Australia: Henry Tax Review
The Government's Response

The Australian Government released the Henry Tax Review on Sunday, in the lead up to the Budget on Tuesday 11 May.

The tax review is designed to be a blue print for taxation debate and reform for the next 25 years. The main author, Secretary to the Treasury, Ken Henry likens this report to the Asprey Review of 1975. While key recommendations of that review were not adopted initially, they shaped reform measures of the 1980s.

The Commonwealth Government also released their initial response to the Report. As discussed below the Government at this stage has accepted a very limited number of recommendations, the centre piece of which is the 40% resource rent tax.

There is a three pronged response: measures that have been adopted (the first wave of reform); areas identified as the focus for a second term agenda; and recommendations that have been ruled out.

The first wave is to reform resource, company and small business taxes and superannuation.

The Government has provided costings of the adopted measures, for the years 2011/12 to 2013/14. The measures are revenue positive in both 2012/13 ($635mn) and in 2013/14 ($2,595mn). The introduction of a 40% resource rent tax from 1 July 2012 more than offsets the costs of all other measures in those years.

This net boost to revenue reinforces our expectation that the Government will project a budget surplus in 2013/14 - two years earlier than projected in the November Mid-Year Economic & Fiscal Outlook (MYEFO).

Here we provide a brief overview of the Government’s response to the Henry Review, as well as updated estimates of the budget position.

Proposals adopted by the Government
The first wave of the Government's agenda is to reform resource, company and small business taxes and superannuation.

The centrepiece is the introduction of a 40% resource rent tax - called a Resource Super Profits Tax (RSPT) from 1 July 2012. This is the only revenue positive measure, of note. Costings estimate that the first full year of introduction (2013/14) will raise a net $9bn. That is net of refunding state government royalty taxes.

There are two risks to this one revenue positive measure in the Government’s package. First is the economic risk - where will the terms of trade / commodity prices be in the year 2013/14 and beyond. The second risk is legislative - will the Senate pass the Government’s reform measures in their entirety.

The other measures, which do not begin until 2012/13 or later, are revenue negative.

- The one exception to this timing is a lower company tax rate for small business, which begins in 2011/12 - costing $50mn in that year.

Key changes adopted by the Government are:

- Lifting the superannuation contribution from 9 to 12 per cent by 2020
- More Government payments for low-income workers into their superannuation
- Compulsory super payments for those over 70 and concessions on contributions for those over 50
- A reduction in company tax from 30 to 28 per cent by 2015
- Small business to benefit from company tax cut from 2012
- Other write off concessions for small business
- An infrastructure fund to be paid to the states each year to start at $700 million in 2012

Framework for future discussion
The Government refers to a second wave of reform. They indicate that in the coming months they will have more to say on a number of other areas considered by the Henry Review, especially:

- making tax time simpler for everyday Australian;
- improving incentives to save (Henry recommended 40% discount on net interest income); and
- improving the governance and transparency of the tax system.
What has been ruled out
The Government was quick to rule out a number of recommendations, notably:

- Include the family home in means tests
- Introduce land tax on the family home – this is a state tax and thus an issue for the states
- Require parents to work when their youngest child turns 4
- Hit single income families
- Restrict eligibility to rent assistance for families
- Do any changes to the tax system that harm the not-for-profit sector, including removing the benefit of tax concessions, raising the gift deductibility threshold or changing income tax arrangements for clubs
- Reduce overall remuneration to the members of our defence forces
- Reduce the CGT discount, apply a discount to negative gearing deductions, or change grandfathering arrangements for CGT
- Remove the Medicare levy
- Reduce indexation of the age pension
- Remove the benefits of dividend imputation
- Think of hitting pensioner and low income concessions for utilities, transport and other essential services
- Introduce a bequests tax
- Align preservation age with pension age
- Offer a government annuity product
- Ask the States to charge market rents to public housing recipients.
- Abolish the Luxury car tax
- Index fuel tax to CPI
- Change alcohol tax in the middle of a wine glut and where there is an industry restructure underway

Debate on the Resource Super Profits Tax
There are two aspects to the Resource Super Profits Tax. Because part of the revenue from the tax is used to rebate resource companies for the state based royalties which will still be levied by the states the RSPT is a partial substitute for the state royalties. State royalties are generally based on the volume of production rather than the value of production and therefore not being directly related to economic surplus. The RSPT is therefore a more efficient way of extracting value for both the state and resource companies than a royalty system. It also provides greater certainty to the resource companies since state governments have been known to adjust the royalties when under budgetary pressure.

However the Government estimates that the net impact of the new arrangements will be a net increase in revenue of $9bn over the full year. The Henry Review provides a theoretical case for higher taxes on “immobile factors of production” after suitable adjustments for “normal” rates of return. With resources being “non renewable” a higher tax rate can be justified on those companies which extract this non renewable factor in comparison with companies which, say, provide services. No doubt the resource industry will dispute the imposition of the tax at such a high rate as 40% which more than “corrects” the inefficiencies of the state royalty system.

Other developed economies like the provinces of Canada; US (Nevada); and Norway have adopted profit based charges for mining although still complement them with royalties. In Canada and US the profit based tax rate is generally less than 20% but because a partial royalty system is still maintained direct comparison with Australia’s proposed 40% rate has not been possible. The Henry Report notes that the effective tax rate for mining in Australia is currently 17% compared to 23% in Canada.

Additional remarks
1) The impact on bond markets of these measures will be minimal. Firstly because there is a 2 year lead time before the partial introduction of the RSPT (raising $3bn in the first year compared to $9bn in a full year). The other measures, which are all funded from the RSPT, are also delayed. There is no significant budgetary impact until 2012/13 when there will be a modest $635mn increase in the surplus.

Detailed estimates have only been provided until 2013/2014. They show a full year $9bn contribution from the RSPT in 2013/14 and a $2bn drag from the first 1% tranche of the company tax cut. The estimated surplus in 2013/14 is $2.595bn. With the second 1% cut to the corporate tax rate being introduced in 2014/15 and presumably costing at around an additional $2bn the current estimates imply that there will be little improvement in the net fiscal position once all measures are fully introduced - pending any growth in revenue raised by the RSPT.

2) The Henry Review provides interesting comparisons with effective tax rates across industries. In Australia the effective tax rates for finance and retail is 27% compared to 17% for mining whereas in Canada the effective tax rate for mining is 23% compared to 13% for finance.

3) The revenue from the RSPT is estimated at a net $9bn in the first full year of implementnation, 2013/14, after rebating around $6bn back to the mining companies in compensation for the state
royalties payments which are assumed to be maintained. These estimates are based on commodity prices staying around current levels. We can be sure that such an estimate will prove to be incorrect given the huge volatility in commodity prices and the massive uncertainties surrounding not only demand conditions but also the supply responses.

A source of vulnerability to the government’s current plan is that if prices do fall there will be no automatic offset. Because the royalties are based on volumes rather than prices those payments will be broadly unaffected by price (on the assumption that production is still profitable) and the other commitments (including company tax cut - $4bn) will be largely unaffected by lower resource prices.

Budget impact
The Government’s initial response to the Henry Review is revenue positive in the years of 2012/13 ($635mn) and 2013/14 ($2,5995mn).

Included in our April Westpac Market Outlook was the article “Australian fiscal policy: surplus in sight”. There we provided our estimates of the improved starting position for the budget given better than expected economic conditions and prospects. Those estimates were on a no policy change basis.

Here we update those figures, taking into account the budgetary impact of these tax changes. This reinforces our expectation that the budget will be in surplus in 2013/14, two years earlier than projected in the Government’s November MYEFO. Indeed, it is likely that the budget will be broadly in balance in 2012/13.

The Government has also announced in recent times a number of measures, notably: health reform costing $5.4bn over four years; delaying the introduction of an Emissions Trading Scheme until 2013 at the earliest, which will save $2.5bn over the forward estimates; and introduced a 25% rise in excise duty on cigarettes, that will raise $5 billion over four year. In broad terms these various measures are revenue neutral.

Bill Evans, Chief Economist
Andrew Hanlan, Senior Economist

<table>
<thead>
<tr>
<th>Underlying cash balance</th>
<th>MYEFO</th>
<th>Budget 2010 *</th>
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<td></td>
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<tr>
<td>2008/09a</td>
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<tr>
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<tr>
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<tr>
<td>2013/14 **</td>
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** Source: Australian Government

### Budgetary impacts of the Government’s Tax Reform Agenda

<table>
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<tr>
<th>$mn</th>
<th>2010/11</th>
<th>2011/12</th>
<th>2012/13</th>
<th>2013/14</th>
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<tbody>
<tr>
<td>Company tax cut</td>
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<td>Small business instant write-off and simplified depreciation</td>
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<td>Refund of superannuation contributions tax low income earners</td>
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<td>$50,000 concessional cap for super balances under $500,000</td>
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<td>Resource Exploration Rebate</td>
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<td>Resource Super Profits Tax</td>
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<td><strong>Total</strong></td>
<td>-</td>
<td>-50</td>
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Past performance is not a reliable indicator of future performance. The forecasts given above are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The results ultimately achieved may differ substantially from these forecasts.