

Personal income tax reform: consensus, outliers, specifics and some sensitive issues[†]

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Abstract

The case for significant Australian Personal Income Tax (“PIT”) reform is overwhelming, as argued by (at least) eleven substantive business, professional and academic research reports and papers in the past few years, including work by this author. Essentially there is broad consensus for company and PIT rate alignment (or equalisation) at 30 per cent and associated simplification measures. Although strongly argued by this author and several other academics, there is generally little support for a substantially increased tax-free threshold. In a revenue neutral analysis, this author has earlier suggested that significant PIT reform necessitates a higher Goods and Services Tax (“GST”) rate of 15 per cent. Both proposals are outliers. This paper builds upon this analysis and emphasises the key factors that significant PIT reform would entail, such as the abolition of Work-Related Expenses, other deductions and

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offsets, the introduction of withholding taxes and much greater use of technological solutions. The final part of the paper considers several sensitive issues that need to be considered before undertaking significant PIT reform, including negative gearing and inter-generational distribution. The author concludes by emphasising the key issues and challenges facing this complex Australian PIT reform debate, including the importance of substantially reducing the number of PIT filers.

I. Introduction

Australia last undertook major tax reform in 2000, which included the introduction of its GST,¹ although some may consider changes to the taxation of superannuation since then as significant reform.² That said, arguably the current focus of debate in Australian taxation policy is reform of the Personal Income Tax (“PIT”) system. If enacted along the lines proposed by some independent researchers, business groups and professional bodies, such reform would have major economic and social implications.

Unfortunately PIT reform is politically “just too hard”. From primarily a political perspective, PIT payers are unorganised and do not have an effective lobby group. Yet, at the 2001 election, 86 per cent of voters considered tax policy as very important.³ The millions of unorganised PIT payers may be contrasted with the powerful lobby groups of business (eg the Business Council of Australia, the Australian Chamber of Commerce and Industry), the professions (eg the Australian Medical Association), agriculture (eg the National Farmers’ Federation), and social and welfare (eg the Australian Council of Social Service (“ACOSS”). Moreover, politicians, certainly over the past 20 years or so, gear their tax policies to the median voter and thus favour middle-income taxpayers to the neglect of lower and upper income taxpayers. Without the support of the powerful business lobby groups, PIT reform has little chance of success.

This author has strongly argued earlier that the Australian PIT system is an outdated relic of the post-war period up until the 1980s.⁴ The Business Coalition for Tax Reform (“BCTR”) recently stated that “... Australia’s personal tax system is holding back the nation” and “personal taxes are now a business issue”.⁵ Over the last few decades, many other OECD countries have reformed their PIT by reducing the number of tax rates and reducing or eliminating high marginal tax rates.⁶ Most OECD countries have higher income thresholds than Australia and lower rates for many

1 *Tax Reform: Not a New Tax, a New Tax System* (White Paper) (Canberra: Commonwealth of Australia, 1998); Pope, J, and Fernandez, P. “Current Tax Reform in Australia: An Ambitious Programme” (2001) 2 *British Tax Review* 135-151.

2 Particularly changes announced in the 2006 Commonwealth Budget, and the earlier abolition of the Superannuation Surcharge Tax (SST), a policy recommendation in Pope, J, Fernandez, P. and Le, V. *The Hidden Costs of the Superannuation Surcharge Tax* (Sydney: Australian Tax Research Foundation, 2003) 1-97, at 89.

3 Davidson, S. “Who Pays the Lion’s Share of Personal Income Tax?” (CIS Policy Monograph 63, Centre for Independent Studies, 2004) at 3.

4 Pope, J. “Reform of the Personal Income Tax System in Australia” (2005) 24(4) *Economic Papers* 316-331; Pope, J., “The Political Economy of Personal Income Tax Reform in Australia” (Paper presented at the Economic Society of Australia 35th Australian Conference of Economists, Curtin University of Technology, Perth, Western Australia, 25-27 September 2006). Published in Conference Proceedings, on web at <www.cbs.curtin.edu.au/cbs/ace2006> at 4 July 2007.

5 Business Coalition for Tax Reform (“BCTR”), *Personal Income Tax Reform: Public Discussion Paper* (Melbourne: BCTR, 2006) at 1.

6 Sandford, C. *Why Tax Systems Differ* (2000) at 51-52 and 158-160.

taxpayers,⁷ although international comparisons are always fraught with difficulty and need to be treated cautiously. There is undoubtedly a strong consensus (majority) recognising and favouring PIT reform, as the Symposium in Sydney in April 2007 demonstrates. The key question is “how?”

The main purpose of this paper is thus to identify and succinctly evaluate the key proposals and arguments put forward to date, building upon earlier work by Pope⁸ and updating it where possible. For clarity, ease of analysis and comparison, it is also important to identify tax revenue and costs on an annual basis rather than over a three year period, as Treasury tends to do when presenting the annual Budget changes. Fortunately all the PIT reform proposals cited in this paper adopt the former approach, although the year and timing differ. Strictly speaking, economists would wish to see all year on year comparisons expressed in real terms. This paper recognises the important distributional issues involved in PIT reform but leaves that debate aside for further work.

II. Defining tax reform

The word “reform” has two meanings based on dictionary definitions. One is to “make or become better by the removal of faults or errors”, or “improve”.⁹ The other is to “form again”, or to “restructure”, to “change”.¹⁰ The former, and probably the more widely used understanding of the term, necessitates a value judgment or personal opinion. In terms of tax reform, changes by an incumbent government may be reversed by a succeeding government, usually but not always of a different political party.

This paper uses the term tax reform in the second sense of the word, namely a “... restructuring or change without necessarily implying the change is for the better”, after the work of the eminent late Professor Cedric Sandford.¹¹ Using this definition thereby avoids any value judgments by the author. In economic terms, tax reform must produce “winners” and “losers” in the short term. However, in the longer term the vast majority, and possibly everyone, should be a “winner” in terms of improved economic growth and higher standard of living arguments over time, with short-term losses to families mitigated through social welfare compensation,¹² although this view

7 Warren, N. *Tax Facts, Fiction and Reform* (Sydney: Australian Tax Research Foundation, 2004a) at 121-122. See also *International Comparison of Australian Taxes*, undertaken by Mr Richard Warburton AO and Mr Peter Hendy, with Treasury secretariat, Report to the Treasurer (Canberra: Australian Treasury, April 2006).

8 Pope (2005 and 2006), above n 4.

9 *The Concise Oxford Dictionary* (1990).

10 *Ibid.*

11 Sandford (2000), above n 6, 157. Discussion here of the term “tax reform” is based on Sandford’s commentary, and acknowledged with thanks.

12 The introduction of the GST in Singapore in the 1990s followed this principle; refer Pope, J. and E. H. Poh “Compensating for the Goods and Services Tax: The Contrasting Policy Approaches of Singapore and Australia” (2001) 18 (2) *Economic Papers* 1-9; and Poh, E. H., Pope, J. and Hasseldine, J. “The Political Economy of Compensating for the Distributional Effects of Value-

may be contentious with those who focus on distributional, equity and shorter-term issues.

Further, Sandford emphasises that reform must be a “non-trivial” change, “more than simply adding a little to government revenue or returning something to the taxpayer”. Examples of meaningful tax reform cited by Sandford that are relevant to the Australian PIT reform debate are “... major changes in tax rates, a change in the tax mix, significant changes in tax administration such as ... a change in the tax unit or the indexation of the tax system.”¹³

III. The recent consensus for pit reform

The consensus for meaningful PIT reform, in terms of the majority of published research proposals, real reductions in revenue, and Sandford’s definition, has been growing gradually in recent years, particularly since 2004. The main proposals are summarised in Table 1. They are identified in terms of their support of a top PIT rate of 30 per cent and their gross costs. Many may be classified as “major” or “significant”, and obviously differ in their scope, detail, timing and phasing-in. Proposals and commentaries by politicians have been excluded.

International bodies also support major PIT reform. For example, Walker, in support of his reform arguments, cites an International Monetary Fund (“IMF”) report that argues that Australia would become more competitive in trying to attract “internationally mobile capital and skilled labour”.¹⁴ The OECD has continued to urge Australia to reform its PIT system, with its latest 2007 report recommending lower income tax rates or an increase in the tax-free threshold, as well as reform of the means-test for family benefits, in order to increase the number of people in work.¹⁵

Added Taxes: The Recent Cases of Singapore and Australia” (2003) 9(3) *New Zealand Journal of Taxation Law and Policy* 267-286.

13 Sandford (2000), above n 6, at 157.

14 Walker, G., “The Tax Wilderness: How to Restore the Rule of Law” (CIS Policy Monograph 60, Centre for Independent Studies, 2004) at 10 (available at <www.cis.org.au> at 3 July 2007) and *Staff Report for the 2002 Article IV Consultation* (Washington D.C.: International Monetary Fund, 2002), at 15, respectively.

15 “Tax cuts key to growth in jobs, says OECD”, *The West Australian* (Perth), 14 February 2007, at 4, citing the latest OECD report at <www.oecd.org> (available on a fee basis).

Table 1: Proposals for PIT Reform, 2004 to 2007 (March)

| Author/Year | 30% Top Rate | Approximate Gross Cost of Package \$ billion | Comments |
|--|---|---|---|
| Walker (2004) ¹⁶ | Yes | Not stated. Emphasises Laffer effect** | IMF supports 30% top rate |
| Saunders and Maley (2004) ¹⁷ | Flat-rate (unspecified; 40% top rate initially) | PIT 16.3 (plus 12 other) | Phased. Overall funding shortfall of \$15 billion |
| Warren (2004b) ^{18*} | 40% "most realistic" | na | Justification for PIT reform in media |
| CPA Australia (2004) ¹⁹ | Yes | Option costs outlined | Phased. 18 scales modelled: rates of 16/29/42 preferred in short-term |
| ACCI (2004) ²⁰ | Yes | PIT 10 (plus 4 other) | Phased. 6 PIT options considered |
| Deutsch (2004) ^{21*} | Yes | Not costed | "Real, robust and fundamental simplification" needed |
| Business Council of Australia (2005) ²² | Yes; 40% top rate by 2007-08; 30% "eventually" | 5.1 in 2007-08 (40% rate) | "Crucial to economic and business success ..." |

16 Walker (2004), above n 14.

17 Saunders, P. and Maley, B., "Tax Reform to Make Work Pay" (CIS Policy Monograph 62, Centre for Independent Studies, 2004).

18 Warren, N., "Slash taxes from the top", *The Australian* (Sydney), 21 October 2004b.

19 CPA Australia, *Reforming Australia's Personal Tax System – a Model for the Future* (Discussion Paper, CPA Australia, 2004).

20 Australian Chamber of Commerce and Industry ("ACCI"), *Taxation Reform Blueprint: a Strategy for the Australian Tax System 2004-2014* (2004). Available at <www.acci.asn.au> (18.11.04).

21 Deutsch. B. "Focus on Tax Simplification" (2004) 3 *Tax Matters*, 6.

22 Business Council of Australia, "Taxation Action Plan for Future Prosperity" (Melbourne: BCA, 2005). Available at <www.bci.com.au> at 4 July 2007.

| Author/Year | 30% Top Rate | Approximate Gross Cost of Package \$ billion | Comments |
|---|--|--|---|
| Pope (2005; updated 2006) ²³ | Yes | 22 (approx.) | Revenue neutral; funding by PIT simplification and GST rate increase (to 15%), with compensation package ^a |
| Humphries (2005) ²⁴ | Yes; flat rate of 30% | Self-funding, with additional medium-term revenue of +15, and more in the long-run | Tax-free threshold of \$30,000 and negative income tax up to that level; removal of all tax expenditures |
| Freebairn (2005) ²⁵ | Yes; eventually, but initially around 40% | 10 | Increase CGT to 30%; emphasises efficiency and simplicity |
| BCTR (2006) ²⁶ | Three "scenarios": Major: 20% Midway: 35% Modest: 40% | Three "scenarios": Major: 37 (net 22) Midway: 19 (net 10) Modest: 8 (net 8) | Major scenario is complex; includes PIT rate alignment with company rate at (interim) 22% and abolition of PIT deductions/concessions worth \$10.5 billion ^b |
| Ernst and Young (2006) ²⁷ | 2007-08: One top rate of 40% ^c | Not costed | Focus on taxation of investment reform including PIT |

23 Above n 4.

24 Humphries, J. "Reform 30/30: Rebuilding Australia's Tax and Welfare Systems" (CIS Policy Monograph 70, Centre for Independent Studies, 2005).

25 Freebairn, J. "Income Tax Reform: Base Broadening to Fund Lower Tax Rates" (2004), mimeo, 1-14, and in Dawkins, P. and Stutchbury, M. (eds.) *Sustaining Prosperity* (2005).

26 Business Coalition for Tax Reform (BCTR) (2006), above n 5.

27 Ernst and Young, *Taxation of Investment in Australia: The need for ongoing reform* (2006).

| Author/Year | 30% Top Rate | Approximate Gross Cost of Package \$ billion | Comments |
|---|--|--|--|
| Australian Industry Group (2005; updated 2006* and 2007*) ²⁸ | Reduce top rate from 47% to 40% (latest) | 9 | Also reduce 30% rate to 15% for taxable incomes of \$6,000-\$30,000 pa |

* An expressed view in a short article or press release, and not a research report.

** This economic term essentially means that a reduction in tax rates leads to an increase in tax revenue because of enhanced economic performance ie higher real incomes, and parts of the hidden or cash economy now entering the official, measured and, most importantly, taxable economy.

na: not applicable.

- For welfare recipients, the elderly and retired, and other low-income persons (cost excluded from \$22 billion gross estimate).
- A phase-in of rate equalisation from 22per cent to 20per cent over several years would allow the “fiscal ramifications” to be more clearly understood. The BCTR included real expenditure cuts of \$15 billion and allowed for a budget surplus of \$7 billion, as well as overall tax simplification worth \$15 billion. See BCTR (2006), at 47-60, especially Table 5.9, at 58.
- For 2006-07 the two top rates should be 45per cent and 40per cent (reduced from 47per cent and 42per cent respectively), a proposal that the Government has since adopted.

Qualifying Table Notes:

- This analysis is based on the original published contributions. Updates and revisions by some of the above bodies and authors taking into account changes to PIT announced in the May 2005 and 2006 Commonwealth Budgets have been included where possible.
- Contributions by politicians and others eg newspaper columnists, to the PIT reform debate are excluded here as they generally represent opinions rather than research-based perspectives. See, for example, the useful review by Ruse, B. (2006), “Secret societies push Costello on tax reform”, *The West Australian*, 3 March, 2006, at 57.

One of the major issues in the PIT reform debate to date is that of the highest tax rate (usually disregarding the Medicare levy). Of the 13 authors and bodies cited in Table 1, excluding the BCTR,²⁹ the balance is evenly divided in the initial or short-term,

28 28 Australian Industry Group (“AIG”), *Building Incentive: An Ai Group proposal to reduce the tax burden* (2005); AIG (2006), cited in the “Rates too high, say business”, *Australian Financial Review*, (Melbourne), 27 February 2006, at 4; AIG, “Pre-Budget Submission: Ambitions for Australia” (Press Release, 2007) 1-3, available at <www.aigroup.asn.au>. The 2007 proposal includes reducing the 40 per cent PIT rate to 30 per cent for incomes between \$75,000 and \$100,000 pa, “subject to close assessment of the risks of adding to inflationary and interest rate pressures”, and reducing the company rate to 25 per cent in a phased reduction to be completed by 2011-12, both at 1.

29 The summaries here exclude the BCTR who had three proposals, modest, midway and major, at 40, 35 and 20 per cent respectively.

with six supporters apiece for a top rate of 30 per cent or less. Those favouring a rate of 30 per cent only in the longer-term are possibly more realistic in terms of the political context of PIT reform. In the longer term the picture changes to eight favouring a top 30 per cent rate against just two for a higher rate around 40-45 per cent, with two (Saunders and Maley; Warren) unspecified.

Thus, focusing on the longer-term reform scenario, there is strong support and consensus from a wide range of business and professional bodies, and independent academics, for a PIT top rate of 30 per cent. It should be emphasised that the presumption here is rate alignment or equalisation with the company tax rate of 30 per cent, a point strongly argued by Pope and others. If the company rate should change, probably in a downward direction, then most commentators are likely to support a correspondingly lower top PIT rate.

Another area of general consensus is that the current tax-free threshold of \$6,000 should remain unchanged. However, there has been some consideration of its complete abolition, as in New Zealand, or a significant increase. These and other proposals not receiving any widespread support are discussed in the following section.

The main area of general consensus is simplification of PIT deductions and concessions (tax expenditures). In 2004-05 personal taxpayers claimed \$23.8 billion in total deductions, including \$11.9 billion in work-related expenses (“WREs”), and tax offsets and credits worth \$13.6 billion, compared with \$104 billion in net tax revenue. a staggering 55 per cent of the Australian population of 20.3 million lodged an individual tax return in 2004-05.³⁰ However, when it comes to specific details it remains difficult to identify any particular consensus. These issues are considered later in s V.

IV. Outliers: pit reform proposals with relatively little support

A. Definition and Approach

The general dictionary definition of outlier is “an outlying part or member” whilst in statistics it means “a result differing greatly from others in the same sample”.³¹ The former should suffice here, although the following discussion is based on a sample of the most important PIT reform studies. Such outliers have been supported by one or a few authors/bodies, but overall do not seem to have any majority or mainstream support.³² The extent to which any particular proposal differs *greatly* from the

30 *Taxation Statistics, 2004-05*, (Canberra: Australian Taxation Office (“ATO”), 2007) at 7.

31 *The Concise Oxford Dictionary* (1990).

32 In terms of Government policy the majority or consensus view of researchers may not matter too much, as political factors come to the fore. For example, in the Australian pre-GST debate on whether food should be included in the base or not (ie zero-rated), the overwhelming business, professional and academic research and lobbying was for the former, yet – after much heated debate – food was eventually zero-rated by the Government.

mainstream remains, as always, a matter of personal judgment. In short, it is a useful starting point.

The main outliers, or PIT reform proposals or arguments with relatively little support to date, are:

- A significantly increased tax-free threshold, to between \$11,000 and \$30,000
- An increased low income tax offset
- The elimination of the current \$6,000 tax-free threshold
- The PIT system is inequitable between Pay-As-You-Go (“PAYG”) and non-PAYG income, especially regarding the use of trusts
- Negative gearing on housing should be abolished
- Any discount on capital gains should be abolished (given a PIT top rate of 30 per cent or less)
- Remove family tax benefits from tax returns ie claim only through Centrelink³³
- Fringe Benefits Tax (“FBT”) simplification or abolition
- Increase the rate of GST as an offset to loss of PIT revenue from significant reform
- Increase revenue from taxes other than GST as an offset to loss of PIT revenue from significant reform
- Abolition or reform of trusts
- Change the tax unit for PIT from that of the *individual* to the *family*³⁴

B. A Significantly Increased Tax-Free Threshold, to Between \$11,000 and \$30,000

Whilst all PIT threshold levels have been affected by bracket creep, the impact upon the tax-free threshold has been particularly significant, a point sometimes disregarded by some.³⁵ If the 1978-79 tax-free threshold had been raised in line with inflation ie

33 They would have to be re-named, presumably!

34 Covick, O., “Put Not Your Trust(s) in Tax Reform: Rather Do the Opposite” (2004) 23(3) *Economic Papers* 257-270, especially at 268-9. Whether this was “tongue-in-cheek” is for the reader to decide!

35 Pope (2005), above n 4, 316-331.

in real terms, it would have been \$13,549 in July 2003 and not \$6,000 ie 126 per cent higher.³⁶ In 2007-08 it is likely to be well over \$15,000.

Three academic reports³⁷ and only part of one business report (the major option of the BCTR) support such a proposal. The main arguments, summarised here, include: lower compliance costs of PIT; lower Australian Taxation Office (“ATO”) administrative costs; (at least) restoration of the real tax-free threshold rate to its 1978-79 level; and greater incentive to work for some casual or part-time workers, including students, house-persons and welfare recipients.³⁸ Another and more recent argument in support of a significantly higher tax-free threshold is lower real wages for some low-income workers in certain occupations (eg in retail, hospitality and child care). Research suggests that this emanates from recent Government industrial relations reform.³⁹ Eliminating or reducing PIT for lower income earners would help ameliorate any decline in real wage levels.

Tax-free thresholds of \$14,000 and \$12,500 (the latter indexed annually) have been proposed by Walker and Saunders/Maley respectively.⁴⁰ The latter argue that the tax-free threshold should be based on a “subsistence income” for a single person, being “the only practical way to overcome the problem of high effective marginal tax rates (“EMTRs”) arising from the interaction of the tax and welfare systems”⁴¹. By contrast, some commentators and bodies seem particularly concerned with various issues arising from a significantly increased tax-free threshold including preventing certain PIT payers gaining an even greater advantage from their tax avoidance practices (eg greater incentive to make use of students and house-persons in income-splitting arrangements). Appropriate anti-avoidance legislation can overcome such concerns or difficulties. Such issues must be addressed in any serious PIT reform proposal.

A theoretical point is that “an income tax with a tax free allowance [or zero rate] and just one positive rate is progressive and may be more or less progressive than a multiple rate system.”⁴² This point is often ignored by researchers and particularly by politicians and in the media.

36 In the UK for 2007-08 the tax-free threshold is 5,225 pounds (at <www.inlandrevenue.gov.uk/rates>), or A\$13,063 at a typical exchange rate of one pound = 2.5 Australian dollars. An earlier comparison, for countries where tax-free thresholds exist with rates converted to A\$ as at 30 June 2001, was: France A\$6,759; Canada (Federal) A\$9,647; Singapore A\$8,117 (selected examples only; Warren, 2004a, above n 7, 121-122).

37 Walker (2004); Saunders and Maley (2004); and Pope (2005), above nn 14, 17 and 4 respectively.

38 Pope (2005) above n 4.

39 Australian Bureau of Statistics (“ABS”) data shows that real hourly earnings between 2002 and 2004 fell by around 20 per cent for female non-managerial workers on AWAs overall. Estimated from Table 5A in Preston, A., Jefferson, T. and Guthrie, R., “Australian Workplace Agreements and Gender Equity” (2007) Women in Social and Economic Research (WISER), Curtin University of Technology, mimeo, at 9.

40 Walker (2004, at 13) and Saunders and Maley (2004, at 6-12), above nn 14 and 17 respectively.

41 Saunders and Maley (2004, at 11), above n 17.

42 Sandford (2000), above n 6, at 52. See the worked example at 52-53.

C. An Increased Low Income Tax Offset

Two calls, from the Australian Industry Group (“AIG”)⁴³ and BCTR (modest proposal only),⁴⁴ to increase the low income tax offset (“LITO”) are in line with current Government policy, with suggested rates now superseded.

D. The Elimination of the Current \$6000 Tax-Free Threshold

There is little if any support for the elimination of the current \$6,000 tax-free threshold. In 2005 the BCTR initially appeared to support the idea, but later its 2006 published report proposed maintaining it (modest option) or increasing it to \$8,600 (midway) or \$11,600 (major).⁴⁵

E. The PIT System is Inequitable Between PAYG and Non-PAYG Income, Especially Regarding the Use of Trusts

It is important to recognise and emphasise the myth of Australian PIT, namely that PIT *overall* is progressive and equitable. It is progressive and reasonably equitable for PAYG taxpayers but not overall once other entities are included. Trusts⁴⁶ and partnerships pay no tax, but are entities that distribute income to other entities (ie individuals and companies), to which normal rates apply. Further, the unit of taxation for trust income is the *family* rather than that of the *individual*, the current basis for all PAYG taxpayers.⁴⁷

Pope has argued very strongly on this point, particularly citing the work of Covick⁴⁸ and relevant data⁴⁹ in support, yet this aspect of the PIT reform debate has largely been ignored by others. Although earlier work did not emphasise previous

43 AIG (2005), above n 28, 2.

44 BCTR (2006), above n 5, 39.

45 Ibid.

46 The main type of trust in Australia is the *discretionary trust*. Trusts may be non-testamentary or testamentary, the latter, arising as part of a will, generally being more beneficial from a tax avoidance perspective. See Covick (2004), above n 34, 259-263.

47 Ironically, some parts of the PIT system and especially the welfare system require family income not just an individual's income (thereby increasing administrative and particularly compliance costs). For discussion of this critical issue see Covick (2004), above n 34; Sandford (2000), above n 6, 54-61; Head, J. G and R. Krever (eds) *Tax Units and The Tax Rate Scale* (Sydney: Australian Tax Research Foundation, 1996); Dwyer, T. “The Taxation of Shared Family Incomes” (CIS Policy Monograph 61, Centre for Independent Studies, 2004).

48 For the way in which trusts and related entity structures provide such an effective way of tax avoidance see Covick (2004), *ibid.*, especially at 259-267.

49 Pope (2005 and 2006), above n 4. Data (cited in Pope (2005), at 320-321) shows, for example, the high compliance costs of trusts (Evans, C., Ritchie, K., Tran-Nam, B. and Walpole, M., *Taxpayer Costs of Compliance* (Canberra: ATO, 1997), at 80, and a high percentage with a loss or nil business income (58 per cent in 2004-05; *Taxation Statistics, 2004-05*, above n 30, at 59), both in marked contrast to that of companies. This analysis clearly shows why PIT reform is long overdue.

Government policy regarding trusts, rate alignment (or equalisation) at 30 per cent would alleviate this inequity to a large extent. This is far preferable than attempting specific legislation to restrict the tax avoidance advantages of trusts. Such a move has been rejected politically at the highest level a few years ago⁵⁰ and is currently most unlikely to garner any new support. A recent concern is a 10 per cent growth in trusts in two years compared to companies and partnerships that have been static or declined as a percentage of all returns.

F. Negative Gearing on Housing Should be Abolished

A few authors and bodies (eg BCTR), argue in favour of the abolition of negative gearing under major reform, but many have ignored it and presumably placed it in the “too hard basket”. The issue is fully discussed later.

G. Any Discount on Capital Gains Should be Abolished (Given a PIT Top Rate of 30 Per Cent or Less)

Pope and Freebairn support the abolition of the current 50 per cent Capital Gains Tax (“CGT”) discount on assets held for one year or more.⁵¹ Freebairn has estimated savings of around \$2.5 billion pa.⁵² Earlier, Evans had argued strongly for its abolition on two main grounds, essentially because of, most importantly, economic distortions to aggregate savings and investment;⁵³ and horizontal and vertical equity distortions.⁵⁴ Against that some, including most business groups and the Government, believe it is a necessary incentive for enhanced investment and the overall growth of the economy.

50 The Government’s proposed entity tax reform, developed under Ralph (Ralph Report, *Review of Business Taxation: a Tax System Re-Designed*, Final Report (Canberra: Commonwealth of Australia, 1999), was effectively abandoned in 2001, mainly due to strong lobbying by vested interests, particularly small business, and, to a lesser extent, technical difficulties in the proposed legislation (see Pope and Fernandez, 2001, above n 1, at 146-147 for a summary of recommendations and ensuing criticisms). The Board of Taxation had advised the Government that there were not compelling reasons to tax discretionary trusts like companies.

51 Above nn 4 and 25 respectively. CGT is the tax payable on any “net capital gain” included with any other assessable income on an entity’s (individual, company, trust or fund) tax return. In 1999 the Government introduced a 50 per cent CGT concession for personal income taxpayers holding assets one year or more.

52 Freebairn (2005), above n 25, at 4.

53 See also Freebairn (2005), above n 25, at 6.

54 Evans, C., “Curing affluenza? a critique of recent changes to the taxation of Capital Gains in Australia”, (2000) 23(2) *UNSW Law Journal* 299-308; and Evans, C., “Taxing Capital Gains: one step forwards or two steps back?” (2002) 5(1) *Journal of Australian Taxation* 114-135. Evans was also a lone dissenting voice in hearings before the Senate Economics Committee.

H. Remove Family Tax Benefits from Tax Returns

The proposal to remove family tax benefits from tax returns, to be claimed through Centrelink only, was included in the major reform scenario by the BCTR.⁵⁵ Other researchers, including some of those published by the Centre for Independent Studies and also this author, strongly support the principle of a greater separation of welfare and family payments (transfer payments in economic terms) and the taxation system *per se*. However, such logic, well founded in economic theory⁵⁶ largely for reasons of efficiency, goes against current thinking by many politicians and governments.

I. Fringe Benefits Tax Simplification of Abolition

The BCTR in its major reform scenario essentially proposed the abolition of Fringe Benefits Tax (“FBT”), with provisions to ensure no misuse of company deductions (with a new test of “personal benefit”).⁵⁷ Other researchers generally have tended not to be drawn into the ramifications of PIT reform on other taxes such as FBT and CGT, presumably because of the complexities of analysing PIT *per se*, although any comprehensive reform by Government would necessitate this. The reform of FBT is also supported by ACOSS.⁵⁸

J. Increase the Rate of the Goods and Services Tax as an Offset to Loss of PIT Revenue from Significant Reform

Realistically, the most that could be saved by the removal of PIT concessions and deductions, including WREs, is around \$5 billion, based on 2004-05 PIT figures.⁵⁹ The GST rate could be increased from 10 per cent to 15 per cent, which would generate around \$18 billion in extra revenue in 2004-05 figures,⁶⁰ with the proviso of a compensation package to transfer payment recipients and the elderly.⁶¹ These two sources thus effectively funded Pope’s PIT reform proposal of rate alignment at 30 per cent and an increased tax-free threshold to the originally proposed \$12,000 at an overall gross cost of \$22 billion, given his revenue neutrality assumption. The latter is very important, as some PIT reform studies do not have any rough costs let alone detailed costs, whilst others have relied upon the reported (and seemingly continually increasing) Treasury Budget surplus and, using BCTR terminology,

55 BCTR (2006), above n 5, 47-59.

56 Against that, a strong case could be made for a negative income tax system that integrates both the welfare system and taxation. However, international examples of this are rare.

57 BCTR (2006), above n 5, at 47-59.

58 “Push for higher GST to share the load”, *Australian Financial Review* (Melbourne), 4 April 2006, 6.

59 Pope (2005), above n 4, at 328.

60 *ATO Statistics, 2004-05*, above n 30, at 85. In 2004-05 GST revenue was \$35.5 billion and in 2005-06 it had risen to \$37.3 billion, an increase of 5.3 per cent.

61 Pope (2005), above n 4, at 329. This would be similar to that in July 2000 when the GST was first introduced.

a “growth dividend”⁶² in tax revenues (effectively the Laffer effect in economic terms) and diaspora effect (return of expatriates) to partially fund their proposals. Of course, abolition of many or all current PIT deductions and concessions remain a core feature of nearly all the proposals to help fund lower PIT rates and/or threshold changes.

Currently all net GST revenue flows through to the States and Territories. There would be undoubted but not insurmountable difficulties in increasing the GST rate⁶³ and using the revenue at a Commonwealth level in order to fund PIT reform. The potential use of a higher rate of GST as a revenue source, if necessary for funding any major Commonwealth PIT reform, is also supported by Covick.⁶⁴

Whilst there is growing awareness of Australia’s relatively low GST rate of 10 per cent, compared to the OECD average of 18.5 per cent,⁶⁵ to date Pope has been the only main researcher to link PIT reform with a “tax mix” change.⁶⁶ However, business lobby groups often allude to this potential tax revenue source when considering wider reform to business and state taxation. The reticence of researchers to link PIT reform with GST rate changes is for them to explain. Possible reasons include potential political difficulties between State and Commonwealth Governments; a reluctance to become embroiled in an even more complex debate over essentially distributional matters; or perhaps a lack of ambition regarding the magnitude of PIT reform. Significant reform, for example reducing PIT by 20 per cent or more (at least \$20 billion in current terms) would necessitate raising revenue from other taxes, unless there were significant cuts in the level of government expenditure or a policy change regarding the Budget surplus, both currently extremely unrealistic scenarios. Revenue savings from simplification of the PIT is simply insufficient for significant PIT reform.⁶⁷

K. Increase Revenue from Taxes Other than GST as an Offset to Loss of PIT Revenue from Significant Reform

Revenue-raising possibilities from other taxes are theoretically recognised but are considered politically unrealistic in an Australian context. For example, payroll tax is less regressive than GST and generally raises relatively higher revenue in European Union countries than Australia where it could arguably be increased to between 10 and 15 per cent. Payroll tax is, however, a State tax much disliked by business that

62 BCTR (2006), above n 5, at 37-38, paras 34-36.

63 This proposition was contested by one prominent economist at a 2006 economics conference, above n 4.

64 Above n 34, at 269.

65 2001 figure; Pope (2005) at 320.

66 Australian Financial Review (2006), above n 58, at 6. This contained a table of reform options from eleven studies including that of Pope and the article also cited OECD data. Refer also Table 1 in this paper. Note that reform options included in the two Tables differ to some degree, with the AFR including two politicians.

67 See Pope (2005), above n 4, at 327-329.

generally would like to see it abolished! Wealth and inheritance taxes, used in some European countries, can also be noted.

L. Abolition or Reform of Trusts

Briefly, ACOSS has proposed the “cutting of trusts”,⁶⁸ Covick⁶⁹ and Pope⁷⁰ have emphasised their role and benefits in the tax system, but neither called for their abolition, preferring indirect measures.

V. Key factors in significant pit reform (the “specifics”)

A. Objectives and Key Data

The content and detail in this section depends essentially on the major PIT reform objectives. The main objectives should emphasise improved efficiency and simplicity, and would include the following. Firstly, elimination, or a reduction to an absolute minimum, of the number of persons who must submit a tax return and who do not eventually pay any tax (ie effectively take persons out of the tax system). Related to this, automate submission of as many annual tax returns as possible, particularly taxpayers whose tax affairs are straightforward. Secondly, reduce tax administration and compliance costs, using benchmark performance figures over time. Thirdly, reduce the percentage of Australians using tax agents, because of the high resource costs and system inefficiencies. This is also a valid indicator of PIT complexity. Fourthly, improve compliance and hence revenue through greater respect for and integrity of the PIT system. Fifthly, improve economic incentives covering a wide range of work, family, welfare, investment, inter-generational, ageing population and migration issues.

In support of these objectives the following PIT data is pertinent.⁷¹ Data for 2004-05 shows that: 11.2 million personal taxpayers lodged returns; and personal taxpayers had total income of \$448 billion, taxable income of \$424 billion and paid \$104 billion in net tax.⁷² Overall, the average PIT rate is 24 per cent,⁷³ a relatively low figure given the highest marginal tax rate is 45 per cent. In 2004-05 personal taxpayers claimed \$23.8 billion in total deductions, including \$11.9 billion in WREs, and tax offsets and credits worth \$13.6 billion were paid to 7.7 million (or 69 per cent) of the 11.2 million personal taxpayers lodging returns. Some 73 per cent of Australian taxpayers use

68 *Australian Financial Review* (2006), above n 58.

69 Above n 34.

70 Above n 4.

71 Amended and updated from Pope (2005), above n 4, at 319-320.

72 *Taxation Statistics, 2004-05*, above n 30, 7.

73 Net tax payable of \$103.6 billion divided by taxable income of \$423.7 billion (*ibid.*). It would be interesting to investigate how many PIT taxpayers would accept a simple, no deduction and no offset flat rate of 24 per cent!

a tax agent, one of the highest figures in the world,⁷⁴ and such fees are tax-deductible, costing \$1.2 billion in 2004-05.⁷⁵

The middle 46 per cent of taxpayers account for 38 per cent of tax revenue; the top 17 per cent of taxpayers account for 59 per cent of tax revenue, yet the bottom 37 per cent of taxpayers account for only 3 per cent of tax revenue.⁷⁶ In 2004-05 around 2.1 million personal taxpayers who lodged returns did not pay any tax! It is the latter figures that many PIT reform advocates use and focus upon in order to illustrate the inefficiencies of the current PIT system.

As noted earlier, if the 1978-79 tax-free threshold had been kept in real terms, it would have been \$13,549 in July 2003 and not \$6,000.⁷⁷ Tax arbitrage is very significant. Whilst 20 per cent of full-time wage and salary earners had gross incomes greater than the top marginal tax rate threshold, only 9 per cent paid tax at this top rate in 2002.⁷⁸

The (net) tax compliance costs of PIT are relatively high – around two-thirds higher than those of the UK⁷⁹ – and estimated at \$1.5 billion in 1994-95, accounting for 4 per cent of PIT net revenue in 1994-95, and for 0.34 per cent of GDP in 1994-95.⁸⁰ Low income earners account for 31 per cent of these costs, a surprisingly high figure. ATO administrative costs of the PIT system are estimated at around \$1.2 billion in 2005-06.⁸¹ Thus the operating costs of the PIT system (compliance and administrative costs combined) are estimated at around \$5-5.5 billion, or 4.1 per cent of PIT revenue in 2005-06.⁸²

The means of achieving the above objectives is generally referred to as tax simplification. However, it is worth noting that this term, particularly in the context of PIT reform, may mean different things to different people and bodies (eg economic,

74 Ibid. See also Highfield, R., “Pre-populated Income Tax Returns: The Next “Big Thing” in Reform of the Administration of Australia’s Personal Income Tax System?” (Paper 24 presented at the 7th International Tax Administration Conference, Sydney, April 2006) 1-30, at 12.

75 *Taxation Statistics, 2004-05*, above n 30, at 11.

76 Ibid., derived from data at 7 and 19 (Table 2.13). a taxpayer is defined as someone who submits a PIT return, thus including 2.1 million taxpayers (19 per cent) who paid zero PIT out of a total of 11.2 million PIT payers in 2004-05.

77 Warren (2004a), above n 7, 106.

78 CPA Australia (2004), above n 19, at 17-18, citing data from Reserve Bank of Australia (2003), Productivity Commission Inquiry on First Home Ownership (2003) and Hansard (2003), Question No. 1638, at 18169, Tuesday 12 August. The position may have changed somewhat since 2003 because of changes in rates and thresholds for higher income earners, and ensuing behavioural changes.

79 65 per cent higher than UK expressed on a social compliance cost of GDP basis when sole traders are included (Australia: 0.63 per cent; UK: 0.38 per cent) (Evans *et al*, 1997, above n 49, at 65). The breakdown of the Australian figure is: 0.34 per cent for personal taxpayers (at 28) and thus 0.29 per cent for sole traders.

80 Evans *et al* (1997), above n 49, at 26-28. This major study has yet to be updated, largely, one suspects, because of political reasons.

81 Highfield (2006), above n 74, at 15.

82 Ibid., at 16.

legal and political). From this author's previous work and analysis to date, and taking into account discussion by other researchers and bodies as presented in Table 1, the major PIT simplification changes recommended are as follows.

B. Abolition of Work-Related Expenses

In 2004-05 7.2 million taxpayers claimed \$11.9 billion in WREs, representing 50 per cent of total personal taxpayer deductions of \$23.8 billion.⁸³ In monetary terms (ie amount claimed) WREs were composed of motor vehicle (car) expenses of around 40 per cent, "other" 36 per cent, clothing (uniform) 9 per cent, self-education 7 per cent and other travel 8 per cent. In numerical terms (ie number of taxpayers claiming) the most important was "other" with 5.4 million taxpayers, then clothing (uniform) with 4.9 million taxpayers (presumably mainly lower income taxpayers), motor vehicle with 2.3 million (presumably mainly middle and higher income taxpayers), with "other travel" (0.7 million) and self education (0.5 million) completing the list. It must be emphasised that taxpayers can claim more than one WRE. Thus each taxpayer making a WRE claim typically claims for two categories.⁸⁴

Overall, higher income taxpayers claim more in WREs per taxpayer. Those with incomes above \$100,000 account for 4.1 per cent of all taxpayers yet claim 8.4 per cent of total WREs.⁸⁵ Thus, although "broad brush", the cost of lowering PIT taxation to a 30 per cent top rate for higher income earners would be partially offset to a greater extent through the abolition of WREs, and other deductions discussed below.

The concern with the abolition of WREs arguably should be focussed on the lower and to a lesser extent middle income groups. For example, around 4.9 million taxpayers claim an average of \$231 for uniforms (and, interestingly, a surprisingly modest increase of just \$4 per taxpayer claim compared with the previous year).⁸⁶ Such a sum may represent an important amount to most workers, and therefore any PIT reform has to factor in such "compensation" on equity grounds. This strongly supports the proposal for a significantly increased tax-free threshold.

Another argument that has been put forward in the media is the impact of the abolition of WREs upon public sector workers, such as teachers, who may generally be categorised as middle income earners. Perhaps the fear here is that abolition of WREs would lead to more aggressive claims for pay increases, or higher expenses

83 *Taxation Statistics, 2004-05*, above n 30, at 7 and 11 (Table 2.4).

84 The total number of taxpayers making a claim in each category, namely 13.9 million taxpayers, divided by the overall number of taxpayers making a WRE claim of 7.2 million, gives a figure of 1.9. The overall average WRE claim per taxpayer is \$1,662. (derived from Table 2.5, at 12, *ibid.*)

85 Freebairn, J., "A Package of Less Special Deductions and Exemptions and Lower Tax Rates" (Paper presented at Personal Income Tax Reform Symposium, University of New South Wales, Sydney, 2-3 April 2007), citing ATO data for the year 2003-04, at 11-6 (Table 2).

86 *Taxation Statistics, 2004-5*, above n 30, at 12 (Table 2.5). This very modest increase (of under 2 per cent) by mainly lower paid employees should be contrasted with the very high percentage increase of 46 per cent in net rental income losses and deductions over the same period (*ibid.*, at 13, Table 2.6), discussed more fully later.

claims to employing government departments. In the overall context of PIT reform this point is merely noted, and the argument not considered of particular merit.

CPA Australia estimated savings of \$4.7 billion pa from abolishing WREs alone.⁸⁷ Abolition of personal work expenses would lower compliance costs for nearly all seven million taxpayers making a WRE claim as less time would be spent completing the annual tax return and keeping associated documentation throughout the year. The administrative costs of the ATO should also be reduced.

Baldry was an early researcher advocating the abolition of WREs, and noted that they had been abolished in New Zealand in the tax year 1989, with the main objective of reducing compliance costs.⁸⁸

C. Abolition of the Cost of Managing Tax Affairs

In 2004-05 some 5.1 million personal taxpayers claimed around \$1.2 billion in deductions.⁸⁹ The crux of the argument here is equity between personal income taxpayers (ie those who use an agent (fee tax deductible) and those who do not (because the value of own personal taxpayer time spent on complying is not tax deductible)) as against equity between personal income taxpayers who use an agent and those who have a business (company, partnership, trust). The abolition of the cost of managing tax affairs as a deduction would achieve the former but at the expense of the latter, in terms of equity perspectives. Overall this author, along with others, supports its abolition.

A further point is that this item could be seen as the acid test for PIT reform. This is because, under a simplified system, the majority of PIT payers with straight-forward returns should be able to comply without the use of paid professional assistance. However, without real simplification, lower tax agent use (with no tax deductibility) may lead to more mistakes in tax returns, possibly higher tax deductibility claims, and ultimately higher administrative costs for the ATO, as well as overall risks to compliance and revenue. If any so-called PIT reform leaves this item unchanged, then critics are much more likely to perceive the changes as cosmetic rather than real.

D. Abolition of Other Deductions, Offsets and Credits

Tax offsets and credits are itemised separately by the ATO. In 2004-05 7.7 million taxpayers claimed \$13.6 billion in total.⁹⁰ The most important in monetary terms

87 CPA Australia (2004), above n 19, at 56.

88 Baldry, J., "Income Tax Deductions for Work-related Expenses: The Rationale Examined" (1998) 37(1) *Australian Economic Papers* 45-57, at 46, including footnote 1. This is an important analysis of the equity v efficiency debate regarding WREs, in the context of the labour market, particularly from a theoretical economic perspective.

89 *Taxation Statistics, 2004-5*, above n 30, at 11 (Table 2.4).

90 *Ibid.*, at 17 (Table 2.11). Total tax offsets and credits increased by 17.6 per cent from 2003-04, mainly due the introduction of the mature age worker tax offset and an increase in total franking credits arising from the strong share market (*ibid.*, at 16).

were total franking credits (54 per cent),⁹¹ termination payments (13 per cent) and Senior Australians tax offset (8 per cent). In numerical terms the low income offset applied to 3.42 million PIT payers, closely followed by total franking credits claimed by 3.35 million. The newly introduced mature age worker tax offset for 2004-05 was claimed by 1.1 million taxpayers at a cost of nearly \$0.5 billion.

Line-by-line analysis of other deductions and offsets is complex. However, a few pertinent comments should be made. The proposal by the BCTR⁹² to abolish the major PIT expenditures/deductions including WREs, passive income losses (eg negative gearing of housing rentals⁹³), medical expenses, geographical zone, income averaging for authors etc, entrepreneurs offset, non-superannuation termination benefits and private health insurance rebate is worthy of support. Interestingly, the BCTR proposed that charitable gifts and donations – likely to be a very sensitive area politically – should be claimed via a single-page tax return⁹⁴.

The issue of franking credits needs to be fully addressed in any major PIT reform proposal, with the potential impacts of simplification on business, superannuation, retirement incomes and so on fully researched. A 30 per cent top PIT rate should assist such simplification.

The relationship between senior citizens, younger retirees and general PIT payers needs to be discussed, particularly regarding the tax free threshold, the abolition of any offsets and recent changes to the taxation of superannuation for those aged 60 or over. Ideally, there should be a standard high tax-free threshold for all taxpayers irrespective of age, work or family circumstances.

The increasingly inter-weaving of Government social/welfare policy with that of the taxation system is clearly shown by relatively recent items such as the “baby bonus” and Family Tax Benefit (“FTB”). The economic efficiency position is clear: separate out transfer payments from the tax system as far as possible, unless comprehensive reform in the form of a negative income tax is introduced. The relationship of welfare payments and PIT is a very complex yet potentially economically fruitful area in terms of productivity and efficiency, and there seems to be a strong political preference for intertwining rather than separating them.

As a “second-best” position, and given possible government intransigence on this, automate as many payments as possible through the PIT system without the need for annual returns, a challenging task to bureaucrats given inevitable budget constraints. Further, some would argue for more and better integration of the welfare system with that of PIT rather than less. One consequence of this would be that analysis of administrative and compliance costs would need to be adjusted for this “transfer”

91 Franked or imputation credits are the amounts distributed by a company after tax has been paid. Franked income has a credit, normally of 30 cents in the dollar, which may be set against other income to reduce tax payable. Any unused credits are returned as a tax refund.

92 BCTR (2006), above n 5.

93 The abolition of negative gearing is not supported at the present time; discussed further in the next section.

94 BCTR (2006, at 52, para 86), above n 5.

component of the system. However, one thing is clear: the inter-relationship of the present tax-welfare system is not working well and reform, one way or the other, is long over due.

E. Elimination of the Annual Refund System and Minimisation of the Number of Annual Tax Returns

The annual refund system for many PIT payers accounted for around \$15 billion in 2003-04, or around 15 per cent of net tax revenue, a needless circulation of money although of course the government does reap substantial cash flow benefits from this system. It can be removed through means of a cumulative PAYG system similar to that in the UK and greater use of withholding taxes, particularly on interest payments by financial institutions. Such a system would also significantly reduce the number of annual tax returns submitted each year. a cumulative PAYG and withholding tax system would impose higher compliance costs upon employers and the financial institutions respectively, as well as increasing ATO administrative costs to some extent. In any major PIT reform these higher tax operating costs should pale into insignificance in comparison to the potential lower compliance costs and efficiency gains overall.

With around 7.1 million PIT payers earning more than \$21,600 who actually paid tax in 2004-05,⁹⁵ such a system, together with an increased tax-free threshold and other simplification measures, should be able to reduce the number of taxpayers who are required to make an annual return to around 3.7 million, or roughly a third of the current level of 11.2 million. This view is supported by the BCTR who, under their major option, advocate a maximum number of 3.3 million PIT returns.⁹⁶ Evans and Drum advocate the removal of “... more than 50 per cent of personal taxpayers from any annual filing obligation whatsoever”⁹⁷ (ie a maximum of 5.6 million filers using 2004-05 data).

95 Such taxpayers account for 97 per cent of all tax paid. *Taxation Statistics, 2004-05*, above n 30, at 19 (Table 2.13).

96 BCTR (2006), above n 5, at 51.

97 Evans, C. and Drum, P., “Ten million reasons for personal tax reform in Australia” in McKerchar, M. and Walpole, M. (eds) *Further Global Challenges in Tax Administration* (2006) 377-394. See also Evans, C., “Diminishing returns: the case for reduced annual filing for personal income taxpayers in Australia” (2004) 33(3) *Australian Tax Review* 168-181. The latter paper discusses the detailed means of achieving reduced filing, particularly in terms of four “enablers”, namely a tax schedule with a small number of rates; appropriate withholding taxes; elimination of most WREs; and limited interaction between PIT and social security systems.

F. Automated Returns and Tax Management Software

There are two main possibilities in this area, closely related to the point above. Firstly, the method of pre-filled in (or pre-populated) returns has been identified,⁹⁸ and for which support seems to be growing.

Secondly, proposed automatic, return-free electronic filing, through the employer, a similar system to that of the cumulative PAYE system in the UK. In the USA, Goolsbee has estimated that even a limited approach for the simplest returns could “eliminate compliance costs for as many as 18 million taxpayers”, worth up to US\$2 billion pa if using paid tax preparers.⁹⁹ Goolsbee also distinguishes between tax management software and electronic filing (a low-cost method of delivery to the tax authority). It is the former that offers the real possibility of a technological solution to tax complexity rather than the latter.¹⁰⁰ It is also contended that “people use tax management software when the costs – either price or learning costs – are low, not when the simplification benefits are high”.¹⁰¹ These approaches and issues are worthy of further consideration in an Australian context.

VI. Other outstanding and sensitive issues

A. Inter-Generational Distribution

The issue of inter-generational distribution is obviously related to wider, complex demographic factors. However, it has a sharper economic focus in terms of two major aged-related policies in Australia, namely the Higher Education Contribution Scheme (“HECS”) loan fee system as a means of financing higher education for many Australian university students and recent reductions in the taxation of superannuation. In short, the former penalises the younger generation (many of those now retiring or contemplating retirement received a university education paid for by the government) whilst the latter, briefly discussed later, obviously favours the elderly, arguably at the expense of the young.

Any discussion of PIT reform must take account of the increasing HECS debt that is currently being repaid through the PIT system and increases still further high

98 Highfield (2006), above n 74. It is a tax office administrative arrangement originating in the Nordic countries, with claimed “substantial benefits” overall.

99 For some of the 1040EZ returns. For childless single people and married couples with one working spouse, estimated time savings are worth between US\$1 billion and US\$2 billion, or up to US\$2 billion pa if using paid tax preparers. Goolsbee A., “The Turbo Tax Revolution: Can Technology Solve Tax Complexity”, in Aaron, H. and Slemrod, J. (eds) *The Crisis in Tax Administration* (Washington DC: Brookings Institution Press, 2004) 124-147, at 125.

100 Ibid, at 126. Goolsbee notes that TurboTax management software costs between US\$7 and US\$30 in 2001 prices – small compared with an accountant’s fees. Goolsbee’s paper and the comments that follow by Goldberg and Mazur are interesting reading. For example, Goldberg notes the issue of the public v private sector in tax software development, at 141.

101 Ibid, at 138.

marginal tax rates for many of those affected. In 2004-05 250,084 taxpayers paid HECS assessment debt of \$632 million, an average of \$2,528 per taxpayer.¹⁰² With recent university student fee increases this sum is likely to grow. The debt was repaid at rates of between 3.0 per cent and 6.0 per cent on a sliding scale above certain threshold income levels,¹⁰³ on top of the usual PIT rates. For 2006-07 these repayment rates have been increased to between 4.0 per cent and 8.0 per cent at threshold repayment incomes of \$38,149 and \$70,847 respectively. Thus, for 2006-07, the highest earning graduates with HECS debt would typically face a marginal PIT rate of 49.5 per cent.¹⁰⁴ From 1 June 2006 a new suite of loans known as the Higher Education Loan Programme (“HELP”) has been introduced, with accumulated HECS debts becoming accumulated HELP debts.¹⁰⁵

The affordability of property for the younger generation is also increasingly being recognised and becoming a political issue¹⁰⁶.

B. Superannuation¹⁰⁷

Suffice it to say that the taxation of superannuation has been simplified and reduced for most Australians aged 60 or over in the May 2006 Budget. Superannuation now becomes an attractive investment vehicle for many taxpayers, particularly those on higher incomes, possibly rivalling property investment and negative gearing in terms of tax avoidance in the years ahead, *ceteris paribus*. The cost of this reform, for comparative purposes, is stated as a total of \$7.2 billion over forward estimates, rising from \$0.1 billion in 2006-07 to \$2.6 billion in 2009-2010.¹⁰⁸ In terms of proposed PIT reform the fiscal impact of these superannuation changes is thus modest, in spite of the associated Government “hype” or “spin”. Some commentators consider the changes too generous to the older generation, especially in the light of the inter-

102 *Taxation Statistics, 2004-05*, above n 30, at 20 (Table 2.15). ATO statistics do not give the total amount loaned to students by government under HECS but only the amount of debt liable to be repaid once income reaches the minimum level. The number of taxpayers with HECS assessment debt fell from 344,257 (with \$655 million paid) in 2003-04 to 250,084 (\$632 million) in 2004-05. Student Financial Supplement Scheme debt of \$57 million in 2004-05 should also be noted.

103 The minimum level was \$35,001 in income year 2004-05, increased from \$25,348 in 2003-04, at 20, *ibid*. This explains the previous figures.

104 *Australian Taxation Office TaxPack* (2007), at 128. PIT rate of 40 per cent for taxable incomes between \$75,001 and \$150,000 pa plus the HECS repayment rate of 8 per cent. The Medicare levy of 1.5 per cent increases the effective marginal tax rate to 49.5 per cent. However, most new graduates would earn less than \$75,000 pa, and possibly a very few more than \$150,000, with varying effective marginal tax rates.

105 *Taxation Statistics, 2004-05*, above n 30, at 20.

106 Not considered further here.

107 See the in-depth analysis by Bateman, H. and Kingston, G., “Superannuation and the personal income tax reform after the 2006 Budget” (Paper presented at the Personal Income Tax Reform Symposium, University of New South Wales, Sydney, 2-3 April 2007).

108 “Simplified Superannuation legislation introduced into Parliament” (Treasurer Press Release No. 131, 7 December 2006) at 2.

generational issues identified above. The longer-term effects of this change are likely to be profound.

C. Rental Housing Market and Negative Gearing

Abolishing negative-gearing is a quarantining measure that would deny the deductibility of certain items until they can be deducted against the gross income stream with which they are associated. As such, tax revenue benefits would be short-term and “transitory” *providing that property owners eventually move into net profit*, (ie accumulated losses are then written off against net profits).¹⁰⁹

The Productivity Commission¹¹⁰ also addresses the issue, but key findings were rejected by Government. The latter stated:

the Government considers that it would be inappropriate to change existing arrangements relating to capital gains or negative gearing. The Government has improved incentives to save and invest by introducing an internationally competitive capital gains tax regime. The Government will therefore not be conducting a review of the tax system with respect to housing or changing the capital gains tax provisions.¹¹¹

The rental housing market in Australia is a specialist area of property economics, and is of some interest in the context of PIT reform because of the tradition of negative gearing of many investment properties. Briefly put, three main “players” are involved and benefit accordingly. First, the Government strongly encourages and supports negative gearing, probably because it does not wish to increase the current level of around 20 per cent public housing in the rental sector¹¹² with its high ensuing costs. Second, private rental housing investors, now numbering around 1.5 million,¹¹³ generally achieve a reduction in their PIT (because allowable housing deductions exceed rents), as well as the opportunity for capital growth. Third, people renting tend to pay lower rents than would otherwise be the case without the negative gearing policy and if rentals were left to “market forces”. Negative gearing was abolished for a short period some years ago but was re-instated after political pressure and, arguably, too short a time-frame. Little wonder then that it remains a “sacred cow”. Currently many investors may be re-assessing their opportunities with a greater emphasis on superannuation and possibly shares rather than the housing market. In the “booming” (resource-led) state economy of Western Australia rents are forecast to rise up to 35 per cent in 2007.¹¹⁴

109 A point recognised by Warren (2004a), above n 7, at 154-5.

110 *Inquiry on First Home Ownership* (2004). Available at <www.pc.gov.au> at 4 July 2007.

111 “Release of the Productivity Commission Report on First Home Ownership” (Treasurer Press Release No. 051, 23 June 2004).

112 Druitt, R. “Five ways to make housing affordable”, *West Australian* (Perth) 23 February 2007, 16.

113 -, “Taxman to check for negative gearing scams”, *West Australian* (Perth), 21 October 2006, 4.

114 “Rents to leap 35pc as market catches up, say expert”, *The West Australian* (Perth) 19 February 2007, at 7.

The question for PIT reform in the short to medium term is essentially this. Should a rational, logical approach be adopted, that would see negative gearing abolished, or should a more pragmatic approach be taken given the economic and social complexities involved? No doubt a compromise on this specific issue could be found, such as “grandfathering rights”; but this would only complicate the overall complexity of PIT and frustrate other reform measures.

Negative gearing, for the present, is rather a “red herring”, because the revenue effects historically involved have tended to be minimal compared with other areas of PIT reform. Unfortunately, this view is weakened by recent ATO statistics showing that the revenue effect is around \$2 billion in 2005-06,¹¹⁵ up from around \$1.2 billion in 2000-01.¹¹⁶ The so-called negative gearing gap has increased dramatically in the past four years, from \$670 million to \$4.1 billion, or around six-fold. Such growth is obviously far stronger than prevailing economic growth.¹¹⁷ However, improved ATO checking and auditing of claims¹¹⁸ may be a better policy than its outright abolition.

Politically, with rental accommodation particularly scarce in some states, particularly the resource-driven economy of Western Australia, any moves to abolish or curtail this measure would be very difficult. Negative gearing can be rightly disregarded at the present time.

D. Effects Upon the Tax and Financial Planning Industry

The impact upon the tax and financial advisor industry from a supply-side and labour-force perspective arising from significant PIT could be large.¹¹⁹ In short, many tax agents and firms such as H & R Block would exit the market and/or diversify into other areas of financial planning and advice. There would be less demand for financial advisers, administrators and others currently engaged in salary packaging and other tax avoidance practices in a wide range of businesses, whether internally or as outside agents or consultants, with ensuing reductions in employment levels and/or re-deployment. There may also be some impact upon accountants and tax lawyers.

115 Above n 113. The negative gearing gap is (in aggregate) the difference between allowable deductions on rental property and rental income earned by landlords, with the difference offset against PIT liability.

116 Estimated by Warren (2004a), Table 9.8, above n 7, at 150 (based on original data from *ATO Taxation Statistics 2000-01*), with further discussion at 149-158.

117 The issue of fraud or rorting is thereby raised, but other explanations are possible eg higher levels of investment in rental housing; higher investor awareness of deductions, capital appreciation and higher interest rates. The ATO states that the main reason for the increase in negative net rental income was that rental interest deductions rose around 20 per cent (\$2 billion) over 2003-04 figures. This was mainly due to three official interest rate rises and increases in the purchase price of rental properties (*Taxation Statistics, 2004-05*, above n 30, at 13).

118 Above n 113. 150,000 letters and 11,000 audits respectively in 2005-06. The latter represents around a 1 in a 136 chance of an audit.

119 This is a much needed area of further economic research.

Assessing the possible reduction in worker numbers and revenue in the industry is problematic. There are currently around 26,000 registered agents, plus, in many practices, those who do not need to be registered. In terms of turnover of annual filing using a tax agent, the loss of over 7 million tax returns pa could be worth around \$1.4 billion pa. Currently around 7 per cent of tax agents annually are leaving the profession.¹²⁰ From an overall longer-term economic efficiency viewpoint, the effects of a “stream-lined” and more efficient tax profession would be beneficial, although may not be well received in the short-term by those affected.

VII. Concluding comments

The case favouring reform of the present PIT is overwhelming, with a clear business, professional and academic consensus in favour. It is a matter of “when” rather than “if”. Significant PIT reform should mean major simplification measures and, arguably, a reduction in PIT revenue of at least 20 per cent of the current level, or around \$20 billion in current monetary terms.

A major issue that has to date been generally well addressed in most papers and reports on this topic is that of funding of PIT reform proposals, without which it merely becomes some sort of “wish list”. Related to this, this author has proposed, under an assumption of revenue neutrality, and possibly controversially, that the Australian GST be increased from its current level of 10 per cent to 15 per cent, with a compensation package.¹²¹ The political difficulties of this proposal, in the context of Commonwealth-State governance, are recognised. As well as helping to fund significant PIT reform, a higher GST rate is supported by longer-term economic data and policies adopted in other countries, a point often made by the OECD in their support of Australian tax reform.

Further, tax avoidance and the ensuing compliance costs are too high and create major inefficiencies in the economy. Rather than reform trusts and other entities and practices (or conversely and unrealistically change the unit of PIT from the individual to that of the family), a simpler approach, albeit a “second-best” approach in economic terms, is to align the top PIT rate with that of the company rate. Even a seven-point reduction (from 47 per cent to 40 per cent) for many higher income earners since 1 July 2006 is starting to have an impact in investment and traditional tax avoidance practices. Thus an alignment at a rate of 30 per cent is likely have a major efficiency impact on the economy for minimal legislative change. Trusts would remain unchanged and continue to offer their various benefits to many in the business community and/or the largely better-off – but the tax avoidance benefits would be considerably reduced and the playing field very roughly levelled.

Significant reform needs to focus on lower PIT payers. This author strongly supports a high tax-free threshold, at least double its current level of \$6,000 and possibly up to

120 See Evans and Drum (2006), above n 97, for further commentary.

121 The emphasis should be on the longer-term benefits for the whole country.

\$20,000.¹²² Simply put, the main arguments in favour are four-fold: lower aggregate compliance costs; an improved tax-welfare nexus; improved work incentives for low paid young and/or casual workers; and, a more recent argument, maintenance of, or a lower reduction in, the living standards of non-managerial workers on AWAs.

At the risk of being overly-simplistic, a PIT payer should for the most part be exactly that: a person who pays tax not someone who completes a tax return and then contributes nothing to the tax revenue of the economy. Arguably, a change in mindset on this and other major issues such WREs, is the crux of the PIT reform debate rather than specific rates and thresholds. The knowledge, technology and tax administrative systems, such as withholding taxes and cumulative PAYG, exist. What is lacking is the political will. a useful PIT reform target would be to take a certain number or percentage of so-called PIT payers out of the system altogether. Although ambitious, a cull of around 7.5 million, thereby reducing the number of PIT payers who complete a PIT return annually to around 3.7 million, or roughly a third of the current level of 11.2 million, is feasible. In other words, only around 18 per cent of the population would need to complete a PIT return instead of the current 55 per cent.

To conclude, Australia is at the cross-roads in terms of its PIT system. There is very strong support by business groups, tax professionals and academics for reform. *Significant* PIT reform, and any associated tax (eg FTB, FBT, CGT) and welfare changes, and set in the longer-term socio-economic context, now needs a “political champion”.¹²³

122 It is possible that enhanced anti-avoidance measures for unearned income may be needed.

123 A term first used by Sandford in his excellent analysis of tax reform in six major countries. Above n 6, at 184-186.

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