Treasury Laws amendment (Enterprise tax plan) Bill 2016

Submission to Senate Economics Legislation Committee

This submission responds to the Government's proposal to progressively reduce the company income tax rate to 25%, beginning with a reduction in 2016-17 to 27.5% for 'small business entities' with turnover below $10 million; and to increase and extend tax concessions for unincorporated small businesses.

ACOSS does not have a fixed view about the rate of company income tax. We have assessed this proposal carefully, as we believe all budget measures should be judged on the basis of cost effectiveness.

On that basis, we **recommend** that the Bill be rejected since the proposed business tax cuts are unfunded and their cost is estimated to quickly rise to $1.8 billion in 2019, and $14 billion in 2026, while the Treasury projects that it will increase household welfare in approximately 20 years' time by less than 0.7%, and that 55% of the company tax cuts would ultimately have to be met from other sources such as personal income tax increases or more spending cuts.

A one-sided Budget strategy

The Bill is being considered at the same time as legislation – mostly carried over from the 2014 Budget – to cut $7 billion over the next four years from social security payments, mainly affecting people at risk of poverty. If passed, those Bills would cut $60 a week from the income of a sole parent with two teenage children and $47 from the income of a 23 year old applying for unemployment payments.

These and other spending cuts will in effect contribute to the $5 billion cost (over the next four years) of the company income tax cuts and related measures in this Bill and the $4 billion cost of the proposed personal tax cuts.

These spending cuts are a clear sign that the Government lacks the revenue it needs to meet the most basic needs of the community; a fiscal challenge that will grow as the population ages. For this reason we believe that any major proposal to cut taxes at this time should be offset by equivalent revenue measures, preferably by closing tax shelters that are inefficient or unfit for purpose. This is a fairer and more efficient approach to restore the Budget than cutting essential benefits and services.

In today's tight budget conditions, the Government's fiscal target to hold tax revenue at or below 23.9% of GDP is misconceived. Another flaw in the present fiscal policy is over-reliance on income tax bracket creep (rather than tax reform) to restore tax revenue to that level over the next few years. This is discussed in more depth in our submission to the

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Committee regarding personal income tax cuts, available at: http://www.acoss.org.au/wp-content/uploads/2016/09/ACOSS-submission-into-Treasury-Laws-Amendment-Income-Tax-Relief-Bill-2016.pdf

Limited economic benefit

Tax reform can strengthen growth in the economy and jobs by reducing reliance on the least efficient taxes and by taxing different kinds of economic activity (investment, saving and workforce participation) more consistently. From this standpoint, the most economically harmful features of our tax system are the tax bias favouring speculative investment in property (negative gearing combined with the Capital Gains Tax 'discount') and the inefficient and distortionary taxes relied upon by the States and Territories (Stamp Duties and narrowly-based Payroll Taxes).

The Treasury has modelled the long term economic impact of a hypothetical cut in the company income tax rate from 30% to 25%, funded by a lump sum tax, an increase in personal income tax, or government spending cuts. The projected overall household welfare 'gain' from these reforms was an increase of 0.1 to 0.7 percentage points over a 20 year period[4].

If Treasury's assumption that in the long term 45% of the budget cost of a 5% company tax cut is offset by higher growth and increases in revenue from other taxes, this suggests that a net $8 billion in foregone public revenue is being used to 'buy' an improvement in household welfare or spending power of much less than 0.7%. If the Treasury modelling is accurate, this is an underwhelming result.

The long delay before any likely economic benefits emerge from the proposed corporate tax cut (around 20 years as modelled by Treasury) is unlikely to be reduced by the early targeting of small and medium sized businesses for company tax cuts and the other measures in this Bill. We are not aware of evidence that smaller businesses in general are more productive, or have contributed more than larger businesses to employment growth in recent years. Innovation by small 'start up' companies benefits the wider economy but it is very difficult to target tax incentives to that sector without rewarding investment in less efficient sectors, or investment that would have occurred regardless.

More substantial economic benefits are likely from a range of other public policies beyond tax reform. These include taking advantage of historically low interest rates to increase public investment in projects vetted by a reputable oversight body; policies to strengthen workforce participation (especially among parents, mature age people and social security recipients); improved urban planning and investment (especially in affordable housing and

[4] Kouparitsas, M et a l(2016), 'Analysis of the long term effects of a company tax cut.', Treasury Working Paper 2016-02. Note that the 0.7% welfare increase from a company tax cuts funded by spending cuts is acknowledged by Treasury to be an over-estimate, since the model assumed that public expenditure had no long-term economic benefits and took no account of the impact of spending cuts on households.

public transport); and investment in quality early childhood and school education for children at risk of falling behind.

In the unusual international economic environment where the risk of deflation may be as great as the risk of excessive inflation, the Government would be wise to keep open the option of strengthening demand through the transfer system, especially payments such as Newstart Allowance, which should be increased in any event to meet decent standards of adequacy. For the same reason, we strongly oppose current Government policy to cut these payments, as other Bills before the Parliament propose. Almost every social security dollar received by low income households is quickly spent in the real economy.

Tax integrity issues

In the present budgetary environment, the Government should close shelters and loopholes in the business tax system before reducing tax rates. Previous business tax reforms, including in 1988 and 2000, were packaged in this way.

The Government has announced welcome proposals to curb tax avoidance by companies operating across borders including a diverted profits tax, mandatory disclosure rules for tax advisers, action to prevent hybrid mismatches and whistleblower protection. This legislation should be brought forward for consideration before any proposed business tax cuts are considered.

The Government and Parliament should guard against one unintended consequence of company tax cuts: the greater opportunity for individuals to shelter their personal income in a private company without contributing to productive investment. They do so by taking advantage of the gap between the company tax rate and top personal tax rate (and Medicare Levy) by retaining income within these structures over a long period of time. Eventually, private company owners must pay tax at their personal tax rate on the income derived from a private company when its income is distributed to them as dividends or wages. However, in the meantime this tax is deferred (to the extent that their personal tax is higher than the company rate) and this 'timing benefit' is often substantial.

As well as active businesses, private companies are widely used by high wealth individuals to take advantage of the 'tax gap' by holding interest bearing accounts and other investment assets (such as ownership of assets that earn royalties) in a private company. Often, the private company is structured as a beneficiary of the owner's discretionary trust.

We suggest that the Committee make inquiries to inform itself about the extent to which the tax cuts in the Bill will benefit the owners of private companies that are substantially engaged in passive investment or tax avoidance activities.

Currently the above 'tax gap' is 21% for companies with turnover of less than $2 million or 19.5% for those with turnover over $2 million. After the first tranche of the proposed company tax cuts in 2016-17, this would rise to 22% for companies with turnover below $10 million. The gap would increase further as the company tax rate falls to 25%.

We recommended in our 2016 Budget submission that to deal with this long-standing tax integrity problem, income retained in private companies should be taxed at a higher rate, offset by 'reinvestment allowances' where there is a need for the owner to build up capital, for example to purchase active business assets. A system along these lines was in place until the late 1980s, when the company tax rate was briefly aligned with the top personal tax rate. Owners who do not need to reinvest could avoid this higher tax rate by redistributing company income to themselves through dividends or wages, in which case they would be taxed at their marginal rate.