From the Executive Director

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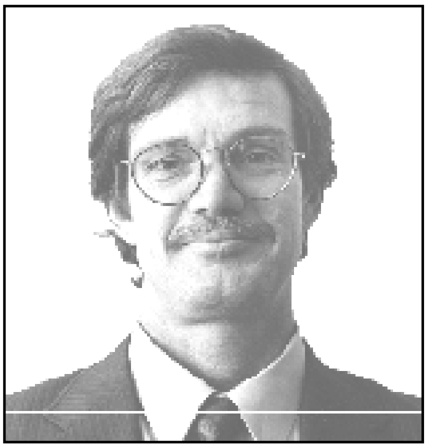
Business Tax Review: Tinkering with a Broken System



THE business tax system has serious weaknesses. The hard question is: how can we fix them?

Unfortunately, the Business Tax Review—the Ralph Committee—which issued its second and most important report on 22 February 1999 has failed to address many of the big questions.

What is needed is a completely fresh approach to the taxation of business. What we appear to be getting is a 'nip-and-tuck job' on the old system—albeit a very detailed and extensive 'nip-and-tuck job'.

The Committee, however, was hamstrung from the start by its terms of reference. It was required to investigate the ways and means of lowering the corporate tax rate from 36 per cent to 30 per cent while raising the same amount of tax revenue. In other words, it was prevented from addressing the most significant weakness of the tax system, which is that too much of the tax effort falls in the first instance on business.

Business, of course, does not in the end bear the burden of tax, but shifts it to individuals—shareholders, employees and consumers. On equity and efficiency grounds, it is far better to impose tax directly on individuals rather than indirectly on them through business.

The Ralph Committee should have, at least, been allowed to explore the merits of reducing the overall effective tax rate on business and investment rather than simply being limited to shifting the tax burden from one type of business to another.

The simple fact is that, even if the company tax rate is reduced to 30 per cent, the tax will be structured so as to raise the same amount of revenue, so the effective tax rate will be the same.

Given that the main change considered in the Review is the elimination of accelerated depreciation, the outcome will be that the effective tax rate will rise for firms with long-life assets—such as many mining and manufacturing firms—and the effective tax rate will be reduced for firms with shorter-life assets—such as business services and restaurants. The overall effective tax rate will remain the same.

Clearly the current accelerated depreciation system contributes to the irregular and perverse tax playing field—where firms of similar nature face different tax rates. The problem is, however, that capital taxation is uniformly too high—even for those businesses that now receive special treatment. In other words, the aim should be to lower the effective tax rates, not to equalize at an excessive rate.

The second major limitation of the Review is that it remains committed to pursuing a flawed ideal—that of the 'comprehensive income tax'.

The primary flaw of such a tax is that it results in double taxation of savings and therefore creates a bias against investment and in favour of current consumption. Under it, invested income is taxed twice—once when first earned and then again when invested—whereas income consumed is taxed once—when first earned.

This bias is the central flaw of our personal and business income tax systems and one of the main reasons for our poor savings record. Dividend imputation has reduced this bias, but not eliminated it. The other flaw of the income tax system is that it requires the impossible. It requires changes in wealth, whether realized or not, to be estimated on an annual basis.

The result is a tax base which is highly complex, loaded with distorting simplifications and open to political engineering. It is the reason why the *Income Tax Act* has expanded to about 4,000 pages and why a review—such as the latest Report of the Ralph Committee—requires 1,200 pages of impenetrable detail in order to recommend minor changes.

If the recommendations of the Review are implemented, it will improve the tax system—but only for a while and then not far enough.

There is an alternative tax base—an expenditure tax—which overcomes the flaws of the 'comprehensive income tax'. Under this tax base, only income that is consumed is taxed. Income that is saved is not taxed until it is consumed, so the tax avoids the need for complex depreciation arrangements.

An expenditure tax system would include a company tax. Such a tax, however, would not only be much simpler than the current company tax but provide immediate write-off of all capital. In other words, it would provide accelerated depreciation for all capital—irrespective of longevity or industry.

The expenditure tax is the tax of the future—globalization will see to it. Any review that aims to prepare the Australian tax system for the 21st century must, at the very least, explore at length the eventual shift from the old income tax system to an expenditure tax. The Ralph Committee—having neither canvassed an expenditure tax in its first two reports on the problems of the current system nor commissioned the relevant research—avoids the issue.

As Albert Einstein once said: 'Problems cannot be solved by the same level of thinking that created them.' This is the trap into which the business tax review has fallen.

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