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Productivity Commission Inquiry: Creating a more dynamic and resilient economy

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Please find enclosed our submission to the Productivity Commission Inquiry: Creating a more dynamic and resilient economy, which addresses key structural challenges in the Australian economy and sets out reforms that we believe are essential for restoring competitiveness, driving productivity, and securing long-term prosperity. In particular, it highlights the urgent need to reduce company tax to attract investment, reform income tax to address bracket creep and strengthen incentives to work, and implement a more effective regulatory framework that fosters innovation and efficiency.

The recommendations draw on extensive research, including previous work published by the Centre for Independent Studies, and are grounded in the principle that sustainable economic growth requires both investment and productivity improvements. We also emphasise the importance of sound public spending discipline to allow for meaningful tax reform without compromising fiscal responsibility.

We commend the Commission for its ongoing inquiry and welcome the opportunity to contribute to this important national discussion. We would be pleased to provide further information or appear at hearings to elaborate on our recommendations.

Thank you for considering this submission.

Yours sincerely,

Michael Stutchbury
Executive Director
Centre for Independent Studies

Cutting company tax

The Australian economy has major structural weaknesses. And if we fail to fix these weaknesses, we risk failure: stagnant growth in wages, incomes, productivity and GDP.

Business investment is at near-record lows as a share of GDP. It has been lower only once: in the depths of the 1990s recession. Mining investment is plummeting and is not being replaced by non-mining investment. There are enormous amounts of global capital, but it isn't going to Australian business investment.

Productivity growth is weak. Australia's economic growth rate cannot be sustained without boosting investment and productivity. These are the only ways we can get sustained growth in household incomes given we are expecting long-term declines in labour force participation.

Australia's company tax is very uncompetitive

Australia is becoming less competitive on many other measures of the regulatory burden; company tax is exacerbating these harmful changes.

Our company tax rate is above OECD averages. Australia's tax rate is well above what should be expected for a country of our size.

Our tax rate is well above global and local averages and these international averages have been declining, while Australia's rate has remained unchanged. Almost all OECD countries have cut their corporate tax rate since 2001. In contrast Australia's rate has remained unchanged. If trends continue, our tax rate will still be above the average even after the tax cut is fully implemented. Australian companies pay more tax than OECD averages. This holds even when imputation and the proposed tax cut are subtracted.

Australia's ratio of company tax to GDP is above its historical average and set to grow strongly. In addition, Australia's effective tax rate on companies (tax as a proportion of profits) and the share of total revenue coming from company tax are both well above OECD averages.

Cutting company tax is one of the best ways to address our economy's underlying weaknesses

Australia needs a boost to investment, productivity and wages. A company tax cut will encourage more investment into Australian businesses, particularly from foreign investors. There is widespread agreement that higher investment will grow the economy, as well as promoting competition, and boosting wages, productivity and access to innovative technology.

Company tax revenue is becoming very reliant on a small number of taxpayers, so the budget is highly exposed to the risks of these individual companies. A tax cut will ease this reliance.

Company tax is like a tariff on imported capital, and should be reformed like these other tariffs. Just as with tariff reforms, the decision to implement a company tax cut should be based on the benefit to the whole economy. It provides tax reductions to all businesses, not just small business, and there are reasons to expect larger businesses to provide the greater economic benefit. Larger businesses have, on average, recently experienced improved profitability, productivity and employment, and provide more workplace flexibility. The budget impact of the tax cut is small or zero:

The economic growth caused by a company tax cut will result in an offsetting increase in tax revenue, significantly reducing the costs of the tax cut — and the offset is likely to be larger if the underestimate of investment response is corrected. In any case, the Productivity Commission at the least should not bind itself to the narrow constraint, for example, of requiring that each element of tax reform, such as for company tax, should be revenue-neutral.

CIS urges caution on the proposals contained in the Productivity Commission draft report for further entrenching differences in the statutory tax rate for large companies (30 per cent) and smaller companies (20 per cent) and for adding a new 5 per cent net cash-flow tax. We question the report's discussion about supposed extent of economic 'rent' earned by bigger companies.

In contrast to its previous reports, the Productivity Commission seems to give undue weight to politically-inspired claims that Australia's weaker productivity performance reflects a loss of economic 'dynamism' due to the increased market power of bigger companies. Economic rents are inherently difficult to measure given they concern the measurement of risk-adjusted returns on capital investment.

Common observation suggests the exposure of much of Australian to competition, including from the rest of the world, has increased in the past two to three decades amid the penetration of the digital economy (for example, retail and media) and the lowering of import barriers (such as for the supply of motor vehicles). Profit margins for some of Australia's biggest companies – the big four banks – have shrunk as they have faced competition through mortgage brokers, digital neo-banks, global tech companies and disruptors such as Macquarie.

The Australian Competition and Consumer Commission has failed to find the big supermarkets have committed "price gouging". The Productivity Commission previously has found that the big supermarkets compete vigorously. Any problem of reduced "dynamism" is much more likely to be the result of increased regulation, compliance burdens and red tape, including new labour market regulations that encourage collusion through so-called pattern bargaining.

For more on cutting company tax, please access CIS research at the links below or in the papers in Appendix A:

The Case Against Tax Increases in Australia

Lower Company Tax to Resuscitate the Economy

Fix it or Fail: Why We Must Cut Company Tax Now

Income Tax Reform and Bracket Creep

The key problems in personal income tax are excessive marginal rates and an increasing overall average tax rate as bracket creep goes unchecked. Political objectives aside, there is a sound economic case for tax cuts. Australia is not a 'low tax country' as some assert. Australia may be below the OECD average in terms of tax and a proportion of GDP. But this excludes Australia's 12 per cent compulsory superannuation guarantee. And it compares Australia with low-growth European economies rather than with countries in the Asia-Pacific with which we trade and compete more.

The government should give priority to instituting a system of automatic annual indexation of bracket thresholds to average wages and to cutting marginal rates. Indexing the tax scales would introduce some needed structural discipline into the tax-and-spend system and remove a form of "stealth" tax that is inherently dishonest and undermining of community acceptance of the tax system. Going further, more ambitious reform options should be considered, such as abolishing the tax-free threshold in order to cut marginal rates; curbing deductions; and removing distortions in taxation of personal saving.

Large income tax cuts are very costly to revenue and the scope is limited over the next few years by the pressing need to bring the budget back into balance and in the longer term by upward pressure on public spending. This constraint reflects the failure of successive governments to wind back expenditure from bloated levels. A more disciplined approach to public spending provides the key to larger medium-term income tax cuts. Until that happens, personal income tax relief is likely to be modest and do no more than check the rising trend in the average tax rate.

Bracket creep chips away at living standards, especially those of younger generations. Australia's younger workers have the most to lose from bracket creep because they are early in their careers and make less money. Young people feel the impact of a tax increase more acutely than those established in their careers with higher incomes and more wealth.

The tax increases faced by those at lower incomes are also larger with only a small increase in nominal income leading to a large increase in their overall tax rate. Young people have less bargaining power and will likely struggle to convince their employers to make cost-of-living adjustments to their earnings, let alone the rise needed to compensate for both inflation and a higher tax rate due to bracket creep.

Periodic tax cuts only help temporarily; they barely scratch the surface in offsetting bracket creep's insidious impact. To genuinely tackle this issue, Australia needs a long-term solution that does not depend on the whims of politicians.

If tax thresholds were indexed to the CPI, the tax liability of high-income earners as well as others would be fixed in real terms until the government legislated a change in tax policy. This would provide transparency for all taxpayers, and avoid the inane recurring debate about whether it is fair that high income earners receive larger dollar tax cuts than low-income earners while ignoring the fact that high earners carry most of the income tax burden.

Further, the Productivity Commission should recognise the productivity costs of the structural increase in the size of government since before the pandemic. It should recommend that tax reform should not become a vehicle to increase taxes in an ad hoc manner in order to validate a structural increase in the size of government.

For more on income tax reform and bracket creep, please access CIS research at the links below or in the papers in Appendix B:

[The Truth About the Tax Burden]

[Bracket Creep: Raiding our Wallets]

[Bracket creep hits young Australians the hardest]

Regulation

Research has pointed to three common themes in regulatory burdens across the economy: planning and zoning creep, environmental regulation and regulatory inconsistency. The requirement for regulatory impact statements accompanying new legislation has become ineffective, similar to how fiscal rules have fallen away. The unchecked regulatory burden accumulates in rising business compliance that undermines flexibility, increases costs and blunts economic dynamism.

This raises the issue that the costs of regulation are inadequately measured (or not measured at all), evaluation of regulatory outcomes are piecemeal and that the costs of imposing layer upon layer of competition are poorly understood. In Australia, financial institutions such as the Macquarie Group have measured their annual direct compliance costs as exceeding $1 billion.

Many reforms are dependent on the working of Australia's regulatory system and its effectiveness for their success. Although the objectives of regulation are desirable, insufficient attention has been paid to the resulting effect on innovation and productivity. For this reason, we consider Australia's governments should legislate to introduce a **Charter Of Regulatory Effectiveness**.

This would have four major objectives:

- **Facilitate decision-making**. Regulators should be given a responsibility to be stewards of the legislation they administer. This should involve keeping the legislation up to date (or advising ministers to do so) and — equally as important — removing obsolete, duplicative and unnecessary provisions.
- **Streamline the process**. The principles of effective regulation should be codified in legislation with emphasis on the importance of encouraging innovation and productivity growth and timely approvals.
- **Accountability.** Responsibility for the regulatory system as a whole should be assigned to suitable ministers and public service departments who should report periodically to parliaments and the public on the effectiveness of the regulatory system.
- **Oversigh**t. *Ex post* reviews should be undertaken of the effectiveness of regulatory systems in particular areas of policy.

These proposals build on those that already exist and, if followed consistently, will result in continuing improvement in regulatory systems. In particular, they will encourage greater innovation and faster productivity growth.

This thinking is supported by the Productivity Commission's interim report to the government prior to the Treasurer's roundtable. The report highlights the need for more effective regulation, noting that Australia had fallen on key international regulation indices. "We have most of the tools and procedures we need to regulate well, but they are just not working," the Commission reports.

It recommends the government provide a more effective counterweight to risk aversion and incentives that have created a thicket of regulations and rules. "It should adopt a whole-of-government statement to commit to regulation outcomes that better promote growth and dynamism, and lead by example by outlining a series of productivity enhancing reforms," the report says. "There should be increased scrutiny of regulatory proposals from Cabinet, parliament and a newly appointed independent statutory commissioner for the Office of Impact Analysis."

The commission also recommends regulators and policymakers be more proactive in managing regulations and better consider the tradeoffs between regulatory objectives, risk tolerance, compliance costs, and broader economic growth. "[Regulators] should be empowered to regard themselves as stewards of the regulatory systems they manage and be accountable for delivering outcomes."

For more on income tax reform and bracket creep, please access CIS research at the links below or in the papers in Appendix C:

Our Prosperity is Slipping Away: Submission to Economic Reform Roundtable

Addressing Australia's Productivity Problem. CORE Blueprint to Unshackle Productivity

Appendix A (pdfs of papers to be added as supporting documents)

The Case Against Tax Increases in Australia

Lower Company Tax to Resuscitate the Economy

Fix it or Fail: Why We Must Cut Company Tax Now

Appendix B (pdfs of papers to be added as supporting documents)

The Truth About the Tax Burden

Bracket Creep: Raiding our Wallets

Bracket creep hits young Australians the hardest

Appendix C (pdfs of papers to be added as supporting documents)

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