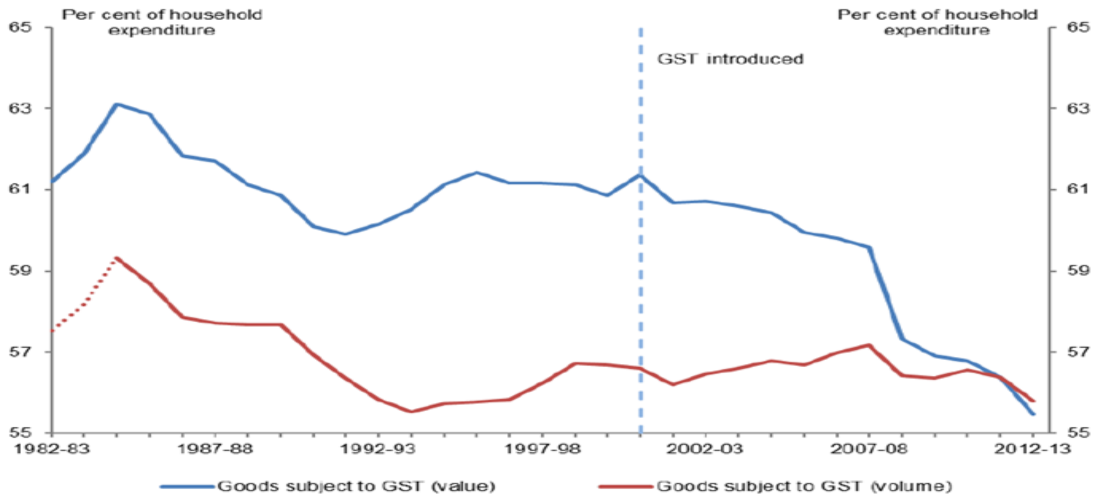
[1] http://www.bloomberg.com/news/articles/2015-03-31/japan-s-parliament-passes-abe-s-plan-for-corporate-tax-cut

[2] HM Revenue and Customs and HM Treasury 2013, Analysis of the dynamic effects of Corporation Tax Reductions.

A reduction in the company tax rate from 30 to 28 per cent was previously announced and costed in the 2010-11 Budget. The rate differed for small and large businesses. This policy was costed under an initial step down in the company tax rate to 29 per cent in 2012-13 for all businesses while small businesses would have a tax rate of 28 per cent. This policy came at a cost of $0.3 billion to revenues in the first step (2012-13) and $2 billion for the second step (2013-14).

Since its introduction in the 2000-01, the value of household expenditure subject to GST as a proportion of total expenditure has fallen from approximately 61 percent to just over 55 percent (Figure 9). This reduction in the value of consumption subject to GST is not reflected in the volume of consumption subject to GST, suggesting that the reduction is driven primarily by the prices of goods and services excluded from the GST rising faster than prices of goods and services subject to the GST.

Figure 9: Proportion of household expenditure subject to GST



Source: PBO based on ABS data

Note: The PBO has estimated data prior to 1984-5 by assuming that the difference between value and volume measures was consistent with their 1984-85 level.

Nominal consumption subject to the GST matters for GST revenues, it has declined as a share of consumption and it is likely to continue to do so given health (ageing population) and education services are expected to expand as a proportion of the economy in the future and are not subject to the GST.

However, the fall in GST receipts also reflects an uncharacteristically high starting point for consumption and savings level which was not representative of longer term behaviour. The GST was introduced at a time when consumption was a historically high share of GDP, and the household saving ratio was at historical lows.

Over the past decade, consumption has fallen as a share of GDP, from being well above to well below its long run average, while the household saving ratio has reversed its long run decline.

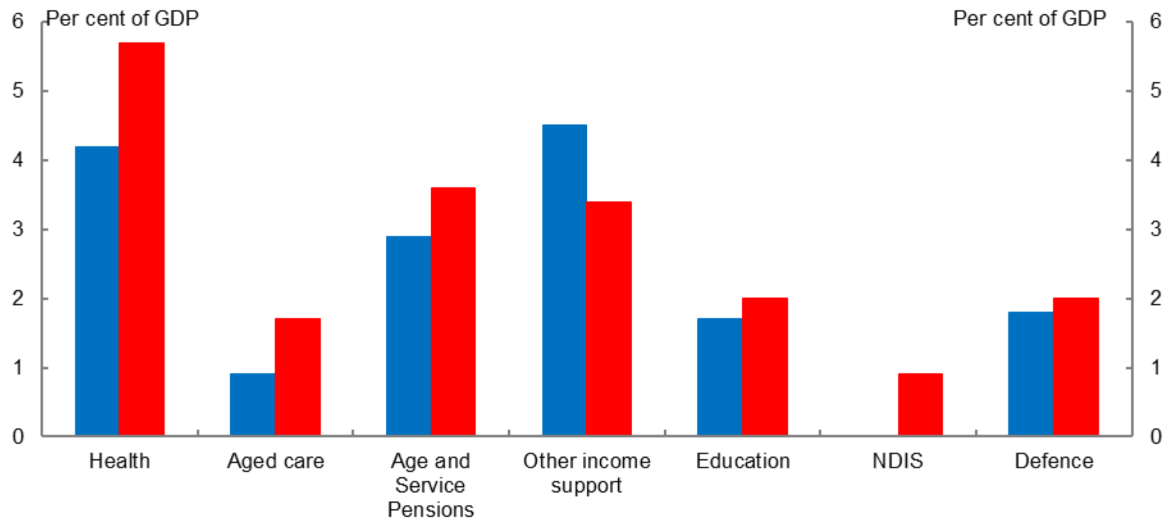
Current trends of lower rates of growth in national income per capita and compensation of employees, as well as faster price growth of goods and services not subject to the GST relative to goods and services not subject to the GST, will have implications for GST revenues.

Expenditure trends

Over the next 40 years, Australian governments will face increasing fiscal pressures as the population grows and ages. Under the current policy assumptions scenario in the IGR real spending growth is projected to average 3.1 percent per annum, leading to Australian Government spending of 31.2 percent of GDP in 2054–55.

This is higher than the post–World War II high of 27.6 percent of GDP. Underscoring this rise in the payments to GDP ratio is an increase in every major government expenditure category as a proportion of GDP with the exception of other income support programs (see Figure 10).

Figure 10: Spending trends 2013-14 and 2054-55 (per cent of GDP)

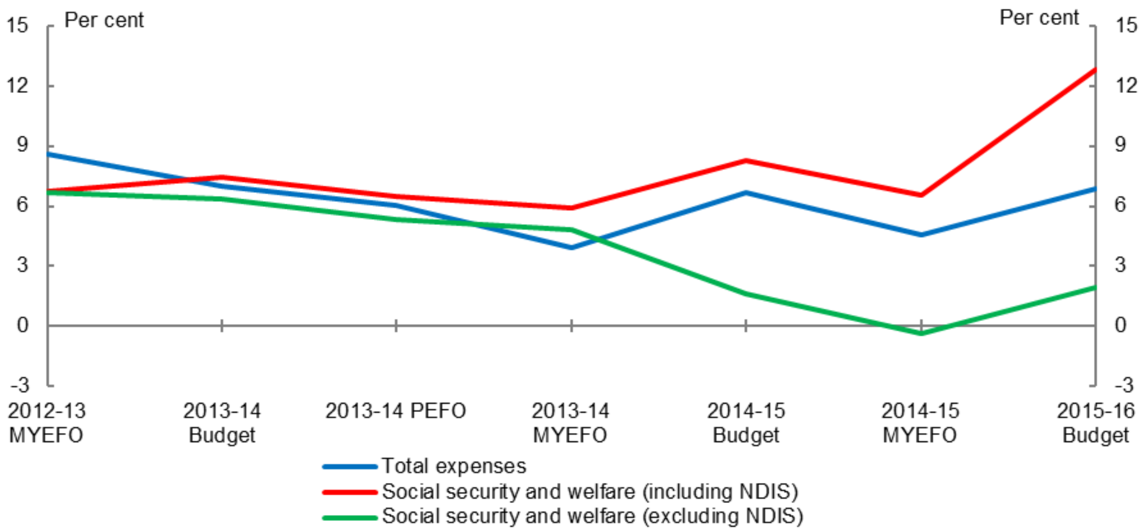


Source: IGR 2015

Currently, around 55 percent of Australian Government spending is directed to health, the National Disability Insurance Scheme (NDIS), aged care, pensions, payments to individuals, and education. These spending areas are sensitive to demographic change as spending is dependent on the size and age structure of the population.

Figure 11 shows rates of real expenditure growth in the social security and welfare function over the forward estimates at each budget update with and without the National Disability Insurance Scheme. In 2015‑16, expenditure growth in the social security and welfare function reflects the costs associated with the substantial ramp up of the implementation of the National Disability Insurance Scheme moving into the forward estimates period.

Figure 11: Total real growth rates over the forward estimates at each Budget and Economic update from 2012-13 MYEFO to 2015-16 Budget



Source: 2015-16 Budget

Tax expenditures are another area that warrant consideration. A significant portion of the current debate around super tax concessions centre around Treasury's presentation of tax expenditure estimates. The three major criticisms of these methodologies are:

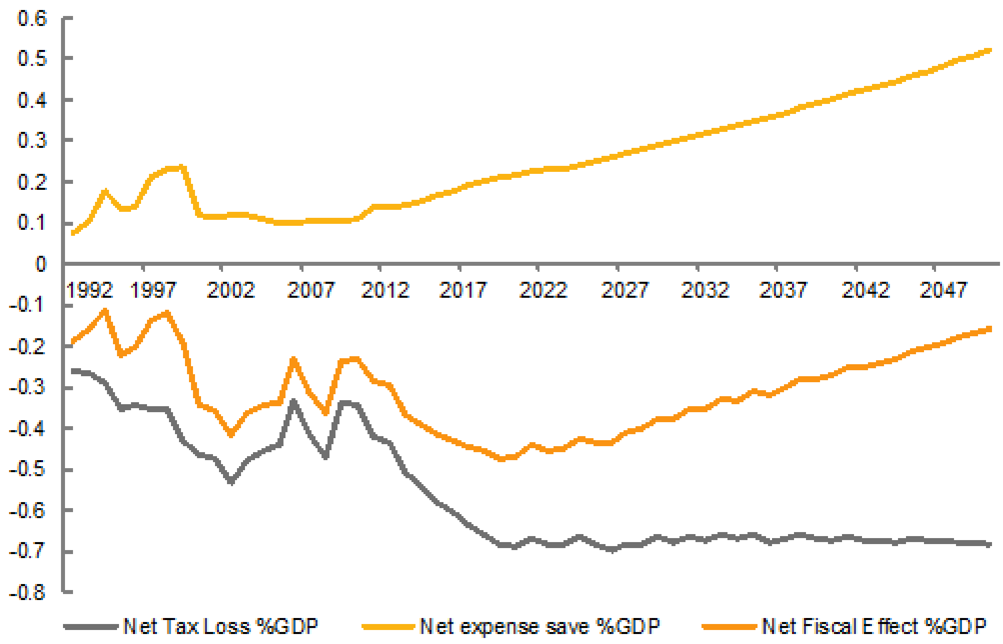
- that they are not costings with assumed behaviour changes in which assets inside the system would reduce year on year;
- the assumption that taxpayers would pay full marginal tax rates ignores likely behavioural changes directed towards the use of tax-effective investments (such as negatively geared housing, shares or investments with deferred capital gains); and
- that the long-term saving in Age Pension outlays should be factored into the cost estimate.

Australia's superannuation system is important in improving retirement income adequacy. Improving retirement income adequacy improves standards of living in retirement. However, it also serves the useful purpose of reducing the reliance on the age pension and other age related transfer payments to minimise the fiscal impact of retirement.

Without such a system, current growth projections for a range of government services would need to be reconsidered. The tax treatment of superannuation is, and should continue to be, calibrated towards helping the system effectively achieve these objectives especially in the current fiscal context. The system should not be viewed as a source of revenue to fund other Government programs or substitute for other taxes in the Australian system.

Estimates of the saving in Age Pension from superannuation changes have been routinely presented by Treasury, but have not been included in tax expenditure estimates. The savings are highest for measures which impact people likely to receive the Age Pension. For example, Figure 12 shows Treasury estimates of savings in Age Pension expenditures that result from an increase in the Superannuation Guarantee rate to 12 percent. It also shows the balance between tax losses and Age Pension underlying the analysis.

Figure 12: Reduction in taxes and Age Pension outlays from the SG



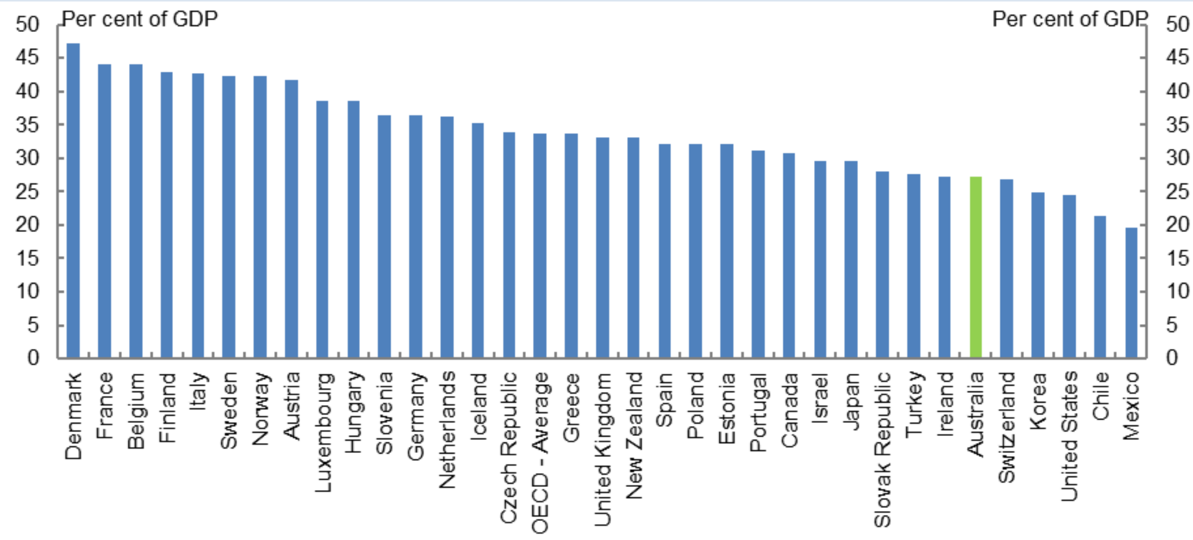
Source: Cooper, Goldberg and Rubin (2013), 'A Super Charter: fewer changes, better outcomes - A report to the Treasurer and Minister Assisting for Financial Services and Superannuation'

These issues and other issues relating to the adequacy of super and the savings it can generate for the budget are discussed in Chapter 1 – Superannuation.

Box 2: Cross country comparisons of the aggregate tax to GDP ratio are overly simplified

An obvious starting point for tax analysis by external observers is to consider the level of aggregate taxation in Australia as a proportion of GDP and compare it to other OECD countries. Advocates of this approach commonly make cross country comparisons that suggest that Australia is a 'low taxing' country (Figure 13). This leads them to draw the conclusion that the aggregate level of taxation in Australia should be raised as a proportion of GDP.

Figure 13: Total Tax as a per cent of GDP - Australia v OECD



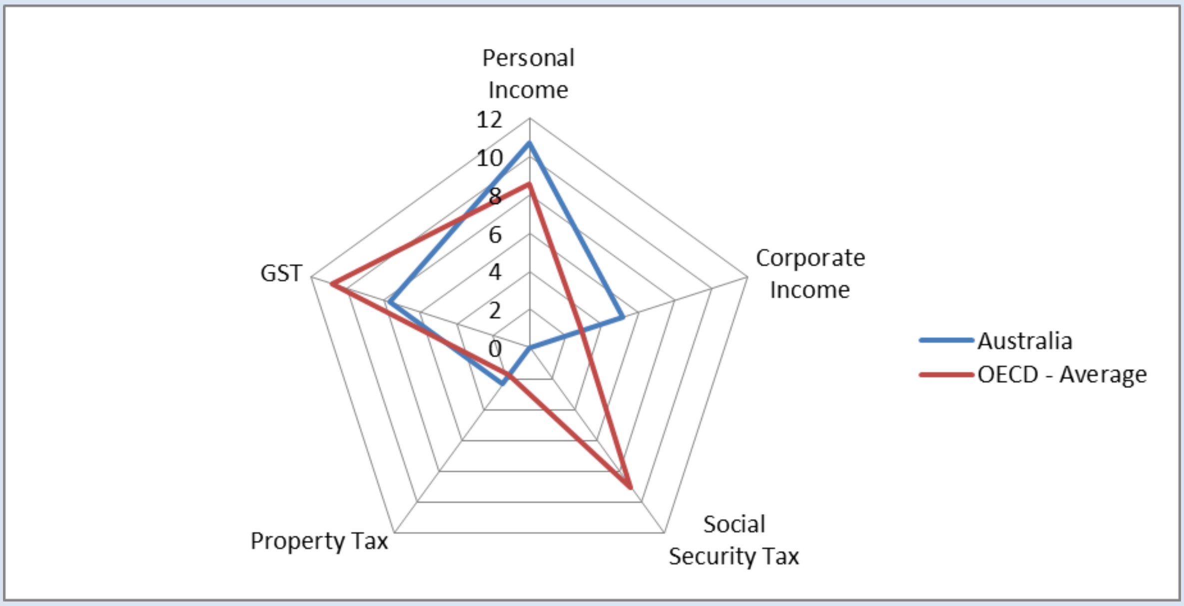
Source: OECD and FSC Estimates

However using an aggregate metric to consider the appropriateness of Australia's tax system has a number of limitations. International tax comparisons should be used with some caution as differences across countries reflect different stages of development of the country, geography, tax and expenditure policy settings, comparative advantage, unique resource endowments, the openness of the economy, productivity levels, societal choices and measurement issues. The different set of circumstances that each country faces may mean that comparing the aggregate tax to GDP ratio across countries is not feasible.

One example is that aggregate tax to GDP ratios fail to capture cross country differences in the composition of taxation. This masks the relative efficiency of the tax mix of an economy and the distributional outcomes of the tax system. At a more granular level, the aggregate tax level masks the tax rates for individual taxes and volume of the base upon which they are imposed.

For example, relative to the OECD average, Australia is more heavily reliant on corporate and income taxes, is less reliant on the GST relative to OECD countries, and in some circumstances such as social security taxes does not have similar institutional arrangements. This is arguably an economically less efficient tax mix in relation to the over use of personal and corporate income taxes and the under use of the GST (Figure 14).

Figure 14: Australia v OECD dependence on taxes



Source: OECD and FSC Estimates

Another common drawback of comparing the aggregate tax to GDP ratio across countries is that it fails to take into account cross country differences in relation to non-tax system issues, such as the size of government expenditure in an economy and how it is funded.

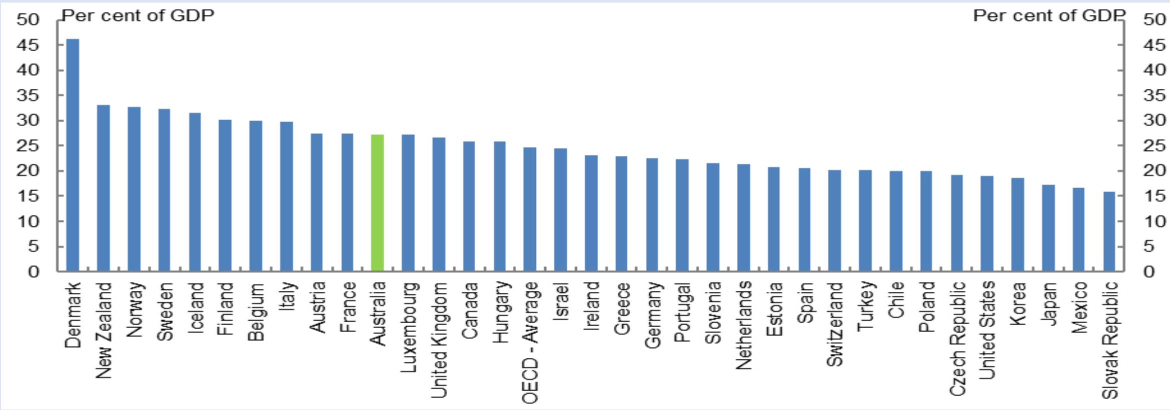
Societal choices around the level of government service provision, and the distribution of government expenditures arguably set the minimum amount of revenue the tax system is required to capture in order to maintain fiscal sustainability in the long run.

For example, Australia does not have a social security tax as found in other OECD members. In Australia, individuals have a 9.5 percent superannuation guarantee (SG) contribution. Due to the compulsory nature, the SG contribution plays the role of social security tax.

However, it is technically defined as non-tax item since it goes to individual account instead of the government and is fully under the contributor's discretion after the eligible age is reached.

Controlling for such distortions in the aggregate tax to GDP ratio in cross country results in a completely different perception of Australia's aggregate tax to GDP ratio relative to its OECD peers (Figure 15).

Figure 15: Total Tax (excluding social security tax) as a per cent of GDP – Australia v OECD



Source: OECD and FSC Estimates

Getting the focus of tax reform right

At its most basic level, the tax reform discussion paper is asking federal, state and territory governments, businesses and the community whether the tax system can meet the current and future needs and challenges of the country.

As discussed in box 2, aggregate international comparisons are less helpful in engendering a meaningful discussion around the sustainability of the tax system in Australia, and are excluded from further consideration.

Further, assessing the longevity of the taxation system cannot be done by considering taxation in isolation. Rather it requires considering whether the long run trajectory of tax receipts is on a stable footing to cover the long run trajectory of government expenditure. In essence, this comes down to a discussion about the fiscal sustainability of the country.

This is because tax systems are primarily aimed at financing public expenditures. The challenge facing Australia is that this is currently not the case, as discussed in the economic and fiscal context.

Governments are therefore left with three high level approaches to improving fiscal sustainability over the medium term. Governments can increase taxes, reduce expenditure, or *fix the mix* of taxation to improve the growth of the economy. The first two options are self explanatory parts of the contemporary discussions around fiscal sustainability.

The third option of *fixing the mix* of taxation has attracted little attention and is not well understood in the community. It relies on the public debt dynamic equation[3], which shows that if the economy can grow at a faster rate that was otherwise the case, it will reduce the overall public debt burden.

This suggests that a revenue neutral reform of the taxation system that shifts revenue collection from relatively inefficient taxes to relatively efficient taxes can improve the fiscal sustainability of the nation by improving productivity – which will ultimately flow through to higher GDP growth (either via a level shift or a permanent increase in the growth rate).

More broadly, the tax system impinges on a range of factors that determine the economic growth of Australia. Specifically,

- the level of taxes raised;
- the mix of taxation;

[3] For a discussion of the economics of public debt dynamics see IMF (2010).

- the quality of tax administration;
- the complexity of tax rules and the tax compliance costs;
- the certainty and predictability for households and businesses of the taxes that have to be paid;
- the network of tax treaties; and
- the specific design characteristics of individual taxes including the availability of tax incentives and the broadness of the different tax bases.

However, in choosing how best to deal with the tax choices facing the government and their implications for the longevity of the tax and expenditure system, the medium term fiscal strategy should guide the appropriateness of various solutions (outlined in box 3).

Box 3: The Commonwealth medium‑term fiscal strategy

The medium‑term fiscal strategy aims to achieve budget surpluses, on average, over the course of the economic cycle.

Several fiscal rules are imposed in order to achieve this objective, including:

- reducing the payments-to‑GDP ratio;
- stabilising and then reducing Commonwealth Government Securities on issue over time; and
- improving net financial worth over time.

Taken on face value, the medium term fiscal strategy implies that increasing the level of tax as a proportion of GDP in the economy is not necessarily required so long as expenditure decisions are made in order to achieve the fiscal rules.

However, it still leaves open the ability for significant tax reform that is revenue neutral across commonwealth and federal governments by fixing the mix of taxation. This would be tax reform focused on improving economic efficiency and therefore productivity. Two key issues which are worth considering in this context, are the relative efficiency and dependence on current taxes, and commonwealth and state/territory taxation and funding arrangements.

The relative efficiency of various taxes

The impact of the tax mix specifically impacts the employment level, the number of hours worked, capital deepening, human capital and the productive use of the factors of production. Taxes that have a smaller negative impact on the economic decisions of individuals and firms are less negative for economic growth.

The relative economic efficiency of various taxes is well documented, most recently by Treasury (2015).

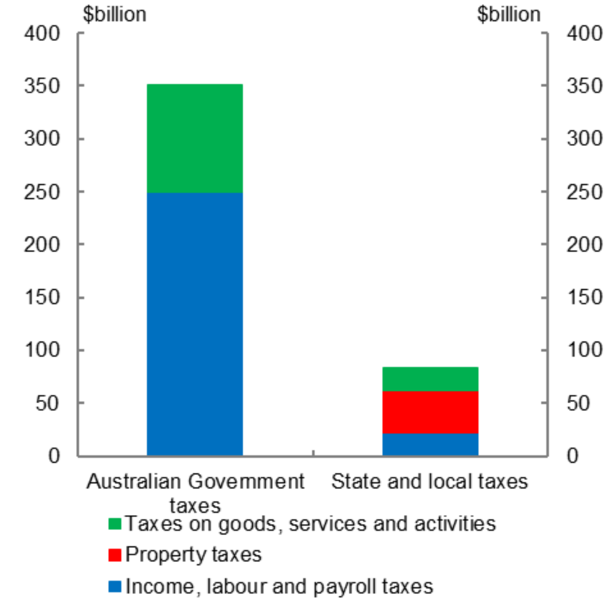
Earlier work by the OECD (2010) drew similar conclusions and suggested that a growth oriented tax reform package that is revenue neutral would be consistent with reducing corporate and personal income taxes, reducing inefficient transaction taxes and shifting towards consumption and land taxes.

In Australia at the Commonwealth and state and territory level, there is ample room to *fix the mix* in a way that promotes growth and is revenue neutral for the country as a whole (Figure 16 and Figure 17).

At the Commonwealth level $249 billion of approximately $352 billion of taxes collected (2013-14), about 71 percent of all Commonwealth taxes are levied on individual and corporate incomes.

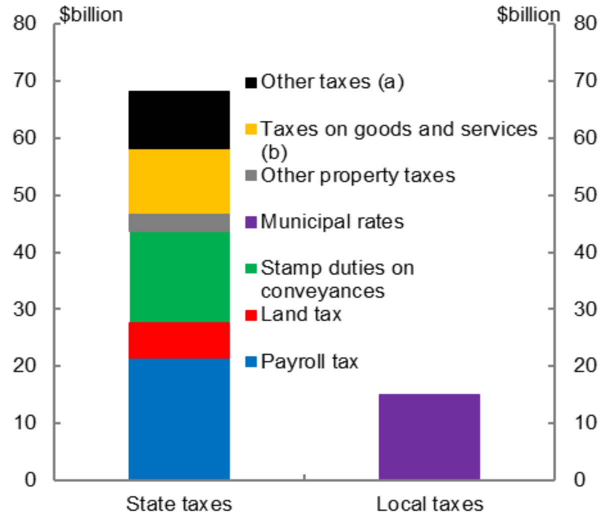
At the state and territory level, a range of stamp duties are levied with approximately 10 billion levied on insurance, approximately 10 percent of state taxes.

Figure 16: Composition of tax revenue by level of government 2013-14



Source: ABS Cat No. 5506.0 and FSC estimates

Figure 17: Sources of state, territory and local government tax revenue 2013-14



Source: ABS Cat No. 5506.0 and FSC estimates
Note: ACT's municipal rates are included in State – other property taxes . (a) Primarily motor vehicle taxes ; and (b) Primarily gambling and insurance taxes. This does not include GST revenue.

Further details on how to *fix the mix* of taxation and the Commonwealth level, the State and Territory level and between the Commonwealth and State and Territories are discussed in Chapter 4 on Business Tax issues and Chapter 5 on States taxes and the GST.

Commonwealth and state and territory taxation and funding arrangements

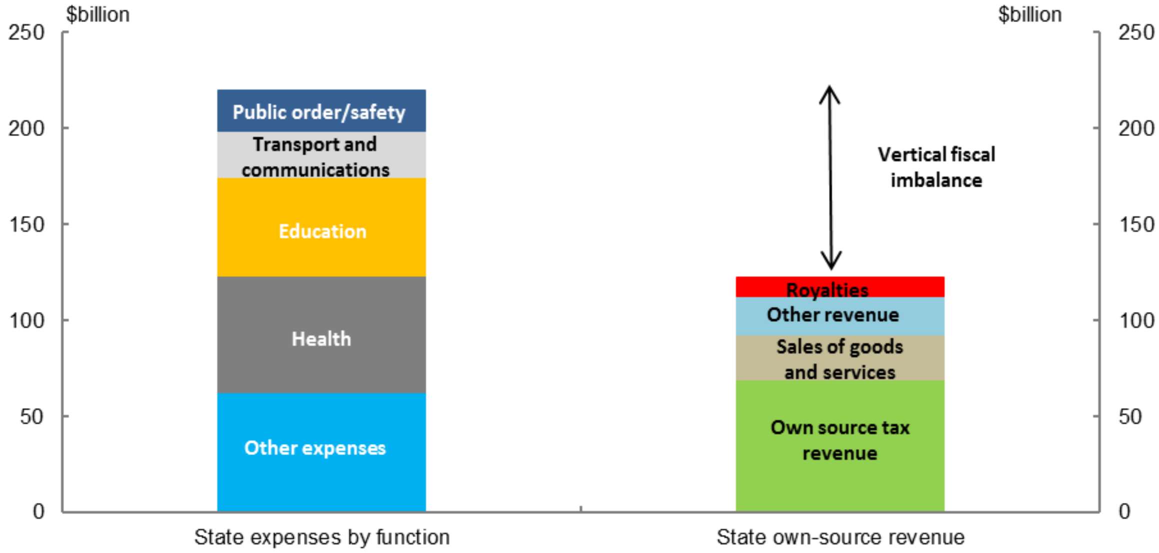
Our federation drives expensive confusion, a lack of accountability and is increasingly harming our global competitiveness. The central problem facing the federation is funding. This is not about the distribution of the money between the states. Rather it is how to address the "vertical fiscal imbalance" which is how we fund the states' obligations when the Commonwealth raises most of the money.

The Australian imbalance is twice the Canadian and USA federations. The vertical fiscal imbalance creates two problems, inefficiency and unaccountability.

The states currently spend $220 billion, but raise only $120 billion (Figure 18). In practical terms the vertical fiscal imbalance means that states are forced to raise their own revenue to supplement federal grants. And as already discussed, most state taxes are inefficient taxes.

While the states clearly have responsibility for service delivery such as health and education, the Commonwealth is responsible for co-funding. This is where the buck passing started. It has never stopped.

Figure 18: State expenses by function and revenues by source



Source: Treasury Tax Discussion Paper (2015)

The federation white paper has asked whether we should reduce the gap and if so, how should that happen. It has also asked whether the tax mix should be recalibrated towards more tax collection by the commonwealth government and if so, how that should happen?

However, since the Federation White paper process began, states and territories have unilaterally begun raising various taxes to try and reduce this gap on their own. While state and territory governments unilaterally raising taxes does go towards the vertical fiscal imbalance, a piecemeal and state by state and territory by territory approach to closing the vertical fiscal imbalance will ultimately exacerbate poor public policy outcomes and lead to an increase in the prevalence of inefficient state and territory taxes.

Further, a piecemeal approach by state and territory governments to closing the fiscal gap fails to acknowledge the benefits and efficiency gains of more centralised taxation arrangements via the commonwealth government, which is a serious option for fixing the tax mix between various levels of government. The recent example of how unilateral moves are leading to poor policy of increased underinsurance and less tax efficiency in relation to stamp duties on life insurance is discussed further in the chapter on state taxes and the GST.

The Tax Green paper should pay serious attention to these questions and propose options in relation to removing inefficient state taxes and supplementing them with more efficient commonwealth taxes.

RECOMMENDATION 1:

State and territory governments should commit to a moratorium on any further tax increases until the Federation White Paper process develops a blueprint for the future of Commonwealth and State and Territory Relations. This will require the timely release of the Federation Green Paper so options for reform can be discussed as part of the Tax White Paper process.

Fixing the mix

To summarise, there is ample scope to fix the mix of the Australian system and drive longer term economic growth. This will involve:

1. switching our reliance from direct to indirect taxes across all levels of government; and

2. reducing the need for states' reliance on inefficient, growth destroying taxes by securing more stable Commonwealth taxation arrangements.

RECOMMENDATION 2:

A growth oriented, internationally competitive and revenue neutral package of tax reform be crafted for the Tax Green Paper that fixes the mix of taxation in Australia by moving away from inefficient taxation sources to more efficient taxation sources.

Getting to a package of tax reform

In light of the FSC's preferred position to tax reform that involves a growth oriented and revenue neutral package that fixes the mix of taxation by moving away from inefficient taxation sources to more efficient taxation sources, the following recommendations are provided to assist in the realisation of this high level objective. The subsequent chapters outline the arguments for these recommendations.

Summary of Recommendations

Overview

State and territory governments should commit to a moratorium on any further tax increases until the Federation White Paper process develops a blueprint for the future of Commonwealth and State and Territory Relations. This will require the timely release of the Federation Green paper so options for reform can be discussed as part of the Tax White Paper process.

A growth oriented, internationally competitive and revenue neutral package of tax reform be crafted for the Tax Green Paper that fixes the mix of taxation in Australia by moving away from inefficient taxation sources to more efficient taxation sources.

Chapter 2. Corporate Tax

Australia's corporate tax rate should be immediately reduced to 25 percent and a medium term objective set to reduce the rate to 22 percent by 2020, to better align it with the average corporate tax rate in the Asian region.

Australia's dividend imputation system provides necessary relief for investors from double taxation of company dividends. There are strong arguments for the retention of the system.

Chapter 3. The GST and State Taxes

Broadening the GST base should occur as part of a package of tax reform which reduces Australia's reliance on company and personal taxation. In broadening the base of the GST, the regressive nature of the consumption tax should be addressed by compensating lower income earners.

As part of a package to lower company and personal taxation and abolish state stamp duties, the GST rate should be increased towards the OECD average.

The 1999 Intergovernmental Agreement on the GST should be renegotiated to enable State and Territories to abolish inefficient taxes and for the GST to be broadened and increased.

State and Territory governments should abolish all insurance duties.

Chapter 4. Australia's Global Competitiveness

Taxation policy targeted at attracting foreign investor activity must be costed on the basis of the investor's options in a global economy and consideration must be given to the impact of taxation settings on Australia's comparative position.

The Collective Investment Vehicle (CIV) regime reform proposal should be removed from the Tax White Paper process and legislation expedited. It is imperative that the CIV regime be in place prior to commencement of the Asia Region Funds Passport and there is sufficient industry consensus for the regime not to be delayed further.

The ability to provide multi-currency functionality must be incorporated into Australia's existing Managed Investment Trust regime as well as any future Collective Investment Vehicle regime.

Funds must receive appropriate treatment under Taxation of Financial Arrangements (TOFA) subdivision 230E in relation to portfolio foreign exchange hedging.

The government introduce a special Managed Investment Trust withholding tax rate of 5 percent for funds participating in the Asia Region Funds Passport.

Chapter 5. Not for Profit Sector

Recognising the important role which the not for profit sector plays, we recommend that the Government ensure that taxation arrangements encourage, rather than discourage, philanthropic giving.

Further consideration should be given to whether the current not for profit arrangements could be improved to better support giving in Australia and/or whether new innovative structures are desirable.

Chapter 6. Tax Administration

The government establish a Tax Expert Panel responsible for drafting minor technical amendments to existing tax legislation, regulation and other legislative instruments. The Panel should be comprised of representatives from industry, Treasury and the ATO and clear guidelines be established for the Panel's remit in relation to legislative drafting.

The ATO undertake detailed cost/benefit analysis based on the above factors prior to changing any industry reporting requirements, such as the Annual Investment Income Report and the Standard Distribution Statement (or its replacement).

The Treasury release detailed assumptions supporting all items in the Tax Expenditure Statements along with costings for any future policies.

2. Business Tax Issues

2.1 Corporate Tax Rate

We welcome the discussion paper's perspective that "Australia's corporate tax rate is higher than many countries we compete with for investment."

-- *Tax Discussion Paper*, Page 74

The Tax Discussion Paper makes the case that open economies are impacted by barriers to investment more so than closed economies, with economic growth and real wages growth being affected. It cites examples of countries which have reduced their corporate income tax to improve competitiveness in recent years.

The FSC agrees with the proposition that Australia's corporate tax rate is high. When compared to peers in the Asian region, the difference is particularly stark.

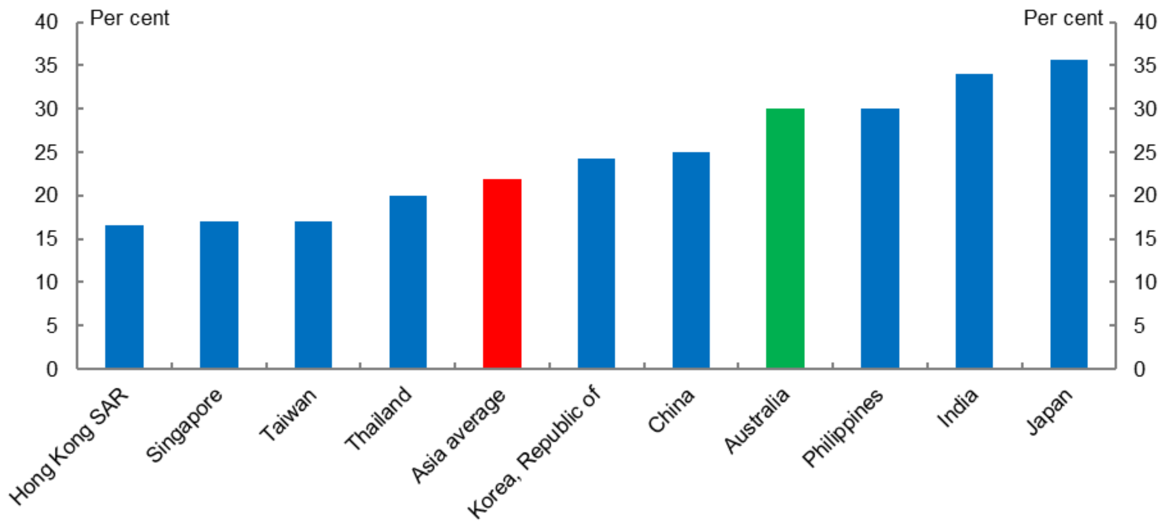
In 2014 Australia's 30% rate was higher than the average rate within the Asia region of 21.91%, the OECD average of 24.11% and the global average of 23.57%.

Countries with a higher corporate tax rate than Australia include France (33.33%), Belgium (33.99%), India (33.99%), Japan (35.64%) and USA (40%).

Countries with lower tax rates than Australia are Ireland (12.5%), Hong Kong (16.5%), Singapore (17%), UK (21%), Korea (24.2%), China (25%) and New Zealand (28%).

The following chart shows how Australia's corporate tax rate compares with other countries is the Asian region.

Chart 1. Corporate tax rate – Asian economies



Impact on Australia's Competiveness

A high corporate tax rate dampens Australia's ability to attract business activity and encourages structuring to reduce the overall tax rate paid by global businesses. Multinational profit shifting is a direct result of inconsistent corporate tax rates being offered between jurisdictions which are easy for corporations to transition between, through structuring.

Not all profit shifting is illegitimate. In funds management it is normal for certain activities to be undertaken in different jurisdictions. For example, asset management might be undertaken in a different location to investors, or fund domicile. Businesses will decide where to base their activities after considering many factors, including the cost and expertise of labour, tax rates and business incentives, and the flexibility of local regulatory regimes.

Global asset management companies can have a significant advantage compared to Australian-based companies. Existing operations in a variety of jurisdictions provide the ability to determine which business activities will be placed in each location. This separation of the value chain means that countries compete to attract business activity across different niches within funds management.

Competitors offer incentives

As an example, Singapore specifically targets funds management activities through the provision of incentives in addition to its low 17 percent corporate income tax rate.

Example: Incentives available in Singapore

Singapore provides a number of specific tax incentives to the funds management industry, including:

- tax exemptions for offshore funds. Qualifying offshore funds managed by a Singapore-based fund manager are exempt from Singapore tax on income from profits, gains, dividends and interest from designated investments;
- tax exemptions for onshore funds. Extends the exemptions for offshore funds to qualifying Singapore-domiciled funds;
- enhanced tier. Funds with a minimum of S$50 million can obtain the offshore and onshore fund tax exemptions without the need to meet residency status restrictions for the vehicle or investor;
- concessionary tax rate for fund managers. A concessionary rate of 10 percent is charged on fee income for fund managers employing at least three fund management or investment advisory professionals with individual monthly income greater than S$3,500; and
- general financial services industry tax incentives including concessions on trading income, fee income and withholding tax exemptions for over-the-counter financial derivative payments.

The combination of a low corporate tax rate and additional funds management and financial services incentives makes Singapore a highly attractive destination to base activities in.

Australian companies without the ability to leverage existing presences across multiple locations cannot take advantage of concessions and incentives as easily as their global counterparts. Where the incentives offered are significant, global expansion to a more beneficial environment does however become more attractive.

It is legitimate for countries to provide incentive opportunities to attract activity. In turn, companies will determine how to best take advantage of the opportunities being offered to them. These are the natural results of an open market place and the end beneficiaries are investors who receive services at a lower cost.

For Australia to remain competitive an appreciation of the incentives being offered in competing jurisdictions is required.

A competitive corporate tax rate

A reduction in Australia's corporate tax rate would encourage more financial services business activity to be domiciled in Australia.

A lowering of Australia’s corporate tax rate would also lessen the impact of inconsistencies between foreign and domestic investor ability to receive the benefit of Australia's dividend imputation system. However these changes cannot be made in isolation and other taxation changes are required to ensure competitive and consistent treatment of foreign investors occurs. *[See International Competitiveness Chapter]*

The Henry Review of Taxation recommended the corporate tax rate be reduced to 25 percent.[4] In the subsequent years, the case has strengthened for a lower company tax rate as our opportunities to trade and compete in our region have increased. As shown above, the average corporate tax rate in the Asian region is 21.9 percent.

RECOMMENDATION 2.1:

Australia’s corporate tax rate should be immediately reduced to 25 percent and a medium term objective set to reduce the rate to 22 percent by 2020, to better align it with the average corporate tax rate in the Asian region.

Costing changes

Australia must change the way it calculates the tax expenditure statement figures for measures designed to attract offshore capital (or highly mobile capital and activities which could move offshore).

The traditional approach of assuming that capital is immobile does not hold in a competitive global marketplace, where jurisdictions such as Singapore, take active steps to provide real incentives to businesses.

Notional “tax expenditure” does not occur when activity is non-existent. Whilst any concessional rate is considered “expenditure” and marked against the full corporate tax rate of 30 percent, it is not a realistic benchmark for activity which does not currently exist in Australia. It is tantamount to counting the hatchlings of foreign chickens as Australian resident tax payers, before any eggs have been laid.

For further discussion and recommendations see International Competitiveness chapter.

Tax administration

For further discussion and recommendations see International Competitiveness chapter.

2.2 Dividend Imputation

Double taxation of dividends is not a desirable feature for Australia’s tax system. The dividend imputation system was introduced to ensure investors are not “re-taxed” on equity investments.

The imputation system has encouraged participation in the capital markets and has created a nation of shareholders. Dividend imputation is inherently embedded in our capital market structure and the principle of avoiding double tax is sound.

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[4] *Australia’s Future Tax System* (The Henry Review of Taxation) 2010 – Recommendation 26 <http://taxreview.treasury.gov.au/content/finalreport.aspx?doc=html/publications/papers/final_report_part_1/chapter_12.htm>

The bias toward equity investment is assisted by Australia's high corporate tax rate. Arguably this bias might be alleviated by a reduction corporate tax rate to be more in line with the typical tax treaty rate applying to passive dividend income.

International issues

At the time of the introduction of dividend imputation in 1987, Australia was a relatively closed economy. Since then Australia has become an open economy competing in a global marketplace for highly mobile capital.

A dividend imputation system provides tax neutrality between debt and equity investment[5] in a closed economy. For large widely-held companies however, the imputation system creates a bias towards domestic capital over foreign (and also between foreign equity and debt).

As the debate on international profit shifting continues, the dividend imputation system does create an incentive for domestic companies with domestic shareholders to pay tax on their profits in Australia. This incentive clearly benefits Australia through additional economic activity and taxation revenue. Meanwhile, the high corporate tax rate in Australia provides a competing disincentive for companies to locate their operations in Australia.

The dividend imputation system may indirectly discourage domestic companies expanding offshore because income from offshore operations may not give rise to fully franked dividends. If foreign taxes are paid, a foreign tax credit may arise for such taxes, reducing the Australian tax payable on that income. Accordingly, any dividend paid by a domestic company from that income will be partially/fully unfranked and subject to tax in the hands of the shareholder (effectively paying both foreign and domestic tax on that income).

Foreign investors do not receive the benefit of imputation, although dividend withholding tax rates are reduced for foreign investors in countries with a double taxation agreement with Australia.

Consideration should be given to whether Australian companies with foreign shareholders should be able to pay dividends to foreign shareholders out of the profits from offshore operations, while providing dividends out of the profits from domestic operations to domestic shareholders with imputation credits attached. As an alternative, consideration should be given to whether foreign tax credits should be passed onto individuals, in much the same way as imputation credits are currently passed on.

Demand for Yield

In the current environment, with an ageing population, investors are chasing yield. Returns on traditional fixed interest securities have been decreasing.

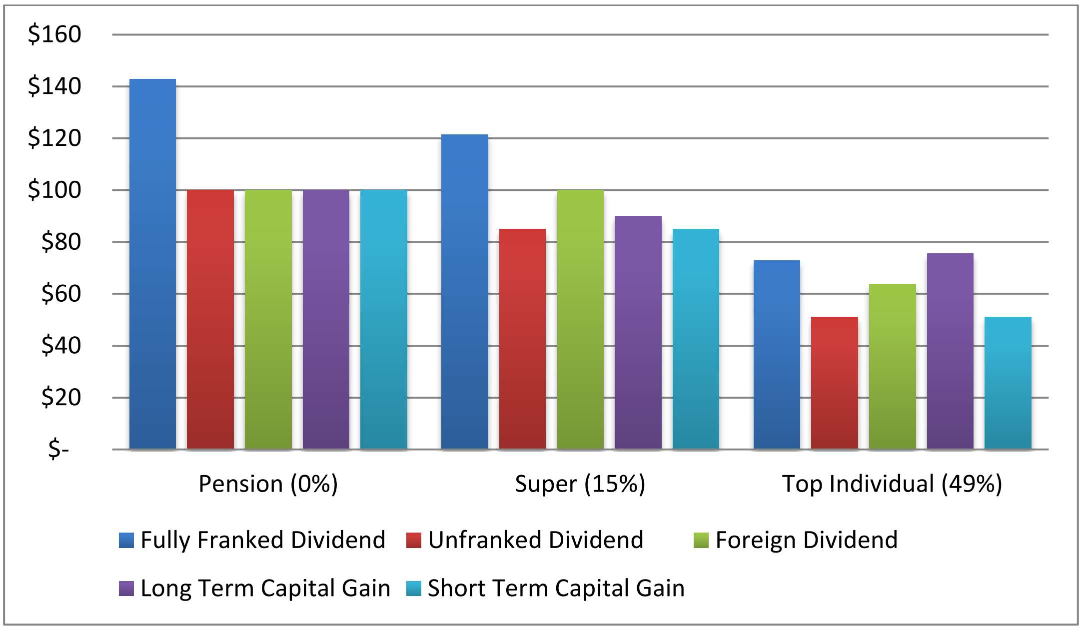
The dividend imputation system together with capital gains concessions has created the following bias amongst domestic investors:

1. low income taxpayers will prefer fully franked dividends over unfranked dividends/interest income and capital gains; and
2. high income tax payers will marginally prefer long term capital gains over fully franked dividends.

[5] Tax neutrality from the perspective of the domestic investor.

Chart 2 highlights the after tax return for $100[6] pre-tax profit.

Chart 2. After Tax Return - $100 Pre-tax Profit



Arguably the provision of franking credits to domestic investors artificially inflates yield and drives a preference for companies which fully frank their dividends.

There is however evidence to suggest that high dividend paying companies tend to provide the highest total return to investors. Further, dividend imputation also encourages Australian companies to pay out dividends because investors are not being taxed twice.

The effect can be seen with comparing the Australian Accumulation 200 Index (total return index) to the ASX200 index. Post the global financial crisis in 2008, the Accumulation Index has posted a 147 percent return compared to that of 89 percent for the ASX200.

Changes to the imputation system are likely to affect company payout ratios. It is not possible to predict the broader impact on Australia's capital markets that would arise if the dividend imputation system was abolished.

Any change to the taxation of dividends cannot be viewed in isolation, and changes must be carefully analysed in combination with the taxation of savings income as a whole.

RECOMMENDATION 2.2:

Australia's dividend imputation system provides necessary relief for investors from double taxation of company dividends. There are strong arguments for the retention of the system.

Refundability of Franking Credits

Refundability of franking credits was introduced in the early 2000s to remove the biases arising between debt and equity investment.

[6] Foreign income has 20% withholding tax deducted at source

The basic premise of Australia's corporate tax regime is that it operates effectively as a withholding tax. Tax is taken out at the company level at 30 percent.

The ultimate burden is carried by the owners of the business, therefore equity owners are levied at their individual marginal tax rate. As a result, individuals and entities in a low tax or tax-exempt environment will receive refunds for tax paid at the corporate level.

Without refundability of franking credits a bias toward debt financing would emerge. This is due to interest payments made in return for debt financing by investors being paid by the company before tax is levied. When received by the individual investor, these payments are then taxed as income, at the investor's marginal tax rate. The result is that no corporate tax is paid on interest payments. In contrast, dividend payments will have corporate tax removed prior to the investor receiving them.

The following example explains this in simple terms.

Example – Comparison of tax difference between debt and equity investment

- *Company A earns $100 profit before interest.*
- *interest of $50 is owed to debt investor (financier)*
- *corporate tax is payable at 30%*
- *the company pays out all profits as dividends*
- *tax rate of debt investor (financier) 0%*
- *tax rate of equity investor 0%*

Profit before interest and tax	$100
Less interest expense	*($50)*
Taxable income	$50
Less tax	*($15)*
Cash available for dividend	$35

The debt investor would receive their $50 interest payment and this income would be subject to tax in their hands at their marginal rate of 0%.

However an equity investor would receive $35 dividend payment and a franking credit for the $15 of corporate tax paid. They would be taxed on their dividend at their marginal tax rate of 0%. If the equity investor were denied the benefit of franking credit refundability they would only receive $35, not the full $50. The extra $15 is provided to them via a refund from the ATO so the total they have received is $50 and the tax they have paid is 0%.

Without franking credit refundability:

- tax-free and low tax investors would prefer debt investment over equity investment; and
- companies would prefer to retain earnings, rather than pay out dividends. However we note that dividend retention policy is a complex decision undertaken by business and, in the listed investment context, is less likely to be influenced by the tax rates of individual investors, than in the 'closely held' company context.

Any changes to the refundability of franking credits would clearly have significant impacts on company behaviour, investor behaviour, and consequentially the Australia stock market.

Sustainability of franking credit refundability

The Tax Discussion Paper raises the revenue concern in relation to cost of franking credit refundability.

The major beneficiaries of franking credits are retirees, superannuation funds and charities within the tax exempt environment, or individuals subject to tax rates below the corporate tax rate Australia.

To the extent that the predominant consumers of fully franked shares are, and continue to be, investors in a low tax (or tax exempt) environment it is necessary to be cognisant the proportion of corporate tax concessions being provided through franking credit refundability.

The issue is complex and cannot be considered in isolation from the sustainability of Australia's superannuation and retirement policy. Any changes to the tax-free status of earnings in retirement phase would lessen the cost to revenue of franking credit refundability. The treatment of franking credit refundability should be consistent with intended policy outcomes for income received in retirement.

It is also necessary to contemplate the impact any changes to franking credit refundability would have on investor preferences.

As described earlier, debt financing arrangements result in interest payments being made to investors prior to company tax being paid. Investors are then taxed at their own marginal tax rate on these interest payments, with investors in a tax-free environment not bearing any liability.

If franking refundability were removed, investors would prefer to provide debt financing to companies rather than equity investment. Any changes would also have a significant impact on the capital markets.

Franking credit refundability in the Not-for-Profit sector

NFP entities (especially philanthropic trusts) hold significant equity holdings and are generally tax-free, thus they fully claim back the amount of corporate tax already paid in dividends from their shareholdings.

Removal of franking credit refundability would have a major financial impact upon NFP entities, particularly tax-free philanthropic trusts and charities.

It would mean NFP entities would effectively be paying tax on dividend income, which in turn would negatively impact their ability to support charitable causes. Such a result would be inconsistent with the Government's desire to grow philanthropy in Australia and the re-formation of the PM's Community Business Partnership.

The following simplified example shows how refundability of franking credits works.

Example – How refundability of franking credits works

Taxable income of company	$100
Corporate tax paid	$30
Post tax dividend	$70

Scenario 1 – Investor on highest marginal tax rate 47.5

- investor 1 would receive $70 and would owe tax of $33.25.
- the company has already paid $30 tax, bringing the total tax received by the government to $63.25 for $100 of taxable income.
- this equates to a tax rate of 63.25%.
- investor 1 receives a credit of its share of the tax already paid at the company level.

Dividend received	$70
Tax paid by Investor directly	$33.25
Tax credit received for corporate tax paid	$30
Difference to be paid by Investor	$3.25

- investor 1 receives a credit for the $30 already paid by the company and just pays enough tax to "top up" to its marginal rate. Or $3.25.
- this results in total tax being paid of $33.25 or 47.5% of the $100 taxable income.

Scenario 2 – Investor on tax free threshold

- investor 2 does not pay any tax as they are below the tax free threshold.
- they receive the $30 credit but do not pay any tax on the dividend.

Dividend received	$70
Tax paid by Investor directly	$0
Tax credit received for corporate tax paid	$30
Refund received by Investor	$30

- the dividend they received is the full $70 and the tax paid at the company level is given back to the investor as a refund by the tax office.
- investor 2 receives $100 taxable income and no tax is paid on this.

3. The Goods and Services Tax and State Taxes

Consensus is building amongst business and consumer groups about the need to change the GST as part of broader tax reform package.

The large number of exemptions and the comparatively low rate of the GST (Australia's rate is half the average of the OECD) underscore an already strong policy rationale for broadening the base and increasing the rate.

GST reform is crucial before we can begin to resolve issues of vertical and horizontal inequity that result from Australia's current tax distribution settings. Broadening the base and rate of the GST and fixing the distribution challenges creates a platform for other areas of tax reform, such as making Australia's company tax rate more consistent with our competitors in the Asia region and abolishing inefficient state transaction taxes which are a drag on our economy.

One of the least efficient of the State taxes is insurance duty. The current settings are driving perverse outcomes such as discouraging people from taking out insurance. The FSC recommends that these should be abolished with the foregone revenue replaced by a more efficient revenue stream (GST).

Despite voluminous literature about why inefficient taxes should be removed, State Governments continue to indulge in a heavy reliance. In Victoria the industry applauded as the former government announced it would abolish duties on life insurance but were left reeling after it became clear the Government intended to apply the higher general insurance rate of stamp duty to a greater number of life policy "riders", while abolishing only the duty applicable to the underlying life insurance policy. This increased taxation on life insurance rather than abolishing it.

The FSC has calculated that this decision has led to an increase in stamp duties payable by 500 percent for the holder of a hypothetical $1 million life insurance policy with a yearly premium of $1,000.

Unfortunately this experience has not been quarantined to Victoria with a number of other State Governments including Western Australia and South Australia who already have similar laws in place and the Northern Territory introducing these changes from 1 July 2015. In many cases the explanatory memoranda to Parliaments have been misleading by reporting that 'equality of tax treatment' was required between disability policies issued by life insurers and those issued by general insurers.

It is recognised government policy, world-wide, that concessional tax and stamp duty treatment should be afforded to policy owners who provide for themselves and their families by securing long term capital benefits by way of life insurance. Australians are already heavily underinsured and despite best intentions, public policy settings such as stamp duties which affect affordability, may lead people to incorrectly assume that they can rely on welfare or government disability payments to meet their needs.

It goes without saying that State Governments should not be expected to "go it alone" with respect to abolishing inefficient taxes. Naturally the revenue foregone by abolishing inefficient taxes, such as stamp duties on life insurance, must be substituted by an alternate source of revenue. The States and Territories face an annual revenue shortfall of $100 billion[7]. The obvious source for this replacement revenue is the GST however there is work to be done in order to rebuild trust over the distribution of GST revenue with State Governments. This should be dealt with by the Federation

[7] The Hon. Tony Abbott MP, Speech to Sir Henry Parkes Dinner, 25/10/2014, Sydney

White Paper, which is reviewing current relations between the jurisdictions. Table 1 below shows the distribution of GST revenues to the States and Territories.

Table 1: GST contribution to total state revenues: Distribution of GST 2014-15 across states

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Amount ($mil)	16,808	11,853	11,734	2,310	4,956	1,911	1,137	3,166	53,875
% of total State revenues	25	20	23	8	31	39	26	52	23

It is abundantly clear that the GST is not effectively capturing the expenditure of Australian consumers. The FSC recommends widening the base and rate of the GST to facilitate a move from an overly heavy reliance on corporate and personal income (direct) taxes, to a more sustainable focus on consumption (indirect) tax. Modelling by KPMG shows that there are significant efficiency gains to be made by recalibrating Australia's GST. These changes yielded increased revenue ranging from 12.1 billion in 2015-16 by broadening the base at the same rate, to $42.9 billion by increasing the rate and broadening the base to include health, education and fresh food.

The FSC has commissioned KPMG to review all of the options for tax reform in Australia. While broadening the base and rate of the GST is relatively straight forward, there may be complexity with respect to broadening the GST base to include financial supplies.

3.1 Goods and Services Taxation

It is clear that Australia's Goods and Services Tax (GST) is not effectively capturing the expenditure of Australian consumers. This has been an increasing trend. Widening the base and rate of GST is required for Australia to move from an overly heavy reliance on corporate and personal income (direct) taxes, to a more sustainable focus on consumption (indirect) tax.

Modelling by KPMG shows that there are significant efficiency gains to be made by recalibrating Australia's GST. The FSC recommends widening the base and rate of the GST to facilitate a move from an overly heavy reliance on corporate and personal income (direct) taxes, to a more sustainable focus on consumption (indirect) tax.

Prima facie, the FSC is of the view that any increase to the general GST rate without broadening the base may increase the revenue gap and cause further market distortions.

Options for GST reform

Since 2002-03, GST revenue has declined relative to the size of the economy. In 2002-03, GST revenue was 3.9 per cent of gross domestic product (GDP) but, by 2013-14, this had fallen to 3.5 per cent of GDP — in dollar terms, this is equivalent to reduced GST revenue in 2013-14 of more than $6 billion. This decline could be addressed by implementing a combination of the following reform options :

- broaden the base (same rate)
- increase the rate (same base)
- increase the rate and broaden the base to include health and education, the two largest consumption items currently not taxed; or
- Increase the rate and broaden the base to include health, education and fresh food.

These changes yielded increased revenue ranging from 12.1 billion in 2015-16 by broadening the base at the same rate to $42.9 billion by increasing the rate and broadening the base to include health, education and fresh food.

The FSC notes the economic modelling commissioned by CPA Australia and performed by KPMG that included analysing the impact of broadening the base and increasing the GST rate.

The following table summarises the additional revenue for the four scenarios modelled:

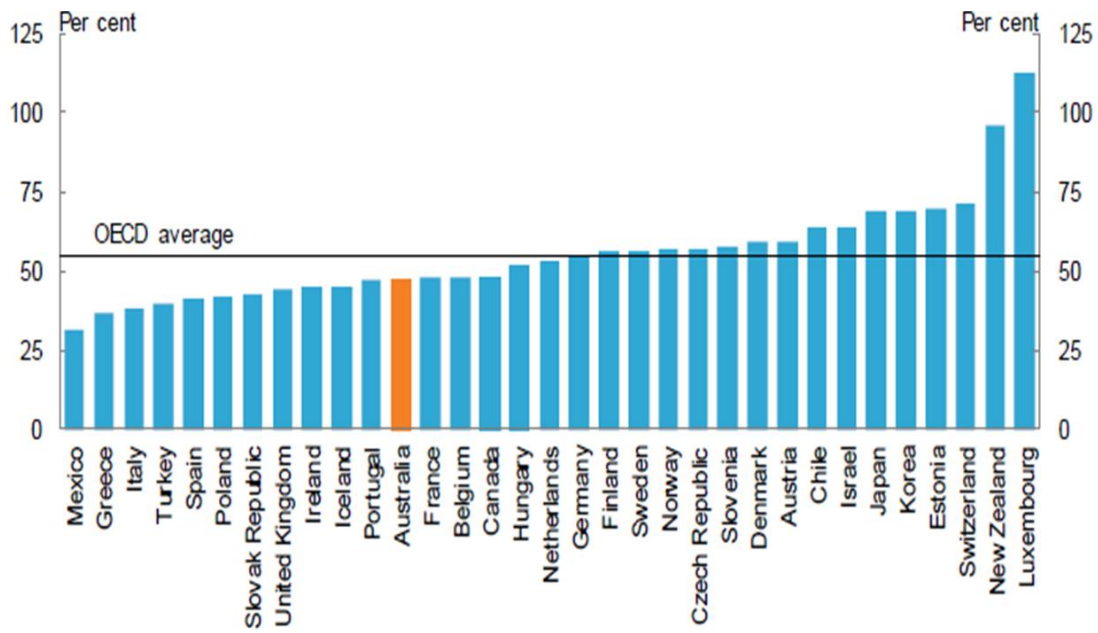
Table 2 : KPMG Report (2015-16, $000)

10% GST rate (broader base)	$12,120
15% GST rate (same base)	$25,952
15% GST rate (broader base including health and education)	$36,841
15% GST rate (broader base including health, education and fresh food)	$42,892

GST base

The decline in GST revenue as a share of GDP has resulted from a decrease in the proportion of household spending on taxable goods and services, and a corresponding increase in the proportion spent on GST-exempt goods and services. Chart 1 below shows that Australia has a lower GST coverage ratio than our competitors in the OECD.

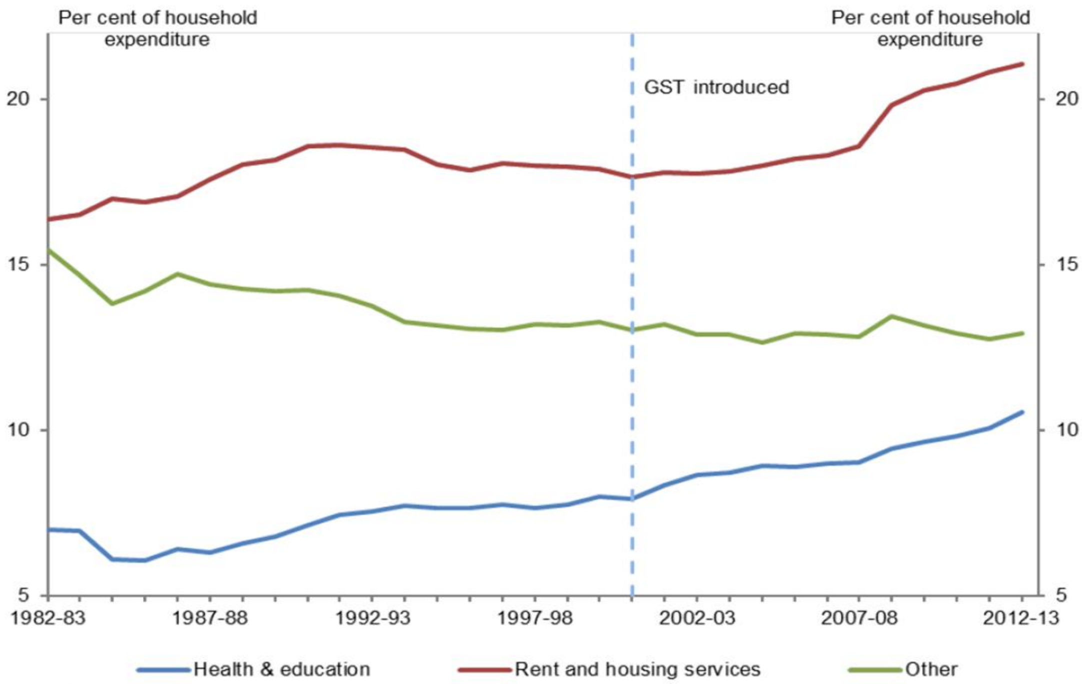
Chart 1. VAT coverage ratios – OECD countries (2012), KPMG, 2015



In particular, the proportion of total household spending on health, education, rent and financial services has been increasing. Spending on these categories in 2013-14 made up 40 per cent of total household spending compared to just 33 per cent when the GST was introduced in 2000-01.

In large part, this has been the result of increases in the relative prices of these goods and services, rather than an increase in the volume of these goods and services consumed. If this trend persists, it will tend to reduce the amount of GST revenue as a proportion of GDP. Chart 2 below depicts these changes.

Chart 2. Proportion of household expenditure in GST excluded categories, KPMG, 2015



Source: PBO based on data from the ABS
Note: Other includes certain food and some financial services.

The decline in GST revenue as a share of GDP has resulted from a decline in household consumption as a share of GDP. Since 2002-03, total household consumption has fallen from 59 percent of GDP to 56 percent in 2013-14, given the unprecedented growth in mining investment which was driven by record high commodity prices throughout the 2000s.

Australia is in a unique position. Individuals have Western consumption habits so comparison to OECD, rather than our regional competitors is appropriate for consumption tax rates. The GST in Australia, at 10 per cent, is roughly half of the OECD average of 19 per cent.

Any change to the GST would require compensation to lower income earners due to the regressive nature of the GST. The modelling performed by KPMG contains compensation to address the regressive impact of changes to the GST.

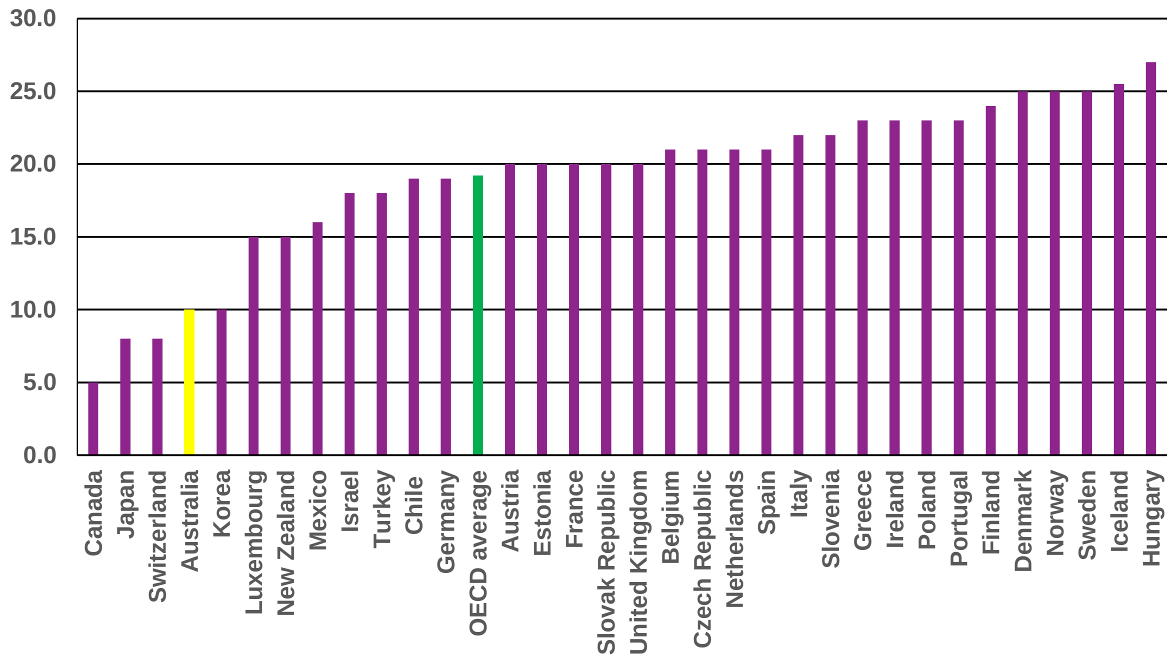
RECOMMENDATION 3.1:

Broadening the GST base should occur as part of a package of tax reform which reduces Australia's reliance on company and personal taxation.

In broadening the base of the GST, the regressive nature of the consumption tax should be addressed by compensating lower income earners.

GST reform is a complex matter and any proposed changes need to be thoroughly researched.

Chart 3. GST rates in OECD member countries in 2014 (%), KPMG, 2015



The FSC considers that any additional revenue available through broadening the base and increasing the GST rate would allow scope to abolish inefficient State and Territory taxes that represent a significant compliance burden for industry. The abolition of these Taxes would reduce cost, red tape and result in a simpler tax system.

RECOMMENDATION 3.2:

As part of a package to lower company and personal taxation and abolish state stamp duties, the GST rate should be increased towards the OECD average.

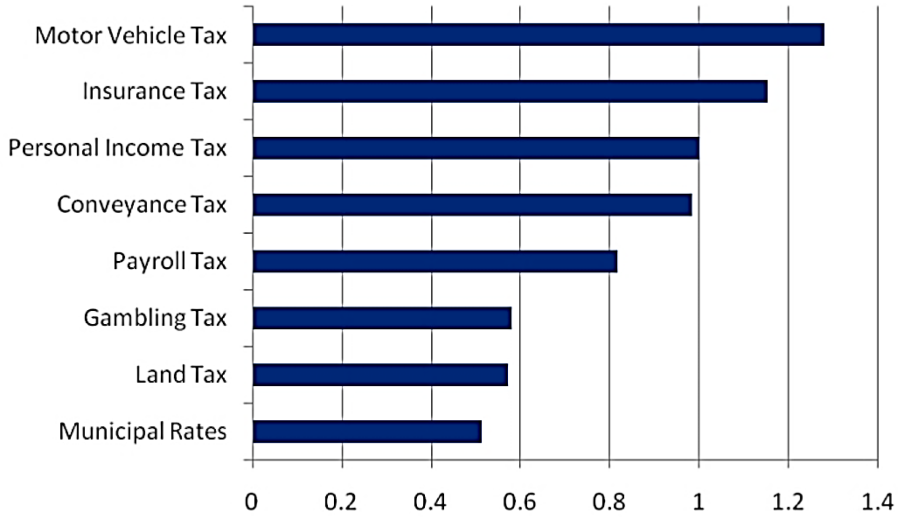
3.2 Abolition of Inefficient State Taxes

The FSC supports the abolition of inefficient State taxes. Stamp duties on life insurance are amongst the most distortionary and inefficient in the economy and have a direct impact on levels of underinsurance in the community.

The FSC understands that this can only occur as part of a broader package negotiated between the Commonwealth and the States and Territories. According to research by Deloitte Access Economics for the Finance Industry Council of Australia, insurance taxes rank as the second most inefficient of taxes levied by State governments[8]

[8] Deloitte Access Economics, 2011 Analysis of State Tax Report, pp. 2

Chart 4. General efficiency rankings of State/Federal taxes



Higher levels of underinsurance in the community have an adverse impact on Australia's social security spending. On disability of an income generating family member, an inadequately insured family has a significant reduction of family income and an increased likelihood of requiring welfare. Research undertaken for the Financial Services Council by KPMG Actuarial found that every one dollar increase in insurance coverage equates to a fifty cent reduction in Disability Support Pension expenditure.

The FSC has surveyed its members to determine the total amount of State and Territory stamp duty collected on life insurance and life insurance rider benefits. Currently life insurance duty is not reported in State budgets as a separate line item and where it is the general insurance applicable to life riders cannot be delineated from the duty paid on non-life insurance products.

Eighty percent of Australia's life insurance industry responded to the survey and the amount of stamp duty paid in 2014 was $377 million. The remaining twenty per cent of the market would be broadly proportional to this and a grossed up sum of the life insurance duty paid in 2014 would be $453 million. This has grown by a staggering 84 per cent in the past five-years.

The figures in these charts are an accurate reflection of the duty paid by eighty per cent of the industry. It is anticipated that the remainder of the industry would be broadly proportional. Table 4 below outlines the total amount of stamp duty paid by life insurance companies in the period 2010 to 2014. It shows that general insurance duty applicable to life insurance products is a larger source of revenue for the States and Territories than duty paid on the life policy (death cover) alone. This contradicts claims by some State Governments that stamp duty on life insurance has been abolished.

TABLE 4: Stamp duty paid by FSC members, 2010-2014, FSC Member survey

Stamp Duty Paid by FSC Life Insurance Members 2010 - 2014

	Annual Life Insurance Duty Paid					Annual General Insurance Duty Paid				
	2010	2011	2012	2013	2014	2010	2011	2012	2013	2014
New South Wales	$17,006,608	$19,881,532	$19,978,461	$19,255,442	$27,299,569	$26,247,441	$31,190,053	$39,546,978	$42,702,304	$51,761,022
Victoria	$11,867,118	$10,280,391	$12,209,667	$13,437,337	$12,825,900	$46,465,975	$54,409,418	$61,306,590	$67,179,988	$81,916,891
Queensland	$8,831,702	$8,412,589	$11,675,128	$9,355,098	$14,474,921	$26,539,431	$34,920,524	$41,256,093	$43,988,409	$54,116,581
Western Australia	$1,483,479	$1,655,652	$1,837,685	$2,357,579	$2,365,430	$34,256,606	$41,657,198	$49,449,773	$57,942,289	$72,764,872
South Australia	$4,637,935	$5,057,316	$5,152,455	$5,540,665	$4,828,364	$18,528,472	$24,688,825	$31,423,548	$34,117,888	$41,841,075
Tasmania	$744,670	$748,273	$777,495	$830,759	$1,221,473	$2,751,962	$3,087,320	$3,487,027	$4,327,539	$4,939,149
Northern Territory	$609,383	$492,755	$571,642	$758,676	$1,082,748	$2,058,015	$2,524,872	$2,958,447	$2,982,173	$3,292,133
Australian Capital Territory	$550,114	$535,466	$585,960	$489,066	$627,586	$3,172,982	$3,409,585	$3,707,691	$3,110,168	$2,636,025
Total Paid	**$45,731,008**	**$47,063,973**	**$52,788,493**	**$52,024,623**	**$64,725,992**	**$160,020,885**	**$195,887,795**	**$233,136,146**	**$256,350,758**	**$313,267,748**

TABLE 5: Total revenue collected by State/Territory OSRs, 2010-2014, FSC member survey

	Total revenue by State/Territory, 2010-2014
New South Wales	$294,869,409
Victoria	$371,899,275
Queensland	$253,570,477
Western Australia	$265,770,563
South Australia	$175,816,542
Tasmania	$22,915,666
Northern Territory	$17,330,844
Australian Capital Territory	$18,824,645
	$1,420,997,421

Table 5 (left) shows the amount of duty paid by life insurance companies in the period 2010-2014. This figure amounts to $1.4 billion overall in a five-year period.This does not include duty paid for general insurance products.

Most States and territories have a different rate and basis for levying taxes collected. Some are sum insured based; some are premium based; some have a combination; some have no duty on life insurance but loaded duties on rider benefits; the percentage of rates levied on life rider benefits vary from state to state and product to product.

This creates a productivity drag on life insurers because it necessitates complex assessment processes, legal fees and systems reconfiguration, all of which would be simplified under a harmonised system, or not necessary at all if stamp duty was abolished.

Attempts to have a 'uniform' methodology for the raising of the state tax have failed on a number of occasions and Australia is one of the few mature economies that taxes life insurance and life riders instead of giving a tax deduction. Appendix A provides a summary of the various stamp duty levies applying to life insurance and associated products in each Australian jurisdiction.

Under the current arrangements there is little incentive for the State and Territory Governments to "go it alone" with respect to abolishing inefficient taxes. While some have formally investigated abolishing inefficient taxes, the good work is often stymied by the absence of an alternate source of revenue. This is an especially poignant point considering that the States and Territories face an annual revenue shortfall of $100 billion. We therefore believe the Federation White Paper must finally address the vertical fiscal imbalance.

The obvious source for replacement revenue is a reformed GST with a broader base and higher rate. Abolishing inefficient taxes will ultimately require a rebuilding of trust between the Commonwealth and the States and Territories over the distribution of GST revenue.

RECOMMENDATION 3.3:

The 1999 Intergovernmental Agreement on the GST should be renegotiated to enable States and Territories to abolish inefficient taxes and for the GST to be broadened and increased.

Efficiency of taxes

A good tax system should follow the four broad taxation principles of efficiency, equity, simplicity and sustainability. This can be difficult for policymakers as nearly every tax will create some level of additional burden to both the consumer and producer. However, substantial benefits can be gained by reducing taxes in goods and services that have demand elastic, individuals with a low ability to pay, or by broadening the tax base to minimise the effect of taxes on incentives and distorting behaviour.

The Henry Tax Review in 2009 concluded that states could improve the structure of the tax system by replacing their reliance on inefficient taxes to fund expenditures with more efficient ones. Some of the key recommendations were the abolition of stamp duties, including insurance and conveyance duties, to more efficient broad based taxes and to broaden the base of the relatively inefficient payroll tax.

Many of these issues are again highlighted in the Australian Government's recent 'Re:think Tax Discussion Paper' which delivers a strong message for the need to create a fairer and more efficient taxation system that can improve productivity in the economy as well as raise the adequate level of revenue to fund public services.

The majority of recent literature for assessing tax efficiency has been based on computable general equilibrium (CGE) modelling (Deloitte Access Economics 2011; Independent Economics 2014; Treasury 2015). These models use economic data to estimate how an economy might react to a marginal change in tax policy through simulation.

Deloitte Access Economics (2011) presented the efficiency rankings of various state, territory and local taxes relative to the personal income tax whilst other literature provided marginal excess burden estimations which are the deadweight losses or how much society suffers as the result of taxes without direct reference to the personal income tax.

We draw together the findings from multiple literature sources however note that the quantitative results are not directly comparable due to differing modelling assumptions and the currency of the data. Instead, we present a qualitative discussion of tax efficiency.

The Treasury working paper on 'Understanding the economy-wide efficiency and incidence of major Australian taxes' uses the most recent data; the findings from this paper will have a larger weight in our discussion. For the taxes that were not studied in the Treasury paper, we will consider the findings from the Deloitte Access Economics paper from 2011.

Table 6: The rankings: DAE (2011) tax efficiency rankings

Taxation Type	Ranking (most to least efficient)
Municipal Rates (residential)	1
Land Tax (residential)	2
Gambling	3
Municipal Rates (non-residential)	4
Land Tax (non-residential)	5
Payroll	6
Conveyance Taxes (residential)	7
Personal Income	8
Conveyance Taxes (non-residential)	9
Motor Vehicle Tax (household)	10
Insurance Tax	11
Motor Vehicle Tax (business)	12

Source: Deloitte Access Economics, 2011

Table 7: Treasury (2015) tax efficiency (most to least efficiency)

Taxation Type	Ranking (most to least efficient)
Land Tax	1
Personal Income Tax	2
Goods and Services Tax	3
Stamp Duty on Conveyances	4

Source: Treasury working paper, 2015

Land Taxes and Municipal Rates

In Australia, land taxes and municipal rates are levied by the state and local governments respectively in all but the ACT (which currently collects both) and NT (which currently does not levy land taxes). Typically, state land taxes include a tax-free threshold as well as progressive rate scales. Additionally, there is some variation between states on how to determine land value with some states using unimproved land value and others using market value.

Treasury (2015) found that a hypothetical broad-based land tax (that includes municipal rates on all properties and a broad-based land tax on the unimproved value of land) would be highly efficient with an estimated negative social excess burden (which implies that such a tax contributes to positive externalities for the economy). Even when considering the current land tax base in Australia, which is quite narrow (more than half of the state land tax base being tax exempt), land taxes were found to be highly efficient under a range of modelling scenarios.

Municipal rates levied by local governments are found to be one of the most efficient taxes in Australia. However, there are some concerns over how land values are determined. For example, some councils charge rates based on the 'improved' rather than 'unimproved' land value, which may deter the improvement of capital. This can create some inefficiency as it reduces the tax base and distorts behaviour. Additionally, we find that both municipal and land taxes on residential property are more efficient than for commercial property.

Gambling Taxes

The gambling sector is highly regulated. Gambling taxes include turnover tax, a tax on net profits and a tax on player loss and licensing fees. Rates for each of these are dependent on the type of gambling and the particular venue. Typically, lotteries are taxed at a higher rate than other forms of gambling. Because of the lack of competition in the gambling industry due to license limitations, there have been arguments that taxes charged on those that generate 'excess profits' can be an efficient way to raise state revenue. Deloitte Access Economics (2011) found gambling taxes to be reasonably efficient compared to other taxes since larger taxes on inelastic goods and services generally contribute to a smaller deadweight loss.

Goods and Services Tax

GST is a relatively efficient tax since it has a relatively wide base (coverage ratio of 47% of all goods and services) compared to other taxes.

Payroll taxes

A payroll tax is levied on employers and is based on the components of employee remuneration. In the long run however, the likely effect is that the cost of will be passed onto employees (through lower wages) and consumers (through higher prices). Deloitte Access Economics (2011) found that current Australian payroll taxes are not very efficient due to complexity, tax-free thresholds and other exemptions. This inefficiency however could potentially be reduced by creating a broader-base and more neutral treatment of the tax.

Personal Income Tax

Estimations from Treasury (2015) and Independent Economics (2014) report personal income tax to be reasonably efficient. However, because it is difficult to incorporate progressivity in a model with a representative household, only a single effective tax rate is applied to labour and capital income after franking credits. As such these calculations may underestimate the true welfare cost of personal income taxes.

Stamp duty conveyance, insurance and motor vehicle taxes

Stamp duty levies on conveyance, insurance and motor vehicles are some of the most inefficient taxes in Australia according to a range of literature. Because they are levied selectively on activities or products and are taxed on the total transaction value rather than the 'value added' component.

This affects the behaviour of taxpayers by discouraging turnover, for example, retention of land for relatively unproductive purposes. Deloitte Access Economics (2011) found that for all three taxes performed poorly in terms of relative tax efficiency with motor vehicle taxes (on business) being the most inefficient. Treasury (2015) estimated a high social excess burden for conveyance taxes, the highest amongst all the taxes they analysed in their paper.

Limitations with tax rankings

It is important to note that there are limitations with CGE models. Firstly, the tax system is complicated and numerous simplifying assumptions are required to make any quantitative analysis tractable. Typically assumptions are refined in numerous ways in order to better capture various features of the tax system, but it still does not capture all of the costs and benefits associated with some taxes.

Secondly, the results relate to comparisons between different steady state (and therefore long-run) scenarios. As such, they provide a basis for consideration of the long-term impact of different taxes but do not provide an indication of the nature and extent of any transitional costs.

Third, because of the complications involved with CGE modelling, all papers discussed used a single representative household in their model, which ignores important aspects such as progressive taxation. Additionally, because these calculations focus only on the issue of tax efficiency, other policy goals and principles of taxation (such as equity, simplicity and sustainability) are not explicitly considered.

Finally, the results presented are for comparison purposes and only relate to average rates of taxes. There will be elements that are more (or less) efficient than the average for various taxes.

Share of state tax revenue

Table 8 below lists the various State taxes and their contribution to State taxation revenues in 2014-15.

Table 8: Distribution of State/Territory Tax Revenue 2014-15 (%)*

Tax	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Avg
Payroll	30	28	32	41	26	32	26	43	31
Property	34	36	29	29	33	25	22	25	33
Conveyance duty	24	25	21	21	20	16	16	25	23
Land tax	10	11	8	8	13	9	6	0	10
Gambling	8	10	9	3	9	10	4	11	8
Insurance	4	6	7	7	10	8	2	8	6
Motor vehicle tax	12	12	17	14	13	17	10	13	13
Other taxes	12	6	3	2	2	0	2	0	9

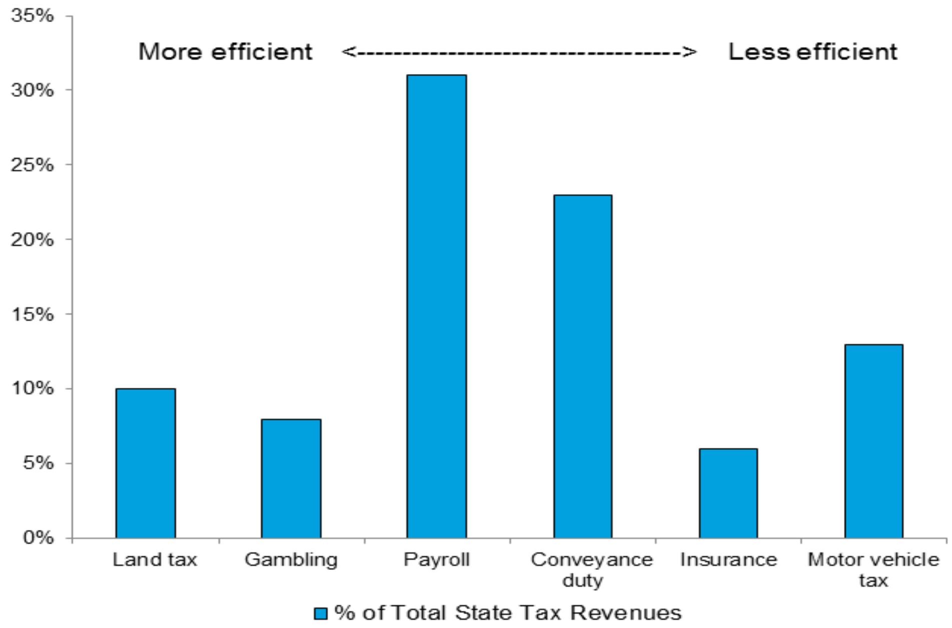
* Totals might not sum to 100% due to rounding.

Source: State Budgets FY2014-15: budget outlook and financial statements.

Payroll taxes contribute the largest proportion of total state taxation revenue at 31 percent followed by conveyance duties at 23 percent. In total, around 73 percent of all state taxes are currently raised through the comparatively more inefficient streams (payroll, conveyance, insurance, and motor vehicle duties).

More efficient taxes such as the land tax contribute to only 10 percent of total state taxes, less than half the amount of conveyance duty taxation revenue each year. There is also some variation in property type taxes due to differing rates charged and also lower turnover.

Chart 5. Taxes by Efficiency as a share of State Revenue 2014-15



Source: State budgets 2014-15: budget outlook and financial statements.

Municipal rates compared to total state taxation revenues

Table 9: Municipal rates compared to total state taxation revenues 2012-13

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Amount ($mil)	3,624	3,890	3,023	1,695	1,238	335	71	97	13,973
% of State taxation revenues	14	20	21	17	23	27	23	17	23

Source: ABS 5506.0 – Taxation revenue 2012-13, updated May 2014

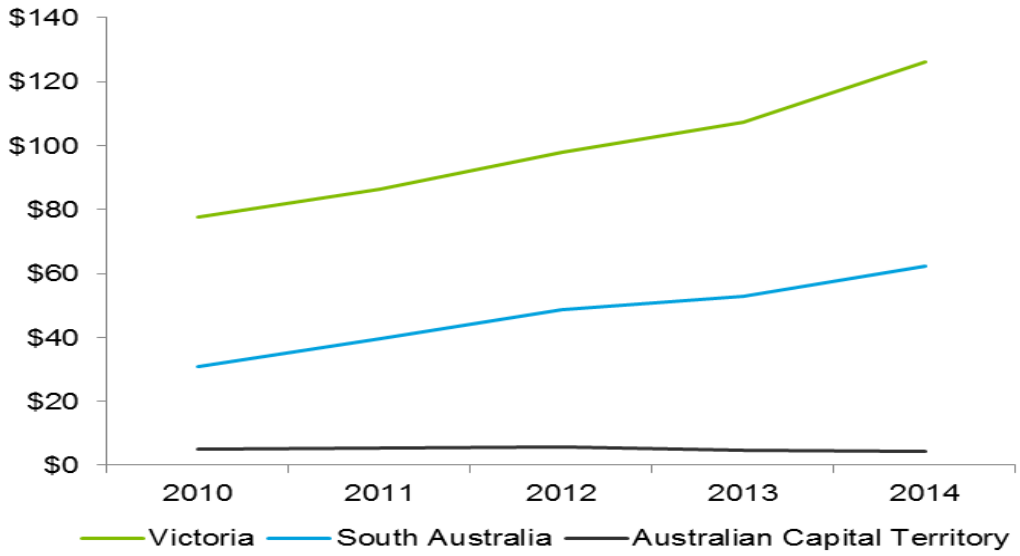
While municipal rates are levied by local governments, as a comparison, the revenue generated by municipal rates is higher than the revenue generated at the state level by land taxes and, in some States, by conveyance duties.

Taxation of Life Insurance

This section discusses recent developments in State taxation of life insurance. Data on taxes paid on life insurance are obtained from the FSC's life insurance members, and includes annual duties paid on life insurance policies and life insurance policy riders which are considered general insurance in some states and territories.

Data was collected by the FSC from a subset of total life insurers (comprising around 80 percent of market share at the national level) and have been adjusted to reflect this.

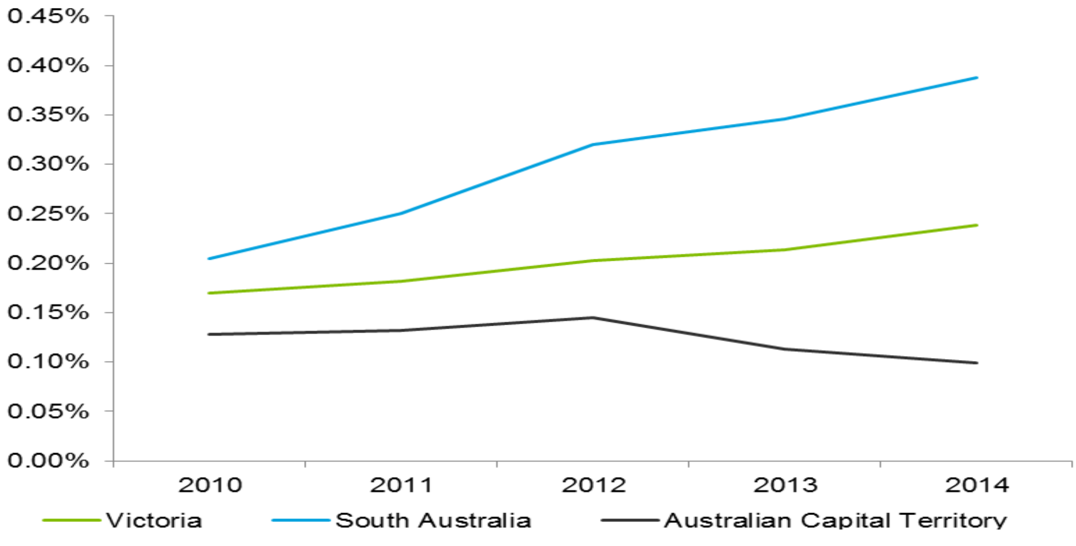
Chart 6. Duties paid on life insurance by selected States ($m)



Source: FSC life insurance members

The level of duties paid on life insurance in Victoria and South Australia have increased over the past five years, while the gradual phasing out of stamp duties on insurance in the ACT have led to a decline in duties paid on life insurance.

Chart 7. Duties paid on life insurance as a share of total State revenues (%)



Source: FSC life insurance members

The increasing share of duties paid on life insurance in Victoria and South Australia suggest that the recent changes to life insurance taxation arrangements in these States have led to an increase in the use of life insurance as a source of State revenue, although it contributes a very small share of total State revenues.

Life and general insurance taxation revenue

Recent developments in Victoria

Table 10: Taxes on life insurance and general insurance in Victoria ($m)

Taxes ($m)	2010-11	2011-12	2012-13	2013-14	2014-15
Paid on life insurance*	77.8	86.3	98.0	107.5	126.3
Collected by State as general insurance duties**	788.7	849.7	890.5	868.8	913.9

* Includes life insurance and general insurance duties paid by FSC life insurance members. Aggregate data has been adjusted to reflect the subset of insurers that reported.

** Includes general insurance policies and life insurance policy riders.

Source: FSC life insurance members, State Budgets

Life insurance taxation policies have been unchanged since 2010-11 until the July 2014 announcement of the abolishment of duty payable on life insurance policies and inclusion of life insurance policy riders as general insurance. Taxes paid on life insurance in 0 include taxes paid on life insurance as well as life insurance riders.

The increase in taxes paid on life insurance is likely to partly reflect the application of duties to life insurance riders in Victoria.

Recent developments in South Australia

Table 11: Taxes on life insurance and general insurance in South Australia

Taxes ($m)	2010-11	2011-12	2012-13	2013-14	2014-15
Paid on life insurance*	30.9	39.7	48.8	52.9	62.2
Collected by State as general insurance duties**	230	265	296	315	315

* Includes life insurance and general insurance duties paid by FSC life insurance members. Aggregate data has been adjusted to reflect the subset of insurers that reported.

** Includes general insurance policies and life insurance policy riders.

Source: FSC life insurance members, State Budgets

South Australia introduced the application of general insurance duties to life insurance riders in 2012-13. There has been continued growth in life insurance duties paid over the period.

Recent developments in Australian Capital Territory (ACT)

Table 12: Taxes on life insurance and general insurance in ACT

Taxes ($m)	2010-11	2011-12	2012-13	2013-14	2014-15
Paid on life insurance*	5.0	5.3	5.7	4.8	4.4
Collected by State as general insurance duties**	42.5	44.9	44.9	33.5	23.5

* Includes life insurance and general insurance duties paid by FSC life insurance members. Aggregate data has been adjusted to reflect the subset of insurers that reported.

** Includes general insurance policies and life insurance policy riders.

Source: FSC life insurance members, State Budgets

The ACT has announced that insurance duty will be totally abolished from 1 July 2016, and has gradually reduced duties on both life insurance and general insurance each year since 2012-13. The gradual phasing out of insurances duties is reflected in the decline in the duties paid on life insurance tax and general insurance duties collected by the ACT in 2012-13.

There are limitations with attributing changes in the duties paid and collected with reference only to changes in taxation policy.

The level of tax paid will also reflect changes in the number of policies written, changes in the product mix (e.g. group and retail insurance products), and changes in premium levels. Insurers have suggested that for some products, life insurance stamp duties are applied at an average rate across all premiums. This rate reflects the insurer's stamp duty liabilities across States.

Insurers have also suggested that there can be a significant lag (e.g. up to 12 months) between the time taken by an insurer to adjust their premiums in response to changes in stamp duty rates. Thus, changes in premiums due to changes in stamp duty rates in other jurisdictions, up to 12 months in the past, may have an impact on the number of policies written.

Stamp duty levies on conveyance, insurance and motor vehicles are some of the most inefficient taxes in Australia according to a range of literature. In total, around 73% of all state taxes are currently raised through the comparatively less efficient taxes (e.g. payroll, conveyance, insurance, and motor vehicle duties).

State governments should seek to increase their source revenue from more efficient taxes and reduce their use of less efficient taxes, such as stamp duties on conveyance, insurance and motor vehicles. Furthermore, stamp duties on life insurance contribute to a small share of total state revenue. While recent reforms in the ACT have led to reduced stamp duties paid on life insurance policies and life insurance policy riders, there is scope for further changes. The changes in Victoria and South Australia have had the effect of increasing the taxes on life insurance products.

In addition, to the extent that stamp duties on life insurance have an impact on individuals holding a level of insurance cover that is less than optimal, there is a broader policy issue that policymakers should consider.

RECOMMENDATION 3.4:

State and Territory governments should abolish all insurance duties.

State Government tax reform appetite

States are an integral part of the conversation around tax reform and we need state Premiers and Treasurers to constructively participate. Reforming Commonwealth-State financial arrangements is essential to our future successes as a competitive, efficient, nimble nation in the Asian century**.**

To make up for their lack of funding, states rely on grants and raising their own taxes, many of which are inefficient and damage the economy. Inefficient state transaction taxes are a drag on our economy of $12 billion and drive perverse outcomes such as discouraging people from taking out insurance

Commonwealth Grants Commission data shows the extent to which State and Territory governments rely on insurance stamp duties. Table 13 below highlights the irony that jurisdictions where life insurance stamp duty has been "abolished" run budgets which are the most reliant on insurance duties. These jurisdictions are Western Australia, South Australia and Victoria.

Table 13: Commonwealth Grants Commission effort ratios - 2012-13 | Insurance tax[9]

NSW	VIC	QLD	WA	SA	TAS	ACT	NT
0.76	1.19	0.88	1.43	1.24	1.02	0.79	1.21

The Financial Services Council has been meeting with advisers for the State Treasurers to explain the case for abolishing insurance stamp duties and to ascertain the degree of support for change. The FSC does not advocate the piecemeal approach to 'life insurance' exemption taken by Western Australia and Victoria.

Those states expose long term disability insurance premiums to the highest stamp duty charge and by applying different stamp duty outcomes to different insurance events for the same sum insured within a single life insurance policy, result in a dislocated and expensive policy administration system. Some jurisdictions such as South Australia, the ACT and Tasmania are progressively winding-down inefficient stamp duties or looking at how to improve the the way the tax is collected.

It is recognised government policy, world-wide, that concessional tax and stamp duty treatment should be afforded to policy owners who provide for themselves and their families by securing long term capital benefits by way of life insurance policies.

We advocate that the concessional stamp duty treatment afforded to premiums for life insurance death benefits should also be afforded to premiums for Total and Permanent Disablement insurance, Trauma insurance and Disability Income insurance, issued by life insurance companies, for exactly the same reasons.

These kinds of insurance benefits can serve as a substitute for government social security programs, provide a layer of protection against financial pressures, can prevent the liquidation of savings and

[9] South Australian Government, 2015, State Tax Review Discussion Paper, pp. 27

assets during hard times and reduce the financial stress which often leads to significant health issues.

Furthermore, we believe it is inappropriate for State and Territory governments to impose stamp duty on life insurance or disability insurance within Australia's compulsory contribution superannuation system, as this cost is funded from the Members' superannuation accounts.

The FSC distinguishes the NSW and ACT regimes in particular as being meritorious. The NSW regime is the preferred model pending abolition and the ACT model has taken great strides forward by introducing a total stamp duty exemption for all insurances over the 5 years commencing in 2012.

CASE STUDY – ABOLITION OF LIFE INSURANCE STAMP DUTIES IN VICTORIA

In Victoria the industry applauded as the former government announced it would abolish duties on life insurance but were left reeling after it became clear the Government there intended to apply the higher general insurance rate of stamp duty to a greater number of life policy "riders", while abolishing only the duty applicable to the underlying life insurance policy.

It was anticipated that Victorians would save around $4 million a year with the decision to abolish life insurance duty in the 2014-15 Victorian Budget. The Coalition Government at the time claimed its decision was "making policies cheaper, reducing taxes and helping people to better protect their families" and that "Every state and territory bar Victoria and Western Australia will levy stamp duty on life insurance".

However the facts show that the contrary is true. While there was less revenue collected from duty on life policies in 2014 (five per cent decline), which is consistent with the announcement in May 2014 to abolish life duty, the general insurance duty collected from life insurance riders has continued to rise. Between 2013 and 2014 the amount of general insurance duty collected on life insurance riders increased by nearly twenty percent. This compares to a nine percent year on year increase in 2012-13 and a twelve percent increase in the previous year.

Table 14: Stamp duties paid by FSC members in Victoria, 2010-2014

	2010	2011	2012	2013	2014
Life Duty	$11,867,118	$10,280,391	$12,209,667	$13,437,337	$12,825,900
GI Duty on riders	$46,465,975	$54,409,418	$61,306,590	$67,179,988	$81,916,891
Total	**$58,333,093**	**$64,689,809**	**$73,516,257**	**$80,617,325**	**$94,742,791**

Unfortunately, this is not a surprising outcome since the new Labor Government's 2016-16 Budget anticipated insurance tax revenues would grow by 5.4 per cent in the 2016-16 financial year before settling into a trend growth rate of 6.8 per cent per annum over the forward estimates. Despite the rhetoric from both sides of Parliament life insurance tax revenues continue to rise.

Compliance Costs

The Financial Services Council has surveyed its members to determine a best estimate for the compliance costs associated with administering the various stamp duty regimes in Australia. This has been done for both the Henry Tax Review in 2008 and for the current Tax Discussion Paper.

The results show there are significant sunk costs associated with compliance, including establishing systems and procedures to meet obligations under the various duty regimes. Once these systems are implemented the ongoing costs are significantly lower. The data shows that compliance has grown by 16 per cent in the time between the Henry Tax Review (2008) and today. This is marginally faster growth rate than inflation in the general economy at 2.4 per cent PA.

Table 15: Compliance Costs Estimate 2008, 2015[10]

Henry Tax Review (2008)	Tax Discussion Paper (2015)	Growth (%)
$73,225,000	$85,455,000	16 per cent

While it is true that most insurers have established processes and systems in place with respect of the stamp taxes applicable to life insurance products, the ongoing costs are still significant and are ultimately passed on to consumers. The following is an outline of some compliance costs for life insurance companies. These have been factored into the estimates in Table 15 above.

- **Systems administration:**
  - adapting systems to take into account rate changes and complexity in characterising a product with all the different riders and elements which make up the product;
  - systems used by insurers were generally acquired some time ago and have been heavily customised—as a consequence they don't tend to automatically characterise a product and require significant manual reprogramming; and
  - ultimately usually ends up as a manual process to extract what actual tax should be paid to each of the State Revenue Offices.
- **Legal and Tax Advice:**
  - determining the characterisation of life policy riders can be a very complex task and this generally necessitates the services of an in house lawyer or external legal counsel;
  - where in-house lawyers or tax experts are in doubt over characterisation they may choose to seek external advice; and
  - some insurers take external advice in respect of product characterisation, but even this can sometimes be inconclusive with a variety of views being expressed as to characterisation.
- **Dealings with State Revenue Offices:**
  - significant cost of external audits if liabilities are later reviewed—an increasingly pertinent point with the respective State Revenue Offices being increasingly active in stamp duty audits;
  - resolving issues around refunds and overpayments if a liability is incorrectly calculated;

[10] FSC member estimates of compliance costs are calculated based on costs applicable to the systems administration, legal and tax advice, staff and time costs and other various requirements imposed by State Revenue Offices.

- o retrieving overpayment from State Revenue Offices can be both time consuming and costly; and
- o reporting varies by state, so for example, data might be collated monthly, but in SA reporting is required annually so it becomes necessary to aggregate the data.

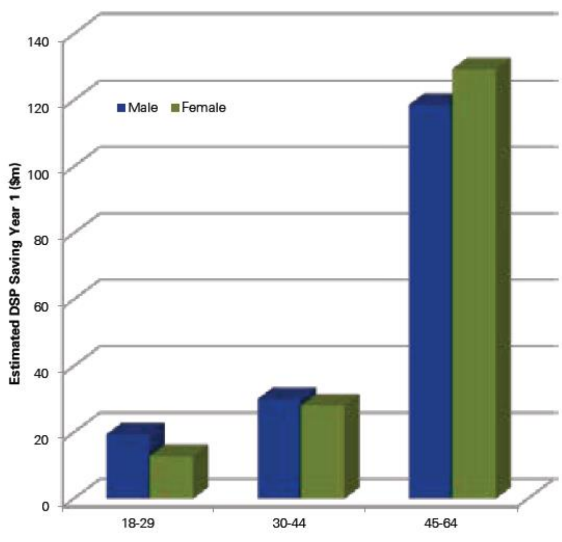
- **Staff and time costs:**
  - o high costs (staff and time) associated with tracing through to life insured – e.g. sell policy in Queensland to a trustee of a superfund in NSW for a life insured that resides in Adelaide; and
  - o significant training costs associated with educating people on how to calculate across each state.
  - o significant resources required to make product changes to accommodate changes in tax arrangements.

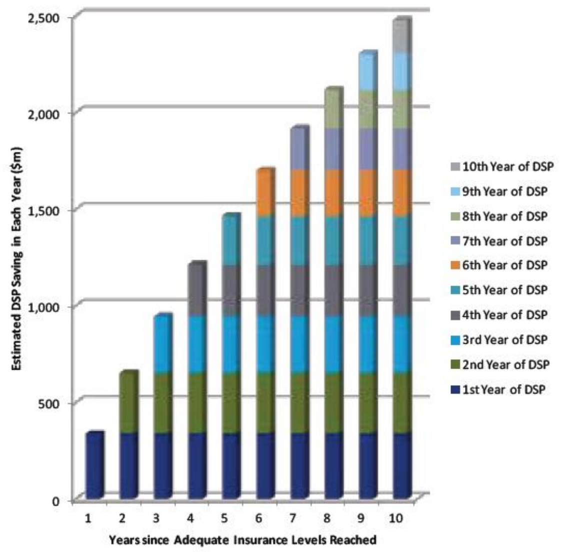
Stamp duties and underinsurance

The level of underinsurance of employed people in Australian families is estimated to be $304 billion per annum against disability[11]. This is a significant level of underinsurance and is even more startling considering that an allowance was made for existing insurance including that held within group schemes in superannuation funds.

The cost of underinsurance is significant to Australia. If Australians were adequately insured, social security benefits could be reduced by a minimum of $340 million in the first year[12], even before the impact of foregone tax revenue is taken into account. After ten years the total welfare spending savings to government for disability support is estimated to exceed $2.5 billion based on the current means testing for the pension.

Chart 8. Cost of underinsurance represented as increased social welfare spending, KPMG, 2012





There is a direct correlation between price and consumer demand for life insurance coverage. In fact, researchers at the *National Bureau of Economic Research* in Boston have shown that if the price of insurance is reduced by ten percent (roughly the amount of stamp duty levied by State

11 KPMG Actuarial, 2014, Underinsurance Disability Protection Gap in Australia, pp. 3

12 KPMG Actuarial, 2014, Underinsurance Disability Protection Gap in Australia, pp. 3

Governments on annual premiums) this will result in a three to five percent increase in insurance coverage[13]

[13] National Bureau of Economic Research, 2003, Price Elasticity of Demand For Term Life Insurance and Adverse Selection, pp.XX

4. Australia's Global Competitiveness

Australia has a large financial services sector. It currently contributes 9 percent of gross domestic product and includes the third largest pool of managed funds globally. By contrast, the level of funds sourced internationally sits at less that 5 percent and is very low by both global and regional standards.

There is significant scope for growth in exports of Australian financial services, given our comparative advantage of a highly skilled workforce, proximity to Asia, and economies of scale due to our large superannuation system. But the industry's external growth prospects have been hampered by our regulatory and taxation arrangements.

The Wallis Inquiry acknowledged this was a problem when globalisation started to provide opportunities for Australia. It stated: "In the face of globalising markets, every effort should be made to ensure that Australia's financial system is able to compete without the impediments of outdated, inadequate or costly regulations or discriminatory taxes." In the 17 years following the Wallis Inquiry, little progress has been made on this agenda despite the rapid pace of globalisation.

Future growth prospects for Australia will be centred on increasing trade in services where we have a comparative advantage. Australia has a comparative advantage in funds management.

Modelling by Access Economics[14] shows that exports in managed funds could increase GDP by $4.2 billion by 2029-30 if we reached the level of exports equivalent to Hong Kong or Singapore.

Australia needs to implement competitive taxation policy settings in order to attract foreign investment. Importantly, taxation policy must be focussed on how to attract more capital to Australia, both in terms of direct investment into Australian assets but also foreign capital that can be managed by Australians for foreign investors.

The Johnson Review[15] examined impediments to international integration and made a number of recommendations to improve Australia's competitiveness. It outlined a clear pathway to reform Australia's taxation settings.

Despite bipartisan support for the report's recommendations, changes have been slow and many recommendations are still outstanding six years on. Part of the reason for this delay is that some changes are complex and require interaction between multiple government agencies to implement.

All too often, however these policy changes are being delayed due to the anticipated 'cost to revenue'. Ironically, the only cost to revenue which occurs in reality is the missed opportunity for more economic activity to be generated in Australia earlier.

4.1 Costing methodology changes

A fundamental shift in approach to policy costings is required for Australia to successfully compete within the Asian region and globally. The traditional approach to costing policy changes must differ when the policy is directed at improving Australia's ability to attract highly mobile capital.

The focus on 'cost to revenue' must be adjusted when examining policies targeted at increasing economic activity that would otherwise be located offshore. Australia is competing in a global economy and the alternative for investors is to choose a jurisdiction with better tax treatment and a more flexible investment regime.

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[14] Deloitte Access Economics 'The economic impact of increasing Australian funds management exports' May 2014

[15] Mark Johnson AO – Building on our Strengths – Australia as a Financial Centre 2009

Instead of costing policy measures using a framework that treats foreign investors as taxpayers who are captured within the Australian economy, the focus must be lifted to Australia's ability to attract foreign investors in the global economy.

Calculating 'cost to revenue' on the basis that foreign investors would otherwise be subject to 30 percent corporate tax within Australia is flawed logic. In reality, no foreign investor would subject themselves to this rate when they can legitimately utilise service providers from alternative jurisdictions and be subject to a lower rate. Offering a competitive tax rate and policy settings that attract and respect foreign investors will result in additional revenue that Australia would not otherwise receive.

RECOMMENDTION 4.1:

Taxation policy targeted at attracting foreign investor activity must be costed on the basis of the investor's options in a global economy and consideration must be given to the impact of taxation settings on Australia's comparative position.

4.2 Progress on Johnson Recommendations

The Johnson Review recommendations relating to funds management are an example of where effective taxation policy has not achieved, even after clear recommendations have been made and accepted by government.

Asia Region Funds Passport

The Asia Region Funds Passport ("Passport") is the only funds management initiative which has achieved significant progress. The Passport is intended to provide a regulatory framework for the mutual recognition of fund operators and investment funds between participating jurisdictions.

Australia's participation in a mutual recognition framework within the Asian region was recommended by the Johnson Review as a part of a package of reforms aimed at leveraging Australia's significant funds management expertise.

Failures to effectively implement recommendations

The Passport represents a significant opportunity to offer the industry a clean slate – one that has not been contaminated by these uncertainties. Unfortunately, related recommendations have not yet been implemented by the government.

Four critical and related recommendations of the Johnson Review are:

1. implementation of an Investment Manager Regime;
2. broadening the range of allowable Collective Investment Vehicles;
3. ensuring ongoing competitiveness of the Offshore Banking Unit regime; and
4. removing uncertainty to create competitive tax settings

The Australian funds management industry's ability to capitalise on the Passport will be hampered if these changes are not in place prior to the Passport's commencement.

Investment Manager Regime

Foreign investors must have certainty about tax treatment when engaging an Australian fund manager. A key recommendation from the Johnson Review in relation to funds management was the introduction of an Investment Manager Regime ("IMR").

The IMR seeks to remove tax impediments to foreign investment through or into Australia by foreign investors. Its objective is to provide certainty of treatment when a foreign investor uses an Australian manager to invest, whether into Australia or offshore. Funds management centres around the globe have similar regimes in place to achieve certainty for foreign investors.

Exposure draft legislation for the IMR has been released and we understand the regime is close to being finalised. The FSC fully supports the approach adopted for the IMR, which mirrors that used in the United Kingdom. The UK approach is well regarded by Australian industry and generally considered a 'world-class' regime.

This policy now requires legislation so investors know exactly what to expect when investing with an Australian fund manager.

Collective Investment Vehicles

Collective Investment Vehicles ("CIVs") allow investors to pool their money together to achieve economies of scale and access to investment opportunities that individual investors alone could not otherwise enjoy.

Like a trust, CIVs offer tax flow-through treatment so that the end investor is taxed at their marginal tax rate. For foreign investors, a withholding tax is taken from distribution payments and remitted to the ATO by the fund.

Australia is limited in the type and number of CIVs that can be used by investors. Australia solely uses unit trusts, which are not well understood throughout Asia. For example, many Asian nations do not operate under a trust law system and refuse to use it for foreign investment. Currently, trusts are the only legal vehicles available to Australian fund managers.

The Johnson Report recommended a CIV regime be developed so that Australia could develop as a fund formation centre. It will be essential for Australian fund managers to have a suite of vehicle types to choose from when developing for the Asia Region Funds Passport ("Passport") funds but a CIV regime will also have broader benefits outside the Passport. It will allow Australian managers to better market Australian domiciled funds offshore.

The FSC maintains that appropriate policy constraints can be developed such that a CIV regime does not result in lost government revenue, 'flipping', or other integrity concerns. A well-designed CIV regime should be seen as an opportunity to grow the pie and increase the number of funds currently domiciled in Australia. This will in turn result in increased economic activity through the necessary fund formation services which must be provided by the jurisdiction in which the fund is domiciled.

It is anticipated that most fund flows into the new vehicle types will be new money from offshore investors. Whilst there will be some natural transfer of investment from existing Managed Investment Trust ("MIT") structures into new CIVs we expect this would be minimal and no greater than the transfers which occur between MIT structures currently. This is due to MITs being predominantly domestic vehicles targeted at attracting domestic investors.

The creation of new of CIVs will allow fund managers to attract new money from offshore investors. The increased activity will not significantly impact the existing MIT base because this activity is not currently undertaken in Australia.

RECOMMENDATION 4.2:

The Collective Investment Vehicle (CIV) regime reform proposal should be removed from the Tax White Paper process and legislation expedited. It is imperative that the CIV regime be in place prior to commencement of the Asia Region Funds Passport and there is sufficient industry consensus for the regime not to be delayed further.

Offshore Banking Unit regime

Recommendation 3.2 of the Johnson Review was to update the list of eligible OBU activities to make the OBU regime more useable and to ensure that the OBU continues to remain internationally competitive.

Fund management activities by their nature are highly mobile and the market is highly competitive. Managers will locate their businesses in the jurisdiction with the most desirable features. The OBU tax concession was viewed as a key policy to establish Australia as an attractive regional financial centre and to facilitate greater non-bank competition for offshore business.

The use of the OBU concession to achieve these policy objectives is a long standing and bipartisan government policy. In 1999 the OBU concession was extended by the Coalition Government to specifically include funds management and insurance companies in OBU activities, so that the Australian regime would be competitive with those in other countries, such as Singapore. This policy position has been further endorsed by the Johnson Report and again supported by the Labor Government in its response to the Johnson Report in 2010.

In 2013 the Coalition Government again provided its support for allowing Australian industry to compete by offering a competitive tax rate to attract activity to the Australian operations of OBUs.

Removing uncertainty to create competitive tax settings

The tax system needs to be designed so that initiatives such as these can be implemented quickly, in response to changes in competitor jurisdiction offerings.

The following policy initiatives are examples where taxation policy settings have not kept pace with developments in the global market place. As a result Australia has been left behind.

Multi-currency collective investment funds

Current Australian tax rules make the issuing of multiple currency class investments ineffective because any currency gains or losses must be netted off across classes. The result is that managers wanting to offer different currency denominations must establish a separate fund for each currency class. This is expensive, results in unnecessary duplication and is inconsistent with the features available for funds in jurisdictions such as the United Kingdom and Luxembourg.

Further, the ability to offer multi-currency class investment funds will be necessary for Australian managers to fully capitalise on the opportunities presented by the Asia Region Funds Passport. Without this functionality, managers will be unable to leverage existing Australian or US dollar denominated (Australian domiciled) managed funds into the Passport regime. Instead additional funds will need to be established in each of the relevant currencies (ie, Singapore dollar, South Korean won, New Zealand dollar).

RECOMMENDATION 4.3:

The ability to provide multi-currency functionality must be incorporated into Australia's existing Managed Investment Trust regime as well as any future Collective Investment Vehicle regime.

Foreign exchange hedging treatment

Portfolio foreign exchange hedging to mitigate against currency movements is a legitimate form of hedging undertaken by many funds. Taxation treatment of portfolio hedging activities must be allowed on capital account. Current rules do not provide appropriate treatment.

RECOMMENDATION 4.4:

Funds must receive appropriate treatment under Taxation of Financial Arrangements (TOFA) subdivision 230E in relation to portfolio foreign exchange hedging.

Competitive Withholding Tax Rates

The Johnson Report recommended a reduction of the Managed Investment Trust (MIT) withholding tax rate from 30 per cent. Whilst the rate was reduced to 7.5 per cent, it was subsequently increased to 15 percent from 1 July 2012 and remains at 15 percent today. This rate is inconsistent with interest withholding tax rate of 10 percent and is encouraging investment to be structured as debt instead of equity.

Further, compared to the equivalent rates in the region – especially those jurisdictions participating in the ARFP, a rate of 15 percent is highly uncompetitive.

RECOMMENDATION 4.5:
The government introduce a special Managed Investment Trust withholding tax rate of 5 percent for funds participating in the Asia Region Funds Passport.

These recommendations will ensure that Australia remains an attractive destination for foreign capital to be invested as well as ensuring the competitiveness of Australian funds in the Passport regime.

5. Not for Profit Sector

Within the trustee sector of their businesses, the FSC's trustee members act as trustee or co-trustee for more than 1,500 charitable trusts or foundations. The FSC has a strong desire to see tax arrangements applicable to the not-for-profit sector (NFP) that operate fairly, efficiently, and encourage, rather than discourage, philanthropic giving.

5.1 Need to support the not-for-profit (NFP) sector: concessional taxation as an incentive for giving

There are generally three types of philanthropic trust structures, with a number of variables within each. They are:

- Private Ancillary Funds (PAF) (often used for family foundations);
- Public Ancillary Funds – Charitable Accounts or Sub-Funds (PUF) (often referred to as community foundations); and
- Testamentary Charitable Trusts (often referred to as will trusts).

Both PAFs and PUFs benefit from being able to apply to the ATO for endorsement as a deductible gift recipient (DGR) which means that donations to them are tax deductible.

Provisions exist in the Income Tax Assessment Act 1997 (ITAA97) (s30-247 to s30-249D) which allow donations to be deductible over a period of up to five years.

It is important that this tax treatment be continued as it ensures PAFs and PUFs can be established with sufficient capital to ensure they are sustainable (i.e. can continue to support charities and projects) and generate sufficient income to meet their minimum distribution requirements whilst still affording the founder the tax benefit (necessary to help encourage philanthropic giving).

It is worth noting that PAFs and PUFs:

- are creatures of statute;
- must distribute prescribed amounts (4% for PUFs and 5% for PAFs) from the trust fund to the beneficiaries annually;
- are established and operated as a not-for-profit (NFP) entity (though note that PAFs/PUFs cannot undertake their own programs and must donate to other charities or projects);
- may only pay distributions to entities that have been granted the status of Item 1 deductable gift recipient (DGR) by the Australian Taxation Office (ATO);
- are Item 2 DGRs themselves which means that any gift to a PAF/PUF is tax deductable (i.e. the founders or donors of a PAF/PUF receive a tax benefit by way of a deduction from their contribution to a PAF/PUF);
- are able to apply to be endorsed as a tax concession charity (TCC) to access an income tax exemption, and if so endorsed, do not pay tax on income and realised capital gains (the trustee, as the legal (not beneficial) owner of the assets of the PAF/PUF, is entitled to an income tax exemption though it is imperative to note that the benefit of this exemption is merely held on trust for the beneficiaries of the PAF/PUF);
- are entitled to cash refunds of franking credits if the PAF/PUF is endorsed as a TCC to access an income tax exemption;

- are bound by legally enforceable guidelines which set out minimum standards of conduct and governance for the PAF/PUF and its trustees;
- must have at least one independent trustee to act as responsible person/entity (this role can and is often fulfilled by a licensed trustee company); and
- can be set up to benefit a broad charitable purpose or a specific named charity.

These arrangements have been developed and refined over years to encourage individuals and the community at large to support charities and charitable causes. Indeed PAFs were only introduced as a new trust structure in 2001 (as part of a broader package of Government initiatives) so to facilitate increased levels of philanthropic giving by business and the community. By conferring DGR status allowing donors to receive a tax deduction for their donation, the ATO encourages private donations to charities thereby relieving some of the pressure on Government to fund the worthy work of charities.

It is clear that Australians have become more philanthropic and willing to support charitable causes since 2000. Data from the Australian Centre for Philanthropy and Nonprofit Studies (ACPNS), Queensland University indicates that the average tax-deductible donation made and claimed by Australian taxpayers to DGRs in 2010-2011 was $461.47. This average amount is double that of a decade ago, and far exceeds the rate of inflation over that period (ACPNS Current Information Sheet, 2013).

It is widely understood that changes to tax arrangements, especially the introduction of PAFs, have helped to drive this growth in Australian philanthropy. Nonetheless, Philanthropy Australia 2011 research indicates that Australians continue to give slightly less than their counterparts in the UK and Canada, and significantly less than US citizens. It is worth highlighting that, measured as a percentage of taxable income, tax deductible donations across most of the Australian high net wealth population was only marginally higher than those among lower income Australians. According to Philanthropy Australia's research, Australian high net wealth individuals donate less than 2 percent of their taxable income, compared to 3.2 percent in Canada and a range of 3.5 percent to 7 percent in the USA.

In this context, and with the Government facing fiscal constraints associated with an ageing population and shrinking working age population (outlined in the 2015 Intergenerational Report, and earlier in this submission), it is important that tax settings operate to encourage rather than disincentivise philanthropic giving by individuals and organisations capable of making a strong financial contribution to the community. There is still major scope, and a growing need, given the challenges facing Australia in the decades ahead, to boost philanthropic giving in Australia.

RECOMMENDATION 5.1:

Recognising the important role which the not for profit sector plays, we recommend that the Government ensure that taxation arrangements encourage, rather than discourage, philanthropic giving.

5.2 Need for clear, simple administrative arrangements for the NFP sector

It is important that administrative arrangements operate sensibly and efficiently, allowing the NFP sector to focus on providing important services to the community. Red-tape and compliance costs should be front of mind when considering the regulation applicable to this sector. Careful cost benefit analysis should be undertaken before imposing new regulatory and administrative obligations on the NFP, recognising the important role charitable entities play in society.

A small but salient example of unnecessary and confusing administrative arrangements is the ATO requirement that the auditor of a PUF confirm compliance with (all) PUF Guidelines (57 items). While the Guidelines rightfully alert the trustees to their responsibilities, they also include matters of generality which, unlike the financial items, are difficult for an auditor to confirm compliance with. Many of the 57 items are not financial in nature or matters on which auditors would typically give an audit opinion.

We understand there is widespread confusion amongst PUF administrators regarding the scope of the audit obligation, which would be best addressed by amending the requirement to allow the trustee/committee of responsible persons to confirm compliance with the non-financial items. Such a change would immediately reduce audit compliance costs.

More broadly, the FSC supports clear, simple administrative arrangements for the NFP sector, which allows the sector to reduce compliance costs and channel funding towards charitable programs.

5.3 What more can be done to encourage philanthropy in Australia?

Despite strong growth since 2000, according to the Prime Minister's Community Business Partnership (the Partnership), levels of philanthropy in Australia have tapered off in recent years. The Partnership, Chaired by Prime Minister, Tony Abbott, has been re-established to bring together leaders from the business and community sectors to promote philanthropic giving and investment in Australia. In this context it is worth noting that PAFs were developed as a landmark initiative arising first Prime Minister's Community Business Partnership in 2001.

The current Partnership's role is to advise the Government on practical strategies to foster a culture of philanthropic giving, volunteering and investment in Australia. Its focus is on priorities such as eliminating institutional barriers to philanthropic giving; considering the potential of innovative investment models; and building research on trends, education and best practice in the sector.

The Partnership's Terms of Reference (ToR) include the consideration of "the potential of innovative investment and finance models and structures to support a culture of giving and service, which may include tax arrangements' [emphasis added] (see ToR, 1.b). Accordingly, in considering the appropriate tax settings for the NFP sector, the Government should be aware of the Partnership's complementary mandate and that relevant submissions may be made to that body.

Given international evidence suggests that tax incentives are the most effective stimulants for growing philanthropy, there will need to be further examination of whether the current arrangements appropriately support philanthropic giving in Australia and/or whether new innovative structures are desirable. As outlined above, there is much potential to significantly grow philanthropy in Australia.

RECOMMENDATION 5.2:

Further consideration should be given to whether the current not for profit arrangements could be improved to better support giving in Australia and/or whether new innovative structures are desirable.

6. Tax Administration

6.1 General tax system administrative issues

There are a number of improvements we believe could be made to Australia's administration of the taxation system. These suggestions relate to activities undertaken by both Treasury and the ATO.

Annual tax administration bills

The complexity of Australia's taxation system means that continual updating of the law is required so that it remains current. This includes updating of both legislation and also legislative instruments and regulations which detail more specific requirements.

The tight legislative timetables for new bills to be passed often means there are insufficient drafting and parliamentary resources to properly maintain these laws. In addition the drafting is often highly technical and complex.

The FSC has long advocated for an annual taxation amendment bill as a vehicle to implement industry driven technical changes. Responsibility for the bill would sit with a panel comprised of industry, Treasury and ATO representatives.

The panel's remit would be technical changes within existing policy and that do not have budgetary impact. The panel would also have responsibility for drafting these changes.

We believe this approach would have a number of benefits:

- less government resources would be utilised as parliamentary counsel drafting time would not be required;
- changes would be implemented in a timelier manner, thereby resulting in less uncertainty within the industry; and
- risks would be lowered as emerging behaviour trends or activities that are inconsistent with existing policy could be identified earlier and legislated against.

We understand that the government may be reluctant to allow drafting changes not initiated by parliamentary counsel. However we would argue that industry practitioners who interact with the taxation law on a daily basis are better placed to design simple, effective changes.

To the extent that parliamentary counsel involvement must be maintained, then we would argue that a signoff procedure could be established to ensure that changes proposed by the panel do not have unintended consequences from a legislative drafting perspective. However we do not see the need for parliamentary counsel to initiate drafting changes as it does not appear to result in better or simpler legislative drafting for minor technical amendments.

RECOMMENDATION 6.1:

The government establish a Tax Expert Panel responsible for drafting minor technical amendments to existing tax legislation, regulation and other legislative instruments. The Panel should be comprised of representatives from industry, Treasury and the ATO and clear guidelines be established for the Panel's remit in relation to legislative drafting.

ATO changes to industry reporting requirements

There is increasing concern in the industry regarding ongoing changes to ATO reporting requirements that do not appear to have clear policy objectives, nor consideration of impact on business and ultimately costs to investors.

We appreciate the ATO's intention to consult with industry and we note there has been a marked improvement in ATO engagement over the past year. However there is concern that certain reporting changes are being initiated through engagement with software development groups instead of the businesses which ultimately bear the burden of reporting.

It is essential that the ATO undertake detailed cost/benefit assessments of proposed reporting changes with all affected industry participants prior to changes to requirements being finalised.

Factors we believe should be considered and reported on publically as part of any reporting changes include:

- policy rationale for the change, including why the additional data is required by the ATO in its enforcement role;
- estimates of additional cost imposed on business to make the change, including assessment of impact on end investors/users as a result of increased cost to business;
- estimates of additional time required by business to make the change;
- consideration of how the change meets the governments deregulation objectives; and
- cost/benefit analysis showing how the change is justified.

RECOMMENDATION 6.2:

The ATO undertake detailed cost/benefit analysis based on the above factors prior to changing any industry reporting requirements, such as the Annual Investment Income Report and the Standard Distribution Statement (or its replacement).

Tax Expenditure Statement and Costings

The Tax Expenditure Statement (TES) is a source of concern for the industry as discussed in the superannuation chapter. Whilst we understand and support its purpose of providing costings of government policy initiatives that result in a notional decrease in tax collected, we are concerned that figures are inaccurate and send a confusing message to the public.

Simply identifying items from the TES and claiming that a policy results in an "x dollar decrease to government revenue" does not take into account the complexity of the taxation system as a whole, nor taxpayer behaviour. We do not believe that if any tax expenditure in the TES were reversed that that the government would receive the relevant forgone income. Instead other second round behaviour would occur as a result of the removal of any tax concession.

Second round effects are not modelled in the TES and whilst we understand the difficulties associated with modelling these in many cases, it is unrealistic to assume them away.

We believe there would be significant benefit in releasing more detailed information in relation to costing assumptions. This would allow industry to provide greater input into the process and to provide additional information when policies are designed. It would also provide the Australians with greater certainty regarding the reliability of the TES.

RECOMMENDATION 6.3:

The Treasury release detailed assumptions supporting all items in the Tax Expenditure Statements along with costings for any future policies.