

SUBMISSION FOR THE GOVERNMENT'S HENRY TAX REVIEW

'Tax simplification and reduction of compliance costs'

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Summary

This submission advocates that very high tax compliance costs and unnecessary complexity in the tax system (and related transfer system) requires that tax simplification be afforded a very high priority in the Henry Review. First, some comments on the tax reform process, tax compliance costs research findings, and key features of a simplified system are made. Secondly, principles for business tax reform from a simplification perspective are identified. Thirdly, the personal income taxation (PIT) system could be vastly simplified by taking some 7 to 8 million PIT payers out of the annual filing system and reducing the undue and currently internationally very high reliance on tax agents. Measures advocated include a withholding tax on interest, a much higher tax-free PIT threshold, a cumulative Pay-As-You-Go system, significant reforms to work-related expenses and also a tax-free threshold for Capital Gains Tax. Other comments include the importance of reducing differences in approach between the tax and welfare systems and the degree of 'churn' between them. The roles of the Medicare Levy and financial planning salary packing industry are also questioned. A clear identification and definition of nuisance taxes at all levels of Government is needed in order to justify their abolition. This submission concludes by emphasising the importance of a comprehensive simplification reform package, including appropriate compensation and timing, that cannot be easily unravelled by lobby groups.

* *The views expressed are solely the independent views of this author, based upon my tax research and experience in Australia over the past twenty or so years, and not those of the university. Generally the points made are supported by Australian and/or international research. A Bibliography of key references, particularly Australian research by Pope or Evans, is preferred to the usual academic paper format of frequent referencing and data citation.*

Background

1 The focus of this submission is on tax compliance costs, and the need for significant tax simplification and reform. As data and information in the *Architecture Paper* suggests, Australia's tax system is overly-complex with high compliance costs and inefficient practices. The international tax literature suggests that, for successful tax reform to be achieved, two important factors are a political champion, usually the Prime Minister (President) or Treasurer (Chancellor of the Exchequer), and a package of measures such that winners and losers are not easily identified and are therefore less likely to lobby to 'unravel' the parts of the reform package that disadvantage them.

2 Tax reform is best achieved during a period of strong economic growth such that, after a period of years, even any 'losers' eventually gain through economic growth and rising living standards. It may be necessary for the government to introduce compensation, either as a one-off payment or ongoing for a number of years. Compensation does not necessarily have to be direct monetary support; it could take the form of educational, housing or other support mechanisms (the introduction of GST in Singapore provides a good example).

3 Australian tax reform in the next few years may be more difficult than it would have been in the 1990s and the early 2000s because of: (i) difficulties in financial markets, slower growth or recession and (ii) Carbon Pollution Reduction Scheme impacts upon the economy. Other things being equal, compensatory mechanisms will become much more important.

Tax Compliance Costs

4 International research demonstrates that tax compliance costs are: (i) high; (ii) very regressive, especially for Goods and Services Tax; and that research into compliance costs and ensuing publicity 'puts compliance costs on the political agenda'. Unfortunately Australia is lagging behind some other countries in this field, despite being a leader in tax compliance costs research in the late 1980s and 1990s. The reasons are complex. Suffice it to say here that research studies are expensive and time-consuming to undertake, are subject to a high degree of political sensitivity, may be subject to methodological criticisms (that do not seem to feature overseas as much, if at all) and proposals simply have remained largely unfunded since the mid 1990s. Thus, as recognised in the *Architecture Paper*, Australian tax compliance costs data is largely dated.

5 On a more positive note, the studies by myself and Evans (both with co-authors) provide a rich source of data. The overall tax system moves relatively slowly, and changes can be updated (and have been to some extent) by expert analysis and opinion, particularly in critical areas or 'where the shoe pinches'. Unfortunately nearly all commentators agree that the direction of change is towards even greater complexity, higher compliance costs, tax avoidance and probably tax evasion.

6 The most recent research shows that Australian business taxpayers bear the brunt of high Commonwealth tax compliance costs, whether expressed in absolute dollar terms, as a percentage of tax revenue or GDP. By type of business tax, income tax clearly incurs the highest compliance costs, followed by PAYE (PAYG), with estimates of the relative importance of GST compliance costs unavailable. Recent research on large business tax compliance costs shows that income tax accounts for 66% of all compliance costs. Differences between industry groups are noteworthy. That said personal taxpayers also incur high tax compliance costs, relatively higher than some other OECD countries.

7 For State (and Territory) tax compliance costs there is comparatively little research. Payroll tax has low compliance costs (dated research by this author) and Stamp Duties generally have high/very high tax compliance costs (largely small studies, business reports or anecdotal). To this author's knowledge there is no authoritative research evidence as to local government tax compliance costs, but generally they are likely to be low.

8 Small business overall incurs relatively high tax compliance costs because of their regressive nature; there is a 'fixed cost' effect and economies of scale are observed. Australian research has shown that small business (net) tax compliance costs are around 25 times higher than for medium business, whilst large business have negative costs (due largely to cash flow benefits of holding tax prior to remittance).

9 Long-standing academic research on tax compliance costs has been supplemented by more recent studies by business and professional organisations, including the Business Council of Australia, although these are generally much less comprehensive.

Key features of a tax system from a compliance cost minimisation perspective

10 The basic tenets to achieve relatively lower tax compliance costs (fully recognising the various objectives, many complexities of a tax-transfer system in an OECD country and challenges within a federal system of government) include: a relatively small number of taxes that each raise a large amount of revenue; minimal tax expenditures (concessions, rebates, exemptions and overall 'special cases') and comprehensive tax base; the use of withholding taxes wherever possible (especially for PAYG taxpayers); infrequent/minimal changes to the tax system (ie less 'tinkering and tokenism'); high exemption or tax-free thresholds (to take a large number of taxpayers who contribute relatively little in tax revenue out of the system); avoidance of grandfathering rights (or where they exist arguably they should be abolished); high quality tax legislative drafting to minimise tax avoidance 'loopholes'.

Suggested reforms or principles for reform

Business Taxation

11 The simplification of business taxation, from an overall compliance cost minimisation perspective, should be afforded the highest priority. Focus should be upon reforms to Commonwealth income taxation and State Stamp Duties. These and other calls for business tax reform are likely to be well advocated by various business, tax and accounting organisations and are not discussed in detail here.

12 In any consideration of business tax reform, two main points should be borne in mind. First, business often lobbies against the State payroll tax, yet its overall compliance costs are very low (given most States' tax-free thresholds of around \$1 million). This researcher therefore strongly supports its retention as a major source of revenue within the overall Australian tax system. Secondly, business often emphasises the total number of taxes it is subject to. It would be preferable to have a larger number of harmonised taxes (refer below) with lower aggregate compliance costs than a smaller number of non-harmonised taxes that may indeed be more costly overall. Without recent reliable data it may be difficult to clearly identify the various trade-offs involved.

13 Tax reform should involve State taxes being harmonised to a far greater extent. Whilst there have been recent moves in payroll tax harmonisation, there is still a long way to go. For example, payroll tax, and probably even Stamp duties, land and other State taxes could be harmonised throughout Australia in every regard (same base; definitions, exclusions etc) other than rate-setting. An impediment to real harmonisation is the role and vested interest of States in the revenue collection process. Also the particular characteristics of a State's economy are often cited. Rather than incur a high level of business tax compliance costs through State rule differences, alternative means (on the re-distribution of revenue side) should be found to redress real difficulties.

14 Overall, a common theme is simplification and this researcher strongly supports this call subject to the provisos that it is across-the-board ie does not favour particular sectors of the economy, size of business or geographical location, or unduly affect personal income taxpayers, who in Australia contribute a heavy share of the tax burden (around half of all Commonwealth Government tax revenue).

Personal Taxation

15 The greatest priority should be to basically take personal income tax (PIT) payers with relatively simple affairs out of the tax system, in some form or another. This researcher, with others, has long emphasised the benefits of a withholding tax on interest payments (a key pre-requisite to the foregoing) and, more controversially, a significantly higher tax-free threshold (at least \$15,000 pa) and a cumulative PAYG system. Even more controversially, simplification would require the abolition of work-related expenses (WREs) or some automatic allowance (general deduction) for workers. Such well-designed measures could effectively take around two-thirds of PIT payers (some 7 to 8 million) out of the annual return tax system.

16 Introducing a withholding tax on interest payments would increase bank and other financial institutions compliance costs, and are likely to be resisted in that sector. However, a withholding tax affords the possibility of a lower tax rate on bank and other savings (that has macro-economic advantages not discussed here), at say a rate of 15%. The additional business and profits generated would indirectly help compensate the higher tax compliance costs incurred by the banking and financial sector.

17 An alternative, less controversial approach to simplification in this area would be to introduce a Scandinavian-style pre-filled in (pre-populated) PIT system whereby returns (at least for taxpayers with relatively simple returns) are generated by the Australian Tax Office and the taxpayer simply checks and signs if in agreement (or has the opportunity to amend if necessary). This proposal largely emanates from the OECD and has received support in the Australian literature in recent years.

18 A fundamental challenge in the PIT area is whether reforms are intended to significantly reduce Australia's very high dependence on the use of tax agents that is far higher than comparable jurisdictions overseas. Arguably this is an 'acid test' on which any PIT reform will be assessed, at least by many impartial observers. If so, there are important implications for some tax agents and possibly overall employment in this sector (depending upon their ability to move into non PIT areas of taxation) as well as ATO administration. The role and size of the financial planning industry in terms of tax avoidance especially salary packaging arrangements should be reduced through simplification reform in order to reduce compliance costs. This too is a criterion in assessing the success of any tax reform package.

19 In recent years the Australian PIT reform literature has focussed upon the role of WREs, with many calls for reform. This researcher would strongly support their abolition, at least significantly if not in their entirety, as in New Zealand and elsewhere. Significant reduction in or abolition of WREs would help lower overall PIT compliance costs. However, nearly all PIT taxpayers would focus on the winners and losers and any overall reform package would need to be carefully crafted.

20 Regarding the issue of negative gearing of rental housing, in a particularly complex policy area, this researcher concluded that, on balance, it was better to keep to the *status quo* because of the wider socio-economic implications. From a compliance costs perspective, abolishing negative gearing would lower costs and should be a longer-term objective. However, there may be higher short term costs depending upon transitional arrangements and effects.

21 Tax compliance costs for Capital Gains Tax (CGT) should be lowered by introducing a tax-free threshold of, say, \$20,000 pa in order to take small investors 'out of the CGT net' (irrespective of any changes to the current 50 per cent 'discount' rules), a principle adopted in the UK.

Other

22 The 'churn' between the tax and transfer systems is also recognised as an unnecessary generator of compliance costs (whether classified as tax or welfare; little if any research has been undertaken specifically on the compliance costs of this interaction). Research focus of such churn eg by the Melbourne Institute of Applied Economic and Social Research, has been on overall efficacy and the behavioural effects. In a wider context this submission re-iterates its call for a much higher tax-free threshold, perhaps around \$15,000 pa (with appropriate anti-avoidance measures where necessary), that would assist some, but notes that current tax policy and many commentators favour the use of tax-offsets to assist persons with low incomes or in need of government financial support. The different approaches of tax and welfare systems, including the unit of assessment, should be reviewed and rationalised where possible.

23 The Medicare Levy needs also to be re-evaluated in any reform package. Arguably, it needs to be abolished and incorporated into tax rates (preferable as it would help reduce PIT compliance costs albeit marginally) or, from an overall economic perspective, increased to an appropriate level that reflects the true costs of the public health system.

24 At a State level the term 'nuisance taxes' is sometimes used to describe a tax that raises little revenue. From an overall reform perspective, Australia's nuisance taxes need to be clearly identified with appropriate definitions for Commonwealth, State and local government taxes. The likely level of tax compliance costs need to be factored in as well. The case for their abolition (or justification for retention) should then be evaluated.

25 There are many other aspects of tax compliance costs and reform that have not been addressed here. Overall, there is a need for far greater, well-funded research in this field.

Concluding Comments

26 Meaningful reform has affected many areas of the Australian economy and everyday life in recent decades yet the tax system, overall, has become far more complex, costly and inefficient, to an extent that reform at the policy level is long overdue.

27 Simplification of the overall system is usually the 'poor relation' given other tax objectives particularly revenue raising and equity. The evidence overall in favour of significant simplifying reform of the tax system is now compelling in spite of a dearth of up-to-date comprehensive Australian tax compliance costs data.

28 From a governance perspective, a comprehensive major package introduced with a short period between announcement and legislation in order to minimise lobbying by real or perceived losers and lobby groups is preferable. Such an approach necessitates that government 'get it right first

time'. Losers of reform in the short-term should be clearly well compensated initially in order to move the whole economy onto a more efficient platform.

29 Thank you for this opportunity to contribute to taxation policy debate and The Henry Tax Review. If necessary, specific points can be followed up through references cited in the bibliography or directly from this researcher as appropriate.

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