



AUSTRALIAN CHAMBER OF COMMERCE AND INDUSTRY

Opinion Piece by ACCI Director of Economics and Taxation Michael Potter for The Australian – “Give Taxpayers the Permanent Benefit of Reform” – 28 February 2006

Give Taxpayers the Permanent Benefit of Reform

By Michael Potter – ACCI Director of Economics and Taxation

IN the lead-up to the May federal budget, some commentators have argued against significant taxation reform, stating that tax cuts will not be affordable after the mining boom ends, that tax cuts run the risk of feeding inflation and higher interest rates or that the surplus should be used to increase spending. Careful examination of these concerns shows they are unfounded and that tax reform should remain a top government priority.

Although there is no question that the mining boom has increased company profits and, consequently, tax revenue, it is argued that the end of the mining boom will cause substantial reductions in revenue, meaning that we cannot afford a permanent tax cut now. The evidence shows that the end of the mining boom will not mean a significant tax revenue reduction.

An analysis by the Treasury in the 2005-06 budget gave several economy-wide reasons for strong revenue growth, including privatisation, capital gains, lower stocks of losses carried forward, increased compliance, dividend imputation and increased incorporation. These items should not be affected by the end of the mining boom.

The mining boom has increased mining profits, but arguably has cut profits for businesses that use minerals and fuels as inputs. In addition, mining represents about 4 per cent of Australia's gross domestic product, so even significant movements in profits will have a limited effect on national profits and company taxes.

Importantly, Treasury's own projections show no change in revenue growth when the mining boom ends (assumed to be about 2008). Revenue is forecast to increase by 4.8 per cent in 2007-08 and 2008-09, with a forecast surplus of \$10.1 billion in 2007-08 and \$10.7 billion in 2008-09.

Previous government reforms mean that Australia should be able to weather the end of the mining boom with little disruption, just as we have been able to weather the Asian financial crisis, the tech boom and the recent housing boom.

Another concern raised about tax cuts is that they will cause inflation and interest rate increases, notwithstanding that only last week the Reserve Bank governor dismissed this argument in his appearance before a parliamentary committee. There are a number of flaws with this argument.

First, responsible tax cuts should represent only a small proportion of the economy. The size

of the economy is almost \$900 billion, so tax cuts in the order of \$10 billion or more represent just more than 1 per cent of the economy. It is hard to see how this could be inflationary.

Second, economic forecasts suggest the economy has room for tax cuts. The Reserve Bank of Australia forecasts inflation to reach 2.75 per cent late this year, well within its target band. The pressures from domestic demand have eased, particularly with house prices and credit growth at more sustainable levels. Substantial increases in business investment are reducing the pressures from capacity constraints.

Third, the Australian Chamber of Commerce and Industry does not subscribe to the view that the funds available for tax reform should be limited to the size of the budget surplus. This is the straitjacket that most of those getting involved in the tax reform debate have tied themselves into. Ironically, this has led some business groups, supposedly speaking on behalf of the business community, proposing anti-business taxation options such as the abolition of work-related deductions, the capital gains tax discount or negative gearing to help pay for reform. We oppose this approach.

We consider that broad tax reform can and should be accompanied by cuts to government spending, to ensure that the reduction in the budget surplus will be limited.

A discussion paper we released last year, Commonwealth Spending (And Taxes) Can Be Cut -- And Should Be, identified ample opportunity to reduce government expenditures. It detailed \$19.5 billion a year in cuts.

Fourth, the ability of Australian companies to increase prices is limited by competition. In particular, 42 per cent of the consumer price index is largely determined by international prices, so tax cuts should not affect this part of the CPI (assuming that tax cuts do not have a sizeable effect on the exchange rate).

Fifth, if tax cuts can cause inflation, then these commentators should be arguing for tax increases to reduce inflation. They are not suggesting the argument is inconsistent.

Significantly, the tax cuts of recent years have not overheated the economy, even with the housing and mining booms. The RBA has argued that fiscal policy has not been a significant influence on monetary policy at all in Australia for the past six or seven years. Indeed, tax cuts should reduce, not increase, inflation, for example by reducing costs for unincorporated businesses and encouraging workforce participation and skilled migration, which reduces wage pressures.

The final argument making the rounds is that the budget surplus should be used for other spending, particularly infrastructure, rather than tax cuts. However, all government spending items should be assessed on their individual merit, independent of the size of the surplus. Spending decisions should be based solely on a thorough cost-benefit analysis of the specific project.

If there are areas of legitimate spending need, funds for these needs should come from cuts to unnecessary spending rather than from cancelling a tax cut.

The private sector, furthermore, can undertake a significant proportion of infrastructure investment. The private sector should be encouraged to build the required infrastructure, particularly by reducing the red tape and tax penalties imposed on infrastructure development.

Australia needs significant, structural taxation reform, including a substantial reduction in the top marginal tax rates to ultimately reach 30 per cent, indexation of personal tax thresholds, the introduction of a stepped rate capital gains tax, reduction in tax compliance costs and reform of superannuation taxes.

Appropriately designed and responsibly implemented taxation reform will not pull the budget into deficit in years to come, will not come at the expense of vital infrastructure and will not be inflationary.

Are tax cuts prudent and justifiable in the 2006-07 budget? Yes, they are.

Michael Potter is director of economics and tax at the Australian Chamber of Commerce and Industry.