Business Council of Australia

Submission to Productivity Commission Study on the Economic Impacts of Migration and Population Growth

4 October 2005

Introduction

The BCA considers that sustained population growth is an important element in ensuring Australia's long-term economic growth and prosperity. Australia's population – its size, growth and diversity – will have a significant role in driving productivity, innovation and economic growth in the future.

The BCA therefore welcomes the Productivity Commission's proposed research into the economic impacts of migration and population growth. This research should provide a welcome addition to the debate on the economic benefits for Australia of sustained migration and population growth.

This research is particularly important given future developments that are likely to influence debate around population and migration policy issues. On current projections, Australia's population growth is set to slow significantly. This, coupled with factors such as the labour participation effects of an ageing population and the growing international demand and competition for skilled globally mobile labour, highlights the importance of a framework for assessing the importance of population and migration growth, as well as the appropriateness of current policy settings in achieving overall objectives.

Economic Impacts of Migration and Population Growth

In assessing the economic impacts of migration and population growth the Productivity Commission should focus on whether such growth can have more than a scale impact on the economy. In considering this issue, the Productivity Commission could focus on some points raised in the BCA publication entitled *Australia's Population Future* (published in April 2004) This publication noted that population growth, by producing larger domestic markets, can produce production economies for firms (particularly domestic producers of non-traded goods), as well as spill-overs associated with knowledge externalities and thick market benefits. These benefits may be particularly beneficial to an economy such as Australia which has a relatively small population, is a long distance from major global markets, and has fragmented domestic markets.

Furthermore, in relation to the economic impacts of skilled migration, the productivity benefits associated with such migration through raising overall skills in the economy, plugging areas of specific skills shortages, and facilitating the introduction of new ideas and knowledge, should be considered.

Consideration should also be given to how broader policy settings influence the economic impact of migration and population growth. For example, the full economic benefits of population growth are only likely to be achieved when appropriate policies for education, infrastructure, business investment and the environment are in place.

Finally, the research should also investigate the impact of migration and population growth on labour force participation, particularly given the serious implications for future workforce participation from population ageing.

Policy Impediments to Population and Migration Growth

As noted above, the BCA is a strong supporter of sustained population growth in Australia. The BCA advocates sustaining population growth at around 1.25 per cent per annum – the rate that has been recorded over the past decade.

Given that Australia's population growth is projected to slow significantly in the future consideration should be given to current policy structures that may inhibit appropriate levels of population growth.

Policies associated with child care and work/family balance could influence the rate of natural population increase in Australia. However, decreases in birth rates in Australia are likely to be the result of wider societal factors and may not be significantly sensitive to policy changes.

As a result, the BCA strongly supports increases in migration to sustain population growth at around 1.25 per cent per annum. In particular, the BCA believes that skilled migration should remain an important focus of Australia's immigration intake. Skilled migrants are an important source of innovation and ideas for Australian business; they contribute to filling skill gaps within the economy and help to improve overall skill and productivity levels within the Australian workforce.

Consideration of policy structures that make Australia more or less competitive to skilled workers and migrants (both foreigner and expatriates) is therefore vitally important. This is particularly the case given the growing international demand and competition for globally mobile skilled workers.

In this context, the BCA believes that attention needs to be given to the impediments to skilled migration that the current taxation system in Australia produces. These impediments will be explored in the remainder of this submission.

However, before we consider how the taxation system in Australia influences incentives for skilled migration to Australia, it is important to make a general point about the significance of overall economic reform to Australia's attractiveness as a destination for skilled migrants.

Attracting skilled migrants to Australia can be particularly challenging given our geographic isolation. To assist in overcoming this disadvantage, and to help position Australia as a destination for skilled labour in an increasingly competitive global market, we need a strong, innovative and dynamic economy which can provide migrants with a wide variety of desirable employment, career and education opportunities.

Therefore, while consideration of tax reform to reduce impediments to skilled migration is imperative, it is also vitally important that we recognise that it needs to be one component in an agenda of economic reform aimed at producing a dynamic Australia economy that is attractive to skilled migrants.

Taxation Impediments to Skilled Migration

Australia cannot afford to continue to maintain barriers to attracting and retaining skilled employees. Unfortunately one of Australia's largest existing policy barriers is the current structure, burden and administration of its taxation system.

The following discussion looks at some specific areas where Australia's taxation system is creating a barrier to the attraction and retention of skilled workers. The section below provides a summary of the Business Council's key recommendations for removing of the more significant of Australia's taxation barriers.

Summary of Recommendations:

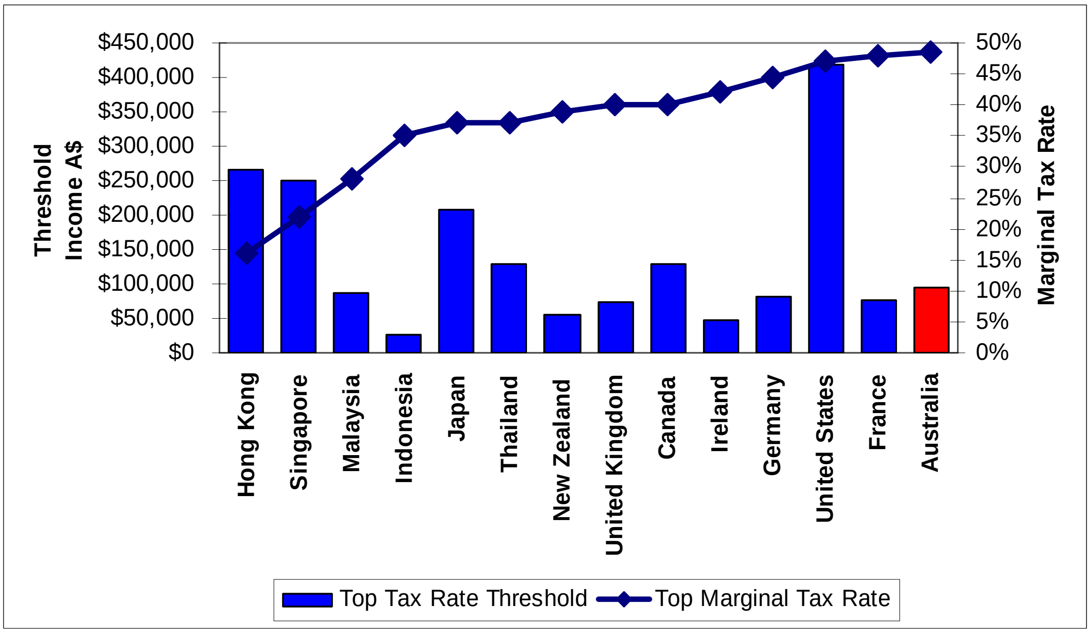
1) Lower the top two highest marginal tax rates to at least 40 per cent in order to make Australia a more competitive destination for attracting and retaining skilled migrants.
2) Simplify the taxation law which applies to temporary and permanent migrants.
3) Ensure that Australian Taxation Office (ATO) is adequately resourced to deal with individual migrant issues through the establishment of a specific ATO Cell. Any common issues should be fed into a specific area in the Commonwealth Treasury so that policy and tax design can be adjusted to ensure that issues such as complexity and administration do not become blocks for temporary and permanent migration flows.
4) Remove specific taxation barriers for temporary and permanent migrants including:
   - review and remove barriers to the attraction of mobile skilled workers in Australia's superannuation system; and
   - review and remove competitive barriers in the treatment of employee share ownership.

Lower the top two highest marginal tax rates

Lowering the top two highest marginal tax rates in the personal tax structure will help make Australia a more competitive destination for attracting and retaining skilled migration.

The highest marginal tax rates (sometimes including social security taxes) on personal incomes lie close to 40 per cent for key competitors such as the US, UK, Ireland and New Zealand as can be seen from the chart below.

Chart: Personal Income Tax Rates of Major Trading Partners – 2005



Source: KPMG

The chart indicates that Australia imposes higher marginal tax rates at lower income thresholds than many of its key competitors.

High marginal tax rates undermine Australia's competitiveness as a location for high-value occupations and activities. In thinking about the importance of taxes on highly skilled workers, consideration needs to be given both to Australia's capacity to attract skilled migrants but also to retain those skilled workers in the Australian economy.

Income and earnings are an important determinant influencing decisions about where to work and live in increasingly global labour markets. Over one-third of respondents in a recent survey of Australian emigrants cited higher incomes as an important factor influencing their decisions to leave Australia.[1] The reality is that many can earn significantly higher incomes (in $A terms) overseas, and lower taxes make these incomes all the more attractive. While the cost of living may be higher in some cases, the value of savings for those intending to return to Australia at some point can be an added incentive.

Rate changes rather than threshold changes are required. Threshold shifts only change marginal rates for a relatively small number of taxpayers. They do not change the marginal tax rates facing taxpayers with incomes above the new thresholds. In addition, the benefits of threshold changes are eroded by inflation over

[1] Hugo, G. Rudd, D. and Harris, K., *Australia's Diaspora: Its Size, Nature and Policy Implications*, CEDA Information Paper No.80, December 2003.

time, and other aspects of the taxation system that are linked to the rate (such as the fringe benefits tax rate for benefits paid to employees) would not be remedied by a threshold change and would become even more anomalous than they are now.

While a rate of 30 per cent would bring the top rates in line with the company tax rate reducing both complexity and room for arbitrage in the system, an initial option is to replace the existing two higher rates with a lower single step at a 40 per cent rate (plus Medicare Levy). This would broadly match the UK and (in typical States) the US systems.

Recommendation:

– The two highest steps in the personal tax rate scale should be substantially reduced to no higher than 40 per cent, and preferably lower.

The complexity and deadweight costs in the taxation law potentially faced by temporary and permanent migrants must be reduced

If a person is a resident of Australia for tax purposes all of the Australian tax laws apply, and they are taxable on the income they earn from both Australian and foreign sources. For non-Australians residing temporarily in Australia, the tax impacts are particularly harsh. As well as paying higher marginal and average taxes on personal incomes than they would in many of Australia's competitor countries, a highly skilled worker who chooses to work in Australia rather than in a competitor economy will also have to come to terms with many other complex features of the Australian tax system – such as fringe benefits tax.

These arrangements are often complex and very costly for businesses that attempt to employ temporary residents, many of whom bring key skills. In addition to dealing with the complexity, to attract the workers it is common that the employing business must compensate for the taxes paid. The taxation of the foreign source income of temporary residents working in Australia is generally incident on employers and represents a direct cost that reduces Australia's competitiveness as location for high-value activities. The tax being incident on business rather than the employee is highly inefficient.

Like high marginal tax rates, these issues undermine Australia's competitiveness as a location for high-value occupations and activities.

Some inroads on complexity have already been made, for example the Review of International Taxation undertaken by the Board of Taxation and Treasury in 2002 and 2003 has lead to some useful simplifications and improvements in the tax arrangements applying to foreign source income, but much more needs to be done to reduce these barriers to Australia's attractiveness for skilled workers.

Recommendation:

– Simplify the taxation law which applies to temporary and permanent migrants by either simplifying specific laws in relation to temporary residents or, more significantly for Australia's economy, review and reduce the excess complexity that all Australian residents have to face in the current tax system.

– Ensure that the ATO is adequately resourced to deal with individual migrant issues so that these do not become a barrier to the attraction and retention of skilled migrants through the establishment of a specific ATO Cell. Any common issues should be fed into a specific area in Treasury so that policy and tax design can be adjusted to ensure that issues such as complexity and administration do not become a block for temporary and permanent migration flows.

Reduce specific taxation related barriers for permanent and temporary migrants

Features of the tax system that specifically disadvantage Australia as a work location for temporary residents should be removed. A number of Australia's key competitor countries have redesigned specific elements of their tax systems in order to take advantage of the global employment market and the increasing supply of internationally mobile, highly skilled labour.

Temporary residents who are following the current trend to spend a longer time in their host countries may find themselves treated for tax purposes in the same way as permanent residents, even though they have no intention of taking up residence, and their visas require them to leave the country.

A number of countries have recognised this problem and have amended their tax systems to reduce the tax bias against temporary residents. This has generally been achieved by drawing a better distinction between 'permanent' and 'temporary' residents and by giving an exemption from tax on certain forms of income.

The Government should be commended for finally achieving passage of its reforms to the taxation of temporary residents previously rejected by the Senate, including: the insertion of a new definition of 'temporary resident' into s. 995-1 of the *Income Tax Assessment Act 1997*; the extension of the existing four-year exemption from the Foreign Investment Fund rules for temporary residents; and the provision of temporary residents with a four-year exemption from income tax on foreign source income derived from assets, capital gains tax on the disposal of foreign assets and interest withholding tax obligations.

However, the Government needs to undertake other reforms aimed at removing barriers to the attraction of the skilled temporary residents[2], for example:

- Implementing an objective test for inbound residence

The current definition of 'resides' in relation to residents for Australian tax purposes does not assist certainty in Australia's tax environment. As a result it can be inconsistent and provides different outcomes for people coming to and leaving from Australia on a temporary basis. Consistent with the treatment adopted by our near neighbours and in order to provide greater certainty an objective test should be developed based on days of physical presence in Australia.

- Exempting the income that temporary residents derive from foreign workdays

[2] A number of these issues were raised in the *Review of International Tax Arrangements: Submission to the Board of Taxation*, Ernst and Young (October 2002) (section 8 pp 87-92)

A number of countries who are competing with Australia in attracting skilled workers including Hong Kong, Singapore, Thailand and Malaysia, ensure that the income that temporary residents derive from foreign workdays is exempted from taxation. Australia should consider similar rules.

- Reform of superannuation for temporary residents (discussed below); and

- Ensuring that other methods of remuneration such as employee share schemes are provided similar or (ideally) less severe tax treatment than our competitors (discussed below).

Recommendation:
– Specific taxation barriers for temporary and permanent migrants should be reviewed and removed in order to ensure that they do not disadvantage Australia in competing for the globally mobile skilled workforce.

Superannuation

Reform is needed in the area of taxation of superannuation for temporary residents. Australia still imposes additional non-recoverable costs on employees and/or temporary resident employers as a result of compulsory superannuation requirements. Further detail on the current barriers in superannuation is provided in Attachment 1. Areas for reform could include:

- excluding temporary residents from having to make contributions to Australia's compulsory superannuation regime through an extension of the current 'senior executive' exemption to all temporary residents. Temporary residents should be excluded from having to make contributions to Australia's compulsory superannuation regime in the same way that the 'senior executive' exemption operates now. This proposal was outlined in recommendation 22 of the BCA submission, 'Review of International Tax Arrangements: Submission to the Board of Taxation October 2002'.

- ensure that employers can claim a tax deduction for contributions on behalf of employees to foreign superannuation funds (sections 82AAR, 82AAC, Income Tax Assessment Act, 1936). Contributions to foreign super funds in respect of international employees are a legitimate business cost for which a tax deduction should be allowed to employers.

Recommendation:
– Review and remove barriers to the attraction of mobile skilled workers in Australia's superannuation system.

Specific issues in relation to the attraction of skilled migrants and the taxation of employee share options

There are a range of areas in the current taxation treatment of employee share schemes which require review in order to ensure that the treatment is not more severe than the treatment provided by other countries which are competing with Australia for skilled and mobile employment. Any potential barriers in the treatment of employee share schemes should be removed. The Government should be wary of areas which provide an uneven playing field for Australian businesses disadvantaging them in their capacity to provide a competitive package when trying to attract skilled employees. Areas which could be considered include:

- the need to harmonise the acquisition rules between share plan rules and Capital Gains Tax rules. The current system including the definition of 'deemed to acquire' is unique to Australia and highly complex. This degree of complexity poses a potential barrier in the attraction of skilled workers from offshore;

- the Fringe Benefits Tax (FBT) and Capital Gains Tax (CGT) exemption should be extended for genuine share plan trusts. An exemption within the FBT and CGT rules for trust activities within employee share plans would bring this treatment order into line with overseas treatment;

- the expansion of the current share plan rules beyond ordinary shares to areas such as listed staple securities;

- simplification of the share valuation rules; and

- bringing the Division 13A treatment into line with international practice through removal of cessation of employment as a taxing event in cases of termination of employment arising from redundancy or retirement. Attachment 2 from a recent Australian Bankers Association submission to the Federal Treasury demonstrates that 11 of our trading partners do not tax employees on cessation of employment.

Recommendation:
– Review and remove barriers to the attraction of mobile skilled workers in Australia's taxation treatment of employee share schemes.

Attachment 1

Attracting skilled migrants and the operation of our superannuation system

There are a range of superannuation related issues which adversely affect the competitiveness of Australia as an employer of globally mobile employees. Australia's regime creates a number of difficulties that result in increased costs to employers, which as a result can adversely affect Australia's competitiveness as a location for globally mobile employees.

1. Compulsory superannuation guarantee creates double contribution cost

Many temporary and permanent migrants who come to work in Australia on pre-arranged assignments will remain members of a retirement plan in their home country, as this makes sense from a lifetime retirement funding perspective, and may even be required under their home country system. This usually requires an employer contribution. In addition, for all but senior executives, a superannuation guarantee (SG) contribution must also be made to the Australian system.

As a result, a double contribution cost arises which usually must be met by the employer, thereby increasing the cost to bring a globally mobile employee to Australia, which in turn reduces Australia's competitiveness as a location to have regional facilities/management. It also often facilitates employees being able to obtain in unintended double benefit.

The Government's preferred solution at present is to address this issue through totalisation agreements. However, this is not completely satisfactory as it represents a piecemeal approach which does not yet cover some of Australia's main trading partners who have their own comprehensive retirement regimes e.g. UK, Singapore.

The simplest alternative approach would be an exemption from SG in relation to all 456 and 457 visa holders. However, recognising that this is unlikely to be palatable to the Government, alternative approaches that would directly address the cost/competitiveness issue could include:

– allowing an SG exemption where contributions are being made to an existing home country fund;

– allowing an exemption for individuals who are transferred to Australia from a related group company (this allows a broader exemption whilst limiting the labour market distortion concerns).

2. Corporate tax treatment of contributions to foreign funds

At present, employers are not entitled to claim a tax deduction for contributions on behalf of employees to foreign superannuation funds (sections 82AAR, 82AAC, Income Tax Assessment Act, 1936). Further, Fringe Benefits Tax (FBT) is payable on contributions in respect of employees who do not meet the exempt visitor definition (section 517, Income Tax Assessment Act, 1936), that is employees on temporary residency visas for periods of less than 4 years. This creates a significant additional cost, in addition to the double contribution cost identified above, further impacting Australia's competitiveness as a base for employing globally mobile employees.

Contributions to foreign super funds in respect of international employees are a legitimate business cost for which a tax deduction should be allowed to employers. The principle underlying the denial of deductions appears to be that retirement fund deductions should be limited to contributions to the Australian retirement system. However, this ignores the fact that contributions to foreign funds for internationally mobile employees are an integral part of the remuneration of such employees, and it is clearly accepted that employee remuneration is a deductible business cost. Therefore, rather than viewing such contributions purely from a superannuation silo perspective, such contributions should be viewed as part of normal employee remuneration costs. To do otherwise has a further adverse impact on Australia's cost competitiveness.

Similarly, there is no justification for imposing FBT on contributions to overseas funds for bona fide globally mobile employees. For such employees who extend their stay in Australia beyond 4 years, this can create four layers of cost to essentially provide the one benefit, being the contribution to the foreign fund, the SG contribution, the loss of the corporate tax deduction and the FBT payable on the foreign fund contribution. In total, these costs add a substantial increment to the cost of bringing globally mobile employees to Australia.

Attachment 2

Comparative analysis of the taxation treatment of employee option plans with Australia's major trading partners

In contrast to Australian tax laws, employees who have been granted options in the following countries will not be taxed on cessation of employment – that is, the retirement of an employee will not trigger a tax event.

United States

The US tax code broadly distinguishes between two types of employee stock option plans:

(1) Statutory Stock Options – (Incentive Stock Options (ISOs) and employee stock purchase plan (ESPP))

(2) Non-statutory options or Non-Qualified Stock Options (NQSO)

ISOs are less common than NQSOs as the benefit received under an NQSO is tax deductible to the company. Under both types of Statutory Stock Options plans (ISOs and ESPP), there is no tax on either the grant or the exercise of the option. The employee is not taxed until he or she sells the shares on the difference between the proceeds and the exercise price. If the employee does not dispose of the shares within two years after grant, and holds the shares for over twelve months after exercise, any gain will be taxed as a long term capital gain when the shares are ultimately sold. There are various stringent legal requirements for qualification and maintenance of this favourable tax treatment.

Non-statutory options or NQSOs refer to a number of types of options to purchase company stock that, do not satisfy the legal requirements to qualify as an ISO or a purchase plan option (because, for example they require shareholder approval). Generally on exercise of the options, the employee will be subject to tax on the taxable amount as ordinary income/wages at his or her marginal tax rates. The taxable amount is the difference between the fair market value of the shares at exercise less the exercise price paid. The individual will also be subject to capital gains tax on sale of the shares equal to the sale proceeds less the fair market value of the shares at exercise. Generally where shares are held for twelve months or more after exercise, any gain will be taxed as a long-term capital gain.

United Kingdom

The UK has a range of approved and unapproved share and options plans. Broadly, where Inland Revenue Approved Share Schemes are provided, no tax is imposed at the time the options are granted. There is also no tax charge on exercising the options providing this is done between 3 and 10 years after they were originally granted. When the shares are later sold, capital gains tax will apply.

If an employee is granted Unapproved Share Options, tax is not imposed at the time the option is granted if the term of the option is 10 years or less. Ordinary marginal income tax rates apply when the option is exercised on the spread between the exercise price and the market value of the shares. When the shares are later resold, any subsequent gain equal to the sale proceeds less the fair market value of the shares at exercise is subject to capital gains tax. Employee share schemes can normally qualify for business taper relief reducing the effective tax rate on any capital gains. The rate of taper relief that applies depends on the number of years shares are held and if the individual is still an employee.

Canada

In Canada, Tax-Preferred Stock Options are not subject to tax at grant. On exercise, the employee is subject to tax on the difference between the fair market value of the shares and the amount the employee paid to exercise them (at ordinary marginal income rates). The employee may be allowed to take a deduction equal to 50% (the discount may differ across Canadian states) of this amount if the shares are common shares and the exercise price, at the time the options were granted was equal to the fair market value of the shares. The objective of this deduction is to mirror the treatment of capital gains. In addition employees can elect to defer taxation at the time of exercise of the options (if they qualify for the 50% stock option deduction) until the earlier of the year in which the shares are sold by the employee, the employee dies or becomes a non-resident. This is provided the amount paid by the employee to acquire the shares does not exceed C$100,000 for options that vested in any one year.

Non-Tax-Preferred Stock Options are also not subject to tax at grant. On exercise the taxable amount is the difference between the fair market value of the shares and the amount the employee paid to exercise them (at ordinary marginal income rates). When the shares are later sold, capital gains tax applies.

New Zealand

In New Zealand, employee options plans are not subject to income tax on grant. Employees will be subject to income tax at exercise on the quoted fair market value less the exercise price. Depending on their purpose for acquiring the shares the employees may be subject to tax on the gain made on sale.

Germany

Employee options plans for listed companies are not subject to income tax on grant. Generally, stock options are taxable when exercised. Taxable income is computed at the time of exercising the option, normally as the difference between the market price of the shares and the exercise price. On sale of the shares, capital gains are taxable only if the shares were bought and sold within 12 months.

Singapore

Employee share option plans are not subject to income tax at grant. Employees will be subject to income tax at exercise on the quoted fair market value less the exercise price. There is no capital gains tax on sale of the shares unless the employee is in the trade of buying and selling shares. Singapore does however in limited circumstances tax at the time of cessation of employment where a Singapore permanent resident leaves Singapore or a foreign employee who is a non-Singapore permanent resident ceases employment.

Hong Kong

Stock Options are not subject to tax on grant. Upon exercise, the difference between the fair market value of the shares and the amount the employee paid on exercise of the options is subject to income tax. There is no tax on sale of the shares as there is an absence of capital gains taxation in Hong Kong.

Japan

Stock Options are not subject to tax on grant. Upon exercise, the difference between the fair market value of the shares and the amount the employee paid on exercise of the options is subject to income tax as employment income and subject to tax at normal progressive rates. If the option income is received during retirement, only one half is subject to tax at progressive income tax rates. When the shares are later resold, the increase over the fair market value at exercise is subject to capital gains tax.

China

The granting of stock options to employees is not a taxable event. When the stock option is exercised, the difference between the exercise price and the closing market price on the day of exercise is considered taxable employment income. If under special circumstances, employees transfer their stock options for consideration rather than exercising them, the net proceeds received is taxable employment income.

Taiwan

The granting of stock options to employees is not a taxable event. An employee's personal income from exercising options must be included in the total declared income for the year in which the options are exercised. When the stock so acquired is sold, the difference between the selling price and the current stock price on the exercise date may be a securities transaction gain or loss.

Korea

Under the Korean tax law, income from options is recognized at the time of exercise, not at the time of grant. At the time of exercise, the employee will recognize, as salary income, the amount by which the value of the shares received exceeds the amount paid for the shares under the option contract (the 'Spread'). Later, when the employee sells the shares received, the employee will recognise a capital gain or loss on the sale of shares.