How do we compare?
Global insights on business taxation

Introduction

Purpose of the Information Paper

1.1 Globalisation of world economies has implications for virtually all arms of economic policy. Taxation is no exception. As Australia embarks on a major review of its business tax system, it would be imprudent to ignore the approach that other countries, particularly major financial players and Australia's trading partners, have taken to developing taxation policy. This does not mean that Australia should be looking to other countries for a blueprint for a new business tax system. Other countries are currently grappling with many of the same taxation issues as Australia and their tax systems are also in a state of flux. Moreover, a variety of factors will cause a country to take one course of action rather than another.

1.2 The terms of reference of the Review of Business Taxation require that the Review reports on the Australian taxation system as a whole compared with international experience. This paper provides information necessary for the Review to carry out that function.

1.3 Taxation systems have a clear objective of raising adequate revenue to fund government expenditure programs. However, they cannot be designed in a vacuum focusing only on domestic issues. To comment that economies are becoming increasingly integrated into the global economy is now hackneyed. To redesign a tax system which does not take sufficient account of international factors would be to risk a declining revenue base, poorer economic outcomes, inadequate foreign investment in Australia and a poor competitive position for Australian enterprises and Australian based multinationals.

1.4 As a result, Australia should be looking for insights from the experience of other countries rather than for an off-the-shelf panacea. It is necessary both to assess what the business tax system needs to deliver and to develop a framework for the tax system before the ideal structure can be determined. These international insights will assist in developing both the framework and the detail of the desired tax system.

1.5 Because of these considerations, this Information Paper serves three purposes:

- to provide information on key design features of tax systems in other countries;
- to give some guidance in developing the best approach to the taxation of business income in Australia; and

- related to the second purpose, to provide information which will assist interested parties during consultations conducted by, and for purposes of making submissions to, the Review of Business Taxation.

Approach

Drawing lessons from international comparisons

1.6 The approach taken in this information paper is to provide summary information on the business tax systems in 26 other countries and to draw out key issues on individual areas of business taxation. Clearly, a detailed description of the tax system in individual countries would require a much longer report than this. Instead, we focus here on major design features and how some of these features interact.

1.7 This chapter provides an overview of the lessons to be drawn from the experience of other countries. As such, the comments here are not confined to the specific findings on individual areas of taxation set out in subsequent chapters. Instead, we draw out key insights into the taxation of business income in Australia relative to that in certain other countries. This involves combining findings from a number of separate areas and hence, it is necessary to range broadly across issues of taxing entities and business income. Following an assessment in Chapter 2 of comparative tax burdens, this paper is divided into three parts.

- Chapters 3, 4 and 5 contain detailed analysis of issues dealing with the business tax system as a whole. These chapters deal respectively with the taxation of business entities, the taxation of different types of business income and with international tax issues.
- Chapter 6 covers the approaches followed by different countries in developing taxation policy and legislation and in administering tax systems.
- The final chapter (Chapter 7) addresses the calculation of effective tax rates. This provides a summarised, yet necessarily qualified, measure of the taxation treatment of business income in different countries.

Focusing on two groups of countries

1.8 The countries included in the international comparison fall into two categories.

1.9 The first category consists of countries for which a comprehensive analysis of the tax system has been performed. The analysis covers the different types of treatment for different types of entities and different types of income or transactions. Each of these countries is then included in the calculation of effective tax rates carried out in Chapter 7. Countries in the first category, referred to in this paper as Group 1 countries, are listed in Table 1.1.

Table 1.1: Group 1 countries — the subject of extensive comparisons

Australia	Netherlands
Canada	New Zealand
Chile	Singapore
France	Sweden
Germany	Taiwan
Ireland	United Kingdom
Japan	United States

1.10 The countries in the first category have been chosen because they represent major world economies; or they are significant economic powers in the Asia Pacific region; or because of significant changes that have been made to their business tax systems in recent years.

1.11 For the second category of countries, the emphasis is on the taxation of business income earned by companies or equivalent limited liability entities. Aspects of the business tax base of such entities are discussed but the analysis does not extend to other entities or to specific types of income such as insurance or funds management. Countries in the second category, referred to in this paper as Group 2 countries, are listed in Table 1.2.

Table 1.2: Group 2 countries — the subject of limited comparisons

Argentina	Israel
Belgium	Italy
Brazil	Malaysia
China	Mexico
Croatia	Norway
Denmark	South Korea
Finland	

1.12 The countries making up Group 2 have been chosen for various reasons. In some cases, certain broad features of the tax systems in those countries are of interest. This is particularly the case with the international dimension of the tax system or with the way in which the taxation of company and individual taxation is at least partially integrated. Countries have also been chosen because of the concessional way in which they treat certain types of income and the analysis attempts to put this treatment in some context by examining the treatment of business income.

1.13 Because of the different ways in which the data have been collected for the two sets of countries, only limited comparison across the two sets is possible. In fact, the comparison is restricted to the treatment of limited liability entities, including the degree of integration of the taxation of entities and individuals and the way in which the domestic taxation of entities interacts with the international aspects of the tax system. This covers the treatment of the foreign source income of residents as well as the treatment of the domestic source income of non-residents.

Key comparisons

Measuring the overall tax burden

1.14 Australia ranks as one of the lower taxed countries in any international comparison of overall tax burdens of OECD countries. Based on *total taxation revenue* collected by governments as a proportion of GDP, the United States and Japan traditionally rank as lower taxed countries. With the recent expansion of the OECD, South Korea and Mexico also have lower tax to GDP ratios. However, Australia rates as a comparatively high income tax country.

1.15 Straight analysis of tax to GDP ratios can be misleading. For example, certain items are excluded from the OECD comparison which work in Australia's favour, such as the Superannuation Guarantee charge. Critics also note that it would be more appropriate to compare Australia with Asia Pacific countries as that is the market in which Australia must compete. Relevant also to a balanced assessment of such comparisons is the fact that government expenditure requirements in countries such as Australia are much greater than in Asian countries, reflecting the much higher level of government provided services and social security benefits.

1.16 These considerations point to the limitations of such comparisons and to the need to exercise caution in interpreting the results. However, one key point emerging from such comparisons needs to be understood as it is crucial to understanding much of the detailed analysis in the later chapters.

1.17 The key point is that Australia does tax *income* (as opposed to consumption and payrolls) at relatively high rates. Of the 18 OECD countries included in the analysis, only four had a higher ratio of income tax to GDP than Australia (based on 1996 data). In some cases, the difference is dramatic, even for major OECD countries. For example, in Australia, income tax revenue represents about 18 per cent of GDP. In Japan, Germany and France, the ratio is only 10 per cent.

1.18 This substantial difference in income tax to GDP is partly explained by the fact that other countries have VAT/GST and Australia currently does not. Australia does rely to a lesser degree on the taxation of goods and services but because its indirect tax base is narrow it has high tax rates that apply to a relatively narrow set of goods.

1.19 A big difference relates to the use of social security contributions to fund many welfare benefits such as unemployment and sickness benefits as well as retirement incomes. The OECD does not treat these as taxes on income but they tend to be paid by both employer and employee based on wages and salaries paid. Australia makes little use of such taxes. Where similar charges apply, such as the Superannuation Guarantee charge, the amount remains the property of the individual and not of the government and hence is not regarded by the OECD as a tax.

1.20 From the point of view of international competitiveness, social security contributions, to the extent they fall on business, may well have a similar impact on business costs as income taxes. However, it is significant that those contributions apply only to labour income and not to capital income. Hence countries that utilise social security contributions more heavily have higher taxes on earned than unearned income. This can lead to lower efficiency consequences from raising government revenue since there is less disincentive to save, but it can raise equity concerns.

1.21 The tendency for other OECD countries to use social security contributions to supplement income taxes has a parallel in the way in which many countries are now taxing company income. There appears to be a growing tendency to apply a low rate of tax to the earnings of companies and similar entities and to then tax the income more heavily in the hands of the domestic shareholders. This is being referred to as the Dual Income Tax (DIT) approach, meaning that income is being taxed differently depending on whether it is income from capital or income from labour and on whether it is being used for further investment or for private expenditure in the hands of the individual.

1.22 A further consideration is that some countries may not impose social security taxes but may achieve the same outcome through

1.23 compulsory contributions. Thus, Singapore requires a compulsory contribution equal to 40 per cent of payroll (with a cap). Up to 20 per cent can be recovered from the employee by the employer. The total contribution will reduce to 30 per cent from 1999, with the maximum employee contribution staying at 20 per cent. However, this is not a tax as it is used to fund individual retirement incomes and vests in the individual contributor. It nevertheless would have a similar impact on the employer as a social security contribution.

Taxing domestic source income

Company tax rates

1.24 The most visible feature of the business tax system of a country is its company tax rate. For many purposes, it is desirable to focus more on the total tax on distributed income rather than just on the tax rate at the company level. Those issues are dealt with below in the context of the way in which the company tax and personal tax systems operate. There are, however, valid reasons for paying particular attention to the company tax rate, notably that this is the rate that applies to undistributed income and, subject to any withholding taxes, to many non-resident investors. It has been the focus of an increasing number of countries in recent years.

1.25 On this score, Australia appears to be toward the higher end of the spectrum. Company tax rates in the 27 countries examined typically fall in the range 28-40 per cent with the median rate being a little over 30 per cent, compared to Australia's rate of 36 per cent. While it would be wrong to use this rate as the overall yardstick for a business tax system, it is a feature that attracts considerable attention as many investors will regard the tax rate as an indicator of other aspects of the business tax system.

Depreciation

1.26 A second key feature of tax systems is the allowance for depreciation provided in each country. This was an area where countries provided substantial concessional treatment until the late 1980s. Some reduction in these allowances occurred after that but the allowable deductions are still typically well in excess of those that could be justified on the basis of the economic life of the assets. The concessional treatment generally arises from accelerated depreciation of the asset compared with its economic life and not from the ability to write off more than 100 per cent of the value of the asset.

1.27 Depreciation allowances in Australia are likewise in excess of economic life. As a result, on average, the degree of concession in

Australia's regime is about on a par with that in other countries. (This comparison is based on a piece of equipment with an expected life of about 8 years.) The median rate in the countries considered appears to be around 20 per cent a year straight-line, about equal to the allowed rate in Australia.

1.28 Australia provides more generous depreciation allowances compared to most other countries for assets with longer economic lives. This tends to arise because of the broad banding approach to fixing the rates as well as the underlying concessional element that is built into the rates.

Some broad comparisons

1.29 At this point, comparisons tend to become somewhat more judgmental. On many of the defining features of the tax system set out below, Australia provides treatment that is less generous than in many countries. It would be a mistake to attempt to match Australia's treatment to the most lenient on all points so any comparison can only be on the basis of overall impressions.

1.30 The following list provides a guide to the areas where the Australian treatment could be seen as at the less favourable end of the spectrum from the point of view of taxpayers. Nevertheless, many other countries have similar treatment in these same areas. Whether overall the Australian treatment is less favourable than in other countries will depend on the particular circumstances of the taxpayer.

1.31 Observations on some of the key features are as follows:

- As already noted, Australia applies depreciation rates which are about average compared with the other countries although more generous for assets with longer lives. Unlike some countries, it does not allow for the amortisation of purchased goodwill. In addition, it has a corporate tax rate which is above the average.
- Australia allows loss grouping but only within a 100 per cent commonly owned group. A number of other countries allow such grouping with less than 100 per cent common ownership, with New Zealand only requiring 66 per cent commonly held interest. In addition, many countries allow losses to be carried back to some extent as well as forward, while Australia restricts the treatment to indefinite carry-forward of losses.
- Australia taxes pension funds on contributions to and earnings of the fund at a minimum rate of 15 per cent. Most other countries exempt pension funds (including both contributions, up to a limit, and earnings) although the beneficiaries may be taxed more heavily in other countries than in Australia. In other words, other countries tend to tax amounts used to fund retirement

incomes only when the amount is received as a pension. This is referred to as an 'expenditure tax approach' since the amount is only taxed when it is available as cash in the hands of the individual for expenditure. By contrast, Australia tends to tax, albeit at concessional rates, the contributions to and the earnings of the pension fund (an 'income tax approach').

- Most countries provide significant concessions to the taxation of capital gains on business assets. These concessions may involve exemption from capital gains tax, taxation at a concessional rate or deferred recognition of capital gains by means of rollover relief. Australia indexes capital gains but in a low inflation environment the advantage of indexation is significantly reduced. It also provides limited rollover relief, notably for small business.
- A number of major countries also allow rollover relief for scrip-for-scrip share tradings. Compared with the Australian system, this mechanism tends to encourage corporate reorganisation, as well as mergers and takeovers.
- Australia's international tax regime is a mixture of favourable and unfavourable treatment. The details are dealt with later in this chapter. In particular, Australia provides a wide range of exemptions from interest withholding tax. However, withholding tax applies in certain circumstances where it generally adds to the cost of borrowing. The interest is frequently grossed-up for the withholding tax so that the additional cost is borne by the borrower.
- In a number of areas where company taxpayers are restricted from doing things directly, it is possible for taxpayers to develop procedures for achieving the same result in a more complex manner. Within the area of capital gains tax, for example, considerable effort is expended in corporate reorganisations to avoid realisation of a gain. In countries with more generous rollover provisions, or those allowing consolidated returns, such convoluted activity will often not be necessary.

1.32 As discussed below, countries have paid considerable attention to the taxation of corporations in recent years. In Australia, the emphasis has been on the benefits flowing to shareholders from the full imputation system. In other jurisdictions the emphasis has tended to be more on reducing the company tax rate even if this means high taxation at the shareholder level and the opening up of a considerable gap between the company rate and the top marginal rate on individuals. This is already an issue in Australia and one that will become more apparent if the company tax rate is reduced to 30 per cent.

Integration of company and personal tax systems

1.33 Interaction between the personal and company tax systems has different implications depending on whether only domestic considerations are relevant or whether there are international dimensions arising from the original source of the income or the country of residence of the taxpayer. The international dimensions are discussed later.

1.34 The Australian imputation system has often been described as one of the few full imputation systems in existence. What this means is that a full credit is provided to shareholders for all tax paid at the company level. As a result, retained income is taxed at the company tax rate (unless it benefits from a tax concession such as accelerated depreciation or R&D deductions) while distributed income is taxed at the marginal rate of the domestic shareholder, with the limitation that credits are non-refundable. Other countries either do not provide a full credit or provide a credit which only approximates the amount of tax paid at the company level.

1.35 While Australia's imputation system remains one of the few of its type in the world, other countries have developed systems which can be just as attractive to shareholders. This may be achieved by exempting dividends paid to domestic residents, by taxing both company income and dividends at concessional rates, or by providing a credit to individual shareholders independent of whether tax has been paid at the company level or not.

1.36 Based on the way in which the imputation system deals with domestic income, Australia's imputation system must be regarded as having many desirable features. Nevertheless, with the introduction of a range of anti-avoidance provisions in recent years, the system has become increasingly complex and more difficult for taxpayers to comply with.

1.37 This type of problem is not unique to Australia. It arises once dividends have a different value to different taxpayers because of the attached imputation credits. Such problems have caused the United Kingdom to modify substantially its system of imputation with effect from 1999, to the point where credits are provided to shareholders but not by reference to actual tax paid at the company level. Instead, a credit is provided independent of whether company tax has been paid. In some respects, this is little different from reducing the tax rate on dividends.

1.38 The United Kingdom system tended to work against the earning of foreign source income via United Kingdom based multinationals because it did not provide any credit at the shareholder level for foreign taxes paid — a structural feature shared by the tax systems of Australia and many other countries. It also encouraged dividend distribution to shareholders because of the desire of tax exempt pension funds to obtain reimbursement for taxes paid on distributed income. The latter incentive gave rise to some blatant cases involving the transfer of benefits to parties attaching a higher value to the refundable credits. The government initially acted to deny refunds of the credits to tax-exempt pension funds but then went further and dismantled the Advance Corporation Tax completely, including denying refunds of credits. Issues relating to mobility of capital and of company domicile reportedly contributed to this decision.

1.39 The United Kingdom experience is not unique in Europe. Italy has made extensive changes to what was formerly a full imputation system. It now taxes the income on new and existing equity at different rates with the average rate not exceeding 27 per cent. Imputation credits are still applied but the treatment is different for different types of dividends.

1.40 The approach to taxing company income at a very low rate and distributed income at a higher rate (a dual rate income tax system) has been adopted in many countries. At least three of the Scandinavian countries tax company income at a rate of 28 per cent with distributions then being taxed in the hands of the shareholders either at a flat rate (30 per cent in Sweden) or with imputation (Finland and Norway). Norway applies an equivalent to an advance corporation tax to unfranked dividends at the point of distribution so that all dividends are fully franked. At least six other countries already have a type of dual income tax system while Ireland and the United Kingdom are moving in this direction.

1.41 Thus, the recent tendency in a number of other countries is to move towards a dual income tax system for the taxation of company income. The rationale is to tax income from capital at a lower rate on the grounds that it is a mobile resource but the income may be taxed at a higher rate in the hands of individual shareholders. This treatment reflects a view that because of the international mobility of capital, high rates of tax will tend either to increase the cost of capital to compensate the investor or to encourage the capital to move elsewhere.

1.42 Of course, the existing tax system in Australia has the same essential features, with dividends being taxed at the shareholder's marginal rate and retained earnings at 36 per cent — effectively even lower after allowing for concessions. The only difference is that Australia's company rate is appreciably higher than that in the other countries referred to above.

1.43 Countries with a dual income tax system need to deal with the problem of individuals seeking to structure their affairs so that labour income is earned through a company rather than directly, thereby gaining the advantage of the lower tax rate on undistributed income. This can involve a higher rate of tax on undistributed income of private companies or specific anti-avoidance provisions to limit the circumstances in which labour income can be earned through a company.

1.44 This movement to a dual income tax system tends to be the most prevalent one in other jurisdictions. There has not been any great tendency for countries to move in a particular direction on imputation, although the moves by the United Kingdom and Ireland to abolish the Advanced Corporation Tax are notable. The policy concern appears to have been far more with the need to reduce the taxation of capital than to reduce the taxation of residents.

Uniform taxation of entities

1.45 The Government has announced in *A New Tax System* that it wishes to move to a system of business taxation which taxes different entities uniformly so that the tax rate on business income is independent of the type of entity used for the activity. Uniform taxation of entities would apply to trusts, limited liability partnerships, pooled investment vehicles and insurance companies.

1.46 What is surprising from the international comparison of tax systems is that very few countries have made much progress in achieving this result. A particular concern in *A New Tax System* is to align the tax treatment of companies and trusts, with a modified treatment of companies representing the benchmark (principally because of revenue and rate considerations).

1.47 One reason why countries have not pursued this vigorously is that it is not common in other countries to use trusts or their equivalents to conduct business activities other than investment activities. The use of trusts for business purposes tends to be more common in Australia and New Zealand than in other countries. In other countries, trusts tend to be used for asset protection and inheritance tax planning and much less for the carrying on of active business. Even in the United Kingdom, trusts are very rarely used for active business purposes.

1.48 It is difficult to be sure why the use of trusts is more common in Australia and New Zealand than elsewhere. Taxation considerations possibly represent a significant part of this, since in both countries the income of trusts can be taxed more lightly than the equivalent income of a company. In other common law countries, it is not always clear cut that there is a tax preference for trusts.

- In Canada income from a trust is not eligible for the dividend credit that applies to distributions from companies.
- In the United Kingdom, the tax rate on undistributed income of a trust is even higher than the corporate rate.
- In the United States, a trust is taxed as a separate entity but to the extent that it distributes all of its taxable income it acts as a conduit. While this would appear to encourage the use of trusts,

a preferred look-through vehicle is provided by so called S-Corporations. These are small business corporations which are taxed essentially like partnerships.

1.49 Whatever the reason, common law countries tax the beneficiary at the company tax rate, the top marginal rate or some other rate that applies only to trusts. Distributed income is generally assessable to the beneficiaries with a deduction to the trustee. In the United Kingdom, all income is taxable to the trustee at a rate of 34 per cent with a credit for the beneficiary on distribution. The result is that tax concessions do not flow through to the beneficiary. This is similar to the outcome that would be achieved under the proposed treatment put forward in *A New Tax System*.

1.50 Overall, there has been no real tendency to move to taxing trusts as companies in other countries, in part because there is not the same tendency to use trusts for conducting active business in other countries. The emphasis has generally been on finding ways to minimise the use of trusts for tax evasion and avoidance rather than on uniform taxation of business income.

1.51 With insurance, there has been more of a move to tax the income of life offices as companies. The United States moved in this direction in 1984 to replace a system that was complex and lacking an overall policy framework. European countries also appear to follow essentially a company tax type approach although the United Kingdom and Ireland are two countries with treatment specific to the industry.

1.52 A significant issue with the taxation of life insurance is the way in which deductible reserves are to be determined in arriving at assessable income. Countries which follow the company tax approach allow actuarially determined reserves to be deducted but restrictions may be applied which reduce the allowable deduction below the statutory reserve requirements.

Taxing international income flows

1.53 The insights into the practices of other countries take on a different dimension when we move from a consideration of purely domestic factors to introduce international dimensions, either through the derivation of domestic source income of non-residents (inbound investment) or of foreign source income by residents (outbound investment). Countries are concerned to ensure that their taxation policies do not unnecessarily add to the cost of capital for residents wishing to invest offshore and lead to a loss of investment opportunities. At the same time they wish to ensure that they receive a fair share of revenue where activities are performed in their jurisdictions or by resident investors. A number of insights can be formulated in this area.

Inbound investment

1.54 Firstly, with regard to inbound investment, countries have typically retained relatively high withholding tax rates under their domestic law on both interest and dividends. However, these rates are then reduced under double tax treaties, in many cases to zero. A zero rate imposes the minimum possible impact on the cost of capital although it can be argued that if withholding taxes are creditable in the other country, the abolition of the tax would be to the benefit only of the revenue in the other country and not to the investor.

1.55 Australia and New Zealand have tended to take a different approach. For both dividends and interest, Australia provides broad unilateral exemption from withholding tax under its domestic law although certain dividends and interest may still be subject to tax. For dividends, the policy approach is very clear, reflecting the fact that under the imputation system franked dividends are exempt from withholding tax while unfranked dividends are taxed at the applicable withholding tax rate. The policy is a little less clear in relation to interest where the basic approach has been to exempt widely held securities.

1.56 The treatment which gives the best outcome is difficult to assess. It may be possible to achieve better outcomes in treaties on other areas if the option of providing a concession on these taxes is available. The most important issue would appear to be to examine closely the policy rationale for the present approach to determine if Australia is achieving the best possible outcome.

1.57 Countries use a variety of approaches to ensure that non-residents obtain maximum credit in their own jurisdiction for taxes levied at source. Under Germany's split rate system, for example, distributed earnings are taxed at a lower rate than retained earnings. A company that distributes retained earnings previously subject to tax obtains a rebate of tax at the company level, while distributions to non-residents and residents alike are subject to withholding tax. New Zealand reduces company tax to the extent that distributions to non-residents are fully imputed, an effect of which is to enable shareholders to obtain a credit for non-resident withholding tax imposed while leaving the overall tax burden unchanged. The sustainability of the New Zealand approach has not yet been tested in larger economies. Implementation of approaches such as these needs to pay particular attention to the provisions of double tax agreements.

Outbound investment

1.58 The second key international area relates to the taxation of residents on income earned from other jurisdictions. While most countries have taken steps to reduce the extent of double taxation on domestic company income, the movement in this direction for foreign source income has been less clear cut. Under tax systems with a foreign tax credit system, the usual outcome for this type of income would be for two layers of tax to apply, one in the foreign jurisdiction and the other in the domestic jurisdiction after the income is in the hands of the individual investor. Views will differ on whether this is the appropriate outcome and such differences are reflected in the tax treatment followed in different countries.

1.59 Countries like Australia and New Zealand have taken a definite policy approach that these two layers should apply. It is also an inherent outcome with a classical system such as in the United States.

1.60 Other countries have taken some steps to limit double taxation of foreign source income. This can be achieved in a number of ways.

- Singapore takes the approach of taxing foreign dividends when received through companies with a credit for foreign taxes and then exempting dividends when paid to shareholders. This has the effect of limiting the global tax to no lower than the Singapore corporate rate.
- The new United Kingdom system to take effect in 1999 will provide a dividend credit to shareholders even where no United Kingdom tax has been paid at the company level. The Canadian system already provides the same outcome.

1.61 These actions would seem to be a recognition — in a world of more mobile capital — that investment opportunities, and associated taxation revenue flows, could be lost if the tax system fails to address the issue.

1.62 A number of countries also have complex provisions dealing with the taxation of certain income of foreign entities which are controlled by domestic shareholders. These measures effectively have an anti-avoidance intention although the New Zealand provisions relate more to economic neutrality because they apply to all foreign source income and not just to passive income.

1.63 The Australian provisions are particularly complex where they apply. The breadth of application can be difficult to define as it depends on the nature of the income earned and the jurisdiction in which it is earned. In the right circumstances, these provisions need not be complex in operation. The rules become complex, however, in a number of areas which will affect taxpayers differently. Firstly, the measures can apply to certain transactions undertaken in all but seven countries. This can cause significant difficulties for taxpayers involved in group restructures or with related party transactions. The problems tend to be exacerbated in transactions where it is necessary to be mindful not only of the tax system in the country where the transaction is occurring but also of the Australian tax system.

1.64 Secondly, because Australia exempts dividends arising from certain jurisdictions, it becomes necessary to keep track of income of different categories until it is remitted to Australia. While this provides an advantage to the taxpayer, it also adds considerable complexity to the tax law.

1.65 Only the United States and possibly Canada, have similar provisions that are as complex. The United States in particular applies the provisions more widely than does Australia. Most other countries applying such provisions have more lenient treatment of active business income and do not pose the same level of complexity in compliance.

Measuring the overall impact of taxation

1.66 Tax systems contain a complex set of treatments of different components of business costs and revenues. This makes it difficult to compare the tax systems in any quantitative manner since favourable treatment in one area may be offset by unfavourable treatment in another. Techniques have been developed to provide such comparisons but they have serious limitations and the results must not be interpreted literally as an indication of the tax burden on particular investments.

1.67 This report utilises effective tax rates to compare tax systems. Bearing in mind the serious limitations of the approach, the analysis compares the effective tax rates arising from the Australian business tax system with the outcomes that would arise if the tax systems of each of the other thirteen Group 1 countries were implemented here. While the absolute measures of effective tax rates have little significance, the comparisons between countries and different types of investments do provide some useful information.

1.68 Overall, the Australian tax system provides relatively neutral taxation of different investments compared with other countries. Nevertheless, significant differences arise for R&D and mining, and investment in plant and equipment tends to be favoured, a feature that is apparent in most of the countries considered. When compared across countries, the Australian tax system gives rise to relatively high effective tax rates on undistributed income of companies but competitive rates once the income is received by shareholders, reflecting the extent of integration of the company and personal tax systems.

Taxation policy, legislation and administration

1.69 One of the key issues dealt with in detail in *A Strong Foundation* is the question of how taxation policy and legislation might be developed to achieve the best possible outcome in terms of efficiency and simplicity and how the tax system should be administered to ensure equitable treatment and minimal compliance difficulties for business.

1.70 These issues have been explored in this paper by examining the approach of other countries, many of whom are wrestling with the same set of problems. A range of factors will bear on the approach best suited to a particular country, including the political, constitutional and legal system as well as cultural factors. At a minimum, insights drawn from the practices of other countries will need to be adapted to the Australian environment.

1.71 The issue that authorities face in formulating policy and legislation is the unavoidable complexity in progressing from broad policy to detailed legislation. The skills required to perform this process are diverse and typically are located in different areas of government. This means that either there needs to be considerable coordination between the agencies involved in the process or that the skills need to be combined in as few agencies as possible. The majority of countries have concentrated the responsibility for policy and legislation in one or possibly two agencies. Some have three or more agencies involved raising issues relating to coordination. It is difficult to conclude which of these models gives the better outcome because of the range of factors involved. However, some lessons can be drawn.

1.72 Most importantly, the process of coordination is a difficult one. New Zealand introduced a policy process referred to as the *Generic Tax Policy Process* (GTPP) several years ago as a means of achieving such coordination between Treasury, Inland Revenue and the legislative drafters. The process has represented an improvement but it has not eliminated all difficulties. The weak link in the chain is where broad policy is converted into more detailed policy prior to the preparation of legislation. It is difficult to ensure that sufficient skilled resources are available to carry out this function, particularly since the skills needed to manage the process are not necessarily found with those who have the necessary tax technical skills. As a result, it is possible for the final legislation to provide a less than reliable reflection of the original policy.

1.73 There is no simple solution to this difficulty. However, given limited resources it is likely that a better outcome can be obtained through greater integration across all stages of the process. The process becomes more difficult to deal with, the larger the number of organisations with detailed responsibility for the development of policy and legislation. It is unlikely that the number of entities will be reduced below two — one responsible for all aspects of policy and the other for drafting legislation.

1.74 Ideally all of the resources would be within the one body which had clearly defined responsibility for the quality of legislation produced, including for the underlying policy. If such a body became too specialised, it may be difficult to attract consistently high quality employees with the range of skills required. An issue would also arise as to whether there should be some form of independent review of both policy and legislation. Several countries have introduced such a step in the process to attempt to improve the quality of legislation. These countries have procedures for providing a report to parliament on the quality of the legislation. The report contains the views of professionals with appropriate expertise who are independent of the process of formulating the policy and legislation. In this way, the parliament is in a better position to understand the underlying policy in the legislation and to draw some conclusions on whether the legislation achieves its objectives.

1.75 Other countries utilise parliamentary scrutiny of legislation to try to improve the quality of legislation. In theory, this is an appropriate place for this process to be carried out so long as the necessary skilled resources are available to the parliament. The United States utilises this approach although some would argue about whether it achieves the desired outcome. In the United States, at least, the process is so structured that extraneous policy matters can become attached to the legislation with the result that the original policy becomes blurred. This is not likely to be a direction in which Australia would wish to go.

Key insights

1.76 In the end, the optimum tax system depends on perceptions of how well the market system works. *A Strong Foundation* has suggested the taxation of comprehensive income as a possible policy principle. While many will agree on this basic approach, arguments for deviations from this model in particular cases will depend on perceptions of market failure, including the availability of information for informed decision making.

1.77 Thus, in examining the taxation treatment in other countries, we must be cautious on how we draw conclusions about the ideal tax system. Nevertheless, important lessons can be learned from the approach that other countries have taken.

1.78 Perhaps the most important insight to be drawn from this overview is the extent to which other countries have taken steps in recent years which acknowledge the significance of globalisation and international capital flows in designing the tax system. There is no uniform approach that stands out but there has been a definite attempt to reduce the rate of tax on company income even to the extent of moving to a type of dual income tax approach. Under this approach, income is taxed at a low rate at the corporate level and possibly at a much higher rate on distribution. This reflects concerns with taxing mobile capital at a high rate.

1.79 The second element of this approach has been the tendency of some countries to reduce the extent to which income with an international dimension is taxed at two levels. Again, there has not been uniform movement in this direction but the actions of several countries provide policy examples. The difficulty here is to define the appropriate policy framework. This framework may well have different dimensions depending on whether a country perceives itself as a capital importer or capital exporter. Since most major economies have characteristics of both, it may well explain why examples of clarity of policy in this area are rare.

1.80 Australia is a significant net importer of capital but also has substantial gross outbound investment. Thus, in taxing income with an international dimension, Australia needs to be mindful of other countries' practices in this area.

1.81 There is no particular country that has procedures for developing policy and legislation that are likely to lead to a better outcome in this area than Australia has achieved in recent years. The problem of excessive complexity in policy and legislative design is not unique to Australia although, based on volume of legislation and related material alone, the Australian system is second only to the United States in complexity.

1.82 Where countries have actively addressed the question of improving the quality of taxation law, the emphasis has tended to be on appropriate coordination of the various agencies involved in the process and on enabling public consultation. The issue of consultation is strongly embedded in the culture of Scandinavian countries where the tendency is to enable all interested bodies, particularly the courts, to provide their views on policy and legislation to the Parliament and not just to the government agencies charged with these responsibilities. The approach that these countries take to consultation could provide useful insights for Australia.

1.83 The second country that has focused on improving these processes has been New Zealand. It has now had several years' experience in dealing with a formalised coordination process for all of the agencies involved in the development of policy and legislation. There have been practical problems in applying this model, largely based on problems of recruiting people with the necessary mix of skills, but its basic features appear to be sound. The one evident lesson is that coordination is inherently easier to achieve in this area, the fewer the number of organisations that are involved and the closer the working relationship between the agencies.