Reforming Australia's system of business taxation

Simpler, lower, productive

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Overview and summary

This report contributes to debates over tax reform by examining the system of business taxation in Australia. Business taxes are some of the largest components in Australia's tax mix and play a key role in the overall functioning of the tax system. They also shape our investment performance, both in terms of the financial and compliance burdens imposed on business, as well as our ability to competitively attract foreign investment. A proper tax reform agenda in Australia must place the taxation of business at the centre of the analysis.

This report identifies five challenges presently afflicting the way Australia taxes business activities:

1. Australia's corporate income tax rate is uncompetitively high by international comparison
2. Additional taxes on business approximately double the burden of company tax
3. State-level taxes add an excessive complexity and compliance burden
4. Complex tax treatment of business activity results in further inefficiencies
5. A growing company tax burden is dragging on competitiveness and systemic efficiency

Given the role of tax settings in influencing investment behaviour, it is unsurprising that Australia's investment performance is declining. In the decade prior to the global financial crisis, non-mining private business investment was typically in the range of 11% to 12% of GDP per annum. Over the past decade it has fallen to average only 8.5%. Australia's stagnant productivity since the pandemic in turn reflects these weakening investment rates. Our increasingly uncompetitive and inefficient system of business taxation is thus a major factor behind our falling investment and productivity performance.

Genuine reform of business taxation must go beyond a narrow focus on corporate income taxes alone. Company tax accounts for slightly over half of the total tax burden carried by business in Australia today. Dozens of additional taxes from state and federal governments have accreted and produced an inchoate patchwork of inefficient business taxes. These violate the core principles of simplicity, efficiency and horizontal equity to which our tax system should aspire.

The business tax reform agenda must therefore marry the objectives of tax reduction with tax simplification. Proposals which adjust tax rates without addressing systemic inefficiencies lower, but do not fundamentally correct, the economic burdens imposed by an inefficient tax system. A comprehensive process of simplification can provide the foundation on which tax rates can be reduced, improving the efficiency of the system and thus Australia's investment and productivity performance.

We identify five reform steps which would deliver a simpler, lower and more productive system:

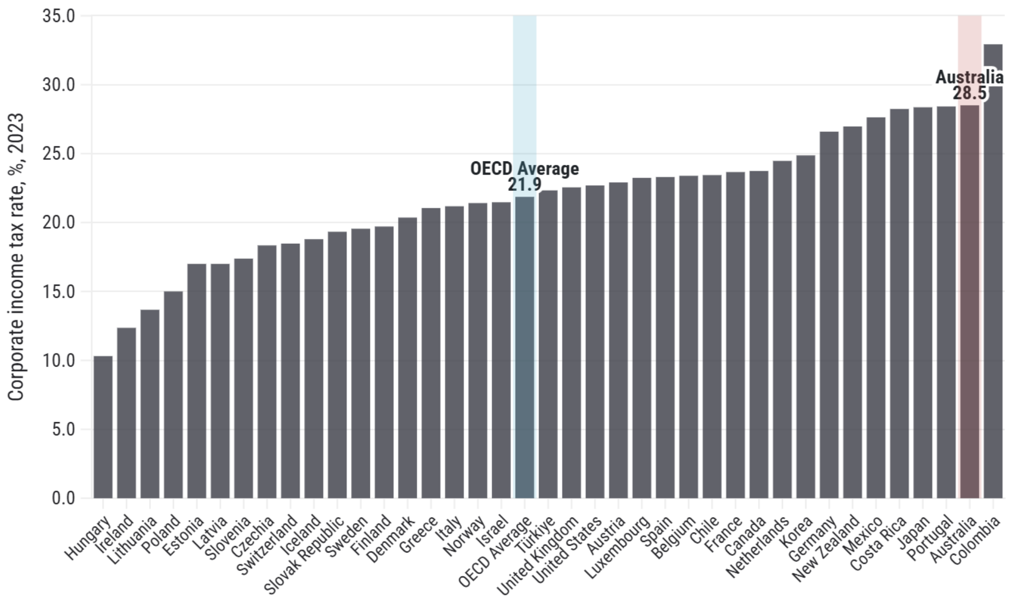
1. Compile a comprehensive inventory of all business taxes levied by Commonwealth and state governments to inform proper system redesign
2. Rationalise the number of taxes on business levied across governments, with a focus on those generating low revenues and/or imposing high efficiency costs
3. Simplify the treatment of business income and expenditure, to widen the tax base and enable a reduction in company tax rates
4. Set overall tax rates at a level comparable with our OECD peers, to ensure Australia remains competitive for investment in emerging industries
5. Undertake tax reform on a whole-of-government basis to ensure the federalism issues contributing to low efficiency and competitiveness are addressed

1. Australia's company tax rate is not internationally competitive

Company tax is the part of our tax system where international relativities matter the most. Capital is internationally mobile and with corporate income taxes typically consuming around a fifth of profits, they make a major contribution to the investment competitiveness of an economy. Outside of industries where Australia possesses significant natural advantages – such as mining and agriculture – our ability to attract capital depends in large part on our relative tax rates.

By comparison to other advanced economies, Australia's corporate income taxes are very high. Our statutory company tax rate (30% for medium and large businesses) is the equal fourth highest in the OECD. Our effective average rate – a measure for prospective investments which adjusts for incentives that reduce the headline rate – is the second highest, ranking only behind Colombia. At 28.5%, Australia's effective rate is much higher than the OECD average of 21.9%, as well as close peers such as the UK (22.6%), US (22.7%) or Canada (23.7%).

Figure 1 Effective corporate income tax rates in the OECD



Source: OECD Corporate Income Tax Rates Database • Ai Group Research & Economics

The effect of company tax is somewhat blunted for domestic investors who benefit from Australia's dividend imputation system. This allows franking credits to be generated against company tax payments that shareholders can deduct against their personal income tax. Dividend imputation avoids double-taxation for domestic investors, making company tax function as a kind of 'pre-payment' of tax on behalf of shareholders. However, dividend imputation cannot be utilised by foreign investors whose income is subject to company tax alone. This makes the comparative level of our company tax rate highly important in shaping foreign investment decisions.

Foreign investment is a critically important source of capital for the Australian economy. In 2024, $81 billion of foreign direct investment and $192 billion of portfolio investment flowed into Australia, raising the total stock of foreign investment to $4.9 trillion. These investments not only bring capital, but also technology, skills and marketing channels into the economy. They are particularly important in emerging and high-technology sectors where they help lift Australia towards the global industrial frontier.

The number one source of foreign investment is the US (27% of the total), followed by the EU (17%), UK (16%) and Japan (6%). Each of these jurisdictions have corporate income taxes significantly below those in Australia and are major investors in other countries which also have lower rates than Australia. Our ability to attract investment from these major sources would be much greater if our company tax rates were closer to the competitive range of our peers.

Indeed, Australia is defying an OECD trend towards lowering corporate income taxes. Between 2017 and 2023, the effective rate of corporate income tax fell in 21 of the 38 OECD economies, lowering the group average from 23.6% to 21.9%. The reduction was especially pronounced in the US, where the effective rate fell 12 percentage points to 22.7%. Australia's company tax settings have not materially changed over this time, resulting in our tax competitiveness steadily declining vis-a-vis our peers.

2. Additional business taxes approximately double the burden of company tax

However, company tax is not the only tax paid by companies. There is a broad set of further taxes, levies and charges from state and federal governments which primarily fall upon business. These increase the total tax burden faced by businesses to approximately twice the level resulting from company tax alone.

Unfortunately, there is no national inventory of taxes and charges levied by all levels of government. The last exercise to compile a list was conducted during the Henry Tax Review in 2010, which found there were approximately 125 taxes levied against individuals and business across all levels of government. Policy evolution over the intervening 15 years means this list is now out of date. The exact number of taxes and charges levied against Australian businesses, let alone their financial burden and economic implications, is presently unknown.

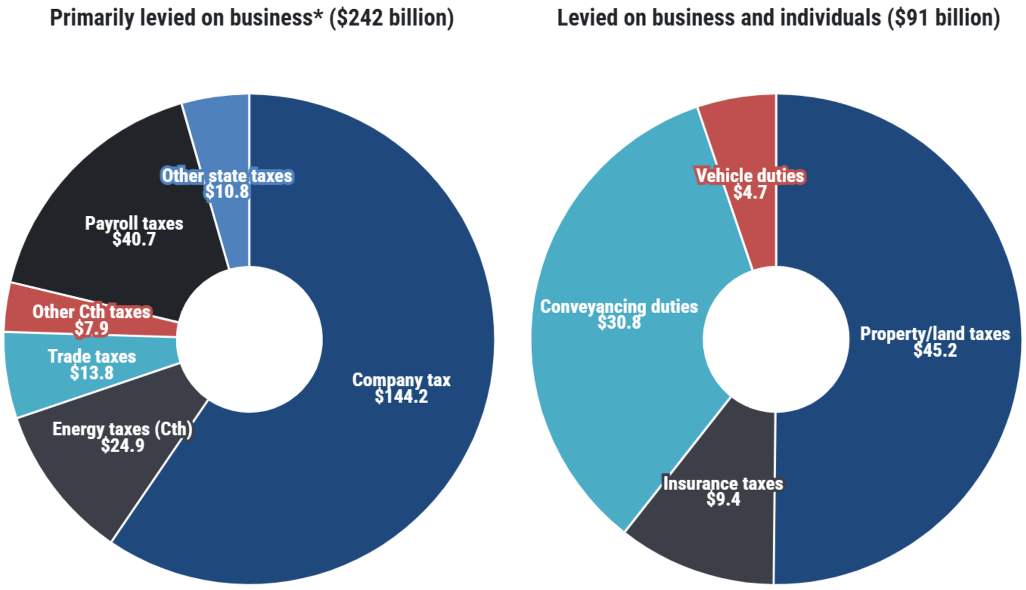
To gain a sense of the impact of 'taxes beyond company tax', we have analysed ABS tax data according to the entity from which the tax is primarily collected. The results are presented in Figure 2 below. The analysis finds that businesses were subject to a further $98 billion worth of taxes in addition to company tax in 2023-24. The main contributors were:

- Payroll taxes charged by state governments on medium and large employers ($40.7 billion).
- Energy excises on oil, gas and petroleum products, including taxes on the sale of diesel fuels ($24.9 billion).
- Taxes on international trade, comprising customs duties on imports and export taxes on certain agricultural products ($13.8 billion).
- A host of smaller charges such as product-specific sales, production and vehicle taxes. These raised $7.9 billion for the Commonwealth and $10.8 billion for the states

When these taxes are also considered, the total revenue primarily collected from businesses rises to $242 billion – of which 60% is company tax, with 40% coming from the additional taxes and levies.

In practice, the total tax burden on business is higher still. There are four other state government taxes – on land, insurance, conveyancing and vehicles – which are levied against both businesses and individuals. These raised $91 billion in 2023-24. While the existing data makes it impossible to account for the exact proportions paid by business and individuals, businesses are likely to carry a significant share of these tax burdens as well.

Figure 2 Australian taxes on businesses by revenue 2023-24



Source: ABS Taxation Revenue, ABS Taxes Classification 2015 • Ai Group Research & Economics
Unit: AUD billions. * Comprises the following GFS codes: TC12 less TC122, TC21, TC411, TC42, TC43, TC51, TC52.

If these four 'mixed' taxes are also factored in, it is likely the overall tax bill paid by Australian businesses is somewhere between $250 to $300 billion per year. This implies a tax burden nearly double that suggested by the $144 billion in company tax receipts. They are a significant and additional cost of doing business, which further weighs on Australia's ability to generate domestic and attract international investment.

This data shows that a focus on the relative level of company tax rates provides an important, but only a partial, perspective on how tax settings affect Australia's investment competitiveness. Of nearly equal impost, these additional taxes also add to business costs and weigh on our ability to generate both domestic and foreign-sourced investment. A proper tax reform agenda must consider the total burden imposed by all taxes, not only company tax, on business in Australia.

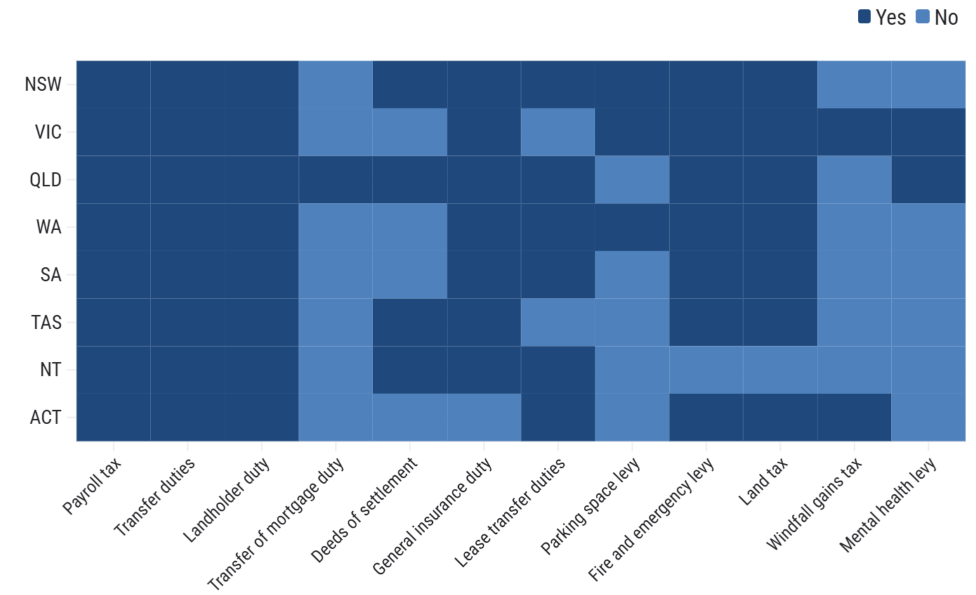
3. State-level taxes compound complexity and inefficiency

Compounding their revenue impost, these additional taxes and charges also greatly add to the complexity and compliance burden of the Australian tax system. These problems are brought into sharp relief when we unpack the state level taxes, which are among the most complex and least efficient taxes in the Australian system.

The larger taxes levied by state governments act as a deterrent to forms of business activity which should be encouraged. The leading example is payroll tax, which is usually levied at around 5% on employer payrolls exceeding $1 million. This is purely a tax on employment generation – an activity the tax system should try to encourage – and as it largely falls on payrolls over $1 million, is a perverse incentive against business growth. Taxes on insurance and conveyancing similarly penalise routine and desirable business activities. Collectively these three types of tax raise $81 billion of revenue a year for state governments, making their financial impost on business activities far from trivial.

At the other end of the spectrum are state charges and levies which can be labelled 'microtaxes' – taxes on narrow business activities that raise very little revenue. Figure 3 provides an inventory of the main types across the Australian states. These include duties on holding and transferring land, transaction taxes on leases and settlements, franchise taxes and levies on emergency services and parking spaces. Victoria and Queensland also add a mental health levy in addition to payroll tax liabilities.

Figure 3 State government duties and levies on business 2024-25



Source: NSW Treasury • Ai Group Research & Economics

As a whole, these state government microtaxes serve little fiscal purpose. The majority are set at low or sometimes trivial rates and therefore generate very little revenue. For one egregious example, Queensland charges a $5 duty for the transfer of mortgages. Despite some (such as mental health levies) having a titular link to service delivery, very few are hypothecated – when revenue is tied to the delivery of the specific service. This reveals they simply function as minor revenue-raising exercises.

However, they greatly reduce the efficiency of the Australian system. They are among the most inefficient of the taxes within Australia's tax mix (Figure 6). State taxes are not administered by the ATO through its centralised filing processes. Each therefore triggers its own tax event with state authorities, requiring businesses to track and report on relevant activities. For businesses with national operations that must comply with eight regimes, the number of state-level taxes could credibly reach toward 100 per year, in addition to Commonwealth obligations.

Many state taxes can be thought of as 'taxes of constitutional necessity'. State governments are limited in the activities they can tax due to constitutional constraint; and have not benefited from the growth in company and personal income tax receipts relative to GDP over the past decade. This allows them very little flexibility in tax design, explaining their reliance on inefficient measures that hinder investment and productivity. Reform of these inefficient taxes therefore requires consideration of fiscal-federal relations on a whole-of-governments basis.

4. Complex treatment of business activity results in uneven rates of taxation

The problem of excessive complexity also afflicts how Australia administers business taxation. In principle, company tax is very simple in application – levied at 30% on company profits (or 25% for small businesses). This embodies a principle known as 'horizontal equity', where profits are taxed at the same rate irrespective of how they are generated.

In practice, company profits are taxed at widely different rates depending on their source. This is due to differential tax treatment for business income streams and expenses. The full complexity of the system of deductions, offsets, exemptions and credits cannot be comprehensively summarised here in this short report. However, some illustrative examples include:

- Fuel tax credits which refund the excise included in the price of some fuels used in certain types of vehicles and machinery
- Product-specific tax credits for certain activities, including minerals exploration by SMEs, digital games, primary production, carbon credits, critical minerals, hydrogen and film production
- Two types of tax offset for some research and development activities, levied at different rates based on the amount of expenditure and business type
- Tax offsets for investors in innovative businesses, set at different rates for early-stage innovation companies and venture capital partnerships
- Excise refunds for customs duties, GST, wine equalisation tax and luxury car taxes for products which are disposed of or exported outside Australia
- A set of rules for the allowable types of business expenses and their method of calculation, with differential rules for motor vehicles, business travel, digital products, repairs and maintenance, depreciating assets, capital expenditure and other operating expenses
- Many concessions and offsets for small businesses, including for capital gains tax, income tax, business asset transfers and instant asset write-offs

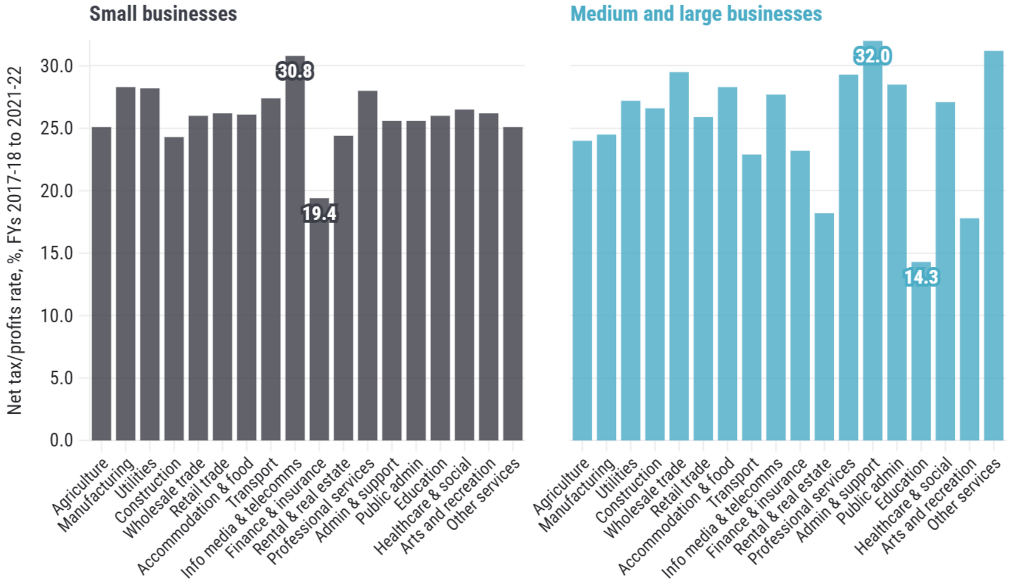
Each of these provisions is extremely complex, with varying activity definitions, eligibility criteria, concession rates, deduction schedules and expenditure caps. Many treat businesses differentially depending on their size, with diverging thresholds for what constitutes a small business. One illustrative example is the development of software used in-house by a business, where there are three sets of rules for how to depreciate and deduct these costs at different stages of the software lifecycle. This is an extraordinary level of treatment complexity for what is a minor and routine business activity.

The impacts of the complexity imposed by these differential tax treatments are two-fold. First, they greatly increase the burden of tax compliance. Businesses need to be aware of all the rules relevant to their business, follow regular changes and maintain records for filing and audit purposes. These costs can be prohibitive for small businesses and even for larger companies impose non-trivial overheads.

They also impact business planning, where the effects of these rules must be modelled for all potential investment decisions. Investment decisions can become less geared to commercial objectives and more oriented towards optimising tax outcomes. Small businesses must be especially cautious they do not grow across a size threshold and inadvertently find themselves ineligible for a tax concession on which they have previously relied. Perversely, this acts as a disincentive for small business growth.

Second, it leads to tax outcomes which diverge from the principle of horizontal equity. Tax treatment rules benefit businesses in uneven ways – for one example, only those businesses which own vehicles benefit from vehicle deductions, creating industry differences in the effective rate of profit taxation. As a result of the complex interaction of these rules, the ultimate rate at which profits are taxed varies widely between industries. Figure 4 estimates the tax to profit rate of Australian industries across the past five financial years.

Figure 4 Tax to profit ratios by industry



Source: ATO Taxation Statistics 2021-22 Companies Table 6A • Ai Group Research & Economics

This data reveals a broad spread of effective rates, which vary from around 15% for education through to 30% for some high value services, depending on the industry and business size. Despite the concessional treatment offered to small business, in nine industries the effective tax rate on profits was higher for small than medium and large enterprises. Inter-industry differences in effective tax rates reduce the horizontal equity in business taxation to a degree that was arguably never a design objective. As piecemeal changes to treatment rules have accreted, horizontal equity has declined.

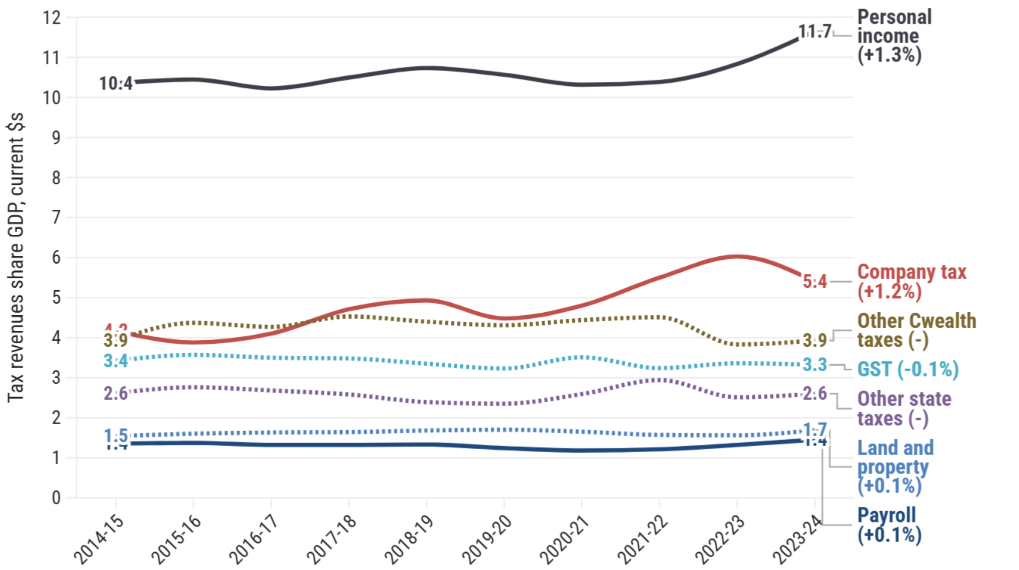
5. A growing company tax burden drags on investment and efficiency

The problems are compounded by the fact that the burden of company tax has been steadily growing. In 2023-24, the overall tax take in Australia rose to 30.0% of GDP. It has been steadily rising since 2010-11, when the share was 25.4% and marks the first time it has crossed the 30% threshold in two decades.

Importantly, just two components of the tax mix have been responsible for this increase. The first is personal income tax, which has risen by 1.3% of GDP over the past decade. The second is company tax, which has risen by 1.2% of GDP. All other components have held broadly steady over this time.

This compositional change has two implications for Australia's tax system. The first is that we are imposing an increasing burden on the activities required to drive growth. A rising company tax burden is a disincentive to investment, while income tax deters labour market participation. At a time when the Australian economy is struggling with low rates of growth, investment and productivity, these are the taxes where we should be lowering rather than increasing the burden.

Figure 5 Australian tax revenues by share of GDP



Source: ABS Taxation Revenue, ABS National Accounts • Ai Group Research & Economics
Label indicates increase in tax share of GDP over last decade

This imperative is especially pronounced for company tax, where internationally mobile capital is highly sensitive to tax rates. Australia's inward investment primarily comes from advanced economy peers, and investors almost always face lower corporate income taxes both in their home economy and other potential jurisdictions. A tax system with a progressively rising company tax burden is also one with falling international competitiveness.

The second implication is that the tax system is becoming increasingly less efficient. Unlike broad-based taxes – such as land taxes and the GST – company and income tax more narrowly target specific activities. As narrower taxes distort behaviour and impose greater economic losses, their increasing share of the tax base lowers the efficiency of the system. The 'marginal excess burden' – a measure of the economic losses imposed per dollar of tax revenue collected – has been estimated at around 40% for company tax (Figure 6). For personal income tax, the corresponding figure is 24%. Yet for broad-based taxes like the GST and land tax, the marginal excess burden is 8%. A tax system with rising reliance on company taxes is one which is becoming progressively less efficient.

The way forward – business tax simplification to enable more competitive rates

This report has shown that the problems with Australia's system of business taxes are complex and multifaceted. In plain language terms, they could be summarised as: *too high, too many types, too federally fractured, too complex* and *too dependent*.

Given the critical role of tax settings in influencing investment behaviour, it is unsurprising that Australia's investment performance remains weak. In the decade prior to the global financial crisis, non-mining private business investment was typically in the range of 11% to 12% of GDP per annum. Over the past decade it has fallen to an average of 8.5%. Australia's stagnant productivity since the pandemic in turn reflects these weakening investment rates. An increasingly uncompetitive and inefficient system of business taxation is a major factor behind our falling investment and productivity performance.

Many reform proposals for business taxation have been made in recent years. Most focus on ways to reduce the overall burden, with the aim of improving international competitiveness and thus raising investment rates. In broad terms, these proposals can be categorised into two groups: either (a) proposals to lower the statutory company tax rate (often from 30% to 25%) and/or (b) proposals to introduce allowances for certain investment activities that will reduce the effective rate of company tax.

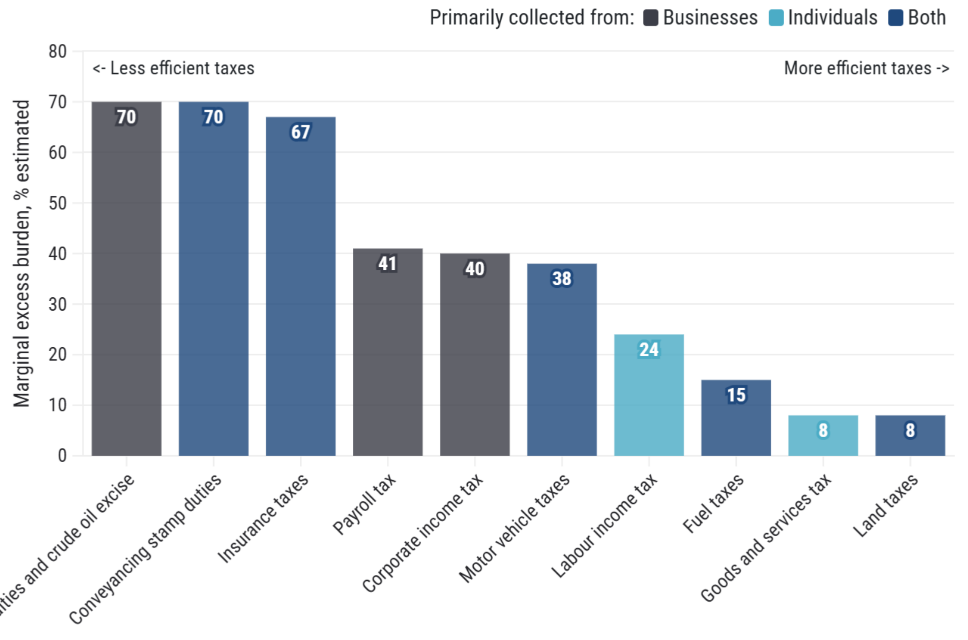
While these proposals have merit, a more comprehensive reform approach is required. Company tax represents perhaps only half the taxes levied against business, with the myriad inefficient additional taxes an equally if not more urgent reform task. Introducing some form of investment allowance would improve international competitiveness, albeit at the cost of increasing system complexity and reducing efficiency. Proposals to lower headline or effective company tax rates, made without systemic reform to the broader tax system, also raise questions regarding the fiscal sustainability of the federal budget at a time when structural deficits are forecast for the next decade.

Genuine business tax reform must therefore *marry simplification with reduction*. There are too many taxes levied against businesses, implemented in complex and inefficient ways across state and federal governments. These violate the core tax design principles of simplicity, efficiency and horizontal equity to which our business tax system should aspire. Reducing the effective rate of company tax would lower the overall burden of an inefficient system but do nothing to address the inefficiencies themselves.

The first step must be the taking of a full inventory of taxes, duties, levies and charges applied to businesses in Australia. A contemporary list does not presently exist, with the exercise last conducted during the Henry Tax Review in 2010. While Commonwealth taxes are administered by the ATO (and reported in the ATO's *Taxation Statistics* publication), collection is more varied at the state level and is not systematically reported. Collecting and publishing information for the federal system would provide a solid evidentiary foundation for considering the areas in which tax reform could deliver the greatest economic benefits. Without this information, any tax reform agenda is flying blind.

Second, there needs to be a commitment from all levels of government to reduce the complexity of the Australian taxation system. This needs to include a recognition that the number of taxes on business must be rationalised. It is economically and administratively inefficient to raise tax revenue through dozens of microtaxes. Rationalisation should focus on two groups: those which raise the least revenue (imposing administrative inefficiency) and those which introduce the largest behavioural distortion (imposing economic inefficiency) (see Figure 6). The recent abolition of around 500 so-called 'nuisance tariffs' by the Commonwealth is a commendable first step and demonstrates the reform methodology which should now be applied systemwide.

Figure 6 Efficiency estimates for select Australian taxes



Source: PBO Australia's Tax Mix • Ai Group Research & Economics
Marginal excess burden estimates economic losses per dollar of tax revenue, measured as a percent of revenue

Third, the treatment of business income and expenditure needs to be radically simplified to support company tax reform. The inchoate system of deductions, allowances, credits, offsets and exemptions which has accreted is itself now an obstacle to an efficiently functioning tax system. It also explains why the headline company tax rate is so high – by reducing the size of the base, higher rates are required to generate the same revenue outcome. Recalling the dictum "*widen the base to lower the rate*", reforms which simplify and improve consistency in treatment rules would provide scope to lower the company tax rate toward internationally competitive levels.

Fourth, international competitiveness must be front of mind in any reform agenda. The Australian economy depends on foreign investment, particularly in the new industries such as clean energy, advanced manufacturing, digital and AI which we aspire to develop. The foreign investors who can supply the capital, technology and marketing channels to develop these industries are internationally mobile and highly sensitive to relative tax rates. Effective corporate income tax rates approaching ten percentage points above our peers will price Australia out of these industries.

Fifth and finally, a proper reform agenda must also be a *whole of governments* endeavour. Many of the problems stem from duplications and inconsistencies associated with fiscal federalism: a business which operates nationally might credibly face over 100 different taxes, duties and levies once all Commonwealth and state taxes are considered. The removal of some of the least efficient state taxes is likely to necessitate changes to federal fiscal relationships, given the constitutional limits on state government taxation powers. This necessitates a leadership role for the Commonwealth in driving a nationally coordinated approach.

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