Policy GRAB

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From the Editor

As disruptive change discomforts our future vision, we variously grapple with balancing budgets – our own, the state's and federal. By casting the net wide we stand to reap innovative financial policy ideas that might inform solutions.

In this edition, the Economics Committee led by Gerard Rennick has produced a number of topical ideas to fire discussion over coffee and barbecues. Keep in mind that topics raised are not LNP policy. As with all subjects raised in Policy Grab, the intention is to provide sound information in keeping with party values and beliefs and to stimulate substantive policy discussion.

In this edition, enjoy:

- Energy Security and Affordability
- Government Deficit – a Breakdown
- Funding Payroll Tax Abolition
- How to Reduce Company Tax
- Income Velocity

As always, we are treated to insightful humour from our multi-talented retiring Chair of the Policy Standing Committee, Richard Williams.

Coming editions are likely to feature Child Protection and Housing.

Paula Collins, Editor

Energy Security and Affordability

(Committee member, name withheld)

As Australia considers investments in new electricity generation capacity, we need to find a fiscally responsible solution that addresses both our current needs and generates a reasonable return on investment over several decades. Reliability issues highlighted by South Australia's power shortages provide a reminder of the need for network flexibility with reliable baseload in a world where technology, shifting costs, policy and customer preferences are all driving additional investments in low carbon sources of energy.

The biggest change on the horizon is household electricity demand from the grid. Tesla founder Elon Musk is leading the change, with battery storage technology seeing dramatic falls in cost and improvements in battery density that enable more power to be stored from the same or smaller sized batteries. Tesla's gigafactory in Nevada promises to deliver further efficiency gains for batteries.

The Tesla Powerwall 2, due to be released in Australia early this year, has sufficient capacity to power an average two bedroom home for a day - double the capacity of its previous model and at a cheaper price per kilowatt hour. The take up by Australian households, a fifth of whom already have solar panels installed, is likely to accelerate as the economics of household solar and battery storage improve significantly. This means less household electricity demand from the grid, and more demand volatility caused by weather and seasons.

A key challenge for coal fired power plants, aside from their emissions intensity, is that they can't easily be turned off when the sun is shining, the wind is blowing, or households are drawing power from their home battery systems. Natural gas plants are superior in this regard.

Policymakers responsible for contributing taxpayer's capital to electricity generation projects need to consider such changes to technology and household consumption patterns. We should be careful to choose the right energy options that will avoid greater asset redundancy over the next 5-10 years. As Prime Minister Turnbull has noted, access to gas is vital to ensure that all options are on the table.

The combination of the ongoing shift to a more services based economy, and more rooftop solar and battery storage, will put downward pressure on our base load power needs. We should think ahead when subsidising long dated investments and encourage the flexibility in our grid that will almost certainly be needed in the future.

Government deficit – A breakdown

Gerrard Rennick

The May 2016 Commonwealth Budget forecast a deficit of approximately $39.2 billion for the 2016-17 year. This figure is derived by subtracting government receipts of $411.3 billion from government expenditure of $450.5 billion.

For the 2016-17 year, the biggest expenditure is revenue assistance to the states of $61.3 billion which is offset by GST collections of $60.9 billion. The biggest actual expenditure incurred by the government is the pension of $45.4 billion. Other big ticket items include medical benefits ($22 billion), family tax benefit ($19.3 billion) and assistance to the states for health ($17.9 billion).

It is interesting to note that disability pensions ($17.1 billion) are greater than the job seeker allowance ($10.5 billion).

> *"Social security and health are the two biggest direct expenditures incurred by government. Greatest scope for revenue is in GST, Superannuation and the CGT on housing."*

One surprising large figure is the Pharmaceutical Benefit scheme which costs $10.8 billion.

Clearly social security and health are the two biggest direct expenditures incurred by the government.

However, it is also important to look at concessions if spending is to be reined in. The Treasury has ranked concessions in the following table.

The largest tax concessions are the capital gains exemption on the principal place of residence ($54.5 billion) and superannuation ($30.3 billion).

The costs of GST exemptions are as follows:

• Health	$4.0 billion
• Education	$4.6 billion
• Financial Services	$3.5 billion
• Food	$7.0 billion
• Child Care	$1.4 billion
• Water and Sewage	$1.0 billion
• Community care	$1.2 billion
Total	$22.7 billion

Given the deficit is circa $40 billion dollars the government is going to have to make large adjustments to both spending and taxation collections. As can be seen by the above tables the areas that provide the greatest scope will be in Health, Social Security, GST, Superannuation and the CGT exemption on housing.

Gerrard Rennick, the Chairman of LNPQ's Economics expert committee, is a finance executive with 23 years detailed knowledge of Financial Reporting, Taxation, Treasury, M&A and Economics. His work experience includes: tax structuring and advice, debt structuring, privatisations, mergers and acquisitions, shared service implementations, lodgement of financial statements and software design and implementation. Strong formal qualifications underpin Gerard's extensive experience: Bachelor of Commerce; Masters of Tax Law; Masters of Finance; and Graduate of the Institute for Company Directors.

How to Reduce Company Tax

Gerrard Rennick

The discussion about reducing company tax overlooks a critical feature of company profits – i.e. "above the line" profits subject to withholding tax.

An Australian owned company that is based in Australia and has no foreign parent or subsidiaries will always be subject to the corporate tax rate - presently 30 cents.

On the other hand, companies which are either a subsidiary or parent of an offshore company can minimise their tax by transferring profits offshore.

How does this happen?

Profits are transferred offshore through transactions such as royalties, interest and management fees. We can summarise these items as "above the line" profits. Such transactions are subject to withholding tax, not company tax.

Funding Payroll Tax Abolition

Gerrard Rennick

In Queensland Payroll tax is levied upon employers at a rate of 4.75% on wages of more than $1.1 million (subject to various conditions). Similar rates apply in other states.

Payroll tax is a tax on productivity that punishes employers for creating jobs. Australia cannot afford to keep levying this tax on employers if they are to remain competitive with its Asian neighbours.

Payroll tax is unevenly taxed amongst employers. For example, a fruit grower who turns over $20 million a year and employees staff that cost greater than the payroll tax threshold due to the labour-intensive nature of the work could pay more tax than a prestige car dealership that also turns over $20 million a year but requires fewer staff. It seems unfair that a tax break is given to an employer selling foreign imported cars but an employer is taxed for growing and selling Australian fruit.

> *"The current payroll tax system taxes employers for giving lots of jobs to people and gives a tax break to those who provide a few."*

Franchises can avoid payroll taxes (subject to control laws) since they operate as multiple owners under one brand but large employers such as Myer and David Jones are taxed on their wages. The current payroll tax system taxes employers for giving lots of jobs to people and gives a tax break to those who provide few.

Consideration should be given to funding the abolition of payroll tax, through the re-introduction of stamp duty on the purchases of shares on the secondary market. (No stamp tax would apply to capital raisings).

Given that a large percentage (circa 40-50%) of shares traded on the stock market are through computerised algorithms controlled by foreign entities, it would much more sense to tax speculation rather than productivity.

The abolition of payroll would increase retained earnings and therefore dividend payouts. The cost of an upfront stamp duty charge would be more than offset by increased dividends in the long term, thus ensuring that long term investors, many of whom comprise the LNP base, are not worse off.

Abolishing payroll tax will make Australian businesses more competitive in the global economy. Australia cannot have a profitable secondary market without a productive primary market.

It is inconsistent to charge stamp duty on the purchase of real property and businesses but not shares.

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Alarmingly management fees can be paid off to offshore contractors, in lieu of paying wages in Australia, thereby encouraging the offshoring of Australian jobs.

Withholding tax rates vary depending on which tax treaty they are subject to, but generally speaking are between and 0 and 10% for "above the line" transactions with our major trading partners.

Because withholding tax rates are lower than the company tax rate an arbitrage is created between "above the line" profits and "below the line" profits. A multinational company can transfer profits through "above the line" profits and save up to 30 cents in the dollar by claiming a tax deduction for the "above the line" profit against Australian income.

If Australia wishes to retain foreign capital it needs to eliminate the difference between withholding tax and company tax. With its massive natural resources and highly educated workforce, Australia doesn't need to attract foreign capital by eroding its tax base. Instead, it needs to prevent profits from being sent offshore.

Economic growth should be driven by reinvesting retained earnings, not foreign debt.

> *"If Australia wants to retain foreign capital it needs to eliminate the difference between withholding and company tax."*

If Australian companies are to remain competitive, they should not have to pay a higher rate of tax than multinational companies who invest in Australia.

In order to ensure Australian companies can compete on the same playing field as multinationals, a rise in withholding tax to 20 cents should fund a cut in company tax to 20 cents.

Income Velocity

(Committee member, name withheld)

When jobs and incomes come under pressure, people ultimately make their dissatisfaction known through the ballot box.

Donald Trump's election, European anti-establishment political parties and One Nation are, in part, a symptom of disruptive technological change that has reduced job opportunities and weakened the bargaining power of workers, especially those with lower education. Participation rates of lower educated workers are falling relative to more educated workers. For decades, we have witnessed manufacturing jobs being displaced by automation. Over the coming years, service sector jobs such as lawyers, accountants and administrative assistants are likely to be disrupted.

> *"Extra household money is likely to be spent in this country, creating new demand, jobs and investment."*

A stronger system of income redistribution that enables all to participate in the economic windfalls of technology related productivity gains could be achieved in line with the following suggestions:

Firstly, get money into the pockets of Australian households by supplementing income (as John Howard did in the late 1990-2000s) and consider related policies such as the United States' earned income tax credit. Extra household money is more likely to be spent in this country, creating new demand, jobs and investment than corporate tax cuts, which may worsen inequality. Tax rates are just one factor affecting the location decisions of international businesses. Human capital and our regulatory framework are arguably more important factors.

Rather than competing on cost, the second thing we should do is invest more in our national comparative advantages. For example, we should seek to emulate the success of Silicon Valley by leveraging foreign demand for Australian universities. Education is now our third largest export after coal and iron ore. Infrastructure investment would be better spent helping to propel Australia's leading universities into the top 20 to boost our terms of trade, rather than simply building more roads and tunnels.

In a world of low real wage growth, it will be increasingly incumbent upon governments to lower income tax rates and supplement wages with income support as John Howard did. We should also invest more in Australia's domestic comparative advantages, such as tertiary education, to set our economy up for long term success.

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